What Has Changed?

"For what you see and hear depends a good deal on where you are standing" – **CS Lewis**

Markets continued their positive performance in the second quarter and the S&P 500 is now up 17% through the first half of the year. Many investors have been caught off guard as the outlook at the beginning of the year was doom and gloom. Cooling inflation, better than expected corporate earnings, and the new AI (Artificial Intelligence) craze have been the obvious drivers of the great start to the year, but as we get longer into this market run up, the question becomes "Is this sustainable"? In order for the answer to be yes, inflation must continue on its downward descent, the Fed has to start talking rate cuts and corporate earnings expectations need to continue to surprise to the upside. In our view, at present, there's a low probability of all three happening in unison.

Although positive on the year, bonds were down slightly for the quarter as the Fed continues to reiterate they need to raise rates even higher to slow the economy and finish the job on inflation. Real estate has performed reasonably well, but we are seeing increasing signs of potential stress. After talking with three of the largest and most well-known regional banks, their comments are the same: loan delinquencies are minimal but they are either making no new loans or very few new loans. This banking outlook isn't isolated to just those three and is happening throughout the country.

The year started with a number of significant risks and despite the rally many of those risks still exist. Below we discuss the first half of 2023, our thoughts on the second half of the year and potential opportunities.

First Half

Once again, the largest and the most vocal investors in the country were dead wrong. At year end 2022, the average forecast of all the major investment firms predicted the S&P 500 to be at 4,009 by year end 2023 with the first half struggling before a second half rally. We ended the first six months of the year with the S&P 500 at 4,450, well above the average year-end target of 4,009, and only one of the 19 analysts on the accompanying chart at right predicted anything higher. So, how can so many "market experts" be wrong?

Firm	Strategist	YE '23 S&P 500 Target	FY '23 EPS Est.
Deutsche Bank	Binky Chadha	4,500	$195
BMO	Brian Belski	4,300	$220
Scotiabank	Hugo Ste-Marie	4,225	$225
Jefferies	Sean Darby	4,200	$232
JP Morgan	Dubravko Lakos-Buja	4,200	$205
Cantor Fitzgerald	Eric Johnson	4,100	$212
RBC Capital Markets	Lori Calvasina	4,100	$199
Credit Suisse	Jonathan Golub	4,050	$230
Bank of America	Savita Subramanian	4,000	$200
Goldman Sachs	Davis Kostin	4,000	$224
HSBC	Max Kettner	4,000	$225
Citigroup	Scott Chronert	3,900	$215
Morgan Stanley	Mike Wilson	3,900	$241*
UBS	Keith Parker	3,900	$198
Barclays	Venu Krishna	3,725	$207
Societe Generale	Manish Kabra	3,650	$220
BNP Paribas	Greg Boutle	3,400	$219
Evercore ISI	Julian Emanuel	-	$222
Stifel	Barry Bannister	-	$220
	Average	4,009	$215

Trying to predict the market in the short term is not easy and the world is certainly not predictable. Hindsight makes things a little easier, so this section of the letter is pretty simple: most pundits got it wrong because the economy proved to be more resilient and inflation less sticky than they expected.

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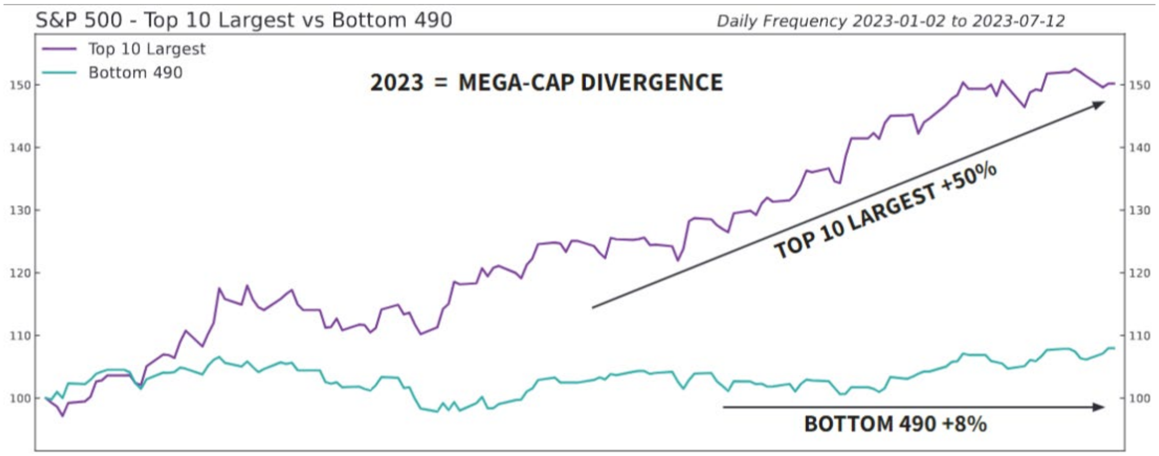
In March, markets quickly reversed course as the dramatic rise in rates during 2022 caused a couple of banks to break. We discussed this in the last newsletter (Q1 Newsletter). Although this appeared to be the potential major catalyst for the next leg down (typically it's something you don't see coming which is why the prediction game is so hard), the Fed jumped in to save the day, guaranteeing all investor deposits and reversing course from taking money out of the system to adding money into the system to try to sure up investor confidence. Markets love liquidity and we believe part of the move in the second quarter was a result of more accommodative money in the system by the Fed and Treasury as they had to sure up the Fiscal Cliff.

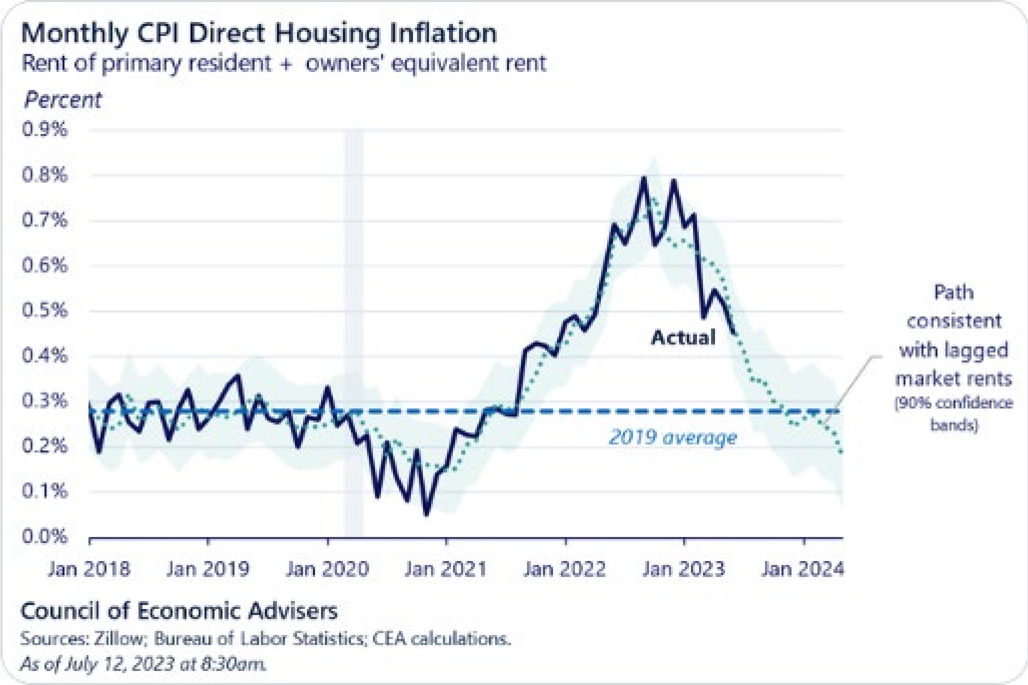
Markets also love a good story, and they got one with AI (Artificial Intelligence). With the introduction of ChatGPT last November, a new language model allowing human-like conversations, stocks in the technology sector have gone parabolic this year as investor interest has surged. The ten largest companies in the S&P 500 (mostly large technology) are up over 50% year to date, while the rest of the market is up just 8% (*below chart*). Although AI is certainly an incredible technology and will only get better with time, its material impact to society is most likely a ways off.



Importantly, AI already powers a huge number of programs and devices that we currently use on a daily basis. The giants of tech, such as Google, Microsoft, Amazon, and Meta, offer many of these via their current products and services and will continue to innovate and broaden out the use cases. But even if AI technology ultimately proves transformative, has the hype around what the technology can actually deliver in short order - and what the market is pricing - gone too far at this point?

Second Half?

So where do we go from here? One thing is sure, markets will remain unpredictable in the short term. Inflation, interest rates, and earnings are likely to drive markets over the coming year. The most recent inflation data came out last week and, at 3%, it is now one-third of what it was last summer. Although there is more work to be done to get to 2%, it appears that inflation is well on its way back to normal levels. The largest single component of inflation is housing costs. The below chart from the Council of Economic Advisors suggests that housing prices will continue to moderate into 2024, which is a huge positive.



In order to tame inflation, interest rates have moved higher at the fastest rate in history and the Fed indicates that it may have more work to do. Interest rate hikes take time to work their way through the system to see the ultimate effect. Small and regional banks have been directly impacted in the last year and will most likely see continued adverse effects. As long as rates stay at these levels, bank balance sheets will remain impaired and many of the loans that they made over the last several years may become increasingly troubled. Many commercial real estate loans in the last three years were made as interest only and floating rate. Those floating rates, now at 7.5%-9%, have reduced or eliminated the positive cash flows at many properties. We are watching this closely as this is the most anticipated next shoe to drop.

Over time stocks tend to follow “expected” earnings. In 2022, earnings grew 12%, while the overall market declined by nearly 20%. For 2023, earnings are expected to decline by 2%, yet the S&P 500 is positive 17%. This is a bit counterintuitive, but markets trade based on anticipated earnings and today the expected earnings for 2024 could be overly optimistic. The US is driven by the consumer, who has been flush with cash since the pandemic. We are seeing savings balances decline and credit card and home equity line balances increase. This is not necessarily an immediate concern as unemployment is extremely low and wages are growing, but we expect to see a deceleration of the excess spending following the pandemic.. As we enter earnings season, it will be less important if a company beats its’ expected earnings for the quarter versus the guidance issued for the upcoming quarters.

Potential Opportunities?

The stock market has dominated this letter because, for most investors, it is their largest allocation. Although it can provide the highest returns over time, it also imposes the most stress along the way. We believe there are a number of options outside of stocks that can provide very solid returns moving forward, which allows us to diversify or potentially eliminate stock market risk depending on one's circumstances. Below are our favorite stock market diversifiers based on the current environment.

1. *Fixed Income* – Includes both corporate bonds and Treasuries. Treasuries are very attractive in the short-term, earning more than 5.25%. This could change quickly if interest rates were to go down over the next year, so there is a lack of permanency to these yields. Bonds, on the other hand, look attractive after a terrible 2022. Overall yields are compelling and there will also be some price appreciation if interest rates end up declining over time.
2. *Private Credit* – If we do enter another round of banking turmoil, the private credit space could be ripe with opportunities. Small and regional banks will probably be unable to offload their troubled loans to the big banks and instead may look to sell the loans to the private credit sector at discounts. There is a lot of money raised and waiting to pounce in this sector as it waits for the opportunity to buy at a discount.
3. *Real Estate* – The circumstances have not presented themselves yet, but as discussed earlier there may be a time to invest into real estate opportunistically. Each day that passes with high interest rates and tighter lending standards, the chances of a short-term period of real estate distress increases.

Thank you for taking the time to read this letter. As always, please let us know if you have any questions related to your investments, taxes, or general planning or if there have been any changes to your overall plan or risk tolerance. This is a great time to set up a review meeting.

In conclusion, please see the next page for updates related to the Schwab merger and our new team member, Gracie Mason.

Sincerely,

Canal Capital Management

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Canal Capital Management's opinions are subject to change from time to time and do not constitute a recommendation to purchase or sell any security nor engage in any type of investment strategy. The information contained herein has been obtained from sources believed to be reliable and cannot be guaranteed for accuracy.

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Canal Updates

TD Ameritrade to Schwab Transition

An important reminder that the TD Ameritrade and Charles Schwab merger will take place for our clients over Labor Day weekend. You can read more about the conversion and what to expect at this link: TD and Schwab Conversion

Key points:

- **There is no action you need to take**, as all accounts will be automatically converted from TD Ameritrade to Charles Schwab over Labor Day weekend.
- If you would like to set up your new Schwab Login ID and password, you will be able to do so through your existing TD Ameritrade AdvisorClient login beginning August 1st. Most clients will have the option to keep their current Login ID.
- Between September 1st and September 4th account access will be unavailable due to the transition, but you can **access the Schwab client portal beginning on September 5th**.

New Team Member – Gracie Mason

We are excited to welcome the newest member of our team, Gracie Mason. Gracie joined Canal Capital in June as a Client Service Associate. In her role, she assists the team in all facets of existing and new client relationships. Gracie's bio can be found here: bio. We hope to introduce you to Gracie in person soon!

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