

From: Aequitas Investment Advisors

Re: The Paradox of a Pretty Good Economy and Not So Great Consumer Sentiment

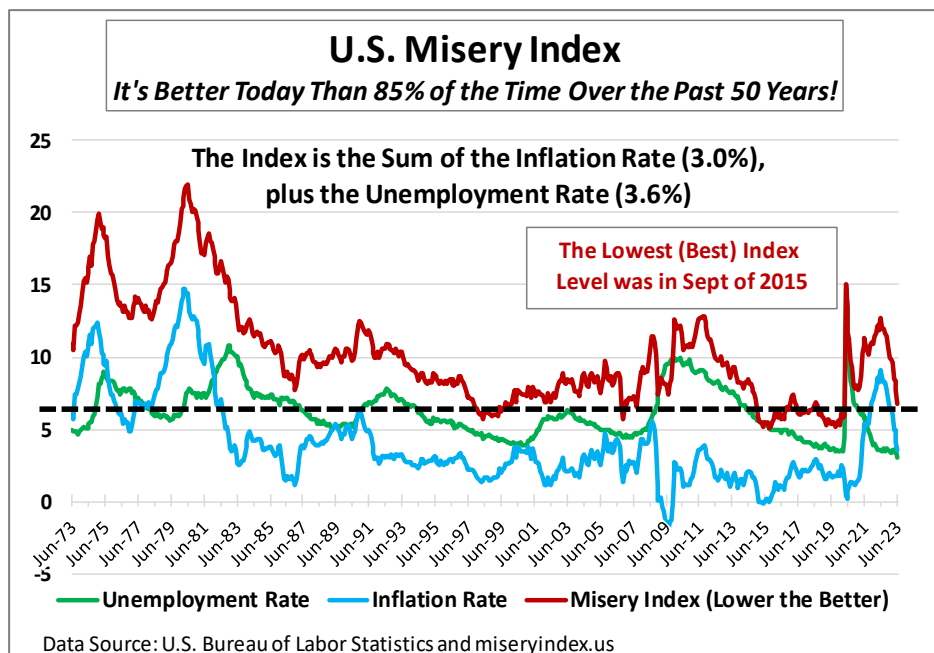
*Warner
is your Team!*

Over the past twelve months, we have seen a number of positive signs for the economy, including the significant drop in inflation from an annualized rate of 6.5% to 3% through June 30th (just one percentage point higher than the Fed's long-term target). The unemployment rate currently stands at 3.6% which remains near its lowest point in more than fifty years, and there are now more Americans employed than ever before. Wages grew faster (+5%) than inflation (+3%) over the past year which helped bolster stronger than expected consumer spending over recent months. Despite higher borrowing costs, consumer debt service payments remain below pre-pandemic levels which should provide consumers with even greater borrowing power once interest rates recede. The U.S. economy grew at a 2% annualized rate during the first quarter of 2023 which was above the consensus forecast. Economists are now raising the odds of a "soft landing" for

the economy, rather than a sharp downturn, which has been the goal of the Federal Reserve in its effort to combat inflation. The resilience of the U.S. economy has also fortified investor confidence as evidenced by the 25% surge in stock prices over the past nine months.

The U.S. Misery Index

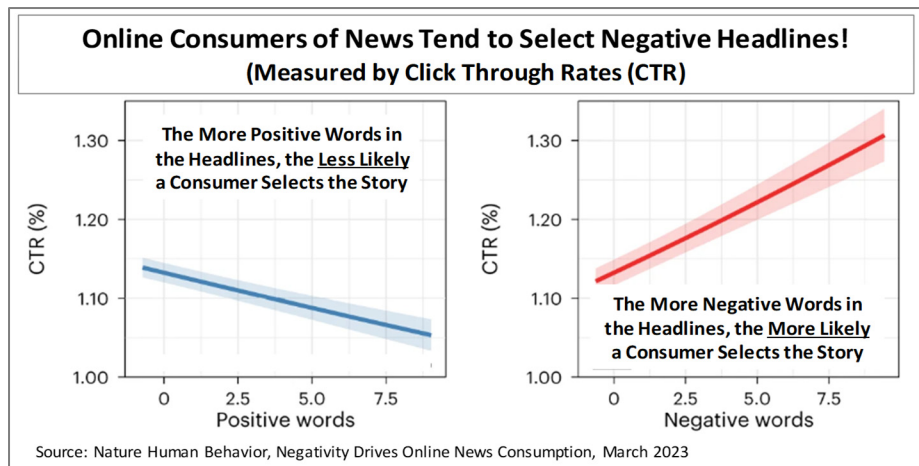
The U.S. Misery Index was designed in the 1960s by the economist Arthur Okun, an advisor at the time to President Lyndon Johnson, as a simple means of measuring how the economy is performing. The Index is computed by adding the current rate of inflation (3%) to the current unemployment rate (3.6%) with the rationale being that if inflation is relatively low and employment levels are high, then consumers in aggregate should feel pretty good about their financial conditions and the economy. Based upon the most recent numbers, the Misery Index has fallen to a level of 6.6 and has improved dramatically over the past two years as indicated in the graph at the bottom left (the lower the red line the better). *In fact, the current Index level is better than it's been 85% of the time over the past fifty years!*



Possible Reasons for Low Consumer Sentiment

While the economy appears to be on solid footing based upon most statistical measures, and consumers have become more optimistic over the past twelve months, sentiment remains somewhat depressed by historic standards. One obvious reason might be that the previous spike in inflation raised prices across the board for most goods and services and consumers are still dealing with those elevated prices. So while the *rate of inflation* has dropped precipitously, the prices of many goods and services remain elevated and it will take time for the impact of higher wages and/or falling prices to favorably impact consumer sentiment. Other factors which might depress consumer sentiment levels are higher borrowing costs, including auto loans and mortgages, and the fact that investment account values have not fully recovered from the bear market of 2022. (Note: as we were writing this quarterly letter, the University of Michigan reported that July's Consumer Sentiment Index soared to an almost a two-year high, so perhaps consumers are beginning to feel the impact of falling inflation and rising wages.)

Another reason consumers might not be feeling better about the current state of affairs relates to psychology. Behavioral scientists have found that *negativity bias*,



i.e., the tendency for negative news to overwhelm positive news, has had an increasing impact on consumer sentiment. While there is no shortage of problems and issues in the U.S. and around the globe which are concerning and challenging, the fact is that news outlets and social media are more than ever perpetuating a disproportionately negative cast to the information on which consumers base their opinions. Ironically, consumers of news appear to *prefer* negative rather than positive words in headlines when selecting articles. Research published by *Big Think* last October entitled, *Negative, Emotionally Manipulative News Headlines Have Skyrocketed Since 2000*, reported the following:

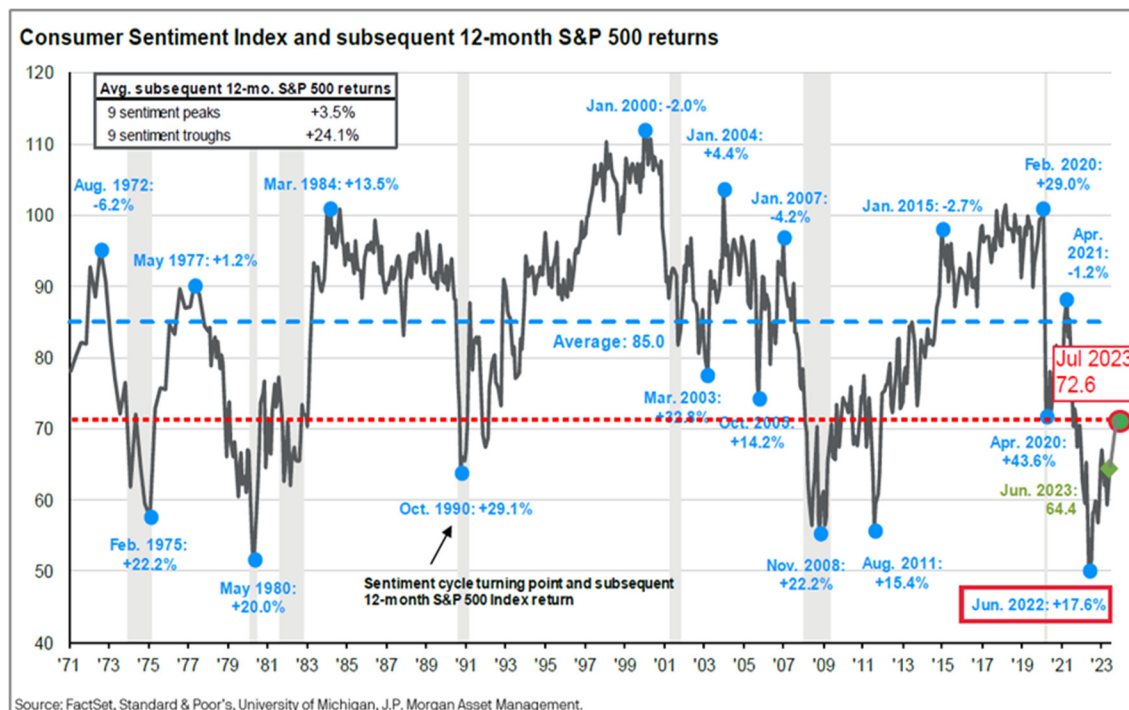
What explains these gloomy changes? It's possible that Americans have developed increasingly bleak views of the world since the dawn of the 21st century, and this is merely reflected in the media. A more nefarious explanation seems more likely, however. User-tracking technology and metrics to measure content reach grew in sophistication and prevalence throughout the 2010s, and these tools revealed that negative, emotionally-arousing headlines attract more clicks and attention than positive or neutral headlines.

The result is a rather *perverse incentive* for news outlets and social media to emphasize negative and emotionally charged headlines in order to attract readers. As a result, we're often missing positive news and, to make matters worse, research has found that it takes five positive bits of information to outweigh one negative bit. It takes much more effort to find positive news given that the media is overwhelmingly feeding us negative headlines. This is clearly a troubling societal trend. At least from the perspective of the economy, however, there is in fact a lot of

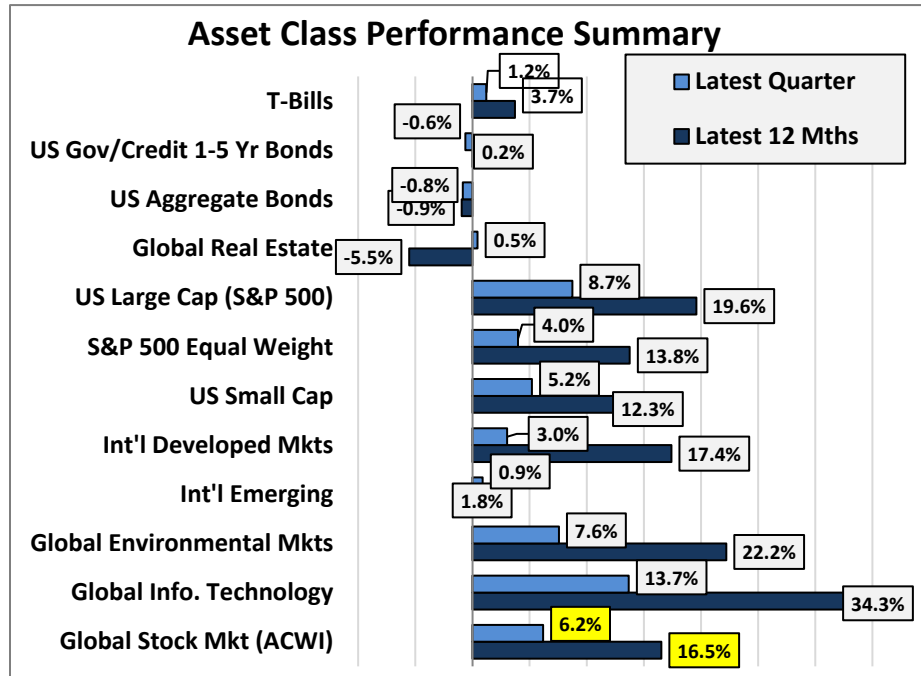
good news and perhaps one of the best gauges to measure that by is the stock market which is an important leading indicator of the economy's direction.

Maybe There's Some Good News in the Consumer Sentiment Data

Sometimes good news can be bad news and vice versa. From the perspective of the stock market, higher *future* gains for investors are more likely when consumer sentiment is low rather than high (a contrary indicator). Conversely, when consumer sentiment is high, future stock market returns tend to be poor. Over the past 50+ years, the average 12-month return for the S&P 500 Index following a peak in consumer sentiment has been just 3.5% compared to an average return of 24.1% for the 12 months following a low point in consumer sentiment. In other words, when consumer optimism had been at a peak, stock market returns over the subsequent 12 months were generally poor, and when consumers were most pessimistic, the subsequent 12-month returns were generally strong. Note in the chart below that the Consumer Sentiment Index hit a fifty-year low in June of 2022, but since that point the S&P 500 Index has provided investors with a 17.6% return (the actual return is somewhat higher when including dividends). Now that twelve months have passed since the June 2022 trough, what might the chart suggest for subsequent returns from this point forward? Unfortunately, the correlation appears to have been strongest at the extremes, but at least with the



current sentiment level (72.6) being lower than the average level (85), it might be reasonable to assume we would experience favorable stock market returns as we look forward. (We see the most promising future long-term returns in sub-asset classes which appear relatively undervalued, including U.S. Small and Mid-Cap Stocks, U.S. Value Stocks and Non-U.S. Stocks.)



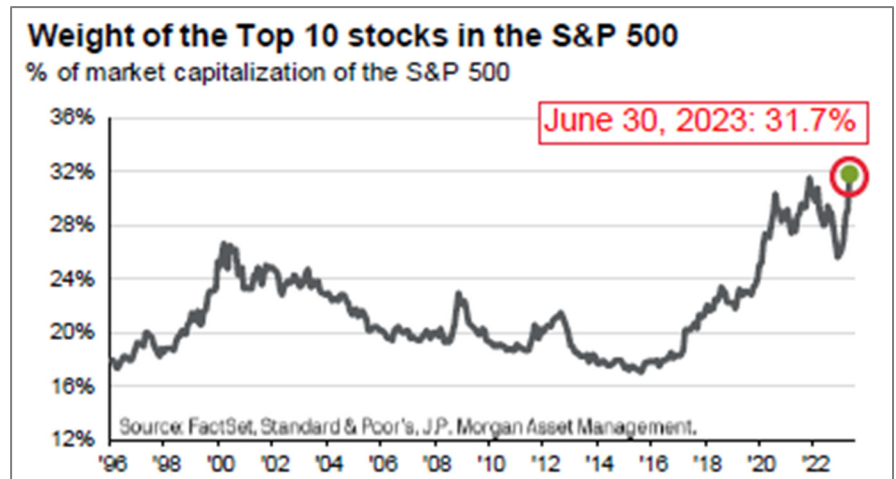
Asset Class Performance Review
Latest Quarter and 12 Months

For the most recent calendar quarter, the Global Stock Market gained a robust 6.2% reflecting an improving economic outlook. Within the sub-asset classes and selected sectors, the strongest gains were in Global Technology (+13.7%), U.S. Large Caps (+8.7%), and Global Environmental Markets (+7.6%). Returns among the other stock market indices ranged from +0.5% (Global Real Estate) to +5.2% (U.S. Small Caps). Returns within Fixed Assets were slightly negative in reflection of the Federal Reserve's monetary tightening policy. U.S. Aggregate Bonds and 1-5 Year Gov/Credit Bonds declined by 0.8% and 0.6% respectively. Last quarter's return on the very short end of the yield curve (30-Day U.S. Treasuries, or T-Bills) was +1.2% which equates to an annualized return of 4.8%. T-Bills and other cash equivalent yields are high at this point given the impact of the Fed's interest rate hikes.

For the trailing 12-month period ending June 30th, the Global Stock Market gained 16.5% led by Global Technology (+34.3%), Global Environmental Markets (22.2%), U.S. Large Caps (+19.6%) and International Developed Markets (+17.4%). The other positive returns among the stock market indices ranged from 1.8% (Emerging Markets) to 12.3% (U.S. Small Caps). The one negative return within equities was Global Real Estate (-5.5%) which reflects investor concern about commercial real estate values, especially office buildings where vacancy rates remain elevated due to the impact of the pandemic. Within Fixed Assets, U.S. Aggregate Bonds fell by 0.9% while shorter-term 1-5 Year Gov/Credit Bonds eked out a gain of 0.2%. U.S. T-Bills gained 3.7% for the period. (Of note, roughly three years ago we eliminated our allocation to Real Estate in our model portfolio in exchange for a dedicated allocation to an Information Technology fund with the goal of bringing our model's weight in the Technology Sector up to neutral as measured by the MSCI All Country World Index. Our current rebalancing recommendations generally include trimming the Information Technology fund in order to capture some of the sector's outsized gains.)

The Top 10 Stocks are Bigger than Ever (And That Could be a Red Flag)

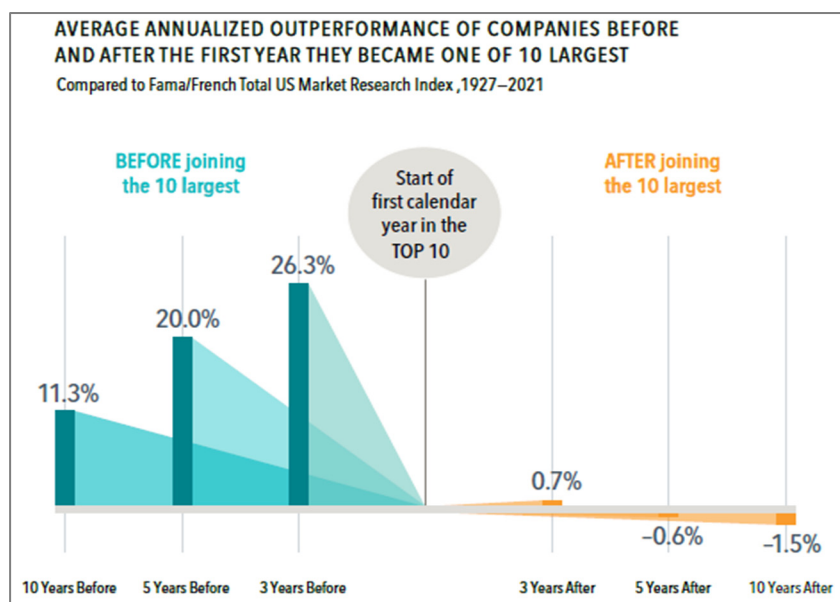
For the year-to-date through June 30th, the S&P 500 Index gained 16.9%, but most diversified investors did not enjoy that robust return given that more than half of S&P 500's return came from just the largest 10 stocks based upon market capitalization (the current "Top 10" stocks are Apple, Microsoft, Amazon, Nvidia, Tesla, Alphabet, Meta, Berkshire Hathaway, JPMorgan and Exxon). The average stock in the S&P 500 gained 6.9% for the first half of the year (i.e., a 10 percentage point lower return than the S&P 500 Index). Due to the outperformance of the Top 10 stocks, the S&P 500 has become *extremely* top



heavy. In fact, close to 32% of the entire market capitalization of the S&P 500 is now concentrated in just the Top 10 stocks. Boiling it down even further, 25% of the market capitalization is concentrated in just the Top 5 stocks. This is the greatest level of stock market concentration on record. Historic data suggests that such concentration may not endure, and if history repeats itself, the Top 10 stocks might underperform the broader stock market over the next 10 years.

Based upon historic returns of the U.S. stock market since 1927, researchers at Dimensional Fund Advisors (DFA) found that as a company's stock appreciated in value to become one of the 10 largest stocks, the performance from that point forward significantly lagged the broader market's performance for the next 3, 5 and 10 year periods.

- From 1927 to 2021, the average annualized return for these stocks over the three years prior to joining the Top 10 was more than 25% higher than the broader market. In the three years after, the edge was less than 1%.
- Five years after joining the Top 10, these stocks were, on average, underperforming the market - a stark turnaround from their earlier advantage. The performance gap was even wider after 10 years.
- Intel is an illustrative example. The technology giant posted *average annualized* returns in excess of the broader market of 29% in the 10 years before the year it ascended to the Top 10, but over the subsequent 10 years it underperformed the broader market by nearly 6 percentage points annually. Similarly, the annualized excess return of Google five years



before it hit the Top 10 dropped by about half in the five years after it joined the list.

DFA's research suggests that the current list of Top 10 stocks in the S&P 500 might underperform the broader stock market over the next 10 years. These highly successful companies might still provide positive returns for investors, but on a relative basis they might significantly underperform. As a point of interest, our model portfolio is designed to be broadly diversified to reduce concentration risk. The largest holdings in our model portfolio include most of the Top 10 stocks mentioned above, but instead of comprising 32% of our model's portfolio (as they do for the S&P 500), their combined weight is closer to 10%. We believe that portfolio diversification across a broad spectrum of individual companies and sub-asset classes not only reduces portfolio risk, but also improves the odds of a successful investment outcome over the long term. Certainly there will be times when a concentrated group of companies outperforms the broader stock market, but history suggests that their outperformance might not endure.

Closing Message

While the economy has largely recovered from the COVID-19 pandemic, the recovery has been accompanied by high inflation, higher interest rates and volatile investment markets which have all contributed to a relatively depressed level of consumer confidence for most Americans. Unfortunately, the increasing propensity of the news media to feed us disproportionately negative headlines only serves to make our societal mood more negative and divisive. The upcoming political season, plus the advent of Artificial Intelligence (AI) may only make matters worse. There is certainly a lot of bad news out there, but there is also a lot of good news which is being underreported. Perhaps in the future we will be able to utilize AI technology to help us, as consumers of news, weed out misleading and inaccurate information so that we can view the world in a more balanced and positive way.

In closing, we offer inspiring words from the *Book of Joy* written by the Dalai Lama and Desmond Tutu.

Until our next conversation or meeting, we wish you and your loved ones a healthy and enjoyable summer!

