



Quarterly Investment Commentary

SECOND QUARTER, JUNE 2023

When presented with complex information, humans use a cognitive process called mental framing to help with making decisions. This mental framework allows us to break down information to better evaluate situations. Framing is also known as the mental lens through which people view and understand information. For example, the phrase “wearing rose-colored glasses” is used to describe someone with a tendency to view the world in an overly positive light, often downplaying any potential problems. Although we don’t claim to be psychoanalysts, the mixed signals coming from the stock and bond markets during the second quarter suggest that investors are viewing the same environment through two very different colored lenses. Through mid-year, the Treasury market continues to flash warning signs of a looming recession. On the other hand, U.S. stock prices are implying the economy will avoid recession and is on the cusp of a new technology boom, led by the advancements in artificial intelligence (AI). For the time being, the nervousness surrounding bank failures is out of sight and out of mind as markets turn their focus back to what’s next for inflation, interest rates, and the economy.

Interpreting the Mixed Signals

Although there is no foolproof predictor of a recession, the Treasury yield curve and futures

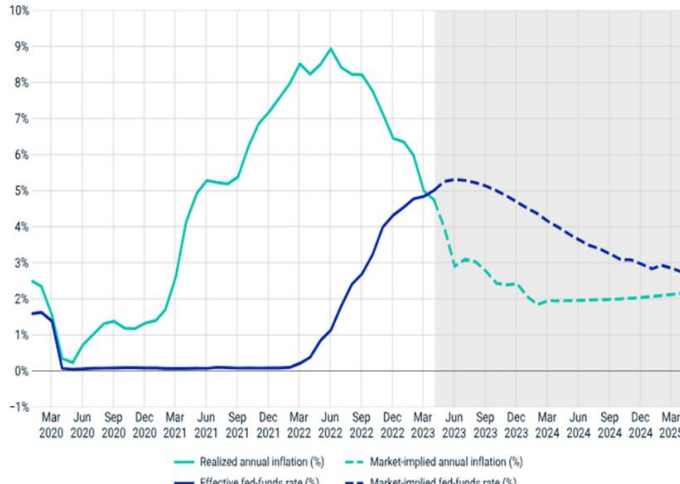
markets continue to signal a high likelihood that the Federal Reserve (Fed) will be forced to cut interest rates at some point over the next year or so. The Fed cutting rates is generally associated with bigger issues, such as a contraction in economic growth, deflation, rising unemployment, and/or an unexpected shock to the financial system. Likewise, the U.S. manufacturing sector¹ is at levels commonly seen with a recession while a larger basket of leading economic indicators has been in full-on recession mode for some time. On the flip side, the housing market has slowed but shows signs of resilience, the labor market is strong, overall economic growth continues to chug along, and stock prices keep rising. How do we make sense of it all? Mixed signals from the economy and markets are not unusual and are a feature of a highly uncertain environment with no clear direction. The phrase “rolling” recession is being used by some to describe the current state of the economy. Rolling patches of weakness are being offset by patches of strength, thereby avoiding an all-out recession—for now. In terms of forecasts, the predictions from Wall Street have taken the form of various flight paths—a soft landing (avoid recession), a hard landing (recession), or a no landing (keeps plodding along).

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* ¹As measured by the ISM Manufacturing PMI



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Market Implied Expectations



The dotted lines are the market-implied expectation for inflation (teal) and the fed-funds rate (blue).

Source: MSCI

Given the oddities and one-offs of the pandemic, using a classical playbook to forecast the future direction of the economy will be challenging. These pandemic-era forces are also contributing to the mixed economic signals we’re seeing and the wide range of market predictions. It’s anyone’s guess on the ultimate outcome, but the future direction will largely depend on the biggest concern, inflation. While we continue to see progress in the rate of inflation, the last mile can be the most challenging, and it will take time for the effects of higher interest rates to do their job.

Despite the conflicting data, there remains an abundance of investment advice in the financial press on how to navigate the current terrain. Whether one has a bullish or bearish outlook, there is generally data to back up the point. The most sensational advice usually touts the get-in or get-out approach.

In reality, a prudently managed portfolio will operate along a spectrum, taking on more risk during certain periods and dialing back risk during others, but never being all-in or all-out. We’ve used this quote from Oaktree’s Howard Marks in the past but feel it’s relevant today: *“It’s better to structure a portfolio that can succeed in a variety of environments versus building the perfect portfolio for one outcome.”*

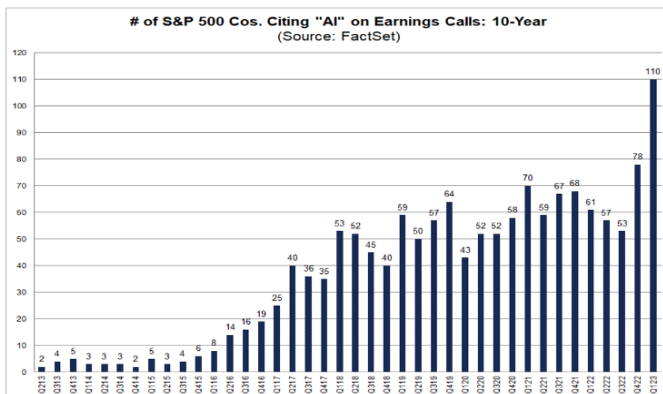
We continue to believe the current environment warrants caution while being mindful of the risks within portfolios. The recent run-up in stock price valuations suggests that the euphoria that gripped markets a few years ago has not been totally extinguished. Though valuations on the broader stock indexes don’t look overly compelling, bonds now offer an attractive source of income while offsetting some of the risks tied to stocks. Ultimately, stock ownership will be a key driver of a portfolio’s long-term success, but we like the idea of generating income from bonds while waiting for opportunities. During these uncertain times, we remain committed to the process of selective investing, which entails taking an active approach to finding opportunities and picking favorable times to enter or trim positions. While we have not mastered the art of predicting the future (nor will we), we will continue to take a thoughtful and balanced approach to managing your investments.

Second Quarter Recap

While the second quarter was calmer than the start of the year, there was plenty of potentially impactful news for markets to digest: The resolution of the debt ceiling debate, a pause in the Federal Reserve’s interest rate hiking campaign, and a possible Russian mutiny that ended almost as quickly as it began. Surprisingly, these notable events ended up having little influence over asset prices.



The U.S. equities markets staged an impressive rally during the second quarter with the S&P 500 stock index up 16% year-to-date. Looking under the hood of the index, the dispersion in returns year-to-date has been high, with the winners being largely the big-name technology companies. The return for the average U.S. stock was 7% while the technology sector was up 40% this year. The surge in technology-related stocks is due to the hope that they can continue to grow with the slowing economic conditions and the potential benefits coming from artificial intelligence (AI).



During the first quarter, 110 companies cited "AI" in their earnings call, well above the 5-year average of 57.

The heightened interest in AI was on full display in the first quarter corporate earnings calls, where executives cited AI almost twice as much as in previous calls with investors. Who can blame them, as it seems that any stock linked to AI technology has seen a meaningful bump in its stock price this year.

Bond yields drifted higher during the quarter as the fears of bank failures faded and the labor market continued to show strength. The yield on a 2-year U.S. Treasury note rose to 4.9% from 4.06% while the 10-year Treasury rose to 3.8% from 3.5%. Bond prices declined during the quarter, which has resulted in a total return for high-quality bonds in the 1.5%² range year-to-date.

AI — Fad Chasing or the Future?

While we don't claim to be experts in the field of artificial intelligence (AI), the recent hype over its growing capabilities deserves some commentary. Artificial intelligence is not a new technology, and many of the largest companies have been using some form of AI across aspects of their business for many years. Amazon uses it to analyze customer browsing and purchasing behavior to recommend products. Search engines like Google and Bing incorporate AI to understand user intent and deliver more relevant search results. And who can forget the 1997 version of Microsoft Office, which used a primitive form of AI to run the big-eyed paperclip, Clippy, which was meant to offer assistance but basically just annoyed.

If the technology has been in use for some time, why are we now hearing more about it? In short, the models that power AI



are becoming increasingly more sophisticated and the volumes of data needed to train the open-source programs are widely available. The release of the AI chatbot, ChatGPT, has also contributed to the hype. ChatGPT is an advanced language model developed by the company Open AI with a major investment by Microsoft. The program offers wide-ranging answers on virtually any topic, can generate song lyrics, write cover letters, and suggest edits to computer programming code—it's Clippy on steroids.

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* ² Bloomberg Intermediate Government & Credit Bond Index



The excitement over this technology is based on the prospects of future productivity increases, such as having AI programs complete menial tasks quickly, accurately, and cheaply. Over time, the hope is that AI moves from the narrow application of replicating human function to deeper analysis in areas like online security or improving healthcare treatments for patients.

The technology is also working through a number of glitches. At this early stage, the Chatbot is described as a “clever parrot”; it will give the answer it thinks is accurate but can’t determine fact or fiction. Is all the AI hype justified or is it just another fad for investors to chase? Given the recent stock price run-up in practically everything connected to AI technology or equipment, the short-term hope is likely being overstated. Although there are many uncertainties and likely increased regulatory scrutiny in the future, the longer-term potential appears significant. Again, these types of innovations take time to play out, and the speculation will likely cause booms and painful busts along the way. The fiber optic communication network in the late 90s and early 2000s was also a transformative industry that took many years to develop. Those stocks that were the brightest stars of Wall Street at the initial stages also experienced disastrous falls—remember JDS Uniphase, Lucent, and Nortel? It is important to keep a cool head and take a thoughtful approach with an investment in a new and relatively unproven technology.

We are excited about the prospects of AI, but paying any price irrespective of the fundamentals can have negative implications on future returns.

Firm Update

We are excited to welcome Jared Fiedler, CFP®, to the firm's investment team. A Fort Wayne native, Jared attended Blackhawk Christian High School and graduated from Purdue University with a Bachelor of Arts degree in finance. He has worked the last three years in Indianapolis for one of the Midwest’s largest investment advisory firms. In 2021, Jared earned the CERTIFIED FINANCIAL PLANNER™ (CFP®) designation. Jared resides in Fort Wayne with his wife Jordan. Outside of work, he enjoys spending time with family, visiting South Haven, MI, and cheering on the Michigan Wolverines. His community interests include Pathway Community Church and World Vision.



AMI would also like to welcome back our summer intern Luke Friskney. Luke will start his senior year at Purdue University this fall and is double majoring in Agricultural Economics and Financial Planning. He is a graduate of East Noble High School and outside of the office enjoys fishing, golfing, working out, and spending time on the lake. Luke continues to be an immense help with investment projects and will be missed this fall on his return to Purdue.

