"PLANNING LIFE WITH A MARGIN OF SAFETY"

April 2023 – June 2023

2nd Quarter 2023

Special Notes:

If you have not already done so, please be sure to send us your 2022 Taxes. You can email them to info@demmingfinancial.com, or mail them to the office.

The threat of cyber attacks and bad actors is more prevalent now than ever before. Please note that Schwab will never call you directly. If you receive a call from someone claiming to be from Schwab, hang up and let us know. Also, please be aware of any suspicious emails you might receive. It is always better to be safe than sorry with your cyber security.

Demming Dispatch

- The TD/Schwab transition occurred over Labor Day (September 4th, 2023). Here are some things to know:
  - You can see our latest breakdown of what to expect and frequently asked questions by following this link: https://www.demmingfinancial.com/schwab-update-and-faq
  - We will do our best to update incorrect/outdated client information (phone numbers, email, etc.) in Schwab as quickly as possible. The process to update this information is new, so please be patient.
  - We will continue to work closely with Schwab throughout the transition to make sure that things go as smoothly as possible.
- Follow us on LinkedIn to stay up to date with blog posts, news, and more

Buying International

In investing, the most normal inclination in the world is to question why an underperforming investment was included in the portfolio. Recently, those questions have surrounded international stocks, which, since January 2008, have consistently underperformed the U.S. S&P 500 index to the tune of 6.5 percentage points a year. Why not go ahead and ditch those foreign stocks and buy American?

A recent report in the Journal of Portfolio Management acknowledges that, in fact, international equities have actually underperformed U.S. large cap stocks for the past 30 years. But looking back over longer time periods, and looking deeper, it found some interesting insights which might be relevant today. Looking deeper over the past three decades, the researchers noticed that foreign companies were not actually performing better, or growing faster, or becoming more profitable. Instead, investors were increasingly willing to pay more for U.S. stocks during that time period. Another way of saying that is that the valuations tripled, as measured by one common measure of price/earnings ratios.

Looking further back in history, the researchers noted that U.S. equities underperformed the EAFE (international stock) index in three of the past five decades: the 1970s, 1980s and 2000s.

What does this mean for investors who are impatient with their international stock performance? It means that returns move in hard-to-predict cycles. International will sometimes outperform U.S. for long periods of time, and then (as has happened recently) the reverse happens—all of this unpredictably. It also means that U.S. stocks are pretty expensive right now; the Cyclically Adjusted PE Ratio is currently up around 30.1, well above the historical mean of 17. If investors decide that the earnings U.S. stocks are worth something closer to what they have paid historically, we could see a pullback in valuations—and those international allocations will become the future hero of investment portfolios.

But aren't U.S. companies inherently superior to companies located in other countries? A whitepaper published by the U.S. Federal Reserve notes that the U.S. has experienced some unique tailwinds to its stock prices over the last 30 years. Both interest rates (meaning the cost of borrowing) and tax rates declined steadily over that period. As a result, profit growth exceeded the overall growth of the

economy. But today, both interest rates and tax rates are likely to rebound, turning the tail winds into headwinds.

None of this suggests that we can actually know anything about what will happen tomorrow, or next year, or even the next several years. All we know is that buying or selling based on yesterday's information seldom leads to great outcomes. Just ask investors who decided to go all-in on Japanese stocks in 1990, after Japanese stocks had experienced several decades of radical outperformance. The subsequent returns have been dismal, and with the benefit of hindsight we can see that those investments were significantly overvalued.

2023 Second Quarter Investment Report

Fears of an imminent recession are getting kind of old at this writing; any investors who retreated some or all of their portfolios to the sidelines in anticipation that the economy was about to tank are now ruing their luck, as the markets delivered another quarter of solid returns. It's another version of the lesson: listen to the pundits predicting disaster at your (financial) peril.

The market gains in the second three months of the year were stronger for larger stocks, but all sectors participated in the sunny investment climate. The Wilshire 5000 Total Market Index—the broadest measure of U.S. stocks—picked up 6.67% gains in the second quarter, and is now up 16.30% in the first six months of 2023.

Looking at large cap stocks, The Russell 1000 large-cap index has gained 16.58% so far this year, while the widely-quoted S&P 500 index of large company stocks jumped 8.30% in the second quarter, and has now gained 15.91% during the year's first half.

Meanwhile, the Russell Midcap Index is up 9.01% through the second quarter.

The Russell 2000 Small-Cap Index posted a 8.09% return over the past six months. The technology-heavy Nasdaq Composite Index, the biggest loser in 2022, is on a tear this year, posting a 31.73% return in this year's first six months.

Foreign markets are delivering positive returns as well. The broad-based EAFE index of companies in developed foreign economies gained 9.66% in the first half of 2023. In aggregate, European stocks are up 8.95% this year, while EAFE's Far East Index delivered a positive 2.58% performance. Emerging market stocks of less developed countries, as represented by the EAFE EM index, gained 3.46% in dollar terms over the last six months.

Despite rising concerns about the impact of remote work and e-commerce on commercial properties, real estate securities produced decent returns. The Wilshire U.S. REIT index posted a 6.66% gain in the first quarter of 2023. However, other alternative parts of a diversified portfolio were not so fortunate. The S&P GSCI index, which measures commodities returns, lost 11.41% of its value in the most recent six months. Utility stocks are posting a rare 7.16% loss so far this year.

Bond rates rose dramatically last year, but that trend seems to have moderated. 30-year U.S. government bond yields barely moved from where they were three months ago, with current yields at 3.86%. 10-year government bonds are yielding 3.84%, and from there we enter the inverted yield curve: 5-year government securities are yielding a higher 4.16%, 2-year Treasuries are yielding 4.90%, one-year government bonds are yielding 5.39% and 6-month securities are now yielding 5.41%. To say this is not normal is an understatement. Whenever shorter-term bonds are paying bond investors more than their longer-term counterparts, it means that bond investors (and, maybe, most professional investors) are feeling cautious about the future of the market.

Municipal bonds are a somewhat less dramatic story at the moment, but there is still inversion going on; 30-year munis, on average, are yielding 3.57%, and 10-year maturities are yielding 2.55%. But the inversion can be seen in 5-year (2.61%), 2-year (2.92%) and 1-year (3.01%) aggregate yields.

Of course, we're all wondering: will the second half of the year be as rewarding as the first half was? Our economic future has seldom been as cloudy as it is today, which is to say that the indicators are all over the place. In America's manufacturing sector, the ISM Purchasing Managers Index, a closely-watched indicator of the health of manufacturing firms overall, suggests that manufacturing has been in a recession for the past seven months. Global indicators are saying essentially the same thing about manufacturing competitors overseas. New export orders for goods have been falling globally at the fastest pace since the end of 2022.

Adding to the downbeat news, the Conference Board's Leading Economic Index has been declining for 13 consecutive months, and the most often-cited recession indicator, the dramatic yield curve inversion in the bond market, is flashing its signals louder than ever. The corporate sector has not been unaffected by all this: financial and non-financial U.S. corporations have reported lower profits for the past two quarters.

But those indicators might actually make up less than half the story. The unemployment rate in the U.S. remains under 4% (bouncing between 3.4% and 3.7%) and the labor participation rate among workers aged 25 to 54 stands at a very strong 83.4%—the highest level since 2007. Consumer spending has remained brisk, with durable goods orders up 1.7% last month over the previous month. U.S. households are still flush with cash that was saved during the pandemic; the Federal Reserve Bank of San Francisco has estimated that

households still have sufficient savings to support current spending levels at least through the fourth quarter of 2023. Indeed, the most recent consumer confidence index, measured by the Conference Board, rose to 109.7, the highest since early 2022.

And, not incidentally, the inflation rate keeps falling. Last year, alarm bells were sounding because June's annualized rate hit 9.1%. Today's rate is an annualized 4.0% and trending towards the mid 3% range for July.

There's no reason to imagine that any of us can predict the future with any accuracy, except to point out that markets have, historically, trended upward and rewarded patient investors. It's possible that a future recession will test our collective patience once again, but it's a test that will be easier to pass due to the gains that this year has provided us already. To make gains across one's portfolio, you need to have diversification and resilience to capture opportunities in any environment.

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