NOTTINGHAM ADVISORS
ASSET MANAGEMENT

Is the Runway Still Lit for a Soft Landing?

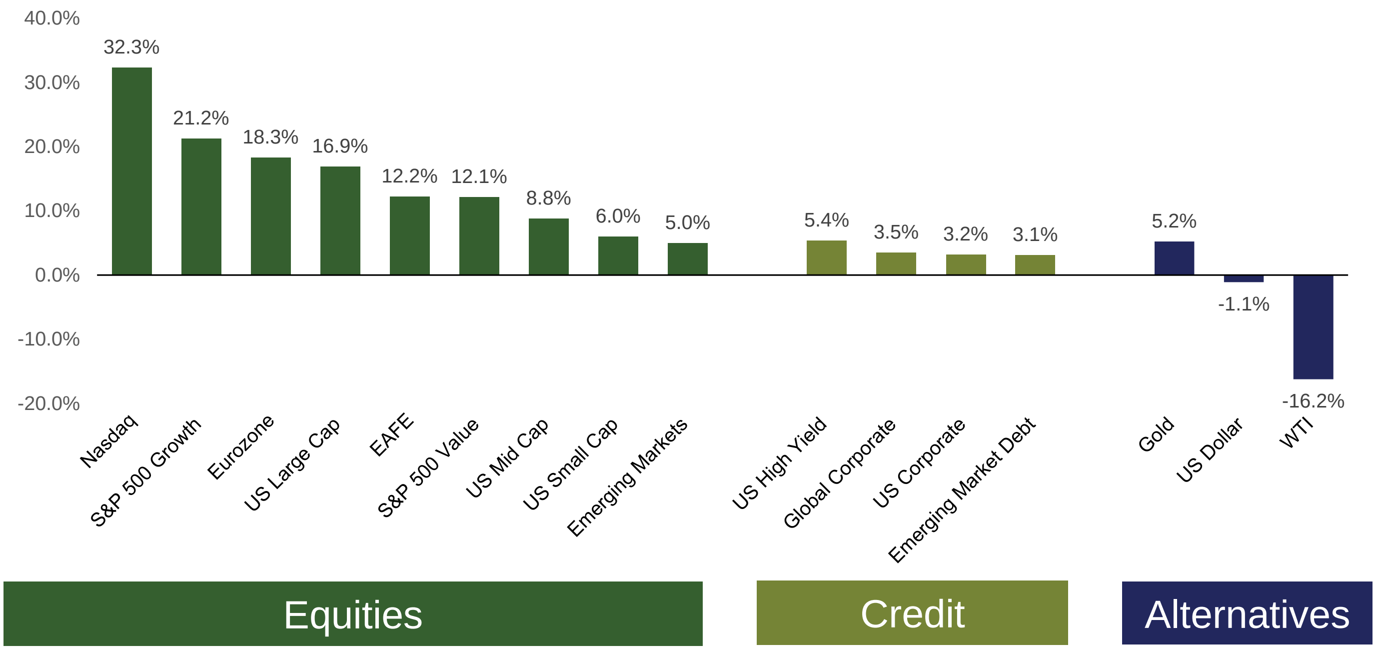
Markets Rebound Sharply in the First Half

Equity markets rebounded sharply in the first half of the year as inflation cooled and the labor market remained strong. Coming off of the worst year since 2008, valuations corrected sharply in 2022, and have expanded in 2023 as fundamental underpinnings for global markets stabilized, and in the case of the US, accelerated into quarter end.

To recap, the S&P 500 rose +16.9% through June 30, followed by Mid- and Small-Caps, as measured by the S&P 400 & 600 Indices, which rose +8.8% and +6.0%, respectively. Performance was exceptionally strong in the month of June, where Mid-, Small-, and Large-Caps rose +9.2%, +8.2%, and +6.6%, respectively on the back of stronger than expected economic data and downward inflation surprises. The data thus far continues to underscore the resilience of the US economy and defy skeptics who believed a recession was imminent in the first half of the year.

While equities have rallied significantly in the first half, it has largely been driven by a handful of Mega-Cap stocks, including Apple (+49.7%), Microsoft (+42.7%), Alphabet (+36.3%), Amazon (+55.2%), Meta (+138.5%), Tesla (+112.5%), and NVIDIA (+189.5%), all beneficiaries from the Artificial Intelligence (AI) boom that has taken the market by storm. Looking at the S&P 500 on an equal weighted basis, the market is *only* up +5.5% year to date. The top heaviness of the market has propelled the S&P 500 Growth Index +21.4% so far this year, well ahead of the S&P 500 Value Index, which has gained a still respectable +12.1%. At the sector level, 4 of 11 sectors remain in the red for the year (Utilities, -5.7%; Energy, -5.6%; Healthcare, -1.5%; and Financials, -0.5%), and an additional 4 of 11 sectors that have posted positive gains, but lagged the overall market (Industrials +10.2%; Materials, +7.7%; Real Estate, +3.7%; and Consumer Staples, +1.3%). That leaves Technology (+42.8%), Communication Services (+36.2%), and Consumer Discretionary (+33.0%) as the only sectors outperforming the market. It should come as no surprise that these three sectors are home to the seven Mega-Cap stocks outlined above.

International markets rose in tandem, with both Developed and Emerging Markets posting positive gains through the end of the second quarter. Developed Markets, as measured by the MSCI EAFE Index rose +12.2%, while Emerging Markets (EM), as measured by the MSCI EM Index, rose +5.0%. Emerging Markets have been weighed down by their heavy exposure to China, which stood at nearly one-third of the index at quarter end. Chinese equities, as measured by the MSCI China Index, lost -5.0% through June 30, the mirror image of the broader EM Index. Put differently, the MSCI Emerging Markets ex-China Index, is up +9.9% year to date, thanks to a heavier reliance on Taiwan, South Korea, and India, and no direct exposure to China. Chinese data has continued to weaken as we go to press, as the reopening post-COVID has fizzled, and a lack of stimulus has dampened consumption. This in turn has put downward pressure on inflation, and may lead to increased deflationary pressures in the medium-term. Add in a 20%+ youth unemployment rate and rising tensions with the West, and the outlook gets murkier. US imports from China hit their lowest level since 2005, according to May data from the US Census Bureau, underscoring the issues plaguing China.



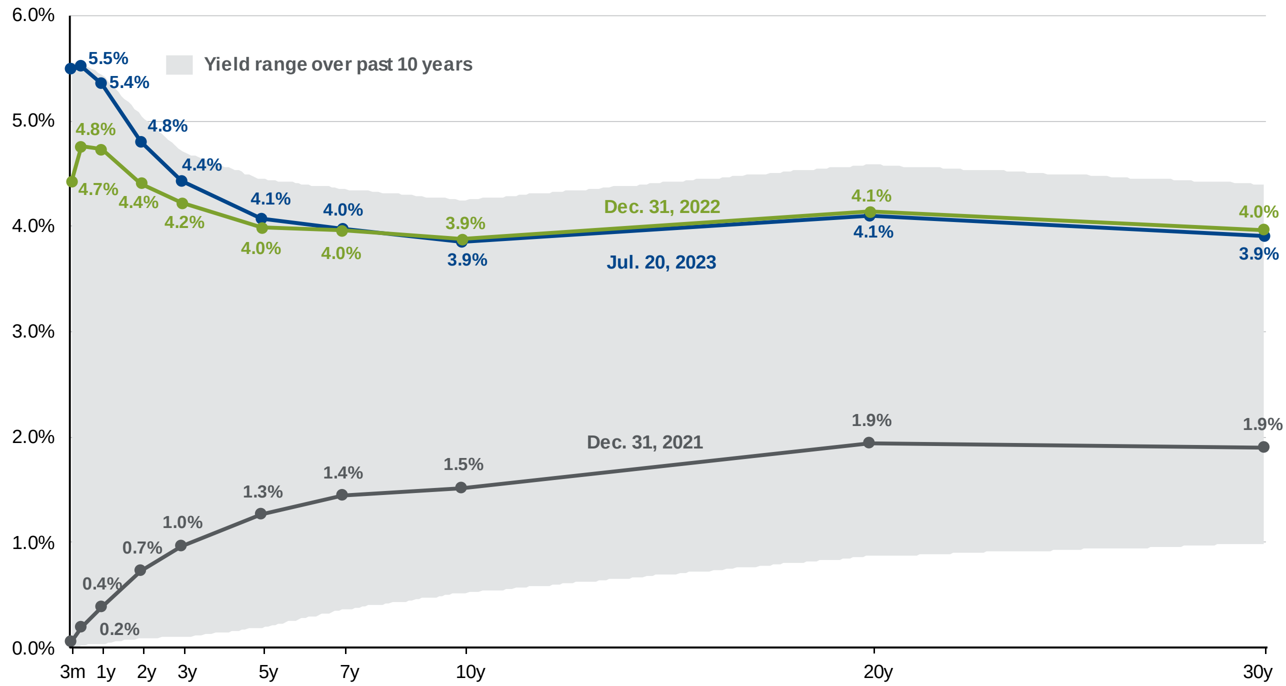
Return in U.S. Dollars. Indices used are as follows: Nasdaq: Nasdaq Composite Index; S&P 500 Growth: S&P 500 Growth Index; Eurozone: MSCI EMU Index; U.S. Large-Cap: S&P 50 Index; EAFE: MSCI EAFE Index; S&P 500 Value: S&P 500 Value Index; U.S. Mid Cap; S&P 400 Index; U.S. Small Cap: S&P 600 Index; Emerging Markets: MSCI EM Index; U.S. High Yield: Bloomberg Barclays U.S. Corporate High Yield Index; Global Corporate: Bloomberg Global Agg Corporate Total Return Index; U.S. Corporates: Bloomberg Barclays U.S. Corporate Index; Emerging Market Debt: Bloomberg Barclays EM USD Agg Index; Gold: Bloomberg 'GOLDS Comdty'; U.S. Dollar: BBDXY; WTI: Bloomberg 'CL1 Comdty'
All Returns 1/1/2023 – 06/30/2023

Bonds posted positive returns across the board as yields declined on the back of better than expected inflation prints, and a Fed "skip" at its June meeting. Long-term Treasury yields ended the quarter lower than the start of the year, as each of the 10YR, 20YR, and 30YR Treasuries rose in price. The broad Bloomberg Barclays US Government Index gained +1.6% year to date, while the Bloomberg Barclays Municipal Index gained +2.7%. Better than expected economic data buoyed credit exposures, as the Bloomberg Barclays US Corporate Index rose +3.2% and the Bloomberg Barclays US Corporate High Yield Index rose +5.4%. Given the significant rise in interest rates over the past year, the starting point for investors today (in terms of starting yield) looks favorable. Rates are near their highest levels in more than a decade, offering investors the opportunity to achieve 4%+ yields to maturity across much of the investable universe.

The Fed

It is widely expected that Federal Open Market Committee (FOMC) will hike another 25bps in July (the Fed meets July 26), but that this hike may be more symbolic given the Fed has already raised its Fed Funds rate to a range of 5.0-5.25%, from *zero* at the beginning of 2022. After July's expected hike, the Fed Funds target will be 5.25%-5.50%, nearly in line with the "Dot Plot" released by the Fed in its June Summary of Economic Projections (SEP), which would imply potentially one more hike this year. The Fed's efforts have yet to dent economic growth, as evidenced by the final print for Q1 GDP that came in at a revised +2.0%, and a recent reading of the Atlanta Fed's GDPNow indicator showing expectations for +2.3% growth in Q2.

U.S. Treasury yield curve



Source: JP Morgan Guide to the Markets, June 30, 2023.

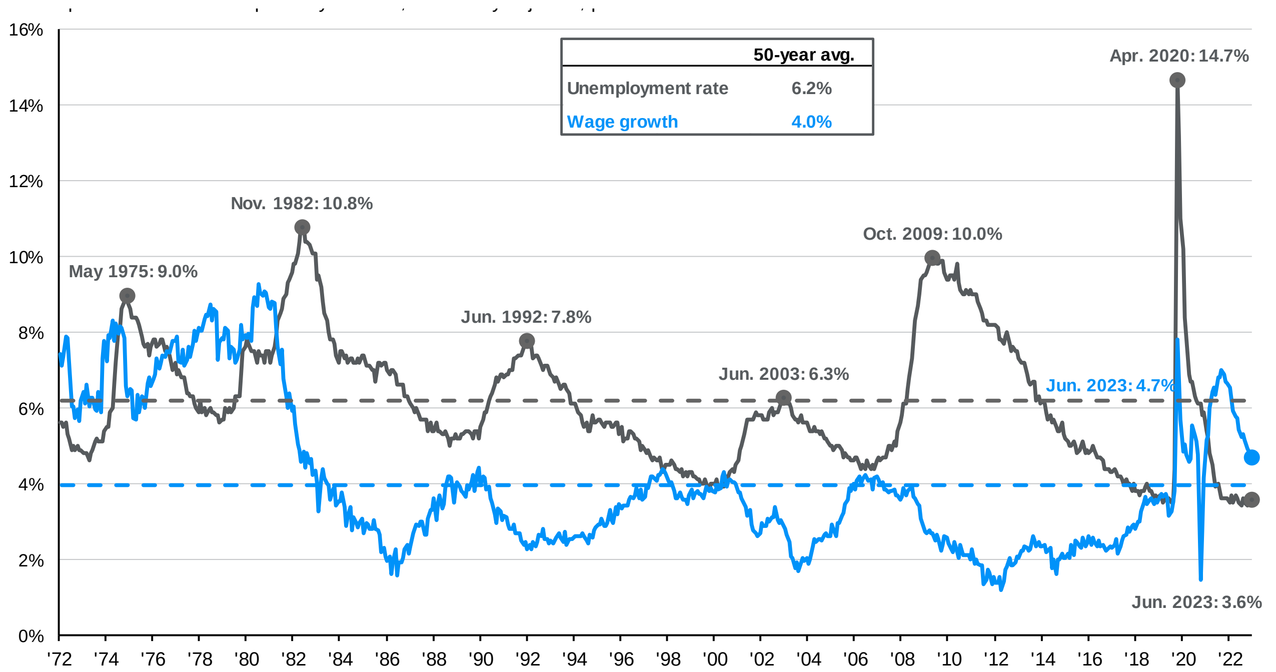
Consumption has remained strong, representative of strong wage gains and a continued spend down of savings. With the consumer representing nearly 70% of the US economy, we would likely need to see a sharp drop off in spending before getting too worried that a recession is imminent. Recent developments at the Supreme Court that struck down student loan forgiveness have cast some shadow on spending for the back half of the year. It is estimated that monthly loan servicing could be in the realm of $300-500/mo, leaving the outlook for consumer spending somewhat mixed; however, while the real impact is unknown, there are also estimates that the total impact on GDP may be minimal, to the tune of 0.2-0.3%. Add to the equation cash in money markets north of $5 Trillion according to JP Morgan, and consumers may have more runway to spend and be able to weather any near term budgetary impacts of loan repayments.

Labor Market

To put it simply, the labor market remains resilient. Job gains have slowed, but are still adding to the labor market at a significant clip. The unemployment rate stands at 3.7% as of June's report, representing 18 straight months of the unemployment rate at or below 4%, and only a tick up from record lows (3.4% in April). There has never been a recession post WWII with unemployment sub-4%. This continues to give us confidence that any economic slowdown, or even recession, could be buffered by the strong labor market, lessening any potential drop off in consumer spending. Additionally, there were more than 9.8 million job openings in the US at the end of May, more than the total number of people looking for a job, continuing to show the supply/demand imbalance that exists within the labor pool. To top things off, the strong labor market creates a feedback loop of continued consumer spending. As long as people have jobs, they will spend, and until the economy sees a significant number of layoffs or job destruction, it will likely continue to muddle along at the ~2% clip we are experiencing now. This can also be seen in overall University of Michigan Consumer Confidence readings, which recently hit a more than 1-year high of 72.6, well exceeding market expectations. The strength and confidence of the consumer has been reiterated in recent weeks as many of the major money center banks, as well as regional and community banks, have reported better than expected earnings and offered positive outlooks on the consumer and stable deposits. Alas, *better than feared.*

Civilian unemployment rate and year-over-year wage growth

Private production and non-supervisory workers, seasonally adjusted, percent

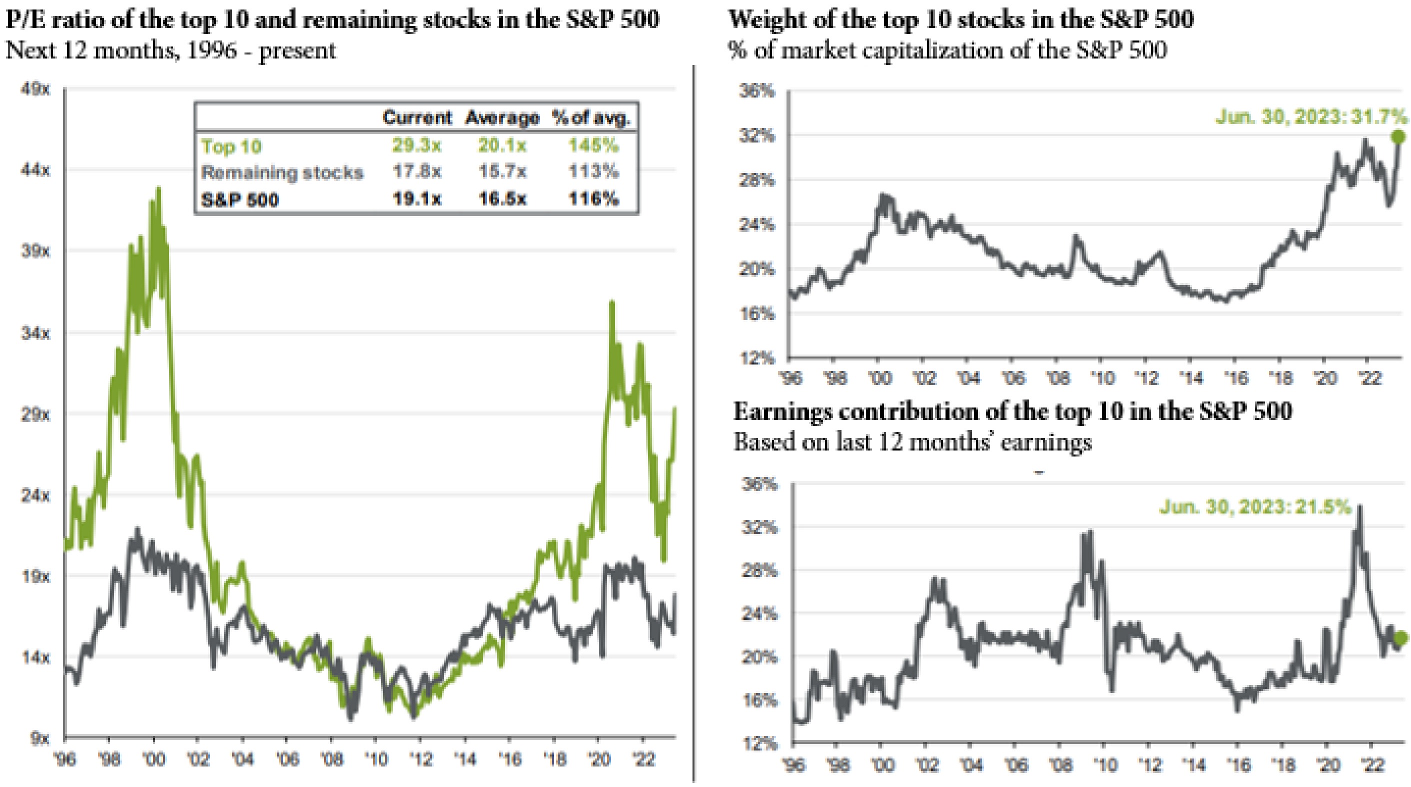


Source: JP Morgan Guide to the Markets, June 30, 2023.

Current Valuations Need Earnings Follow Through

As we wrote about in January, much of the decline in equity market valuations last year was due to multiple compression (to the tune of nearly -20%). Fast forward to today, and earnings estimates have only just started to nudge higher, meaning that much of 2023's equity market performance has been due to multiple expansion. As of June 30, the S&P 500 traded at 19.1x 2023 earnings, a meaningful expansions from the beginning of the year, and above its 25 year average of 16.8x. With earnings season just getting under way, it will be important to hear from companies on the current state of the consumer, as well as their outlook for the rest of the year. This real time barometer of consumer behavior will be important to justify the current run up in market multiples. Put differently, the top 10 names in the S&P 500 trade at nearly 30x earnings, while the rest of the market trades at a multiple of nearly half that. Small- and Mid-Caps trade at an even wider discount, a comment we have echoed in recent publications. The next two weeks will be a key moment for the market, as the majority of the Mega-Cap's report earnings, and how the market reacts to those earnings will be critical given the run-up in share price (i.e. multiple expansion) so far this year.

With that said, there are areas of the market that remain attractive, and perhaps more so than the S&P 500. Specifically, Mid- and Small-Caps continue to look appealing on both a relative and absolute basis, trading at significant discounts relative to long-term averages. What's more, should the current equity market rally broaden out to the *"other"* 1,493 stocks that comprise the S&P 1500 (the combination of Large-, Mid-, and Small-Cap Indices discussed herein), Mid- and Small-Caps should stand to benefit. Looking to the month of June, Mid- and Small-Caps outperformed, as they have in July as we go to press. An important point to make within the Small-Cap universe post-Silicon Valley Bank's (SVB) collapse, is that nearly ¼ of the S&P 600 is made up of Financials. Said another way, SMID-Cap stocks are light on Technology, heavy on Value oriented sectors, in stark contrast to the S&P 500's composition.



Source: JP Morgan Guide to the Markets, June 30, 2023.

US Dollar

With signs of inflation rolling over in the US and the Fed closer to the end than the beginning in terms of raising rates, interest rates themselves look to have hit their peaks, which in turn has put downward pressure on the US Dollar. As it stands now, the Dollar is at a more than 1-year low, which should help benefit International equities. As the Dollar weakens, International currencies strengthen, adding to total returns. International currencies may get an added boost in their own rights as many major global central banks continue to raise rates. Should the Fed pause or slow their pace further by skipping meetings, interest rate differentials could favor foreign markets, and put downward pressure on the Dollar. Long story short, a weaker USD would be a boon for US investors investing overseas.

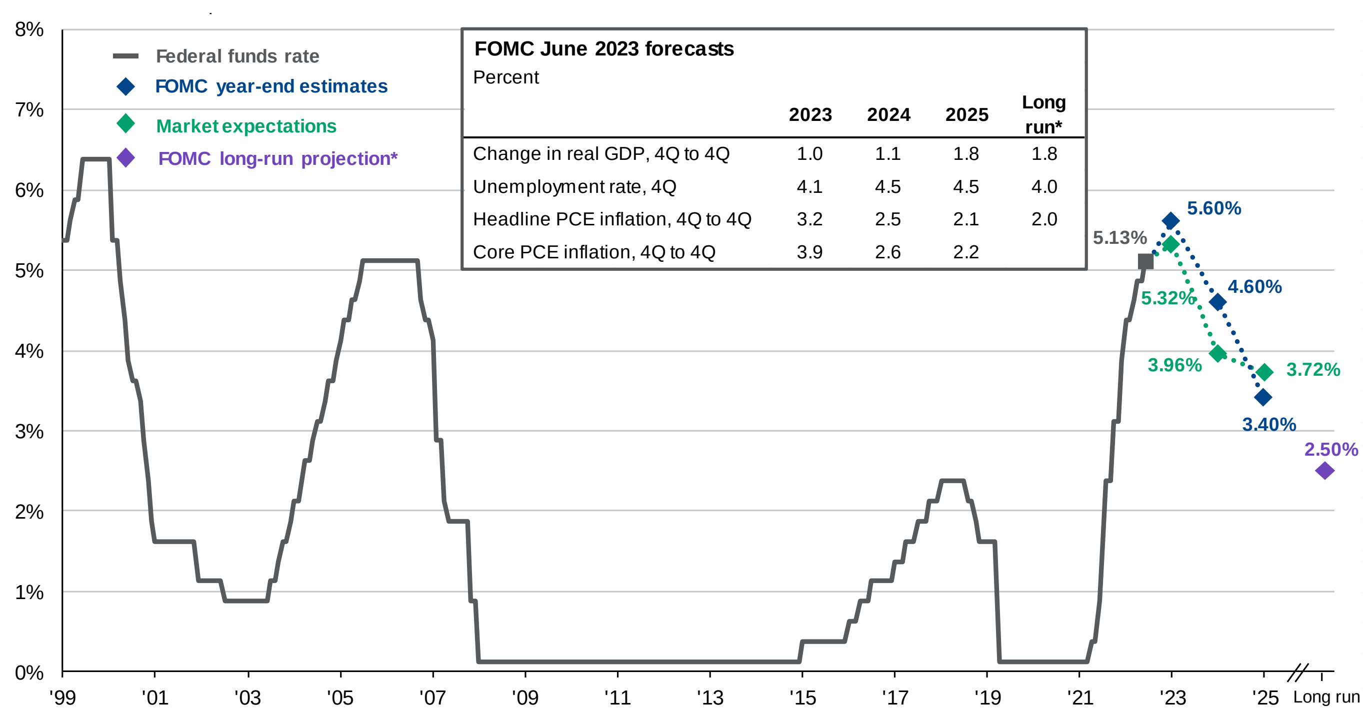
Looking out longer-term, headwinds for the Dollar continue to be twin deficits in the US, mainly budget deficits to the tune of $1 Trillion annually, and current account deficits from importing more than we export. Historically, twin deficits have had a strong correlation with a weaker USD. Taken together, a weaker USD and attractive valuations (relative valuation and starting dividend yields at statistically significant levels) make international markets even more appealing for long-term investors, and should serve as a portfolio diversifier in a multi-asset portfolio in the medium- to long-term.

Coming into 2023, Nottingham's fixed income allocations were broadly underweight duration (interest rate sensitivity) given expectations for higher rates. Now that the Fed is likely closer to the end of its rate hiking campaign, it is possible we have seen the highs in yields for the cycle. With that said, during the first half of the year, we added duration through longer maturity Treasury exposure. We also extended our short-duration corporate bond exposure a few years. So far in July, we have continued to add Treasury duration. Taken together, these portfolio adjustments underscore the value we see in high quality fixed income securities.

Moreover, short-term Treasuries yield more than 5.25% risk free. In a world without any free lunches, this one is pretty close. Cash continues to be viable asset class and there is meaningful opportunity cost to let funds stand idle in checking and savings accounts earning little to no interest. Additionally, Treasury securities may offer higher yields than bank CD's, and more favorable tax treatment. Treasury interest is not taxable at the State level, whereas income from CD's is taxable at both the Federal and State levels.

Federal funds rate expectations

FOMC and market expectations for the federal funds rate



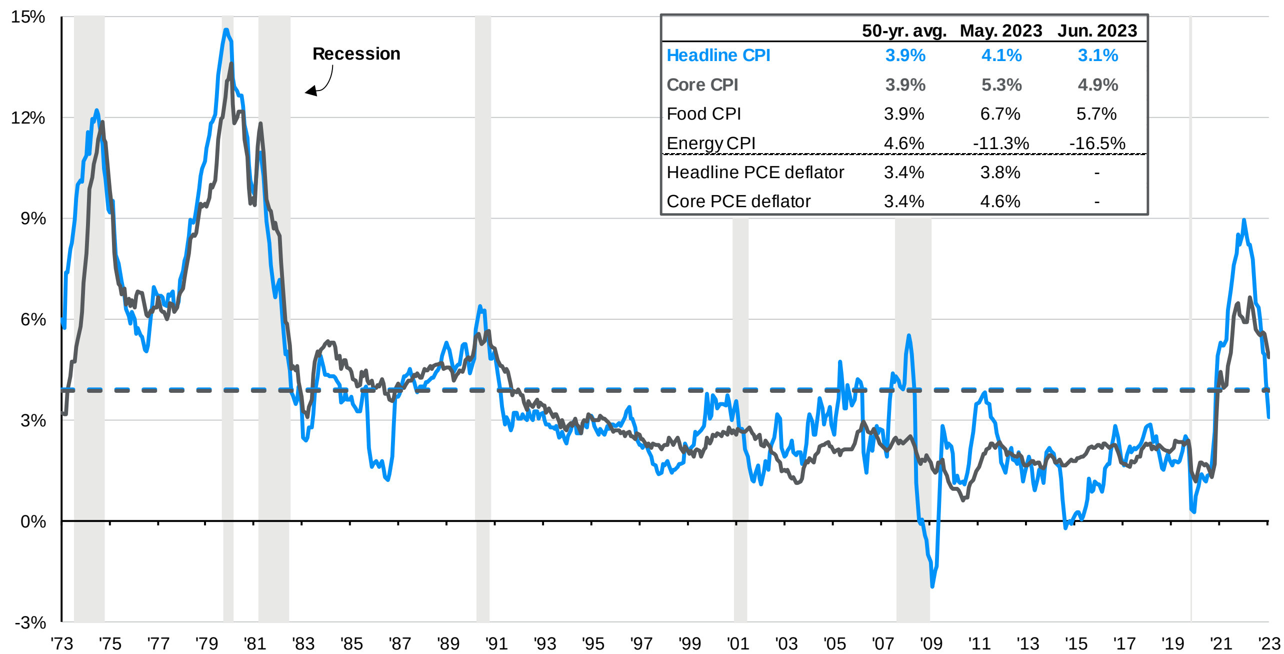
Source: JP Morgan Guide to the Markets, June 30, 2023.

To re-iterate a point made in January, the market continues to position for slowing long-term economic growth (i.e. the old 2% GDP may be more like 1.50-1.75%) and inflation that comes back under control. Should inflation subside to the 2.50-3.0% levels (above the Fed's target of 2% inflation), nominal GDP (GDP + Inflation) may be hard-pressed to surpass 4%. Perhaps not coincidentally, the high watermark for 10-year yields (a proxy for nominal GDP) was a touch over 4% – a level that has been tough to sustainably breach this year. Given that inflation expectations remain well anchored, should a low inflation, low growth future be in the cards, high quality bond duration looks like a viable hedge. Adding high quality bond duration may significantly reduce the level of risk needed to achieve a 5-7% annualized portfolio return. Forward return expectations now come close to hitting those targets with bonds, or at least significantly less equity exposure than previously required over the past decade. Asset allocations can be adjusted to de-risk portfolios and achieve more income and stability to help investors achieve their long term goals and objectives.

Inflation by many measures continues to slow, and has been continuously for the past year. Headline CPI has fallen by nearly two-thirds from its peak (from 9.1% Y/Y in June 2022 to 3.0% Y/Y in June 2023), and from 4.0% in May, to the lowest level since March 2021. Headline inflation would be even lower if owner's equivalent rent was excluded, given there's a lag between reported figures and real time indicators from the likes of Zillow and others. Core CPI (ex food & energy) has fallen in tandem (from 6.6% Y/Y in June 2022 to 4.8% Y/Y in June 2023), measuring its smallest monthly increase in more than two years. Core CPI remains elevated largely due to sticky food prices, while energy prices have fallen sharply. Moreover, the money supply continues to shrink, after booming during the pandemic. The contraction in M2 is widely seen by many as a leading indicator of falling inflation in the future. *Good signs.*

CPI and core CPI

% change vs. prior year, seasonally adjusted



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Portfolio Positioning

In summary, there's ample opportunity for investors looking to play offense, defense, or a little bit of both. At Nottingham we are still straddling the fence, finding opportunities to add to attractive long-term positions (i.e. Small- and Mid-Caps, International, Fixed Income), while also playing defense (Healthcare, Minimum Volatility, Premium Income). In the second quarter we were keenly focused on rebalancing portfolio allocations, trimming exposure to US Large-Cap Growth and AI, while adding to Small- and Mid-Cap exposures.

As the market rally gains steam, signs of breadth expanding is evident in the fact that Small- and Mid-caps led the charge in June, and are following suit thus far in July. Bank earnings were largely better than feared and deposits have shown signs of stabilizing. With continued strength in the labor market, and signs of inflation coming back under control, recession fears continue to abate. Goldman Sachs recently reduced their recession probability to 20%, from a high of 35% earlier this year, highlighting the fact that as time goes on, expectations for recession are diminishing. It is notable that Goldman's base case for recession in any given year is 15%.

With a strong labor market and falling inflation, it will be paramount that earnings season, especially from Big Tech, live up to the hype (multiple expansion) and deliver on the bottom line. Should earnings fall short, or company outlooks disappoint, current valuations could come into question. A hawkish Federal Reserve could complicate things too. On the flip side, a broadening of the rally to the bottom 1,493 stocks, a dovish Fed, and strong earnings could send the market to new all-time highs, given the market is *only* about 5% from record levels.

Thank you for your continued support of Nottingham and trust in our Team. To hear more about our outlook, talk asset allocation, or see how we are positioning portfolios for a range of outcomes, please give us a call. We would love to hear from you.

Matthew J. Krajna, CFA
Co-Chief Investment Officer
July 2023