Davenport Asset Management Quarterly Update | Q2 2023

June 30 2023

Market Returns	Q2 2023	2023
U.S. Large Caps	8.7	16.9
U.S. Mid Caps	4.8	9.0
U.S. Small Caps	5.2	8.1
International Developed Markets	3.0	11.7
Emerging Markets	0.9	4.9
Intermediate Term Bonds	-0.8	1.5

Source: Morningstar Direct. Please see index for definitions.

The year is halfway over and equity returns have probably surprised many investors. We came into 2023 with predictions for a recession and rampant negativity; yet, the major indices have managed to post impressive gains so far. For the second quarter, the S&P 500® Index and Russell 2000® Index advanced 8.7% and 5.2%, respectively, bringing year-to-date gains to 16.9% and 8.1%. Even more impressive, the tech-heavy NASDAQ 100® Index is up 39.4% year-to-date, the best start to a year for the index since 1985.

How have markets managed to muster such an impressive feat in the face of obvious headwinds? We can point to a few things. For one, the much anticipated recession has yet to come to fruition. Economic activity has slowed, but prospects for a "soft landing" have improved. Despite all the financial media's fear mongering, investors have realized a slowdown doesn't mean the economy will fall into shambles. Next, we have the Federal Reserve and monetary policy. Inflation has cooled to the lowest level in two years (4.1%) and investors are sensing we are close to the end of this tightening cycle. While we may see more interest rate hikes as the Fed tries to steer us towards its goal of 2% inflation, the heavy lifting appears to be behind us.

Then there's the hot topic of artificial intelligence (AI), which took the investment world by storm in the second quarter. AI, which we discussed in more detail in a recent thought piece, promises to bring a wave of innovation and significant benefits to both enablers and users of the technology. Most of the large creators of the technology are huge technology companies, helping explain the aforementioned move for the NASDAQ as well as the S&P information technology sector, which finished the quarter up a whopping 42.8% YTD. The fact we are entering a period of slower economic growth has only increased the allure of perceived AI beneficiaries, as they may be able to post meaningful growth in an environment where growth is becoming more scarce.

Fueled in large part by the AI craze, market gains have been incredibly "narrow." That is, there have been limited winners and shares of a few giant companies have driven the market. To put a finer point on it, ~75% of the S&P's gains have been powered by 7 companies: Apple, Microsoft, NVIDIA, Amazon, Meta, Tesla, & Alphabet. These companies now account for an astounding 28% of the S&P 500. The average return of these seven companies is 82.5% vs 6.6% for the rest of the index. Looking at it a little differently, the equal weighted S&P is up 7.0% versus 16.9% for the market cap weighted index, again highlighting the heft of the largest constituents and lack of upside participation from many other sectors/stocks. More economically sensitive sectors such as Energy and Financials are down 5.5% and 0.5%, respectively, year-to-date.

This dynamic leaves investors in a tricky spot. Shares of many large tech companies and perceived AI winners have shown huge short-term gains and look a little too popular at the moment. We own some of these companies and acknowledge they are now clearly more fully valued, but are largely maintaining positions given their longer-term potential. On the other side of the coin, you have the numerous stock market laggards that have been left in the dust of the AI rally. Many of these overlooked names have become incrementally attractive, with their valuations already discounting economic weakness. Interestingly, while the overall valuation for the S&P 500 looks full at 19.2x forward earnings, the multiple on the equal weighted S&P is much more reasonable at 15.3x.

We are making sure to maintain balance in our portfolios. We are clearly excited about emerging technologies such as AI, and think in some cases the hype is warranted. However, we recognize the best incremental opportunities in terms of risk/reward may rest in other areas. We also recognize there are still potential threats to the market. Recession risk is still present and investors may be underestimating the Federal Reserve and the potential for ongoing interest rate hikes. Too, investor sentiment has improved significantly in recent months. Starting the year, we argued dour investor sentiment and low expectations could provide a tailwind for stocks. That case is harder to make today. The silver lining here is that much of the recent positivity has been focused on a few areas and the average stock doesn't appear expensive. Hence, it may not be a smooth ride from here but we still think there are deals to be had. Please refer to our strategy letters for a discussion of specific ideas and we look forward to reporting back to you in a few months.

Bloomberg Market Returns	Q2 2023	YTD	2022
U.S. Govt/Credit	-0.9	2.2	-13.6
U.S. Govt/Credit Interm	-0.8	1.5	-8.2
High Yield Corporate	1.8	5.4	-11.2
Municipal 1-10Y Blend 1-12Yr	-0.5	1.5	-4.8
U.S. Govt/Credit 1-5 Yr	-0.6	1.2	-5.5
U.S. Govt/Credit 1-3 Yr	-0.4	1.1	-3.7

Source: Morningstar Direct. Please see last page for index definitions.

Entering 2023, the general consensus amongst Wall Street pundits forecasted falling inflation and less restrictive interest rates. The Federal Reserve did take a "hawkish" pause at its most recent June meeting following ten consecutive hikes that cumulatively raised borrowing costs by 500 basis points (or 5%) in a compressed timeframe. Countering a temporary pause were the Summary of Economic Projections (SEP), which indicated the Fed remains on high inflation alert and plans additional rate hikes. The truth is inflation and labor market conditions remain above the Fed's target level. Achieving an appropriate neutral interest rate that contains economic excess yet prevents outright contraction has proven a difficult task.

In addition to the Fed and monetary policy challenges, markets faced a regional banking crisis (SVB, First Republic and Signature Bank), commercial real estate (CRE) concerns and a debt ceiling showdown. The scale and reach were generally contained but did illustrate how jittery and volatile markets remain. The 2-year UST quickly fell from 4.7% to 3.9%. While somewhat of a generic catchall phrase, geopolitical risks remain at home and abroad. The impacts on commodity markets, supply-chains and potential lost international customers weigh on corporate America. Domestically, division rather than negotiation has become the defining characteristic from the local to federal level. In financial not political press, I have heard the famous Ronald Regan line referenced this year – "The most terrifying words in the English language are: I'm from the government and I'm here to help."

As we look ahead and continue our focus on maximizing risk-adjusted returns, our base case scenario is very optimistic with a backdrop of high nominal coupons in both the corporate credit and U.S. Treasury markets with inflation trending down. Our process remains rooted in fundamental credit research and relative value analysis to create durable income generating portfolios. As credit investors, we remind ourselves daily that we are not owners of companies but rather lenders and it is a great time to have the capital and ability to provide liquidity.

Credit spreads, which are the additional compensation above a UST of similar maturity, offer incremental all-in yield and have room to offer more spread in time, in our opinion. The consumer is the engine of the economy and headwinds are increasing. The impact of the Fed's higher interest regime has a lag component that is now felt, as evidenced in rising delinquency rates across individual consumer borrowing markets. After a three year pause, student loan repayments resume to the tune of tens of millions of borrowers responsible for payments that are estimated to be in the ballpark of $400/month. Combine this with many auto borrowing payments in excess of $1,000/month and the aforementioned economic engine doesn't look so rosy. This translates to higher corporate borrowing costs and those able to lend will command a higher coupon and future income streams.

Turning to the Treasury market, we believe flexibility and patience are what matters most. An inverted yield curve will not persist indefinitely but earning 100 basis points more on a 2-year UST versus a 10-year UST affords an enticing low duration position of nimbleness and income. Many valid drivers have evolved for the case of longer UST rates to rise. Topping our list is the fact that the Treasury will have to issue longer maturity debt to fund federal deficit spending at more attractive levels as it cannot exclusively fund in the UST bill market and the fact that many international buyers who consistently bid on UST bonds can now achieve higher yields in their home economy due to global inflation and elevated rates. In conclusion, we continue to leverage opportunities to generate above index income with the structural flexibility to lock in higher for longer rates as market opportunities present themselves.

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Index Definitions: U.S. Large Caps represented by the **S&P 500 Total Return Index.** U.S. Mid Caps represented by the **Russell Midcap® Index.** U.S. Small Caps represented by the **Russell 2000 Index.** International Developed Markets represented by the **MSCI EAFE Index.** Emerging Markets represented by the **MSCI EM Index.** Intermediate Term Bonds represented by the **Bloomberg Intermediate Government/Credit Index.**

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The ICE BofA **US High Grade Corporate Master Index** tracks the performance of US dollar denominated investment grade corporate debt publicly issued in the US domestic market. The ICE BofA **US High Yield Master II Index** is an unmanaged index comprised of over 1,200 high yield bonds representative of high yield bond markets as a whole. All information provided by ICE is owned by or licensed to ICE. ICE retains exclusive ownership of the ICE Indices, including the ICE BofAML Indexes, and the analytics used to create this analysis ICE may in its absolute discretion and without prior notice revise or terminate the ICE information, Indices and analytics at any time. The **Bloomberg Municipal 1-10 Year Blend 1-12 Year Index** measures the performance of short and intermediate components of the Municipal Bond Index — an unmanaged, market value-weighted index which covers the U.S. investment grade, tax-exempt bond market. A **Treasury Index** is an index based on recent auctions of U.S. Treasury bills and is commonly used as a benchmark when determining interest rates, such as mortgage rates. A **High Grade Corporate Bond** is believed to have a lower risk of default and receive higher ratings by the credit rating agencies. A **Leveraged Loan** is a type of loan that is extended to companies or individuals that already have considerable amounts of debt or poor credit history. A **Municipal Bond**, commonly known as a muni, is a bond issued by state or local governments, or entities they create such as authorities and special districts. A **Convertible Security** is a security—usually a bond or a preferred stock—that can be converted into a different security—typically shares of the company's common stock. A **Preferred Stock** is a class of stock that is granted certain rights that differ from common stock. A **Mortgage Master** is an investment similar to a bond that consists of a bundle of home loans bought from the banks that issued them.

A security's credit rating is the grade a rating agency assigns to indicate the risk of default and, in some cases, takes into consideration the potential loss to investors in the event of default. Further information and a more extensive discussion on credit ratings can be found at www.sec.gov/ocr. Users are cautioned that rating agencies may assign different meanings to similar terms.

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