



## Second Quarter 2023 Commentary

Dear Clients,

Please find enclosed your Second Quarter 2023 Investment Reports.

The quarter continued a strong performance period for technology related stocks, particularly those with exposure to artificial intelligence related revenue. In fact, the technology heavy NASDAQ index completed its best start to a calendar year in the 52-year history of the index (up over 32%); more about that later in this letter. U.S. large cap stocks were up the most among our broad asset class indexes at 9.7% total return. Mid cap, small cap, developed international, and emerging market stocks also all posted gains for the quarter. Conversely, broad bond indexes produced slightly negative returns both domestically and internationally as the strength of the U.S. labor market continued to support the view that central banks may need to keep rates “higher for longer.”

### Benchmark Returns

|                                | Last Quarter | Last Twelve Months | Last Five Years |
|--------------------------------|--------------|--------------------|-----------------|
| US Large Cap Stocks            | 9.7%         | 20.9%              | 12.8%           |
| US Mid Cap Stocks              | 4.8%         | 13.7%              | 8.6%            |
| US Small Cap Stocks            | 5.3%         | 14.8%              | 6.6%            |
| Developed International Stocks | 3.0%         | 18.8%              | 4.4%            |
| Emerging Market Stocks         | 0.9%         | 1.7%               | 0.9%            |
| US Bonds                       | -0.8%        | -0.9%              | 0.8%            |
| Global Bonds                   | -1.5%        | -1.3%              | -1.1%           |

Data source: YCharts. Past performance does not guarantee future results. It is not possible to invest directly in an index. Last five years data is annualized. Indexes in table are:

US Large Cap Stocks: CRSP US Mega Cap TR

US Mid Cap Stocks: CRSP US Mid Cap TR

US Small Cap Stocks: CRSP US Small Cap TR

Developed International Stocks: MSCI EAFE NTR

Emerging Market Stocks: MSCI Emerging Markets NTR

US Bonds: Bloomberg US Aggregate TR

Global Bonds: Bloomberg Global Aggregate TR

The recent strength of technology stocks may cause one to wonder: why not just own technology stocks and nothing else? There is no doubt that artificial intelligence (and other technologies) will create opportunities for corporate profits, and for bettering humanity’s standard of living. However, investors must remember that the total return of an investment is a function of the price paid for an investment, the dividends received while holding the investment, and the price available to sell the investment. The key item to notice in this arithmetic is that the price paid is one of the three components that determines total return.

Let’s take the simple example of a stock that currently pays no dividends, like Amazon. It closed the quarter at about \$130 per share, up 55% for the first half of the 2023 calendar year. What will it take to deliver the same return for the next 6 months? Well, the price on December 31, 2023 would need to be about  $\$130 \times 155\% = \$202$ . You can repeat this example for succeeding six-month intervals. Your total return in each subsequent time period will not depend on the level of interest rates, the profits that Amazon produces, whether or not China invades Taiwan, or who wins the next U.S. presidential election. It will only depend on what you can sell the stock for, and how much you paid when you purchased it.

While this basic math is correct for calculating the total return, the limitation in the reasoning is of course that the person who buys the stock when you sell must decide on a price they are willing to pay. What will influence their decision?

There will come a point in the buying and selling process when buyers must evaluate the profits a business could reasonably be expected to produce for its owners in the future. There are many factors that could influence this



subjective evaluation process, but if a buyer does not think ahead to what the next buyer will pay, his or her total return will be at risk.

A similar evaluation process exists for the market and the economy as a whole. We know that in any economic endeavor, future output is a function of time spent working and the productivity of that work. Thanks to economists and demographers, we have a reasonable estimate of how many working age people live in a country, how many of them work, and how much time they spend at work. We also have reasonable estimates of how many people are being added to the working age population, whether through births and retirement or through net migration. (And in the global calculus, we do not even have to worry about net migration as a factor in determining economic output except to the extent that it influences productivity). Finally, we have reasonable estimates (from an order of magnitude standpoint) of total output in individual countries and globally in aggregate. With this data, we can infer how much more productively humans are working over time.

A remarkable observation arises when we consider this productivity change: historically, the rate of economy-wide productivity growth does not change dramatically in the short run. Well, certainly not as dramatically as one might expect given the breathless proclamations of venture capitalists, business tycoons, media, and politicians. In fact, would it surprise you to know that according to McKenzie (among many other well-respected sources), U.S. labor productivity growth has actually slowed in the 2000s as compared to the overall post World War II average? The internet, cellphones, and all the technological advances we have enjoyed in the past twenty-five years have not meaningfully changed the pace of human innovation in the United States or globally. In fact, the only visible permanent “kink” in the rate of human productivity growth in the past thousand years took place during the Industrial Revolution.

Could the advent of artificial intelligence be the next great advance in human history? Of course. But if the invention of cars, radio, airplanes, television, nuclear

power, computers, satellites, the internet, cellphones, etc. is a guide, we are more likely to continue along the trajectory of the past two hundred years. To be clear, this is an undoubtedly positive trajectory, but one that is incremental in progress. It is a trajectory where, for stock owners, innovation compounds over time at 8% to 10% annualized clips, not at 75% annualized clips.

So what causes these more volatile changes in short term total returns? Is it really a dramatic revaluation of the growth in possible output? To be fair, for individual companies it could be. But for entire segments of the economy, high volatility is driven less by changes in the underlying fundamentals and more by changes in investor sentiment. In brief, the classic human behavioral factors of “fear” and “greed” drive short term valuation swings as much as they ever have. Inflection points in these herding tendencies are challenging to forecast as they are often triggered by a not easily anticipated cascading chain of events (e.g., who had the Wagner march on Moscow on their prediction list for this past quarter?).

We thus encourage clients to approach capital markets with humility. This approach translates into our diversified recommendations. When you see an entire market sector up 32% in six months, we encourage you to not be tempted to chase the returns and put all your eggs in that basket. By the same token, we encourage you not to feel the pressure to dramatically sell the sector in an effort to front run a fear of collapse.

We continue to employ a long-term historically supported perspective in our guidance. We believe this approach, combined with an asset allocation customized to your specific financial circumstances, will prove prudent amidst the drama often produced by market cycles.

As always, we remain grateful for your trust.

**Leavell Investment Management, Inc.**