PRIVATE CAPITAL MANAGEMENT

Q2 2023 Commentary

July 2023

Market Trivia:
What company's market capitalization exceeded the entire Russell 2000 Small-Cap Index at quarter-end?[1]

Q2 Market Recap

Stocks continued their rally in the quarter fueled by better-than-expected economic data, smaller earnings declines, and a renewed enthusiasm for the potential for artificial intelligence (AI) to reshape our economy. This rally surprised many investors who were positioned for tougher economic conditions, leading to a meaningful positive shift in investor sentiment during the quarter. First quarter U.S. GDP growth was revised upwards, highlighting the resilience of the U.S. economy as it faces higher interest rates and stubborn inflation. Looking overseas, we see slowing growth in the Eurozone and an underwhelming post-COVID economic recovery in China. Japan remains a positive outlier as economic activity and corresponding stock market gains were strong. The operating environment for small to medium sized banks remains challenging as deposit rates increased while lending standards tightened in the quarter. Narrowness in U.S. stock gains continued in the quarter as the top ten companies in the S&P 500 accounted for over 95% of YTD performance. On an equal weighted basis, the S&P 500 was up 6.9%.[2] Foreign equities delivered a good quarter driven by a weaker U.S. dollar and better than expected corporate earnings.

Taxable investment grade bonds posted a negative return for the quarter as the U.S. yield curve shifted higher. Junk bonds outperformed investment grade and municipals. U.S. REITs had a strong month but trailed broader based stock indices. Commodities bounced in June but remain negative for the year.

Asset Class	Benchmark	June	Q2 2023	YTD
U.S. Large Cap Stocks	S&P 500 TR USD	6.6	8.7	16.9
U.S. Small & Micro Cap	Russell 2000 TR USD	8.1	5.2	8.1
Intl Dev Stocks	MSCI EAFE NR USD	4.6	3.0	11.7
Emerging Mkt Stocks	MSCI EM NR USD	3.8	0.9	4.9
Global Stocks	MSCI ACWI NR USD	5.8	6.2	13.9
U.S. Municipal Bonds	Bloomberg Municipal TR USD	1.0	-0.1	2.7
U.S. Taxable Bonds	Bloomberg US Agg Bond TR USD	-0.4	-0.8	2.1
U.S. High Yield Bonds	Bloomberg High Yield Corporate TR USD	1.7	1.8	5.4
Intl Dev Bonds	S&P International Sov Ex-US Bond TR USD	0.7	-2.1	1.4
U.S. REITs	MSCI US REIT NR USD	4.8	2.3	4.8
Broad Commodity Futures	Bloomberg Commodity TR USD	4.0	-2.6	-7.8
Gold	DJ Cmmdty Gold TR USD	-2.2	-2.5	5.4

Data from Morningstar as of 06/30/2023

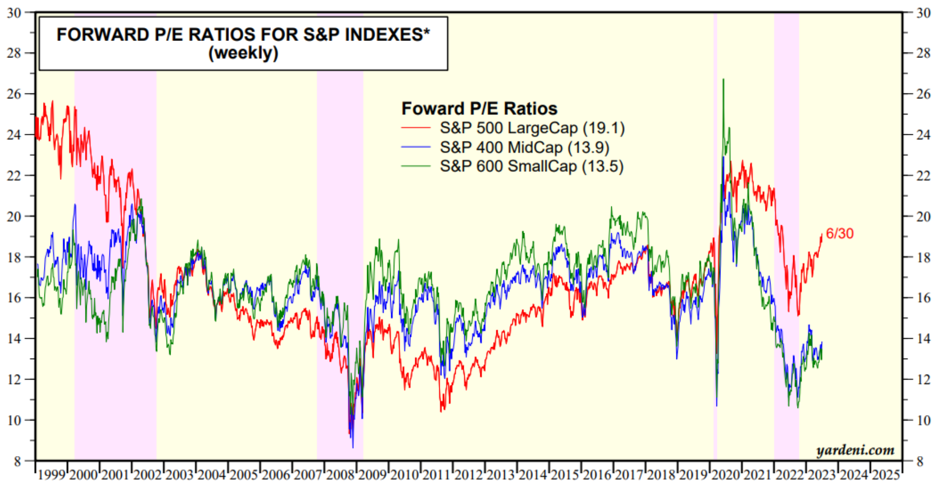
Strong stock market performance in the first half of the year, on average, is followed by additional gains later in the year.[3] June marked the fourth monthly gain in a row and the S&P 500 now sits under 10% from all-time highs set in December 2021. With positive momentum and chatter about recession risk declining, should investors add to their stock allocations to capture future market gains? We urge clients to stay disciplined

[1] Apple Inc. Source Strategas Group.
[2] Morningstar as of 6/30/2023
[3] https://www.bloomberg.com/news/articles/2023-06-25/where-stock-market-is-headed-after-wild-first-half-five-charts, retrieved 7/6/2023.

and remind them that downside risks remain in this market. Stock market valuations have largely increased due to rising stock prices, despite declining earnings. Inflation is expected to continue falling this year, but history shows it may take time to reach the Federal Reserve's target rate. This increases the risk of central bank policy error by keeping financial conditions too restrictive for too long. Markets typically bottom sometime after central banks have reversed course and cut rates. If October 2022 does mark the cycle lows in stocks, it would be a rare occurrence where a bear market reversed to a bull market without a Fed pivot. Not only does the Fed plan to keep rates high to tame inflation, but markets are also pricing in additional rate hikes later this year. The narrowness of stock returns doesn't inspire confidence either. We typically see small caps lead large caps out of bear markets and wider participation historically has resulted in larger stock gains.

Stocks Are Back

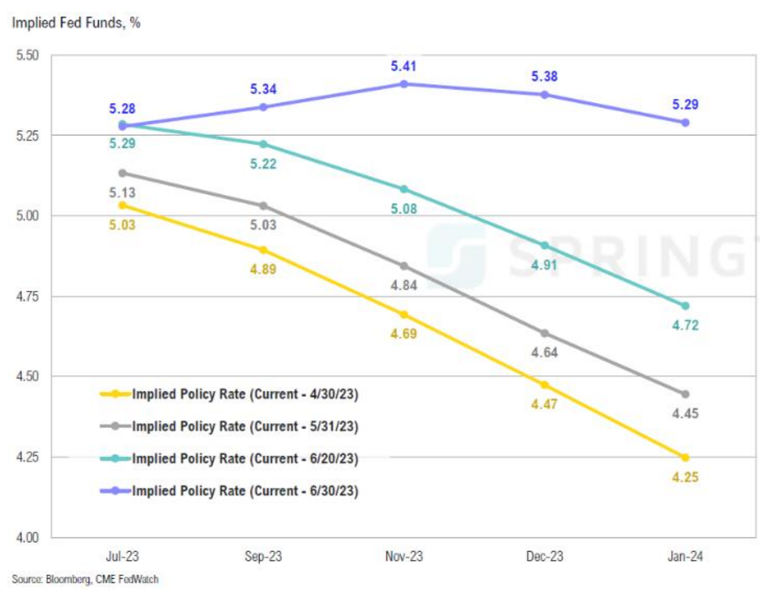
Mega cap technology stocks delivered massive gains to shareholders in the first half of the year. Increased profit expectations and renewed interest in artificial intelligence resulted in the growth of the top seven tech firms by more than $4 trillion this year alone. Institutional investor sentiment shifted from 2008 crisis era levels of pessimism to above average optimism in one of the largest two-week swings in history.[4] As a result, the Nasdaq 100 index is trading near a 12-month forward price-to-earnings ratio of 27x. This metric is well above the 10-year average of 21x. S&P 500 earnings are expected to decline -7.2% in Q2 2023. Why would investor sentiment drastically improve facing a decline in expected profits? The simple answer is investors expect better economic conditions in the future and are less concerned about a near-term decline in profits. Additionally, sentiment-driven moves in the stock market can run longer than expected. Valuations for small and mid-sized companies remain reasonable at under 14x forward P/E (see chart above) and should continue to be part of a diversified portfolio.



* Price divided by 52-week forward consensus expected operating earnings per share.
Note: Shaded red areas are S&P 500 bear market declines of 20% or more. Yellow areas show bull markets.
Source: I/B/E/S data by Refinitiv.

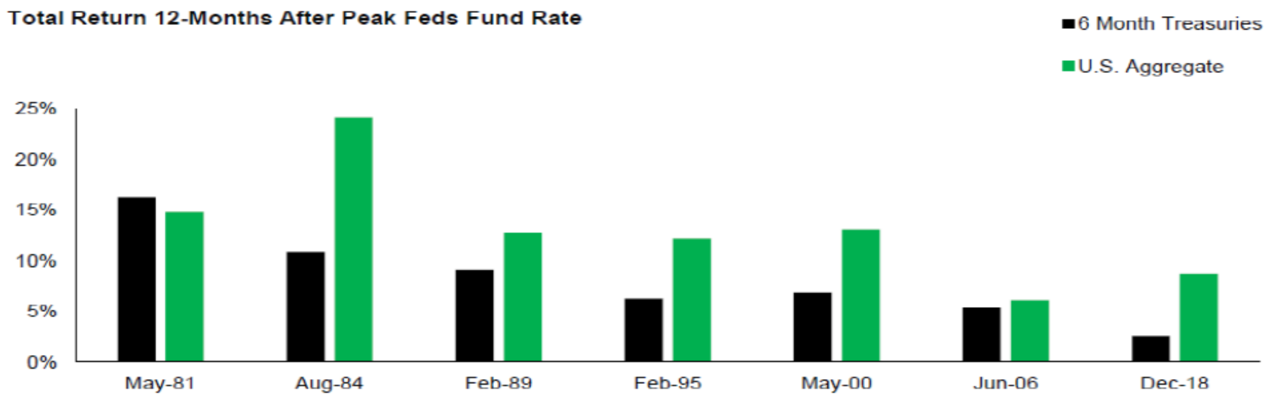
How High Will Interest Rates Go?

Forecasting interest rate movements is notoriously difficult. Our current environment is no exception. Starting in the second quarter, market participants expected the Fed would hike one more time and pause. Stronger than expected economic data and a tight labor market have since changed expectations that the Federal Reserve will continue to tighten monetary policy to rein in inflation (see chart to the right). The U.S. Treasury yield curve now sits at the highest levels in over 15 years. High interest rates tend to expose weak or overleveraged parts of our economy. Think of the housing bubble in the 2000s and recent poor risk



[4]AAII sentiment survey as of 6/21/2023

management and liquidity issues with financial institutions. Higher interest costs will dampen growth as borrowing costs rise. Higher discount rates result in lower valuations. At the same time, higher interest rates



Source: Goldman Sachs Asset Management and Bloomberg as of 1/31/2023. "6 Month Treasuries" proxied by the U.S. Treasury Bellwethers: 6 Month Index and "U.S. Aggregate" proxied by the Bloomberg U.S. Aggregate Index.

can increase expected returns for bonds. Following a poor multiyear stretch of performance for bonds, many investors flocked to money market and short-term Treasuries seeking yield. While this trade may feel good now, history shows that intermediate term bonds tend to outperform short term bonds following Fed rate hike cycles. Additionally, intermediate term bonds historically have provided a large diversification benefit when risk assets falter. Inflation may drive interest rates higher in the short term, but it is hard to ignore the return potential from traditional bonds in the future.

Recession Risk Revisited

We compile various leading and lagging economic indicators to help inform our view on economic trends (see chart below). The U.S. economy continued to grow, albeit at a slower rate during the quarter. The May unemployment data showed an increase 339,000 non-farm payrolls and an increase in the unemployment rate to 3.7% with no meaningful change to labor force participation. Worth watching is the rising number of initial claims for unemployment insurance which has steadily ticked higher from a year ago. Average hourly earnings grew by 0.3% for the month and 4.3% year-over-year, essentially unchanged from last quarter.

	Indicator	Latest Data	Date	Q2 2023 Recession Signal	Q1 2023 Recession Signal
Leading Economic Indicators	Interest Rate Spreads (2Y - 10Y Trsy Yield)	-1.06%	June-23	Yes	Yes
	Stock Market Performance (S&P 500)	16.9% YTD	June-23	No	No
	Quit Rate	2.6%	May-23	No	No
	U.S. Consumer Spending (MoM)	0.1%	May-23	No	No
Lagging Economic Indicators	US Manufacturing PMI	46%	July-23	Yes	Yes
	US Services PMI	54.4%	July-23	No	Tbd
	Global PMI	52.7%	July-23	No	No
	Unemployment Rate (U3)	3.7%	May-23	No	No
	Inflation (CPI)	.1% (MoM) / 4% (YoY)	May-23	Yes	Yes
	Index of Consumer Sentiment	64.4	June-23	No	Yes
	Real GDP Growth (Quarter over Quarter)	2.0%	March-23	No	No
	Corporate Earnings Growth (S&P 500 - YoY)	-6.8%	June-23	Trending yes	Trending yes
	Housing Prices (YoY)	-0.2%	April-23	No	No
	Residential Building Permits (National - YoY)	-12.7%	April-23	Trending yes	Trending yes

Sources (in descending order): Federal Reserve Bank of St. Louis, Morningstar Advisor Workstation, U.S. Bureau of Labor Statistics (BLS), U.S. Bureau of Economic Analysis (BEA), S&P Global and JP Morgan, BLS, BLS, University of Michigan, BEA, Factset (Q2 2023 data is an estimate), S&P Case-Shiller U.S. National Home Price Index, U.S. Census Bureau

The global economy grew at a slower pace in the quarter led by services while the manufacturing slump deepened. The J.P Morgan Global Composite Output Index fell to 52.7 in June which is a four-month low in the series.[5] The U.S. yield curve further inverted during the quarter driven by hawkish monetary policy from the Fed and slowing economic momentum. Using history as a guide, the yield curve typically inverts 6 – 24 months ahead of a recession. The U.S. yield curve has been inverted for 12 months. We see pockets of strength in experience-

[5] J.P Morgan Global Composite PMI, retrieved from https://www.pmi.spglobal.com/Public/Release/PressReleases?language=en, July 6, 2023

based industries while durable goods and traditional manufacturing sectors are facing tougher conditions. There continues to be a lot of noise with regards to economic data as we return to our pre-pandemic economy. To be sure, recent economic strength appears to have postponed the likelihood of a recession to occur at a later date.

Parting Thoughts

Chasing returns is not a long-term investment strategy, rather a speculative one. We encourage investors to pay attention to valuations and avoid getting caught in the greater fool theory. Higher rates alongside a strong consumer are creating pockets of opportunity in lower risk assets such as corporate bonds. Select private market investments continue to offer compelling risk/return characteristics for suitable investors. We will be closely watching economic trends and quarterly earnings as they are released in the coming weeks.

Our team is here to help you navigate these challenging times. Thank you for your continued trust.

Sincerely,
The Private Capital Management Team