HILLTOPBANK
Wealth Management

QUARTERLY MARKET INSIGHTS – SECOND QUARTER 2023

To the Clients and Partners of Hilltop Bank Wealth Management:

As we fly past the halfway post for the year, the Federal Reserve is continuing its fight against inflation but slowing the pace of tightening. The economy has remained resilient on the strength of spending on durable goods and particularly new construction. Finally, while growth is slowing, equity markets are discounting the severity of any possible recession, and have been unusually reliant on one theme driving overall returns, generative artificial intelligence.

Where We Stand Now

Through the first two quarters, we have an economy that continues to roll along. Investment in fixed assets (buildings, manufacturing equipment, and other things purchased for the longer term), is providing support for slowing spending from consumers who are just now beginning to empty out their savings from the pandemic. GDP increased 2.0% in the first quarter of the year, and is on track for a similar figure in the quarter just ended.

Two bright spots in our economy are in two different areas of construction. First, new residential housing construction, which was up 21.7% for the month in May, is evidence of a significant bet by homebuilders that residential supply will remain tight. That makes sense given that 23.5% of homeowners have a mortgage with a rate below 3%, and 90% of U.S. homeowners have a rate below 6%. Logically, it would represent a painful tradeoff for anyone looking to move into a new home to give up a rate like that to start a new mortgage at today's higher level. The second area of strength is in the new construction of manufacturing facilities, where almost $100 billion more is being invested than in January of last year. That's been primarily caused by generous subsidies provided by the federal government.

On the inflation front, PCE inflation (the version the Federal Reserve keeps an eye on to set policy) is at 4.6% year-over-year, which is still much higher than the stated goal of 2.0%. On a monthly basis, prices continue to rise at about 0.4%, and if that monthly figure does not improve, we are looking at inflation bottoming in July and staying above 4% through year-end. This represents a tricky situation for the Fed. The closer we get to a tipping point for the economy, the slower they want to go so as not to overshoot the mark. However, if they move too slowly, inflation expectations can become entrenched, and inflation becomes even more difficult to eradicate. The Fed is currently on track to raise rates twice more this year but has cautioned that incoming data may change that plan.

The Next Technology of the Future™

The broadest possible way we can conceptualize technology is as the total accumulation of all useful ideas humanity has ever had. In that sense, the technological progress made over our time here on Earth has been truly remarkable, if not exactly linear. Brad DeLong, an economic historian, estimates that 70,000 years ago, in the early Paleolithic Era, the growth rate of technology was 0.001% per year. Between 8,000 and 6,000 BCE, as we made the transition from hunter-gatherers to agrarians, the proportional rate of growth of our good ideas jumped incredibly, eleven-fold, to 0.011% (it turns out herding and agriculture were very good ideas). From there, through the end of the Stone Age, the Bronze Age, and the Iron Age, advances in craftwork, organization, and literacy led to a technological growth rate of 0.03%. Then, between year 1 and the 1500s, the rate of growth went through several periods of acceleration and deceleration, from 0.022% during the Dark Ages, to 0.052% by the end of the Middle Ages. From 1500 to 1770, there was another acceleration in growth to 0.149% as the industrial revolution got underway. Finally, after 1870, DeLong argues things really exploded. Our total stock of good ideas grew twenty-fold, at a rate of 2.125%.

Now to be sure there is almost certainly some spurious precision in those figures, but they tell a plausible story of the technical achievement of the human race. Our knowledge and abilities have advanced at an increasing rate since we first started using tools, and various developments have either accelerated that rate (e.g., literacy, electricity) or slowed it down (e.g., plagues, famine). Up to and including today, our technological prowess is growing at an increasing rate, and in order to maintain that growth, you need new, good ideas. In the first half of 2023, a new candidate has emerged and is being touted as the very latest Technology of the Future.

Supplanting cryptocurrencies, the metaverse, and driverless cars as the next, new, dynamic-shifting development is generative artificial intelligence. While admittedly not an expert in machine learning, or large language models, the dialog around all of these technologies seems eerily familiar: A technological innovation triggers great excitement, people race to capitalize on it, excitement grows beyond the technology's current ability, and as disillusionment sets in the shiny new thing is discarded in the popular imagination. Often, it's at that point that experts continue the work (with much less fanfare), and are eventually able to harness it into something actually useful in the future.

Another example of this same pattern played out with the internet in the late nineties and early 2000s. There was excitement, a bubble, disappointment, and retrenchment. In the case of the internet, however, its promise was eventually realized (the best that can be said for the others is that the jury's still out). Take, for instance, Amazon, one of the hottest stocks of the dotcom bubble and which also turned out to be one of the greatest beneficiaries of the internet age. If you bought and held Amazon a decade ago, you have to be pretty pleased with your investment. On the other hand, if you bought Amazon at the height of the market in 1999, you would not have seen a positive return for an entire decade, until 2009. In addition, for every Amazon, there is a Pets.com, Books-a-Million, or the hundreds of other dotcom-era stocks that did not survive.

The point is, whether AI turns out to be as significant as the internet, or more like cryptocurrency, we probably have yet to reach the peak of excitement let alone the realization of its promise. The reason it's relevant to us today is because it's the single best explanation for first-half equity returns that have been fairly peculiar.

According to attribution analysis - where we look into what actually drove index returns – in the first two quarters of 2023 just seven stocks were the cause of three-quarters of the total market return. These seven companies are seen by many to be the most likely beneficiaries of generative AI, and you are probably well familiar with all of them. Given their large-cap nature and their prevalence in index-weighting schemes, it is also likely they already represent a noteworthy portion of most equity portfolios. Regardless, do these returns mean we should abandon diversification, and load up on these seven?

As investors, we ought to be mindful of not only what markets are doing, but also how they affect the way we think. In the field of behavioral finance, there are numerous studies focused particularly on regret avoidance, or "fear of missing out". Constantly, investors make irrational decisions based on psychological biases that tell them they need to take certain actions to minimize possible future regret. This can make it tempting to chase trends and explains a great deal of why bubbles keep inflating long after their underlying rationale ceases to make sense. In the context of 2023, whether generative AI is more like the internet or cryptocurrency, chasing the next Technology of the Future is simply a gambling exercise in timing and luck, a good way to be caught holding the bag in a speculative environment, and not a basis for long-term investment. For whatever its promise, it seems unlikely that three-quarters of all good ideas hatched at all publicly traded companies in 2023 have happened at just those seven companies.

Our Own Good Idea

On the topic of technology and investing for the long term, Hilltop Bank Wealth Management has also made an investment in the future we share with all of you. Specifically, and as I am sure you will be aware based on the many mailings sent out on the topic; we have implemented a great improvement in our technological capabilities. This will allow us to continue to provide you with the level and quality of service you have come to expect from us. While most of the enhancements will be behind the scenes, you can all look forward to an updated, and in my opinion much-improved, online client interface and the convenience of a brand-new mobile app. This will allow you to stay up to date on everything happening with your investments, although as we attempt to be mindful of how market movements impact our thinking, I would strongly encourage you not to check it every day.

Best,

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