SALEM PARTNERS
WEALTH MANAGEMENT

2nd Quarter 2023 Investment Letter by Erik Ridgley, CFA July 12, 2023
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We wish all our clients and friends a wonderful summer! Below we provide our outlook for the balance of the year and a review of markets in the 2nd quarter of 2023. GOOD NEWS: We are pleased to report very positive equities returns and the most attractive investment grade bond yields in over 15 years. Inflation fell to 3% in June 2023 after peaking at 9% in June 2022, and forward earnings estimates have stopped falling and are now rising. It's too early for the Fed to declare "mission accomplished" on inflation, but it's not too early for investors to anticipate it. BAD NEWS: Russia's war on Ukraine continues, however the armed paramilitary mutiny that forced Putin to de-escalate and negotiate compromises with "traitors" foreshadows a plausible path to a durable cease-fire. Credible reports that China's President Xi scolded his junior partner Putin that going nuclear is unacceptable helps explain why US and NATO keep successfully calling Russia's bluffs with weapons for Ukraine. SILVER LININGS: China's support for Russia and threats to take over Taiwan have spooked corporations and governments in U.S. and Europe, triggering a new consensus in favor of "de-risking" global supply chains away from communist China. Foreign direct investment into China has "tumbled to its lowest level in 18 years," per Nikkei Asia. Finished goods trucked from new factories built in northern Mexico (instead of China) are filling up new warehouses built in Laredo, Texas (the world's biggest "land port"). Annual spending on construction of new U.S. manufacturing facilities has increased to $193 Billion per year from $80 Billion per year, driven by semiconductors and electric vehicles, which are beneficiaries of targeted federal tax credit deals for mega-corporations (e.g. Intel, Toyota), low-cost electricity compared to Europe, and anti-China tariffs (one thing Democrats and Republicans agree on). These new trends will persist for years.

Asset Class Benchmark Returns in 2023 – Year-to-Date (YTD) and 2nd Quarter

YTD	2nd Qtr	Asset Class
YTD: +16.89%	2nd Qtr: +8.74%	U.S. Large Cap Equities: S&P 500 Index
YTD: +13.93%	2nd Qtr: +6.18%	Global Equities: MSCI All Country World Index (ACWI)
YTD: +11.67%	2nd Qtr: +2.95%	Foreign Developed Equities: MSCI EAFE Index (EAFE)
YTD: +9.78%	2nd Qtr: +3.04%	50/50 Allocation: 50% ACWI / 50% Muni Bond
YTD: +8.09%	2nd Qtr: +5.21%	U.S. Small Cap Equities: Russell 2000 Index
YTD: +4.89%	2nd Qtr: +0.90%	Emerging Markets Equities: MSCI Emerging Markets Index
YTD: +5.45%	2nd Qtr: +2.65%	Real Estate: S&P U.S. REIT Index
YTD: +5.38%	2nd Qtr: +1.75%	Junk Bonds: U.S. Aggregate Corporate High Yield Index
YTD: +2.09%	2nd Qtr: -0.84%	U.S. Fixed Income: U.S. Aggregate Bond Index (AGG)
YTD: +2.67%	2nd Qtr: -0.10%	Municipal Bonds: Bloomberg Barclays Muni Bond Index

Our Outlook: 25% Chance of Soft Landing vs. 50% "Soft-ish" vs. 25% Recession; Falling Inflation

With the economy decelerating and inflation receding, many investors have given up hope that the Fed can beat inflation without throwing the U.S. into a "hard landing" recession, but this bearish view is increasingly looking to be too pessimistic, due to structurally tight labor markets (caused by the retiring generation of baby boomers) and fiscal spending in the U.S. (i.e. American Rescue Plan Act, Chips and Science Act, Inflation Reduction Act, and Infrastructure Investment and Jobs Act), Europe, and China. For a window into consensus expectations, Goldman Sachs recently cut their forecasts for a recession (i.e. hard landing) in the next 12 months from a 35% chance to a 25% chance. We believe markets are assigning

a 50% chance of a "growth recession" (i.e. soft-ish landing, per Fed Chair Powell) which we define as two or more quarters of 0.0% to +1.0% real GDP growth (QoQ% SAAR) and a material increase in unemployment rates, and a 25% chance of no recession (i.e. "soft landing" with no increase in unemployment rates).

What Happened to the Banking Crisis? Was It Even a Crisis?

Back in March, we didn't call it a crisis in the updates we emailed to clients, because we were confident regulators could handle this episode, and we wanted to convey that assurance to our clients. Bank runs are not fun, but they are also not uncommon. As a veteran of the Great Financial Crisis in 2008 it helps to keep things in perspective. Regardless of semantics, the critical phase of this episode ended after First Republic Bank was placed into FDIC receivership, to zero out all the bond holders and share owners, and then sold to JP Morgan. As we wrote in our 1st Quarter investment letter: "FDIC receivership for SIVB and SBNY made all their depositors whole, and the Fed created a new lending facility to grant all banks the ability to exchange AAA-rated securities at par value for cash, without recognizing losses on assets classified as held-to-maturity. As a result of these actions the worst of this episode seems to be behind us. Panic by a small number of general partners of venture capital firms controlling a large concentration of deposits triggered a bank run. From a policy perspective, the FDIC's goal is not to prevent all bank failures, but rather to ensure that individual bank failures do not cause the banking system to fail, without using taxpayer dollars, which was achieved." Since then, investors seem to have priced in the hits to future earnings facing the banks and the bank stocks have stopped going down in lockstep as a group. Treasury Secretary Janet Yellen said she has a "watch list" of 30 banks that the regulators are concerned about, and we believe the banking system is resilient enough to absorb them if they are placed into FDIC receivership.

The Fed's Economic Projections for Inflation and Fed Funds Rates

FOMC June "dot plot" summary of economic projections signaled the Fed will hike rates on July 26th and September 20th and then pause the Fed Funds Rate at 5.75% for an extended period, and then begin cutting Fed Funds Rates in 2024. The rule of thumb is that Fed Funds Rates should be 1% higher than inflation rates to force inflation down. The Fed is now forecasting core personal consumption expenditures (PCE) inflation rate, its preferred measure of inflation, which excludes energy and food, to fall from 4.6% in May 2023 to 3.9% by December 2023 (and Fed Funds Rate of 5.6%), and to 2.6% by December 2024 (and Fed Funds Rate of 4.6%), and then to 2.2% by December 2025 (and Fed Funds Rate of 3.4%), and thereafter to the 2.0% target (and Fed Funds Rate of 2.5%) over the long run. However, bond markets think the Fed will stop hiking at 5.50%, and be forced to cut rates sooner i.e., the futures markets are pricing in that the Fed will start cutting rates on March 20th, and cut to 4.25% by the end of 2024, per Bloomberg <WIRP>. Notably, the ends of Fed Funds Rate hiking cycles have historically been followed by 12-month periods of well above average equity returns, using data from the past 30 years, with the one exception being 5/15/2000.

Consensus Expectations for Corporate Earnings and Interest Rates

Consensus estimates for S&P 500 EPS growth are +0.2% in 2023 and +11.3% in 2024, after growing +7.4% in 2022, per I/B/E/S data by Refinitiv. Year-over-year quarterly EPS estimates are -2.8% in 1Q23, -8.9% in 2Q23, -0.5% in 3Q23, and +8.3% in 4Q23. The 2nd Qtr. was the trough earnings growth quarter.

S&P 500 revenues per share are forecasted to grow +1.9% in 2023 and +4.7% in 2024, after rising +11.5% in 2022. Net profit margins are projected to decline to 11.9% in 2023 from 12.4% in 2022, and expand to 12.7% in 2024, per I/B/E/S data by Refinitiv.

Wall Street's full year consensus forecast for U.S. real GDP is +2.1% in 2022 (actual), +1.3% in 2023, +0.7% in 2024, and +1.9% in 2025, and the quarterly forecasts (QoQ%, SAAR) are +2.0% in 1Q23, +1.3% in 2Q23, 0.0% in 3Q23, -0.5% in 4Q23, +0.7% in 1Q24, and +1.3% in 2Q24, per Bloomberg <ECFC>. Average U.S. real GDP growth has been 2.2% over the past decade.

The highly respected UCLA Anderson Economic Forecast predicted in June (based on an assumption that the Fed will stop hiking the Fed Funds Rate at 5.75%) that U.S. real GDP will grow by +1.4% in 2023 (up from +1.3% in Mar), and +1.2% in 2024 (down from +1.8% in Mar), and +2.1% in 2025.

Both Europe and Japan are growing their economies at or above trend rates. Europe's economy is forecasted (per ECB) to grow +3.6% in 2022 (actual), and +0.9% in 2023 (down from +1.0% in March), and +1.5% in 2024, and 1.6% in 2025, vs. its trend rate of +1% real GDP growth. Japan's economy is forecasted (per JCER) to grow +1.2% in 2022 (actual), and +1.1% (up from +0.9% in Mar) in 2023, and +1.1% in 2024 (up from +1.0% in Mar) vs. its trend rate of +0.5% real GDP growth.

Price/earnings (P/E) multiples are 19.8, 14.6, 14.0, 13.4, and 13.2 for S&P 500 large cap, S&P 400 mid cap, S&P 600 small cap, foreign developed, and emerging markets, respectively, where E is EPS on next four quarters (NFQ), per Bloomberg consensus. The long-term average for U.S. large cap NFQ P/E multiples is 15 ½. Thus, U.S. large cap equity valuations are 28% above average. U.S. mid cap and small cap equity P/E multiples are cheaper than their historical averages.

The Treasury yield curve is currently pricing in Fed Funds Rates to fall to 4.50% one year from now, and 10-year Treasury yields of 3.95% at year-end 2023, per Bloomberg <FWCM>. Importantly, the yield curve is priced for 10-year Treasury yields to remain between 3.9% and 4.0% for the next 4 years. The Treasury yield curve represents the "real money" pricing of many trillions of dollars of U.S. Treasury securities across maturities from 7 days to 30 years, based on bond investors' expectations for the future, which is why it commands the respect of equity investors and the Fed. Of course, the yield curve always reserves the right to change its mind, which it has been doing much more frequently in the past 1 ½ years.

The yield curve is inverted, with 10-year Treasury yields lower than 2-year Treasury yields by 86 basis points (bps), after a nadir of 106 bps inverted on June 30th. Yield curve inversions have been a reliable leading indicator of future economic downturns.

High yield bond spreads (over 10-year Treasuries) eased from 502 to 466 basis points, after peaking at 530 bps on June 23rd, indicating that credit markets have priced in an economic slowdown (but are not yet pricing in a recession).

<u>Review of 2nd Qtr. of 2023: Above Average Returns for Equities; Markets Climb a Wall of Worry</u>

The S&P 500 index of stocks rose +8.74% in the second quarter of 2023, including dividends, from 4,109 to 4450. 10-year Treasury yields rose from 3.47% to 3.84%. West Texas Intermediate (WTI) crude oil prices per barrel declined from $76 to $71, after rising to $83 on April 12th. The US dollar currency index strengthened from 102.51 to 102.91, after trading down to 101.01 on April 13th and trading up to 104.33

on May 31st. U.S. unemployment rate rose slightly from 3.50% to 3.57%. The Fed's 5-yr forward breakeven inflation rates rose from 2.26% to 2.29%, after first falling to 2.12% on April 28th and then rising to 2.37% on May 25th.

U.S. economic activity decelerated in the 2nd quarter under the cumulative weight of 5.00% of Fed Funds Rate hikes over the past 15 months. The U.S. economy *real* GDP (QoQ% SAAR) was +1.3% in 2Q23 (est.), +2.0% in 1Q23, +2.6% in 4Q22, +3.2% in 3Q22, -0.6% in 2Q22, and -1.6% in 1Q22. But earnings, revenues, and expenses are all reported in nominal terms, not real terms. The U.S. economy *nominal* GDP (QoQ% SAAR) was +5.4% in 2Q23 (est.), +7.8% in 1Q23, +9.7% in 4Q22, +11.5% in 3Q22, +8.1% in 2Q22, and +6.4% in 1Q22 (Note: the relevant formula is "Nominal GDP = Real GDP + CPI Inflation Rate").

The Fed's preferred measure of inflation, Core PCE (YoY%), was +4.5% in 2Q23 (est.), +4.7% in 1Q23, +4.8% in 4Q22, +5.0% in 3Q22, and +5.0% in 2Q22. U.S. headline CPI inflation (YoY%) was +4.1% in 2Q23 (est.), +5.8% in 1Q23, +7.1% in 4Q22, +8.3% in 3Q22, +8.7% in 2Q22, and +8.0% in 1Q22. The Fed's target rate of inflation is +2.0%.

Business and Income Tax Planning Can Result in Significant Tax Savings

Small business owners looking to contribute up to $300,000 per year of pre-tax money into their retirement plans should consider cash balance defined benefit pension plans. Founders launching start-ups with high growth potential can utilize qualified small business stock (QSBS) to exclude from their taxable income a portion of gain on the sale — up to $10 million or 10 times the cost of the investor's basis, whichever amount is greater. QSBS can be "stacked" to multiply the tax savings for a spouse, children, and multiple trusts. Private investors and limited partners can also receive the tax benefits of QSBS. Incentive stock options (ISOs) are typically offered to executives and key employees, with potential tax advantages, and non-qualified stock options (NSOs) can be granted to any employee, as well as to consultants and board members. For clients with very significant wealth and liquidity, they can use PPLI to place large sums of money in domestic entities that grow free of any taxation while maintaining access to liquidity. The US code contains various tax benefits to incentivize entrepreneurs to start and grow businesses, and we help make sure our clients don't miss out on them, so they can focus on building great businesses.

Estate Tax Law Changes in 2026 Will Cause Some Wealthier and Older Individuals to Revise Plans

We at Salem Partners Wealth Management try to make sure that we are planning well ahead of any potential tax or regulatory changes in order that our clients can be ready for new environments. One such significant change on the horizon is a reduction in the amount of money that individuals can give away during their lifetimes, or pass along upon death, free of estate or gift tax. This amount gets cut in half starting on January 1, 2026. We encourage clients to start understanding whether they may want to address these changes in their current estate plan in anticipation of this change in the laws. We can send a summary of the change in the laws and potential strategies to take advantage of current laws that has been prepared by Andy Katzenstein at Proskauer Rose if you send us an email.

In 2025, an individual will be able to pass along an estimated $14.4 million free of estate or gift tax during their lifetime or as part of their estate. In 2026, that amount will be get cut in half. That means a couple which today could pass along $28.8 million to their children or grandchildren tax free can only pass along half of that tax free in 2026.

The most obvious clients who may want to think about doing something to take advantage of current laws would be those who are older (70+) and with an estate valued comfortably over the limit in 2026 ($7.2 million for an individual and $14.4 million for a couple) and a clear beneficiary. Clients that check the net worth box but are younger may also want to consider strategies that take advantage of the laws but leave access to the capital in the hands of the donor during the donor's lifetime.

As always, we are happy to discuss considerations regarding your estate plan at your convenience. We understand that the implications of these and other estate plan issues are complex and want to support you to the greatest extent possible. We also want to make sure that our clients who do want to address the changes can do so before the crush of planning that is likely to occur in 2025.

Proven and Repeatable Processes: Portfolio Rebalancing, Tax Loss Harvesting, and Tax Deferral

Portfolio rebalancing is a useful tool for long-term investors because it serves two important purposes. First and foremost, it keeps asset allocations in line with targets that have been codified in clients' investment policy statements (IPS). Second, it can be a mechanism to naturally "buy low, sell high", because it involves adding to an asset class that has decreased in price (e.g., >10%) relative to the overall portfolio, and cutting back an asset class that has increased in price relative to the overall portfolio. Good judgement, disciplined decision-making, and operational excellence are necessary to obtain the best results for every client from portfolio rebalancing.

Another proven methodology for long-term investors to take advantage of market volatility is tax loss harvesting. Unlike tax loss selling, tax loss harvesting precludes adverse impacts to investment returns, by simultaneously replacing the sold securities with very similar securities, while avoiding IRS wash sale rule violations. We actively implement tax loss harvesting throughout the year whenever material market declines create opportunities.

Tax losses provide economic value because investors can use them to offset capital gains tax, and unused tax losses can be carried forward into future years until they are fully used. The maximum federal tax rate on short-term capital gains is 40.8%, including the 3.8% net investment income tax, and for Californians the maximum combined state and federal tax rate is 54.1%. Although no one likes down markets, tax loss harvesting can effectively reduce negative returns by up to 54.1%, without sacrificing full participation in the inevitable market recovery for long-term investors.

Tax deferral strategies involve delay or avoidance of realization of capital gains through judicious planning and portfolio management. Unrealized capital gains can be permanently eliminated over time with prudent trust & estate planning, via step up in cost basis when wealth transfers from one generation to the next.

Risk Management

Asset allocations should be based on well-designed investment policy statements to enable investors to get through bear markets without selling equities, by using fixed income or cash to draw upon until stock markets have recovered, which is common sense short-term risk management. However, comprehensive risk management should also account for the long-term shortfall risk of not achieving long-term portfolio growth objectives due to sub-optimal asset allocations and portfolio construction. Along the way,

contingency risks (i.e., low probability and high impact) need to be efficiently managed with various tools including adequate liquidity, appropriate insurance protection (note: we do not sell insurance), coordination with clients' trusts & estate attorneys, and proactive tax planning with clients and their CPAs.

Long-Term Investing

To paraphrase Warren Buffett, successful investors need to invest for the long-term and avoid being swayed by the fear and greed of others that can cause irrational swings in the market. We do not let the daily noise and volatility of the markets deter us from our mission to be faithful stewards of our clients' capital. As long-term investors, we and our clients have committed ourselves to adhere to well-defined investment policy statements, which have been custom-built for each individual client, to achieve their long-term investment objectives, while accepting the inevitable price fluctuations of the public markets.

As fiduciaries, we relentlessly seek out the lowest costs and best terms for our clients. As trusted advisors, long-term relationships are of primary importance to helping our clients achieve successful outcomes through personalized financial planning and disciplined implementation.

Conclusions

We are happy to report very positive equities returns and the most attractive investment grade bond yields in over 15 years. With the economy decelerating and inflation slowly receding, many investors seem to have given up hope that the Fed can successfully defeat inflation without throwing the U.S. into a recession. This bearish view is increasingly looking to be too pessimistic, due to structurally tight labor markets and large fiscal spending programs across the developed economies and China. We believe there is a 25% chance of a recession, 50% chance of a "soft-ish" landing, and 25% chance of no recession. U.S. large cap equity P/E multiples are higher than their long-term averages, but U.S. small cap and mid cap P/E multiples look compellingly cheaper than their historical averages.

The Fed has been successfully implementing a credible plan to bring inflation down on a multi-year glide path towards its 2% target, and investors are now anticipating the Fed's last rate hike on July 26th. This will allow the Fed to begin cutting Fed Funds Rates in early 2024, following the rule of thumb that Fed Funds Rates should be 1% higher than inflation rates to keep forcing inflation down. Notably, the ends of Fed Funds Rate hiking cycles have historically been followed by 12-month periods of well above average equity returns, using data from the past 30 years, the exception being 5/15/2000.

We wish all our clients and friends a wonderful summer. We will keep working hard to generate superior long-term after-tax investment returns for each of our clients with personalized financial planning and customized portfolios, and we are grateful for the trust and confidence our clients have placed in us.

Please let us know if you have any questions. Thanks!

Best Regards, Erik

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- Equity (stocks), fixed income (bonds), and other investments do not always gain or lose value at the same time. Historically, volatility has been reduced over time by holding multiple non-correlated asset classes in a portfolio.
- Diversification within an asset class is important because it can eliminate idiosyncratic (i.e., individual security) risk within an asset class, but it cannot eliminate systemic (i.e., market) risk of an asset class. No investment strategy or allocation can eliminate risk or guarantee investment returns.
- Although single-asset class diversification is an important tool in the toolbox of investing, relying on it alone might cause an investor to forego the benefits of other non-correlated asset classes that may help them achieve their long-term goals. Asset allocation differs from single-asset class diversification because it involves being diversified across multiple diversifying asset classes.
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