Second Quarter 2023 Commentary

There was plenty of economic data reported during the second quarter, all seeming to point to a relatively soft economic landing being successfully engineered by the Federal Reserve, and stock market participants cheered the news. True, consumers are finding it more difficult to obtain favorable financing terms for house or car purchases due to higher interest rates, but they are still feeling flush from Covid-related stimulus funds. And while GDP growth slowed somewhat, it's still squarely in positive territory and not in any immediate danger of falling into recession. More on that below.

The FDIC seized one more regional bank during the second quarter, in addition to the two from Q1, but the failure of First Republic Bank in May now seems like a distant memory to most market participants. With strong results almost across the board from corporate earnings, the U.S. stock market extended its run of strong performance from the first quarter into the second quarter of the year. After posting a positive 7.5% through March 31, the S&P 500 index returned 8.7% for the next three months, for a first-half total return of 16.9%. While the Dow Jones Industrial Average returned "only" 4.9% during the first six months, that's still twice as much as cash-like short-term Treasuries earned during the same period.

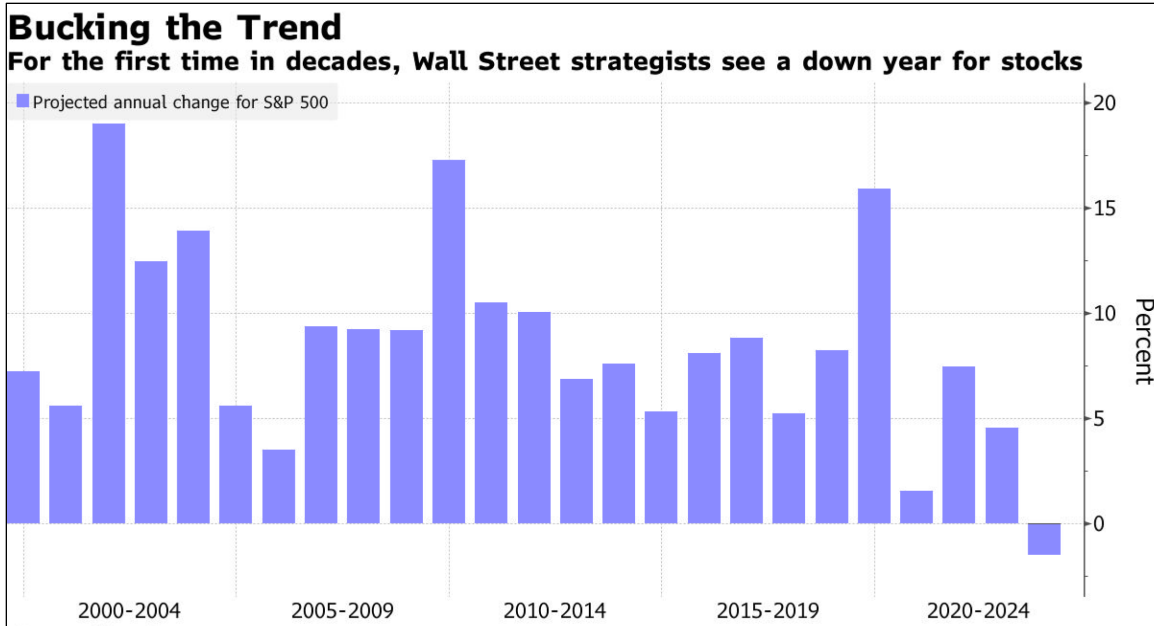
The tech-heavy Nasdaq 100 experienced its best first half ever—yes, even better than anything it achieved during the dot com bubble of the late 1990s—climbing almost 40%. Even with all that growth, though, the major stock averages are still below their most-recent all-time highs which were achieved in late 2021.

The stock market performance over the last six months has had us reflecting on a number of topics. Let's examine a few.

On Economic and Market Forecasts

Harvard economist John Kenneth Galbraith once said, "There are two types of forecasters: those who don't know, and those who don't know they don't know." We put ourselves firmly in the first category but, unfortunately, the loudest stock market pundits fall into the latter. At the beginning of this year, for the first time in decades, Wall Street strategists forecasted a down year for stocks (see chart at the top of the next page). Those who paid attention to these "experts" and pulled their cash out of the market missed one of the best starts to a year in stock market history.

You might be thinking that while making stock market predictions can be hard, predictions about the economy are still worthwhile to heed. Au contraire. It is much the same. We recently saw the second chart on the next page, and it blew us away. The graph shows the historical 10-year



source: Bloomberg

Treasury rate (the bold green line) versus the beginning-of-year forecast from the Fed's Survey of Professional Forecasters (represented by the dotted lines). The vertical gray bars, by the way, denote periods of recession.

source: Bloomberg, Philadelphia Fed Survey of Professional Forecasters, Apollo Chief Economist

In English, what the chart above says is, "In nearly every single one of the last twenty years, professional forecasters called for significantly higher interest rates than were actually achieved." On top of that, as you can see on the far right side of the chart, the forecasters drastically under-estimated the 10-year rate for the current year. They had predicted the 10-year Treasury rate to be in the neighborhood of 2%, but as of this writing the actual rate is nearly double that at 3.8%.

With all this egg on the face of forecasters, we can't help but point out one more John Kenneth Galbraith quote, "The only function of economic forecasting is to make astrology look respectable."

On Recessions

Over the last 18 months or so, we have been asked countless times whether we are in a recession or if one is coming soon. Based on the above, you will not be surprised to learn that we always respond in the same way: "We don't know." What we do know is that, over this time, it has always felt like we are but a month away from one, since that is what all the "experts" keep saying. While we don't know if we are entering a recession any time soon, it is evident that—if we do enter one—it would be the most telegraphed recession in history.

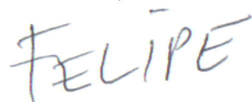
The other thing that we sometimes think, but typically don't say out loud, when asked if we're going into a recession is, "We hope so." In a capitalistic society, recessions are a normal occurrence of the business cycle. Again and again the U.S. economy experiences booms that turn into euphoria, and busts are an inevitable way for the economy and the market to correct itself. For us long-term investors, these busts can provide the opportunity to buy stocks at lower prices. Whenever you worry about a recession, remember this: the 20th century saw more than a dozen recessions, yet the Dow Jones Industrial Average rose from 66 to 11,497.

On Compounding

The definitive biography of Warren Buffett is called *The Snowball* for a reason. Just as many tiny snowflakes can combine together to eventually form a snowball larger than you are, provided you have a large enough hill, the power of compounding has made Buffett one of the richest men in the world. Yes, most of that is due to his investing acumen, but a large part of it is that his economic snowball has been rolling down a very large hill. Consider this: while Warren Buffett is today worth more than $100 billion, over 95% of that was accumulated after his 65th birthday. Read that one again.

What does that mean for us? Invest for the long term. Don't try to time the market. Don't get in and out of stocks, remembering Peter Lynch's famous quote: "Far more money has been lost by investors in preparing for corrections, or anticipating corrections, than has been lost in the corrections themselves." Let time be your friend. Three months is a very short time in the stock market, but we look forward to reporting to you on our progress again in October.

Sincerely,



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