PATIENCE & MONEY

THE 282 GROUP OF WELLS FARGO ADVISORS

"Whoever wishes to win in this game must have both patience and money" – Josef De La Vega, Dutch Trader, 1688

Third Quarter 2023 Commentary

WHERE'S THE RECESSION?

Equities

Ryan Culpepper

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During the first six months of 2023, we continue to ask ourselves, where is the recession? Where is the retest of the October 2022 lows? As I am writing this, the S&P 500 up over 15% for the year. That is over a 30% annualized pace of return. Who called that to start the year? We track several analysts and economists across many financial institutions. I don't think anyone saw the first half of this year rebounding as it did. As we came into 2023, there were a lot of analysts and economists predicting a recession in the first half of the year. Here at the 282 Group, we just don't see it coming this year.

Many market pundits predicted a retest of the lows of October of 2022. As you look at the investment landscape for the last six months, we have certainly had reasons for this market to sell off. From a super-hawkish Fed, to the Russian-Ukraine war escalating, to inflation remaining double than what is deemed acceptable, even the largest banking collapse in U.S. history has not derailed this stock market.

Many experts are casting doubt on this rally by telling you that most of the return has been by only a handful of stocks. We would say not so. In fact, after doing our own research, there are over 170 stocks that are outpacing the return of the S&P 500 today. The storyline should not be that only a couple of stocks are leading the charge.

We believe we are beginning to see a broad-based stock market rally. What did well in 2022 is doing poorly in 2023. What did poorly in 2022 is doing great in 2023. Many market strategists all told us to stay defensive with our stocks. To buy high dividend stocks instead of Growth stocks. In June, our research now favors growth stocks over value for the first time in over a year. We were supposed to have a big recession in the first half of 2023 with single digit returns for the year. Go back and read some of the January research papers that some of the largest investment houses were publishing coming into this year. Including our own Wells Fargo.

Did any of them tell you that we would be on pace to have over a 30% annualized rate of return on the S&P 500 by mid-year. Not at all. If you read stock market predictions coming into this year, you would have thought we were crazy to own stocks. In fact, I felt like I was the only equity portfolio manager pushing back on the idea of deep recession. We were telling clients that this is a time to buy stocks. We even told some of you that the selloff in 2022 may turn out to be a generational buying opportunity. It's starting to look that way.

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In January of 2023, we gave you 5 reasons to buy and own stocks for this year. We stand by that for the second half of 2023 as well. Most of the stock market returns for 2023 may be in, but a retest of the October 2022 lows seems like a low probability event for us.

So, what happened?? It's all about expectations…
We are not going to go so far to say the United States won't eventually end up in recession. After all, just keep saying a recession is coming and ultimately you will be right. Each day we can wake up and say it's going to rain. One day we will be right. That's what it feels like these market pundits are doing to us. Every day they are telling you it's going to rain and almost every day it has been beautiful in the US stock market this year. So why? Why are stocks up so much when everybody was saying they would be down? It's simple really, stocks have beat a low bar of expectations.

Here's an illustration: a lot of us that read this newsletter own our homes. Many of us have done home projects and understand the frustrations they can bring. Let's say you have decided to get a nice backyard remodeling job. We are going to add beautiful gazebo with an outdoor cooking and entertainment area. After some research, the expectation to complete the project is around four months. As you are planning and searching out different contractors to handle the job, you set your household calendar that nobody's going to be using your backyard for at least four months. Maybe you even pencil in a neighborhood party in month 5 to show off the new back yard. Again, a four-month project is our expectation.

Most of us have had projects done on our home and most of them have probably been delayed. The contractor told us it would take four months but has recently changed his tune. He is now telling us it will take 10 months. He just can't find the labor and material to get the job done on time. Well, suddenly with that expectation, your heart sinks, you might get upset. It's very disappointing. That is very much like what we went through last year in stocks.

Stock market analysts across the board were lowering stock market earnings expectations. Stock prices followed the earnings estimates lower. Low expectations were set to such a degree that coming into 2023, even my Uber driver was asking about the recession to come. Most stock market pundits thought that this would be a very rough year for the stock market. So, like in our home improvement project, the expectation on stock market earnings were very low.

After a few weeks, we got a phone call from our contractor. He tells us that a couple projects were canceled, and they now have the time, labor, and material to get our job done in only six months. The news still bad as far as our four-month time frame expectation goes. We still can't have our party in month 5. It's still going to take 50% longer than what we originally planned. But because our expectation was for a 10-month project, we are now happy and excited to get our project going. Well, that's much like what's happening in the stock market and a lot of the reason why we made a case for the S&P 500 to return over 20% in 2023. This was not our base case, but we were not scared to print that idea back in January.

You see the bar for company earnings was set so low that even if we had a shallow recession, we felt like stocks were priced to rally on that news. In the first two quarters of the year, most analysts were expecting a 12% or more year over year decline in earnings. What we got was something closer to a 7% year over year decline. The predicted earnings collapse simply did not happen. We all know companies have had to raise prices to keep margins in line due to high inflation. They had to pass those higher prices on to the consumer. And instead of demand drying up as predicted, we have actually seen an increase in demand in many areas of the economy.

As we talk to our different clients across the country, many of whom run companies, we would now suggest that the economy may still be growing slowly but not contracting. We will see in the coming quarters. Everybody expected the stock market price to earnings ratio to decline. That's not what happened.

In fact, earnings have expanded much faster than what was expected. In the second quarter of 2023, many companies started beating earnings expectations easily. We're still seeing it today. The effect of slower inflation is now starting to prove as margin stability in the S&P 500. As we look at the 2nd half outlook for earnings in the S&P 500, there are many narratives still surrounding this economic recession we've all been waiting for. What we feel we may be seeing is that the S&P 500 might be about to go through some form of healing process. There are a lot of moving parts to this that only time will tell. We should see some stock prices accelerating to the upside as the better earnings news continues as well as better expectations of growing earnings for the future. Going forward we should see a slowdown in the goods industries and other pockets of the economy. That said, a re-test of the lows of 2022 would now require some sort of black swan type of event in our view.

Analysts across Wall Street are now upgrading their earnings estimates for the second half of the year. With that fact in plain sight, we expect the majority of stock prices to move higher over the coming 6 months as they follow the tide of rising earnings estimates.

Stay Bullish.

Stocks offer long-term growth potential but may fluctuate more and provide less current income than other investments.
Index returns are not fund returns. An index is unmanaged and not available for direct investment.
The S&P 500 [Standard & Poor's 500] is a market-cap weighted index composed of the common stocks of 500 leading companies in leading industries of the U.S. economy.

GOLDEN HOUR

Fixed Income

Sam Pennell, Jr.

First Vice President-Investment Officer | PIM Portfolio Manager

This time of year is wonderful. Each season has its charms but summer in our beloved South stands out as a favorite. How can you not love the heat, the humidity, or the way you can feel the sun on your skin long after you've gone inside? We've often said the South's heat separates the men from the transplants.

Summer has so many fond memories: picking fresh peaches with my grandmother for her to make the most incredible cobbler; trips to the coast filled with salt, sand, and ocean breezes; family cookouts with hot dogs and cold watermelon; running barefoot in the fresh cut grass; watching the lightning bugs performing their bioluminescent dance after a long day to the amazement of our kids; it's all perfect. 4th of July has always been a personal favorite celebrating the great American experiment and the pursuit of a more perfect Union with parades and fireworks. My, it's all so easy to enjoy.

Just as the season has changed, we have been, and continue to be, in a state of change in the markets. Now's a good time to remember the only constant is change itself. Soak in these moments in the sun as a fixed income investor. They too may change. For now, find a lemonade and hammock. It's really nice, and fruitful, out here.

Skepticism of the 2023 recession call by the 282 Group has been well documented over recent

quarters. Those calls for the worst to happen over the first 6 months of the year appear to be overblown in scale and have led certain strategies to underperform in results. We continue to push back against the fear trade because it "felt safe". A lot of money was made in equities and bonds generated ample income over the past 6 months. If fear was not the driving force of the investor's decision making, portfolios should be vastly improved from January's start. In fairness to those that made the recession calls, it's difficult to know when you're wrong and when you are early. Time will tell.

To refresh your memories, we came into January proclaiming this was yield's year with the advice to reset portfolios at these newfound interest rates and extend your duration after last year's ultra-short term US Treasury trade matured. In second quarter of this year, we reminded to you to not get caught up in the noise of the banking crisis and ongoing geopolitical tensions, but rather, keep your focus on quality companies paying attractive and competitive yields. As we look to the second half of the year, we will encourage you to take a breather, look around and survey the landscape. What has worked so far this year in the bond market? What will work going forward? What pitfalls should be avoided? Why should I even buy bonds right now?

What worked?

The bond aggregate index is up for the year roughly 1%. After the last two years in bonds (the worst in history) this should be cause for a celebration. With the relative calm in bonds there have been pockets of better results than what the bond index has provided. Individual corporate bonds continue to make a case for being a part of the allocation, driving better results than the index. Institutional preferred stocks have also been a bright spot not only for their competitive yields but also their attractive tax treatment as a qualified dividend income instead of ordinary income.

What's up the road?

As we look forward there may be opportunities for municipal bonds for investors in the highest tax brackets, especially as property tax and other taxes may climb in certain areas of the country. We feel Investment Grade (high quality) corporate bonds will continue to be a sector of the bond market we will see demand. With decent issuance and yields consistently above 5%, there's a possible place to 'clip a coupon'. With the Fed signaling 2 more 25bps rate hikes this year (half a percent), and the market confirming it agrees; Corporates, Municipals, and Preferreds may find a place in some income investor portfolios.

What to avoid?

In our view, there's still too many unknowns in the commercial real estate (CRE) market and its debt issuance for us to be interested. The world is still adjusting to post-Covid era life. In our travels across the country, we've seen areas of growth and contraction. Different property types that are doing well, while others languish. Many CRE loans will have to be refinanced in the coming quarters at higher rates. What's the mean for investors? In our opinion CRE has heightened credit and liquidity risks we'd rather not add to our bond portfolios. Our long-standing view has been to not "stack risk" in a portfolio, meaning risks like these are highly correlated to the risk of the equity markets and does not diversify you. If you are looking for more equity-like risk in your portfolio, buy more equities. Sounds like common sense to us. Our advice: leave distressed debt investing to the specialists.

Why bonds now? "Easy" Income

Our best reason for owning bonds has not changed as we look to the future. Our primary function for bond investing remains to generate sustainable, quality income for our clients. We want our bond allocations to be "beautifully boring". As the Fed continues to normalize interest rate policy after a decade and a half of rates at or near zero, this is the easiest income we have produced. This will continue to be the greatest silver lining of a difficult 2022: Yield is back. The market again has a positive real risk-free rate of return. That means after

adjusting for inflation, the Fed Funds rate is making money. Institutional money market funds are yielding well above 5% and that's on the rise as those are closely tied to the Fed Funds rate. With cash having a positive yield, this means good ideas get money flows and have the potential to flourish, while bad ideas get assigned to the trash bin.

Head. Heart. Hands.

There's an old rule of thumb in our business. If you spend 4% from your portfolio income, you'll maintain your principal through retirement. With money markets now yielding over 5% and bonds more, we see a vast majority of those reading this having their basic income needs met either through our efforts, their own effort or a combination of the two. We'd challenge you to think what to do with your easiest income generated in 15 years. Many can do more than they thought possible.

There's an old Hebrew proverb that says, "A generous person will prosper; whoever refreshes others will be refreshed." Ideally, we want to advise from a position of abundance not scarcity. If we can acknowledge our basic income needs are being met, our head is in the right place to think more strategically about what to do with money. We encourage our clients to make this a back-of-the-envelope math equation. Essentially, know your annual spend and compare to all income sources. Easy so far, right?

Second, we need to get our heart in check. Can we emotionally detach ourselves from the noise and uncertainty that is always a part of investing to make good money decisions. If we can align our head and heart, it is easier to open our hands and not squeeze every penny as if it's our last. Again, most of you reading this do not have an income problem, so the question is are you living, or simply alive?

Next, it's time to open our hands. With open hands you'll travel more to see family and new places, help a neighbor in need, give to honorable causes, think strategically and intentionally about generational planning...the possibilities are endless of what can be done. We've seen and been a part of some truly creative and thoughtful strategies. Creating and updating an investment plan can connect the head-heart-hands. We'd welcome the opportunity to come alongside you to walk you through that process. For those that have already done this with us, there's a peace of mind that their personalized strategy is in place. It's easier to enjoy your assets when there is a purpose to every dollar.

We have found where you put your treasure your heart will also be. It's amazing what open hands can do...

So, here's the challenge: Are your head, heart, and hands aligned? Where's your treasure? What is the posture of your hands: open or clinched? What do you allocate your hard-earned assets to? Leverage us. Where here to help.

Happy summer, enjoy the easy stuff, and live open handed.

Investments in fixed-income securities are subject to market, interest rate, credit and other risks. Bond prices fluctuate inversely to changes in interest rates. Therefore, a general rise in interest rates can cause a bond's price to fall. Credit risk is the risk that an issuer will default on payments of interest and/or principal. This risk is heightened in lower rated bonds. If sold prior to maturity, fixed income securities are subject to market risk. All fixed income investments may be worth less than their original cost upon redemption or maturity.

Bond laddering does not assure a profit or protect against loss in a declining market.

Duration is an estimate of how a portfolio or bond will react to changes in interest rates, representing the approximate change in price for a 1% change in yield.

THE US JOB MARKET

Everyday Economy

The 282 Group

Financial Advisors

The U.S. job market remains tight

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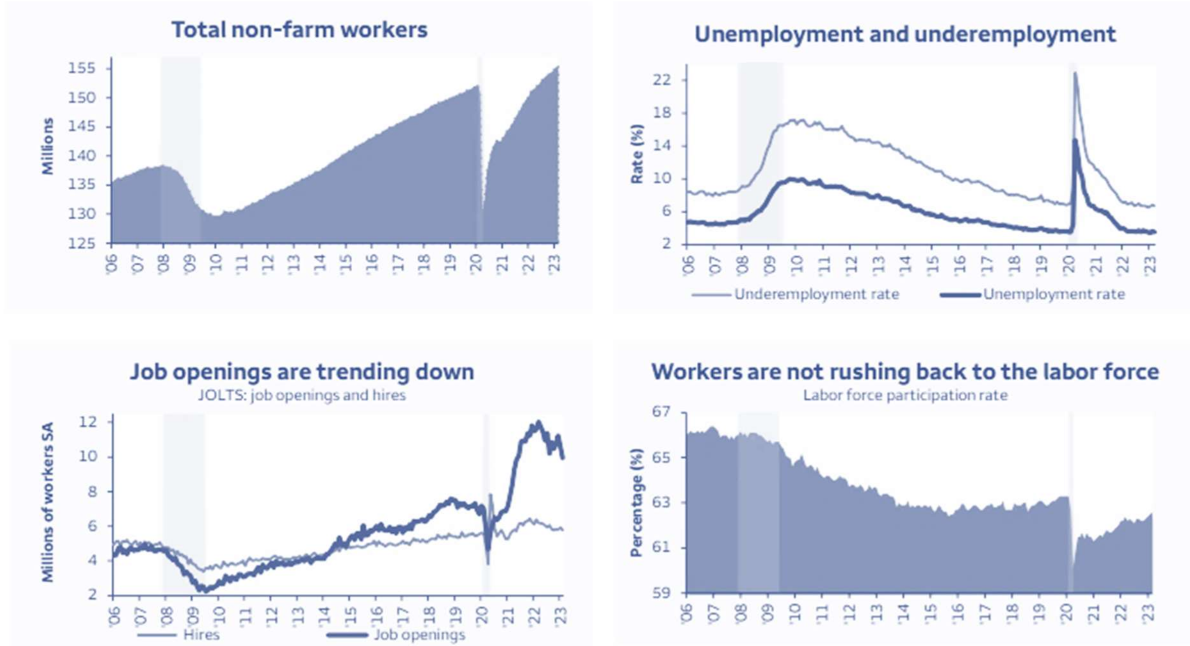

Sources: Bloomberg and Wells Fargo Investment Institute. Monthly data from January 1, 2006 to March 31, 2023. JOLTS hires and job openings: monthly data from January 1, 2006 to February 28, 2023. JOLTS = Job Openings and Labor Turnover Survey. Shaded area represents a U.S. economic recession. SA = seasonally adjusted.

Key takeaways

- The gap between job openings and unemployment remains wide, signaling a still tight labor market in the first quarter of 2023.
- Our view is that the imbalance will narrow over the course of 2023 as businesses reduce the pace of hiring in the face of slowing economic growth.

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