MIRACLE MILE ADVISORS
With You Every Mile

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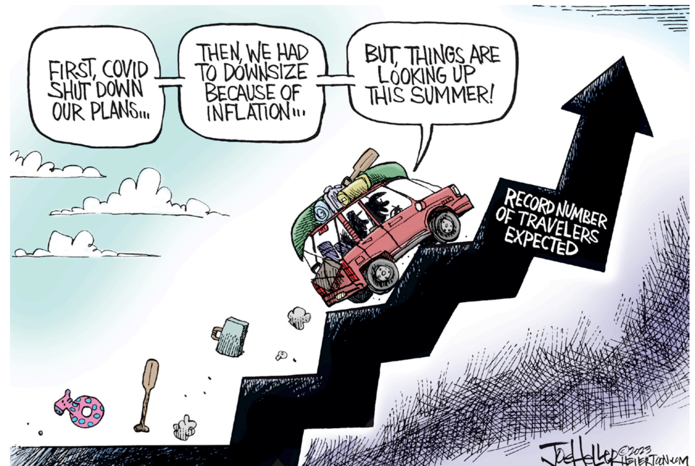
Climbing Up the Wall of Worry

The threat of a recession and subsequent poor market performance has been the theme this year and is something we have written about at length. While stock market performance has been strong year-to-date, significant warning signs remain, and the coast is far from clear. However, compared to previous quarters, we are optimistic that with shrewd judgment and tactical portfolio management, investors can maneuver through the market and find the sweet spots buried within.



Progress and Patience

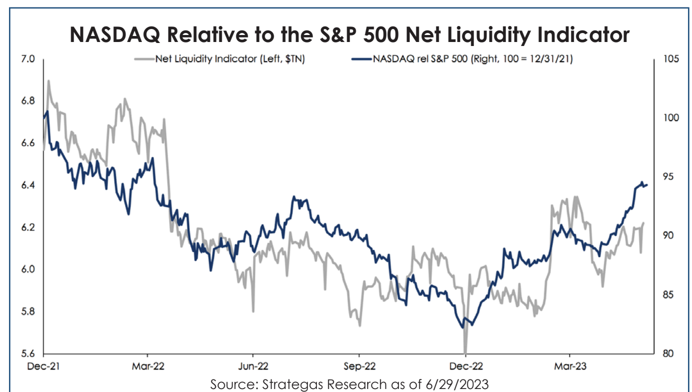
Given the unusual number of significant macroeconomic events in the first half of 2023, overall market volatility remained surprisingly stable. In fact, recent stock market volatility was the lowest since the onset of the pandemic. Key factors contributing to this stability include:

- Congress resolving the debt ceiling issue
- Stress in the banking sector being only a modest drag on the economy
- Prospects for the Fed to pause or end interest rate hikes
- Better than expected first-quarter earnings
- $400 billion of added stimulus
- Declining inflation
- Stabilization in the housing market

Economists revised growth forecasts upward because of the positive developments stated above and a growing number of experts positing that an economic recession may be avoidable.

But uncertainties remain – the lagged effect of all the interest rate hikes on the U.S. economy, the uneven pace of inflation improvement due to the tight labor market, the extent of falling corporate earnings, a persistent inverted yield curve, very few stocks performing well (narrow market breadth), high valuations in the best-performing stocks, and comparisons to historic markets keep us cautious on the outlook for the economy and the markets.

Besides the Fed's fight with inflation, the banking crisis, and the debt ceiling, market breadth is probably the next most significant occurrence to be aware of. At the end of May, the top 10 holdings of the S&P 500 accounted for more than 100% of the YTD performance of the index. This means that the remaining 490 holdings were net detractors to overall performance. Crucially, since 1990 market breadth[1] has never been this narrow. Thankfully we saw an improvement in June with more stocks participating - but there is still plenty of room for further improvement. We see this in our portfolio performance, as do most active investors allocated to a broad set of assets.



Source: Strategas Research as of 6/29/2023

We believe the narrow market breadth is primarily due to liquidity – the silent factor for markets this year. From January 19, when the U.S. hit the debt ceiling, through June 2, the U.S. was in a period of increased liquidity, with the Treasury spending down its Treasury General Account (TGA) by a net $400bn.[2] This stimulus spurred risk-taking (see chart) and temporarily offset the Fed's Quantitative Tightening (Q.T.) and the resulting impact.

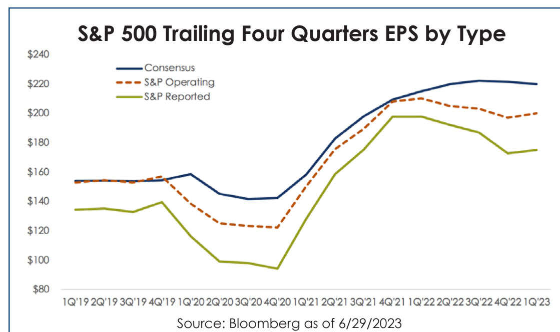
With the debt ceiling deal now complete, we have entered the 'payback' stage. As the Treasury issues new debt, we expect less speculative parts of the market like energy, healthcare, industrials, and other value areas to be favored again as markets begin to reflect tightening financial conditions.

What This Means for Investing

Growth

We see risks to U.S. equities and are diversifying with assets and strategies that help buffer against the downside. This year's narrow rally in the S&P 500 by the top mega-cap companies has been driven by the excitement of artificial intelligence (A.I.). This new technology promises to transform the operations and efficiency of these businesses. While we think A.I. will likely become a key long-term performance driver for mega-cap technology companies, we see valuations as grossly exaggerated. On a price-to-book basis, the MSCI All Country World technology index is trading in the 90th percentile of the past 20 years' valuations. The MSCI USA tech index is even more expensive, at 25 times 12-month forward earnings, a 34% premium to its 20-year average[3]. While current valuations are extended, we are maintaining some mega-cap technology in portfolios to have exposure to this leadership group. Still, we are doing so within the context of a diversified portfolio of assets more appropriately valued.

The performance of the bottom 490 stocks will determine the forward path of the overall domestic market. The rally must broaden for growth to be sustainable. However, earnings are contracting and credit conditions for U.S. businesses and households have continued to tighten. Despite this, developed market equities are not pricing in the slowdown that will likely be seen (see chart), opening the door for a sharp correction should S&P 500 earnings contract this year (which is expected).



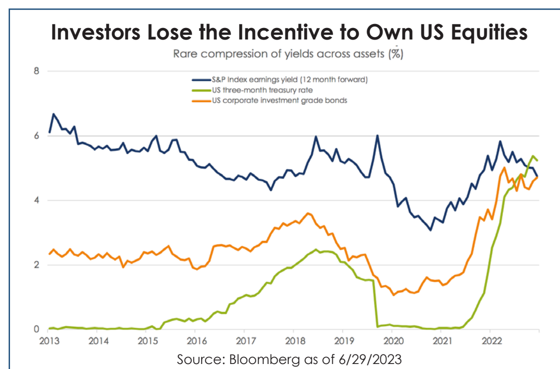
Fortunately, the few mega-cap stocks aren't the only game in town, as they were for much of the previous decade. Over the past year and a half, as inflation has sharply risen and interest rates have followed, various other sectors such as energy, health care, and industrials have been good options, as have foreign stocks that are outpacing U.S. stocks for the first time in years.

Sure, the U.S. equity market is the world's largest and often the biggest single component in a well-diversified portfolio. But now, other assets and markets look more attractively valued. For example, MSCI EMU, the Eurozone equity benchmark, is trading at 12.3x forward P/E, and MSCI Emerging Markets is at 11.7x.[3] While China accounts for about a third of the MSCI Emerging Markets index, and we expect growth there to resume, there are also numerous opportunities in Asia that should benefit from increased infrastructure spending and the global technology supply chain.

Stability

Fixed income remains attractive on just about all fronts. Right now, all three asset classes – stocks, bonds, and cash (Treasury bills) have roughly the same yields when comparing treasury and corporate bond yields to the earnings yield[4] of the S&P 500 index (see chart). This condition implies that there is currently no extra return (risk premium) for taking on the added risk in domestic corporate stocks or bonds, which either reflects the overvalued nature of stocks and some bonds relative to Treasury bills, or gives evidence to the market's perception that cash/Treasury bill yields should fall. An answer will come soon.

Furthermore, interest rates will likely peak, so we have been locking in the current higher rates and the potential for additional performance in the case of economic weakness. Given economic uncertainties, we prefer higher quality, mid-duration corporate bonds and a mix of shorter and longer-dated municipal bonds (barbell approach).

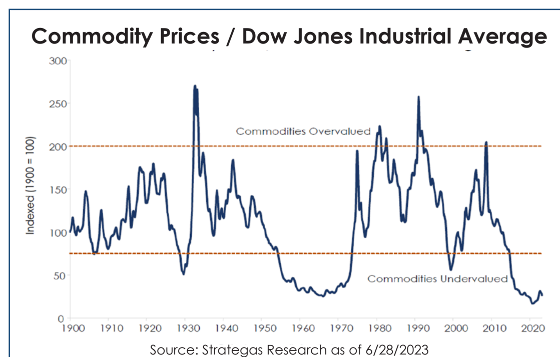


Diversification

With higher interest rates for longer, the correlation between stocks and bonds has increased, and thus some of the diversification benefits of a portfolio that only has these two asset classes have diminished.

Within the equity and fixed income asset classes, we find hedged equity and private credit attractive and useful complements to the traditional asset class preferences mentioned above. Additionally, we continue to favor a mix of real assets, from commodities, managed futures, and gold. Commodities are inexpensive relative to other asset classes and should continue to benefit from under-investment in the near-term and increased demand associated with energy transformation in the long term.

While near an all-time high, gold remains attractive as a recession hedge, a benefactor of future lower interest rates, a weaker U.S. dollar, and supported by global central banks buying to bolster their currencies.



Summary

New bull markets typically require many characteristics that this market environment still lacks, such as lower overall valuations, higher risk premiums, and supportive monetary policy. But while the current setup isn't perfect, there are opportunities. Investors should avoid the temptation to wait on the sidelines. They should continue to invest for the long term, use diversification to manage risk, and make strategic decisions with a forward-looking perspective. We believe a well-balanced portfolio of domestic and international companies trading at attractive values, diversified with quality fixed income, and complemented by select real assets, remains the best way to capture the full opportunity set while managing downside risks.

Planning First: Patience and Prudence

As you know, financial planning is an essential part of life that can help you reach your financial goals, such as saving for retirement, buying a home, paying for college, or creating a legacy. A successful financial plan requires significant diligence and analysis on the front-end, and shrewdness and trust on the back-end. Managing your investment portfolio is no different, as it is vital to have a similar approach to ensure the long-term success of your plan.

Here are some tips for managing your investment portfolio with patience and prudence – necessities for generational success.

1. **Have a thoughtful plan**. Before you start investing or hiring an advisor, it is essential to have a plan. This plan should include your financial goals, risk tolerance, and time horizon to ensure that your investments work in service of your life and not the other way around.

2. **Engage in a consistent process**. Once you have a plan, sticking to a disciplined investment and rebalancing strategy is essential. Once set in motion, it's also necessary to periodically stress-test using conservative assumptions. As fiduciaries, your advisors and our investment strategy group meet frequently to ensure your investments are forward-looking in an ever-changing market, aiming to preserve capital, avoid risks, and identify new opportunities. For example, the sharp rise in interest rates has created opportunities for fixed-income investors that have not been available for decades. This has allowed many investors to rebalance their investments to achieve more consistent returns with lower levels of risk.

3. **Use a time-tested philosophy**. When investing, using a proven, evidence-based investment philosophy is vital. At Miracle Mile, this means being well-diversified, buying undervalued, quality assets, and not chasing momentum. This also means investing in a strategy that aligns with your beliefs and risk profile over a long period, reducing the odds of making emotional decisions at inopportune times.

4. **Use prudent asset allocation**. When it comes to wealth preservation, the key is always to remain diversified. This means allocating your assets between different asset classes, such as stocks, bonds, alternatives, and cash. While this approach may not hit grand slams in any year, it will consistently hit singles and doubles, which is more important in ensuring the success of your investment plan over a decades-long period.

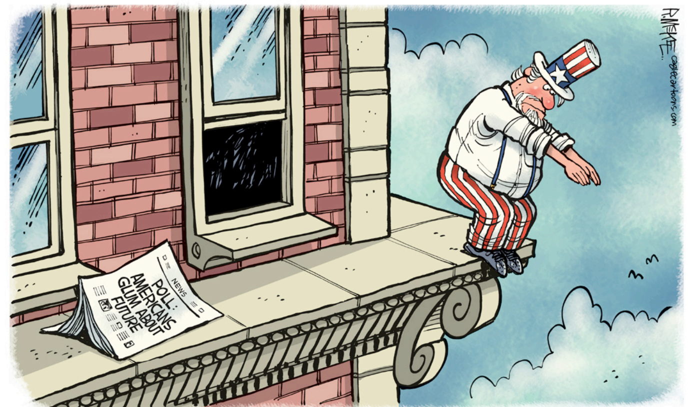
Investing is a long-term endeavor. Don't let short-term market fluctuations or the latest trends discourage you from sticking to your plan. Employing a time-tested philosophy will help you stay focused on your goals, reduce your risk, and maximize your returns. Most importantly, you will maximize the probability of reaching your financial goals and protecting your wealth.

Does More Risk = More Return?

Not necessarily. While a general relationship exists between risk and return in the stock market, it is not always a direct correlation. In some cases, riskier investments lead to lower returns. Several factors can affect the relationship between risk and return, including the overall market environment, the specific asset, and the investor's risk tolerance.

Some examples of how risk and return can be different:

- **A highly volatile stock (meaning its price fluctuates a lot) may not necessarily have a higher return than a less volatile one**. The more volatile stock may have a lower return over time. This is because the high volatility can lead to a higher absolute value of losses compared to gains (even if gains happen more often).
- **A stock in a new industry or developing a new product (e.g., A.I. or Crypto) may have the potential for a higher return than one in a more established industry (e.g., Healthcare or Consumer Staples)**. However, the new companies in emerging industries also have the potential to collapse, a threat that is minuscule at best in mature industries. The fall of bitcoin-related industries is a prime example of this, as the return potential was exponential, but so was the potential for failure.
- **By definition, companies in emerging market areas are higher risk but also carry the potential for a higher return**. However, most of this is built upon speculation that the emerging market country will seemingly 'emerge' and ramp up its production and efficiency. With speculation, there is always a risk that the expected scenario may not pan out. This is why unbiased, deep analysis and diligence are necessary for every investment, specifically for those in unproven markets and industries.



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A more risk-averse investor may accept a lower return in exchange for a lower-risk investment. For example, an investor saving for retirement may be willing to invest in a bond fund with a lower return than a stock fund in exchange for the lower risk. If an investor's plan is successful with a 5% return, taking on more risk is unnecessary.

It is important to remember that there is no guarantee of returns in the stock market. Low-risk investments can lose money, especially when purchased at expensive levels. Higher-risk investments can be better investments if bought at attractive prices. By understanding the relationship between risk and return and doing so within the context of a comprehensive financial plan, investors can make more informed and rational decisions about where to put their money.

Staying Diligent Amidst Potential Chaos:

2023 has proved to be a positive year thus far for stocks, despite headwinds coming from multiple directions. We will continue to be diligent and tactical in our moves, not being blinded by acute market movements but strategizing for long-term portfolio growth and taking advantage of opportunities when they present themselves. Our fixed income and diversification allocations will follow suit and be data-driven, matching the specific client situation.

As the mid-way point of the year is upon us, now is an excellent time to reflect on the first six months of 2023 and create a game plan for the back half of the year. This is precisely what our team is doing for you, and we look forward to what will come.

If you have any questions or concerns, please feel free to reach out.

Best Regards,
Your Miracle Mile Team

A Quick Firm Update:

We are excited to announce the hiring of our first Chief Executive Officer, **Bruce Milam**.

Bruce will oversee firm operations and the continual enhancement of our client offering and overall client experience. He comes with over 20 years of industry experience, most recently serving as a Partner and Chief Operating Officer at a top Seattle-based wealth management firm.

SOURCES:
1 Percent of S&P 500 stocks outperforming over the last 3 months
2 Strategas Research as of 6/28/23
3 UBS Global Investment Research & Insights
4 Earnings yield; 1/[p/e ratio]

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