



*The first half of 2023 is in the books.*

What an eventful start to what was expected to be an eventful year. Coming off a treacherous 2022 for investors, where seemingly all asset classes suffered declines, 2023 was set-up for more trouble. Extreme political divide and a looming debt ceiling crisis was circled boldly in red on the calendar. As expected, the crisis was avoided with a last-minute deal. Surprisingly, the Market barely flinched during the whole process. What has yet to be addressed is the massive mountain of debt the government has accumulated, to the tune of \$32 Trillion... and counting.

During so many periods of concern and chaos, the Stock Market has a way of fighting through conventional wisdom as the consensus tends to get too extreme. It happens both positively and negatively, where rallies and sell-offs gain momentum after catching people off guard. The ultimate result tends to be a reversion to the mean. That certainly has taken place in 2023.

The Stock Market catapulted that wall of worry from Spring to Summer like few times in recent history. As usual, Tech led the way. The Tech-heavy Nasdaq recorded its best first half since 1983 and the third-best since its creation in 1971. Big moves are quite common for the Nasdaq. They come in both directions. The 2023 strength followed one of the worst years, which was 2022. Despite its monster gains to start the year, both the NAS and S&P have only clawed back 3/4 of what they lost in 2022.

#### Reviewing our 2023 Outlook

We anticipated a strong start in our 2023 Outlook back in January. Pessimism was so pervasive. 2022 was the worst year in a decade and a half for stocks and the worst year ever for bonds. The set-up seemed ripe for a reversal. That said, we sure didn't expect things to be this strong nor for this long. We wrote:

*"A rally to start the year would catch most by surprise. We could see that play out: The Economy keeps slowing, the Bond Market tells us inflation is less of an issue and the Fed will ultimately end its choking rate-hike campaign. That would provide more breathing room for stocks for another Bear rally before ultimately bottoming out. That's our base case right now. We're staying nimble. One thing seems certain: The volatility will continue in 2023. We are prepared and positioned accordingly."*

The powerful rally sure caught most on Wall Street offside. The S&P 500 closed out the first half of the year a whopping 8.5% above the Street's average forecast of 4,100 for the whole year. Those predictions were made in December. The Street has been scrambling to play catch-up as the Market kept rising. The chase was on. The Market sure has a way of keeping one honest and humble.



The sustainability of the super strength definitely caught us by surprise. It was a rip-roaring rally like few before. The thing is, we're still not sure if this is a new Bull or merely a continuation of the 2022 Bear. Bear Market rallies are always amongst the most violent. It checks a lot of boxes there.

#### Understanding the Rally

Why did the Stock Market keep rising, despite a banking crisis, the serious threat of an American default and the Fed's aggressive tightening campaign in an attempt to break runaway inflation? It's an obvious question, which confused many investors from around the globe. The simplest answer: Time and time again, worst-case scenarios generally fail to materialize. The 20% S&P decline last year went a long way to price in the bad stuff. Expectations were low. Sentiment got super sour. Investor emotions can go to extremes which tends to catch people offside. The Market mostly takes the middle. Billy Joel was right: "The good ol' days weren't always good and tomorrow's not as bad as it seems."



The Fed also launched an aggressive response to the Silicon Valley Bank failure. It threw \$400 Billion into the financial system, pouring liquidity back in. The Fed completely reversed its tightening, bringing back that punchbowl. Though not exactly healthy, the Market responded favorably.

Another issue: The recession that so many economists anticipated never arrived. Americans kept spending on travel and leisure. Everyone who wants a job has one. The unemployment rate still sits near 50-year lows. There's never been a recession with that. Consumer spending accounts for 70% of economic activity. When you have a job, you have an income. When you have an income, you tend to spend. This has kept the Economy buoyant, despite clear areas of sluggishness. It's been a sort of rolling recession for a year now. A formal recession may take hold in 2024. It sure hasn't yet.

#### Digital Revolution: The Age of AI



Perhaps most important, a disruptive investment theme exploded in 2023. It had the Bulls partying like it was 1999 again. That theme is Artificial Intelligence (AI), and it is indeed changing the game for good.

AI took the Market by storm, led by Microsoft's substantial investment in the private start-up OpenAI, the creator of ChatGPT. It ushered in the advancement of Large Language Models, which provide human-like answers in seconds to a wide variety of topics. Machines keep learning. Computers are understanding text and generating new text in multiple languages throughout the cybersphere and across the globe. It happens in an instant. With the vast quantity of data out there, these machines are getting smarter and smarter. It's real intelligence artificially developed through highly complex digital computing platforms. And most industry experts believe it's just getting started.

Quantum computing will take AI to the next level. The approach will be significantly faster and more efficient to a point where the possibilities are infinite. Quantum computing replaces the conventional approach of using binary bits like zeros and ones for data. It has the power to simulate the physical world in a way that is much, much faster. Quantum computing will likely play a major role in our lives, like advancing medicine and expanding space exploration.

### Bubble or No Bubble?

Today's AI revolution strikes some similarities to those 1990s, and the Dot-com days. That was when the Internet exploded in popularity and transformed the entire planet onto the World Wide Web. It changed everything for sure. But the euphoria was far more eager and fast-acting than reality proved out. Not everyone succeeded. Many failed. But the innovators that became game-changers of yesterday are the Tech Titans of today. Many of them are the big players in AI, while scads of swift-acting start-ups represent the innovators of tomorrow. It's fast-moving and fiercely competitive. It's all very investable.



Artificial Intelligence is believed to represent as much as a \$2 Trillion economic opportunity by some estimates. It is now on the doorstep of the Tech sector for the next decade ahead. It won't stop there. Companies from pretty much every industry will embrace some form of AI into their businesses in order to innovate and ultimately reduce costs. That will take time. Costs will definitely rise on the front end, with the benefits primarily landing on the back end.

Integration of AI into everything is the next stage of the Digital Revolution, rivaling the Industrial Revolution, which modernized societies a century and a half ago. Artificial Intelligence is expected to help solve our global energy crises, assist in caretaking for both young and old, as well as advance education around the World. Expectations are sky-high. And the possibilities are real. So are the risks. We are invested here and will continue to build exposure in all things AI in the coming years with eyes wide open.

### All About Chips



Semiconductors are used in just about everything today. They make the modern economy possible. What used to be a very economically cyclical item has become a staple throughout our homes. Refrigerators, televisions, and even washing machines all run on semiconductor chips. Chips empower the Digital Age. It has us rethinking the cyclicity of investing in semis. They're now a constant. The average new car has nearly 1,500 chips. Cars are the ultimate mobile device. We're invested there.

The bigger concerns around semiconductors are those used in highly sensitive military systems. The most advanced integrated circuits let nations stay far ahead of their rivals in terms of weapons systems and intelligence gathering. It's a crystal-clear statement of geopolitical power. The United States has it. China wants it. There's not a lot of trust around this subject. Further complicating things is the fact that the vast majority of these advanced chips are manufactured in Taiwan.

China is the second largest economic power behind the US. Nobody else is even close. China desperately wants to be the leader in the Digital Age. It views the 21st century as its period to rise above the rest. AI presents the opportunity for China to assert its power and influence around the globe and benefit economically and geopolitically. China is playing catch-up after believing it missed out on the expansion of the Internet in the 1990s. The stakes are quite high. China aims to be the standard setter for all things digital.

### Cold War Brewing

The US is still the dominant global power. It's especially the case both economically and militarily. It's been that way since the Second World War. The Western World counts on this continuing. There are, of course, no guarantees.



As the World's two largest economies move increasingly farther apart, companies are responding. The politics of Covid shined a bright light on vulnerabilities. Among them were supply chains. Many companies are relocating their business operations to friendlier regions. Reshoring manufacturing to North America has gained momentum. Those that covet the Chinese customers are doubling down on diplomacy to maintain good relations. Bill Gates, Elon Musk, and Jamie Dimon made symbolic trips to China with the goal of warming relations that have turned quite cold.

Secretary of State Blinken and Treasury Secretary Yellen made trips too. Relations seem to have stabilized in response, but they're still far from good. Expectations are building for the Chinese and American Presidents to meet again later in the year. This relationship is as critical as any around the globe. Even though a cold war has been brewing, there's a significant co-dependency in place. Many of the interests of the United States and China are intertwined. Each economy relies on the other to fully function. They're quite inseparable.

### New World Order

China is trying to become the new global peacemaker. It recently brokered a deal between sworn enemies Saudi Arabia and Iran. China has become the largest customer of the Middle East. It buys a lot of Oil and exports substantial goods. China now accounts for more trade than the United States and Europe combined.

China also offered a peaceful solution to the war in Ukraine. It sounds good. To be clear, China always has an objective. Its goal is to assert its influence where its greatest interests lie. China tries to counter the US at every angle, offering an alternative. China has increasingly grown closer with Russia, though the alliance has become quite complicated and controversial. China is also reportedly in Cuba, which has all sorts of national security alarms ringing.

To counter these moves, The United States has strengthened ties with the Quadrilateral Security Dialogue. It's more commonly called the "Quad." It's an alliance between Australia, Japan, India and the US. The group aims to support a "free, open and prosperous" Indo-Pacific region. It's clearly designed to keep a check on China's aspirational activities in the region.

India and China share a 2,000-mile border. They aren't exactly friendly neighbors. The boundaries have been contested for decades. A good part of India's strategy to deal with a belligerent Beijing has run through Washington. Both see China as a threat. But India's strategy also runs through Moscow as well.

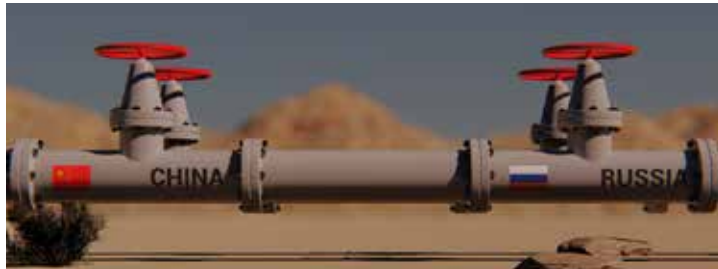


### What About Russia?

Beijing has to be concerned about the risk that Vladimir Putin's hold on power erodes. A weak Putin is not a good look for President Xi, especially if China has to do even more to support Russia economically. Our sources believe Xi may do so, but through increasingly gritted teeth. China and Russia don't necessarily share ideologies. China cares much more about trade and Global Economy. The one thing they do mutually share is their distrust of the United States and the West.



To that end, Putin and Xi have built up a strong alliance. They've called each other best friends. The friendship is strained. Putin miscalculated Ukrainian resolve and Western support. President Xi made a miscalculation too. There are definite limits to these Chinese-Russian ties.



China has got to be thinking beyond the now. What's the alternative? If Putin were to go, there's no guarantee that who would follow would be any better. Russian hardliners are circling. To so many global stakeholders, the alternative could be even worse.

The Market continues to ignore this risk, looking at the situation as a non-event for now. There's no question that something bigger, like a full-out coup, uprising, or even a civil war, would bring major stress back to the Market. Energy is the obvious sector that would be impacted. Russia is the World's third-largest Oil producer and still a key supplier of natural gas to Western Europe. The price of Oil would likely spike high in such an event. The Market has a longstanding tendency to ignore geopolitical uncertainty, until it doesn't.

### Investing Overseas



The United States is India's largest trading partner. But it also trades actively with Russia, taking advantage of the steep discount for Russian Oil amidst sanctions. India needs imported energy. It's a key beneficiary for lower energy prices.

India also buys military equipment from Moscow. In fact, it has purchased an estimated 20-times as much military equipment from Russia than the United States in the last decade. That's about to take a big turn.

India just replaced China as the World's most populous nation. What's more, India's population is much younger. The majority of Indian people are under the age of 30. The Indian government has invested enormously in education and infrastructure. India has been the recipient of supply chain shifts away from China, which has been strained by symptoms of both Covid and Cold War.

With annual GDP of \$3.5 Trillion, India is now the World's 5th largest economy. It now outpaces the United Kingdom and France, trailing only the United States, China, Japan and Germany. Its economy is also growing the fastest of the bunch, estimating 6%+ growth in 2023. India is expected to surpass Japan and Germany before the decade ends, putting them at number 3.

We are warming up to international markets again, something that hasn't been a prime focus for a while. International investments have lagged the US for over a decade, but that trend seems prime for reversal. Demographics are compelling in many regions overseas, where growth is faster and seemingly more sustainable. International stocks are much cheaper and tend to pay higher dividends. We have already rotated some money in this area. We plan to increase our exposure over the course of the decade.

### Back at Home - Resilient Economy

Recession has been avoided; At least for now. It can be attributed to a super strong job market. It's certainly present in the service industry. Companies can't find enough workers. There are 1.5 jobs open for every person looking. That means they have to pay people more. Wage growth remains elevated. That keeps inflationary pressures present. We see it at restaurants, on the menu and with the bill. We're paying for it everywhere. But people keep spending. Consumer spending accounts for 70% of economic activity. It's looked like this: Boom to bust in buying stuff. Bust to boom in going out and about. It's kept America's Economy buoyant for years.



### Holiday Road



What's being called the revenge tour continues. Clark Griswold would be proud. After years of sheltering in place, Americans keep traveling at record pace. They're on the road, in the air and along the high seas. TSA reported record traffic over the 4th of July weekend. 2.8 Million people passed through airports from coast-to-coast in a single day. That's the most ever, eclipsing the previous record from Thanksgiving weekend in 2019. That was before Covid.

People are cruising again at record pace. Traffic is back to pre-Covid highs. Cruise ships said over the Summer that lead times for North America are now further out than they've ever seen. That's a long time. Hotels and theme parks are jammed too. It's been quite a campaign. There's reason to believe that travel peaks this Summer. Once school starts again, people will likely be grounded for a bit and will be paying off those credit cards that financed the Summer fun.

### Mountains of Debt



Those credit card bills are racking up. Americans now owe a record \$988 Billion. That's up 17% from a year earlier. It translates to roughly \$5,700 per person. Those between the ages of 40 and 49 hold an average of about \$7,600 in credit card debt, the highest of any age bracket.

High inflation is pushing more consumers to put non-discretionary spending on cards. Many are having a harder time paring back their lifestyles despite the price pressures. It's only a matter of time for reality to set in. Interest rates are compounding the problem. The average annual percentage rate is over 20%, making it a really costly debt for consumers. We say it all the time: Credit card debt is the worst kind of debt.

Washington has not exercised financial discipline for decades. Our nation had a surplus as the new millennium set in. Now, there's \$32 Trillion in Federal debt. It's consistently increased, regardless of who occupied the White House. The debt was manageable with ultra-low interest rates. The problem is, interest rates are no longer low. In 2023 we will spend over 10% of our annual federal budget on net interest on the debt. The Congressional budget office estimates it to push through 15% in the next 10 years, becoming larger than Medicare and Defense spending. Staggering.

### Problems for Properties



The cost to service debt has increased significantly with rate hikes. Our nation's debt is well north of 100% of the annual GDP. Real Estate feels it first. Commercial property owners, particularly those with office buildings, are struggling to pay debt as borrowing costs surge. Regional banks are big lenders here. Those smaller banks were already in trouble. Loan defaults are inevitable. Many commercial properties are worth far less today than they were appraised pre-Covid.

Big cities from coast-to-coast have a problem. Office space is vacant. Small businesses tied to the workplace keep struggling. Lunch providers and drycleaners top the list. Many have already called it quits. San Francisco is considered the worst. Our Golden City by the Bay is in bad shape. Hotels and retailers have pulled out. Visitors have second thoughts. The magnetic force of the Pacific Coast has dimmed. Investors are seeking alternatives. The truth sure can hurt. Yet opportunity circles.

### Inflation is still an Issue

The Federal Reserve has been counting on falling rental prices to help drive inflation lower for the rest of the year. But housing prices have been stubbornly strong. Home prices exploded again higher in the Spring. There is just such little supply to meet the strong demand with multi-year lows of inventory due to homeowners being rate-locked. Even 7% mortgages have not done much to halt the climbing housing prices.



The price of Oil has fallen 40% in a year. This is deflationary. Lower fuel prices are huge for Consumers. Paying less at the pump means more Dollars available for discretionary items. Other commodities like Lumber and Copper have fallen too. It's because demand has slowed. China has not experienced the recovery that was anticipated at the start of the year. And Europe keeps getting dragged down by recessionary pressures.

Despite these price declines, inflation is still an issue. The Fed has been resolute on the subject, despite the Stock Market's optimistic attitude. Getting down from 9% to 5% inflation was fast. Getting from 5% to the Fed's desired 2% should prove much more challenging. The Bond Market has not shared the Stock Market's optimism. The yield-curve remains inverted, with the spread between the 2-Year and 10-Year Treasury a full 1%. This marks the greatest disparity between the two instruments since 1981. You recall that was also a period of hyperinflation.

### Earnings Season is Near



It's that time of year. Every quarter Corporate America turns in its report cards so investors can measure results. It's all about expectations. Estimates have been all over the place in 2023. Expectations were pretty bad to start the year. Earnings have come in less bad all year. That's what the Market looks for. As a discounting mechanism, the Market prices in expectations and moves forward. So, it's not about good or bad. It's really about being better or worse. Less bad equals better on Wall Street.

The 500 companies in the S&P recorded their best reports relative to expectations in Q1 since the 4th quarter of 2021. Forward guidance has been better too. S&P earnings are expected to decline 6.4% for the June quarter. That would mark the third straight quarter of contraction. It would also be the biggest quarterly earnings contraction since Q2 of 2020. That was deep in Covid when earnings fell nearly over 30%. Since earnings have shrunk, the rally means the Stock Market is even more expensive. That trend has to change for further gains.

The Street will likely be looking past this quarter with a focus on the rest of the year and into 2024. That said, expectations have gotten pretty high for a strong recovery. Earnings are expected to eke out a slight increase in Q3, but the growth rate is expected to ramp up big time in Q4 to the tune of 8+%. That growth is expected to be driven by Tech and Communications Services sectors. They alone are expected to account for half of the growth. Not every company is thriving in this environment. The Street still might be a little too optimistic about the rest of the year.

### Stock Market or Market of Stocks

One thing was clear about the 6-month Stock Market rally. It was led by a narrow group. The top 7 stocks alone account for 1/4 of the S&P 500 index. Apple and Microsoft account for a whopping 15%. The top 7 were up a blended average of 70% in H1. Those were the Tech Titans who led the charge in this AI revolution. The remaining 493 combined stocks were flat. More than half ended midpoint of the year in the red. Participation was not broad-based.

Weak breadth has been a major bearish thesis. Just 23% of the stocks in the S&P 500 outperformed the index. That was the lowest since 1986. The spread between the S&P 500 and the S&P 500 Equal Weight is the widest since 1999. You remember that party. This again reflects the dominance of the largest companies.

There is no question that the path of least resistance for stocks in 2023 has been higher. It's come on the back of expectations for a Fed pause, a soft-landing for the US Economy, lower inflation, better-than-expected earnings, and of course, the game-changing growth story of AI.

### Sour Sentiment Turned Sweet



Investor sentiment sure changed heading into Summer. There's nothing like price to change attitudes. Bulls in the Investors Intelligence report ticked up to 53% as June concluded. Keep in mind, the number of Bulls was just 20% to start the year, rivaling the panicked Covid crash levels.

The June report recorded the largest collection of Bulls since November 2021, which marked the Market top. Sentiment is a contrarian measure, as investors tend to be optimistic at tops and pessimistic at bottoms. The number of Bears fell to 20%, the lowest since early January 2022, when the Bear Market took hold. The Market tends to tip when everyone is fishing from the same side of the boat. It's generally just a matter of when.

### Breaking it Down



We still anticipate a great deal of volatility for the second half of the year. The Fed has made it clear that its campaign to tame inflation is incomplete. More hikes are ahead. The Stock Market has priced in a lot of good, and that good needs to deliver and most likely exceed expectations in the coming quarters. We will learn a lot in July when Earnings Season begins. We expect another sell-off to ensue before 2023 is complete.

Year 3 is the strongest of the Presidential cycle. That's certainly been the case in 2023. But Washington remains sorely divided. Despite the bipartisan Debt Ceiling deal, there's an increasing likelihood that the government shuts down in October, after the September 30 fiscal year-end.

We still like Growth investments but are very mindful that they are not cheap at the present time. We are finding international markets increasingly more attractive and are invested there. We always seek stability and predictability, where it exists, and these are very uncertain times. Blue Chip dividend stocks and the Bond Market fit that bill, to provide some stability as we take some calculated risks in Tech. Hold on tight for H2. The eventful ride continues.

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