BLUE GRANITE CAPITAL, LLC

INVESTMENT COMMENTARY, JULY 2023

A funny thing happened while all eyes were focused on looming recession data and higher interest rates for the U.S. economy—we just had a bull market (20% rally from the market low). Admittedly, given the negative headlines and performance of most stocks it nevertheless does not feel like a bull market. Perhaps the largest culprit of this dichotomy is the Nasdaq's 32% rally driven predominantly by only 7 stocks resulting largely from an abundance of lofty expectations for Artificial Intelligence (AI). In recent months not a day has gone by without the media's mention of the life-changing promise that AI holds for our future. Seemingly, overnight every company boasts AI as a tool they will not only use internally, but also as a product they will develop and monetize. Makes you wonder how we survived without AI all our lives!

The bear market, which began in 2022, lasted 248 trading days and was the second longest in history dating back to 1948. Bear markets last on average 142 trading days, so the recent one was a bit longer and more painful. Through the first half of 2023, the S&P 500 has gained more than 15%. In historical context we note that on 10 other occasions with similar gains through the 2nd quarter, the market remained positive for the full year with an average gain of 23%. Not to be outdone, The Nasdaq gained 31.73% in the first half, its best start since 1983 and has risen more than 35% from its October lows.

What stands out this year is the concentration of stocks leading the rally. As mentioned earlier, only a handful of leading technology and communications stocks (7 mega-cap stocks to be exact) have led this year's equity performance thus far. These stocks have dominated their peers by a substantial margin. Much of this is on the back of AI and how profitable it will be for those companies involved, resulting in a very distinct difference between growth and value stocks. Through the 2nd quarter, growth stocks in the S&P 500 outperformed value 21% to 12%. We believe the current disparity between growth and value and tech vs. non-tech stocks will not last indefinitely. Throughout history, growth and value have each flexed their muscles and led with periods of dominance, only to fall back to earth due to excessive valuations and a number of factors which influence pricing and performance. This time should be no different.

Through the first 6 months of 2023, the U.S. economy has defied recession expectations enabling stocks to climb the proverbial 'wall of worry'. The market continues to rally despite fears the Fed's aggressive monetary policy will tip the economy into a recession by overly slowing growth, reducing corporate profits and suppressing consumer spending. Despite promising signs of lower inflation, it remains a nagging problem and the Fed has signaled that is committed to further rate increases to meet their target of a 2% long-term inflation rate. Given the inflation data, this certainly limits the odds of rate cuts anytime soon.

Despite economic forecasts to the contrary, the anticipated recession has not taken hold of the U.S. economy. The unprecedented money supply pumped into the economy during the Covid era appears to have delayed the intended impact of higher rates, while consumer spending has remained exceedingly strong. That said, we do not think investors should underestimate the Fed's objectives nor outcomes. In the past, recessions began on average 13 months after the Fed's last rate increase so, according to history, we have more time for the possibility that potentially higher interest rates will indeed slow consumer spending and the economy and curtail the bull market that we are enjoying.

Higher rates have had a negative impact on the economy, the housing market and corporate profits, yet simultaneously have created a new paradigm for the bond market. We have not seen bond yields at such attractive levels since the financial crisis of 2008-09, and current treasury rates are the highest in 18 years, ranging from roughly 3.75%-5.45%, depending upon the maturity date. As a result, your portfolios directly benefit with greater income generation and enhanced risk mitigation.

Entering the second half of the year there remains no shortage of factors that might give investors pause. Most economists continue to predict a recession with unknown timing, which reminds us of the old joke that "God created meteorologists to give economists credibility." We are less concerned about if or when an actual recession begins and instead stay focused on investing in high quality stocks at reasonable prices which, in our opinion, there are many.

Thank you for your trust and support, and we hope you enjoy a wonderful summer.

Warmest Regards,

Scott, John & Dave