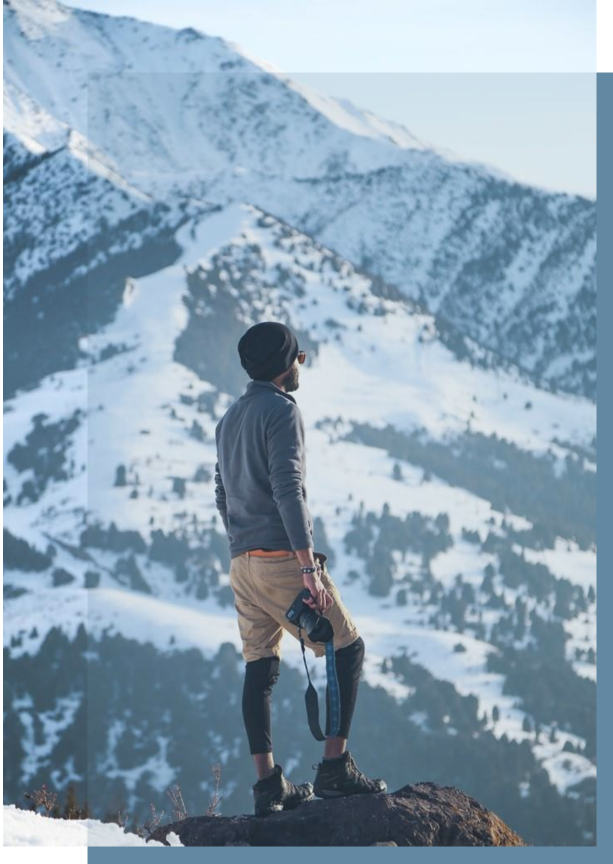
PERSPECTIVES

Benefit Financial Services Group Newsletter

Quarter Ending June 30, 2023



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Market Recap

Patrick Powers, CFA®, CPA/PFP, CFP® (Managing Principal)

The U.S. equity market got some wind in its sails in the second quarter, after a very choppy first quarter, in which the rapid rise in interest rates left some regional banks in precarious financial positions (resulting in three of the four largest bank failures on record). The S&P 500[1] Index is now up 15.91% year-to-date (its best first half since 2019) but that is small potatoes compared to the technology heavy NASDAQ[2] Index which is up 31.73% year-to-date (its best first half since 1983). The rally was ignited largely by Microsoft's (MSFT) release of its artificial intelligence (AI) search engine (ChatGPT). Suddenly, everyone could make use of this phenomenal technology and investors began to see its promise. The NASDAQ Index is still around 14% off its peak in November 2021, but it has recovered large amounts of its losses in 2023.

After much back-and-forth, the president and Congress agreed on a deal to raise the debt limit in June, avoiding the impending possibility of a U.S. default. Amid the discussions, stock and bond markets seemed to take the news in stride. Federal Reserve officials paused on raising the benchmark federal funds rate in June after more than a year of increases, but signaled they were leaning toward resuming rate increases if inflation doesn't cool further. The Bloomberg U.S. Aggregate Bond Index[3] was up 2.09% year-to-date, which is a far cry from its disastrous 13% decline in 2022. In fact, bonds are, for the most part, generating some very nice yields right now.

However, if you look underneath the hood, the stock market rally is not as broad as you think. By looking at an equal weighted index (vs. market capitalization weighted index like the S&P 500), you can get some idea of the health of the overall stock market. In a market-cap weighted index, the larger the company, the more its returns affect the entire index. Today, the ten largest companies (mostly technology related stocks) in the S&P 500 account for 31.7% of the index and over 95% of the year-to-date performance![4] In an equal weighted index, the top ten holdings account for just 2.36% of the index and the index has returned 5.94% year-to-date.[5] I can't remember seeing such a big difference in performance between the two indices.

The good news is that we are starting to see larger companies hold their gains but settle down a bit. The smaller companies are starting to make a move upward. Market gains broadening out would be a very positive development. Only time will tell, and we will watch it closely.

As always, we will work with that the market gives us to work with and that is why it is important to understand these issues. Wishing you (and the equal weighted S&P 500) a great second half!

Forecast

Steven Yamshon, Ph.D. (Managing Principal)

As the old saying goes, even a broken clock is right twice a day, and this is why so many economists, money managers, and stockbrokers make bold predictions about markets and the economy even if they have no knowledge or basis for making such a call. Eventually, they all will be right! The truth is, no one can be sure of a recession until we are in one or it has passed, and I suspect this will also hold true for the future. However, some basic economic principles still are valid and one of them is that a bear market, except for 1987, has never occurred without a recession. The stock and bond market downturn in 2022 was not due to a recession (at least not yet), but simply investors having an inflation scare that began in late 2021. As inflation declined from roughly 9% in 2022 to 4% in 2023, investors attitudes have changed, and this, combined with AI mania, is pushing the stock market averages up in 2023.[6] Déjà vu 2000.

The three indicators that we use have a favorable track record for predicting a recession that leads to an earnings decline of 10% or more.They are: 1) The slope of the yield curve, which is simply the relationship between interest rates and time to maturity[7], 2) the Leading Economic Indicators (LEI) over a 12-month period[8], and 3) the increase or decrease of the money supply as measured by M2[9]. One of the reasons why we look at several indicators and not just one, is that looking at one alone may give a false signal, just as the yield curve gave a false signal of a recession in 1998. By October 2022, all three indicators were negative. In the past, every time these three indicators have coincided and turned negative, a recession has followed an average of 11-15 months later.

The timing of any recession is difficult to predict, but in our opinion, it is already baked into the cake and now is only a matter of time. Taking out the trusty crystal ball that Anne Bancroft used in the movie, *Love Potion Number Nine,* we think that a recession could occur in 2024. Although it seems that the U.S. stock market has broken away from reality since the S&P 500 is dominated by a small handful of multi-national mega cap technology stocks, we are of the mindset that earnings are still linked to the economy and business cycle. Earnings, in most cases, do not decline unless there is a recession. The big question is, how do we determine when earnings will decline and by how much?

Portfolio Management

Michael Allbee, CFP® (Partner/Senior Portfolio Manager)

Like Janus, the Roman god of doorways, investors are looking in two directions simultaneously. In one direction, they are looking at the potential earnings increases that AI will eventually add to the S&P 500, due to some combination of augmented productivity and staff reductions.[10] In the opposite direction, they are concerned about a slowing economy and the potential for a recession, which should decrease earnings in the short term. The S&P 500 reflected this dichotomy, entering a new bull market on June 8th after exiting a 248-trading-day bear market (its longest since 1948).[11]

As of quarter-end, the S&P 500 trades at 19 times expected earnings over the coming year, up from 15 times in October. What's driving this? A lot of mega-cap Price-to-Earnings (P/E) multiple expansion. Seven stocks have accounted for the bulk of the market's positive performance (returning an average of 85% this year). These "Magnificent Seven" stocks are all involved in the AI race.[12] If anything, the performance of the Magnificent Seven is an argument for diversification, because you never know which stocks drive performance in any given year.[13] But as the drifter, Vin Tanner (played by Steve McQueen), said in *The Magnificent Seven*, "All I'm saying is that sometimes you bend with the breeze, or you break."[14] The AI revolution is going to have to live up to the high end of expectations to justify current valuations. If not, stock prices of these mega-cap stocks (and frankly, most stocks caught up in the AI mania) could break, especially if we enter into a recession. The combination of power, greed, and mania can be deadly. At BFSG, "We know what fear is. We live with it all our lives. Only the dead are without fear."[14]

We live by Warren Buffet's words, "Be fearful when others are greedy". In today's economic environment, we are laser focused on the defensive characteristics of high-quality bonds. The yield-to-worst for the Bloomberg US Aggregate Bond Index at the end of the quarter was 4.68%. Compare that to the average since the turn of the century (3.57%), since the Great Financial Crisis (2.68%) and since the end of the last tightening cycle (2.20%). We feel clipping coupons at these levels isn't a bad place to hide while we wait for better stock market valuations. The returns from the bond market year-to-

date have been nearly completely driven from yield/income at +2.0%, we still have another half year of yield/income to come. If we get a flight to quality in a stock market sell-off, bonds should get an additional boost.

Talk With Us!

Paul Horn, CFP®, CPWA® (Senior Financial Planner/Wealth Manager)

As wildfires in California become more frequent and intense, considering the need for wildfire insurance has never been more important. For homeowners and residents in high-risk areas, understanding how this insurance works is crucial to safeguarding your real estate investment and for peace of mind.

The Basics

Most standard homeowner's insurance policies include coverage for fire damage, including damages from wildfires. However, it's crucial to verify damage from wildfires is covered, as it's not always the case, particularly in areas highly susceptible to wildfires. When you apply for a home insurance policy, insurers charge for coverage according to the level of risk they assume by taking you on as a policyholder. Because of this, some insurance carriers will charge higher premiums, increase deductibles, cap payouts, or deny coverage altogether for homes in high-risk regions.

The Coverage

A typical wildfire insurance policy covers the structure of the home, personal belongings inside the home, additional structures on the property like sheds or detached garages, and loss of use or additional living expenses incurred if you're forced to vacate your home due to a wildfire.

However, insurance policies can vary greatly, so it's important to understand what's covered and what's not. For example, some policies may not cover additional living expenses, or they may have a limit on personal property coverage. Some may also exclude coverage for smoke damage, which can be a significant issue even if your home isn't directly affected by the flames.

The California Landscape

California's unique geographic landscape and increasing drought conditions have resulted in a higher frequency of wildfires. These factors have also led to a significant shift in the insurance market. Some insurance companies have even stopped offering coverage in areas most at risk, leaving many homeowners looking for alternatives. Admitted carriers like Allstate and State Farm are leaving the state because reinsurance companies are increasing rates too fast and insurance companies can't get the California Department of Insurance to raise rates fast enough.[15] Apparently, Californians aren't "In Good Hands" anymore with Allstate, and "Like an Elusive Neighbor, State Farm isn't there" (for Californians).

The Fair Access to Insurance Requirements (FAIR) Plan

Fortunately, in California, there is the Fair Access to Insurance Requirements (FAIR) Plan. The FAIR Plan is a state-mandated insurance pool designed to provide basic fire insurance coverage for homeowners who have been unable to obtain coverage through the traditional market. Enrollments have jumped in recent years to 272,846 homes in 2022.[16] However, it's important to note that the FAIR Plan should be seen as a last resort as the coverage is basic and may not fully cover all aspects of potential damage. For instance, the FAIR Plan does not currently offer personal property or replacement cost dwelling coverage types. Additionally, the plan will not cover:

- Houses with existing damage that have no repair plans
- Long-term vacant or unoccupied homes
- Properties used for federally illicit means

It is important to consider a Difference in Conditions (DIC) insurance policy that is designed to fill in the gaps of the perils not covered by the FAIR Plan. In addition, FAIR Plan policies are capped at $3 million for all coverages combined.

What Are The Options For Homes Over $3M

For coverage higher than $3 million, most insurance brokers are layering insurance with the FAIR Plan covering the first $3 million and then obtaining homeowners insurance through a surplus or excess line carrier. These insurers provide coverage for homes that carriers through the standard marketplace won't take on as clients. Surplus lines do not abide by the same state regulations that standard carriers do, making them more expensive than the average homeowners insurance policy.

Prevention and Mitigation

Alongside insurance, it's also critical to focus on wildfire prevention and mitigation efforts. This includes creating a defensible space around your property, using fire-resistant landscaping and building materials, and having an emergency evacuation plan in place. New home builders are beginning to use better materials for fire prevention.

Improve the insurability of your home by focusing on fire prevention. Some of the best ways to do this include home hardening (closed eaves, fiber cement board siding, dual-pane tempered screen windows, removing wood around the house), creating a defensible space (100-150 ft.), using exterior wildfire sprinkler systems, and removing highly flammable plants like Bougainvillea.

Insurance companies are increasingly recognizing these efforts and are offering discounts or incentives to homeowners who take active steps to protect their properties. Some companies are even working with homeowners, offering resources and guidance to make their homes more resistant to wildfires.

Conclusion

Successful financial plans must consider both wealth accumulation and wealth preservation. Wildfire insurance in California is not just a policy to protect your property; you're protecting peace of mind. It is, essentially, a line of defense that helps you rebuild and recover in the aftermath of a wildfire. However, it's also a complex product that demands understanding and mindfulness about its terms and conditions. We want to ensure that you have adequate coverage, help you understand your insurance policy's limitations, and sort through your insurance options so you can make better informed decisions. Our team can help with annual policy reviews, so before renewing an existing policy, Talk with Us!

In the News

- Congrulations to Henry VanBuskirk, CFP®, on his 1 year anniversary with BFSG. He has been a great addition to our team and we look forward to many more years to come at BFSG.
- Barron's names BFSG Institutional Services to "Top 100 Institutional Consulting Teams" (2023). Read the press release here.
- BFSG's Senior Financial Planner, Paul Horn, CFP®, has been named as a Five Star Wealth Manager in Orange Couny, CA. Read the press release here.

Disclaimer: Awards and recognitions by unaffiliated rating services, companies, and/or publications should not be construed by a client or prospective client as a guarantee that he/she will experience a certain level of results if the Firm is engaged, or continues to be engaged, to provide investment advisory services; nor should they be construed as a current or past endorsement of the Firm or its representatives by any of its clients. Rankings published by magazines and others are generally based exclusively on information prepared and/or submitted by the recognized adviser. The Firm did not pay a fee for inclusion on this list.

This annual ranking is performed by Barron's. Registered Investment Advisors, Institutional Consultants, and Wealth Management Firms complete a questionnaire about their practice. Barron's verifies the data with the advisors' firms and with regulatory databases and then they apply their quantitative and qualitative measures to generate a ranking. The formula features three major categories of calculations: (1) Assets under management (2) Revenue (3) Quality of practice. In each of those categories they do multiple sub calculations. Barron's measures the growth of advisors' practices and their client retention. They also consider a wide range of qualitative factors, including the advisors' experience, their advanced degrees and industry designations, the size, shape, and diversity of their teams, their charitable and philanthropic work and, of course, their compliance records. More about the methodology can be found here.

To receive the Five Star Wealth Manager award, a wealth manager must satisfy 10 objective eligibility and evaluation criteria that are associated with wealth managers who provide quality services to their clients for the time period July 25, 2022, through February 10, 2023. Factors taken into account include assets under management and client retention rate. Candidates also undergo a thorough regulatory and complaint review. More about the methodology can be found here.

The Score Board

	06/30/2023	YTD Change
Dow Jones Industrial Average	34,407.60	4.94%
S&P 500*	4,450.38	15.91%
NASDAQ Composite*	13,787.92	31.73%
MSCI EAFE (USD)*	2,131.72	9.66%
Bloomberg Commodity Index	101.48	-10.04%
U.S. Aggregate Bond Index	2,091.60	2.09%
10 Yr U.S. Treasury Bond Yield	3.84%	-38 bps
30 Yr Fixed Mortgage Rate	7.15%	49 bps
Prime Rate	8.25%	75 bps
Crude Oil ($ / Barrel)	$77.19	-12.03%
Gold ($ / Oz.)	$1,919.35	4.34%
U.S. $ / Euro €	$1.09	2.18%
Core Inflation (excluding food / energy)		5.30%
Inflation (including food / energy)		4.00%

**Without Dividends; **Unadjusted 12-Months ended May 2023; bps (1 Basis Point = 1/100%); UNCH (Unchanged)*
Sources for Score Board and quoted statistics: WSJ, US Dept. of Labor, Federal Reserve

Sources:

1. The S&P 500 Index is designed to be a leading indicator of U.S. equities and is commonly used as a proxy for the U.S. stock market. Price return only.
2. The Nasdaq Composite is a stock market index that includes almost all stocks listed on the Nasdaq stock market and is heavily weighted towards companies in the information technology sector. Price return quoted.
3. The Bloomberg U.S. Aggregate Bond Index is a broad-based index used as a proxy for the U.S. bond market. The index was created on July 7, 1973.
4. The top 10 companies in the S&P 500 Index are AAPL (7.5%), MSFT (7.0%), AMZN (3.1%), NVDA (2.7%), GOOGL (2.1%), GOOG (1.8%), META (1.7%), BRK.B (1.7%), TLSA (1.6%), UNH (1.3%) and XOM (1.2%). Standard & Poor's. (May 2023).
5. The S&P 500 Equal Weight Index equally weights the stocks in the S&P 500 Index. The general goal of an equal weighted index is to represent the performance of its constituents in equal proportion to one another.
6. Headline Consumer Price Index (including food and energy) for All Urban Consumers (CPI-U) unadjusted 12 months. Bureau of Labor Statistics (BLS). (May 2023). Retrieved July 5, 2023, from https://www.bls.gov/news.release/cpi.nr0.htm.
7. The slope of the yield curve as measured by 10-Year and 3-month Treasury Constant Maturities. St. Louis Fed Economic Data (FRED). (May 2023). Retrieved July 5, 2023, from https://fred.stlouisfed.org/series/T10Y3M.
8. The Leading Economic Index (LEI) provides an early indication of significant turning points in the business cycle and where the economy is heading in the near term. The Conference Board. (May 2023). Retrieved July 5, 2023, from https://www.conference-board.org/topics/us-leading-indicators.
9. M2 consists of money in circulation plus checkable deposits in banks plus savings and time deposits, certificates of deposits, and money market funds. St. Louis Fed Economic Data (FRED). (May 2023). Retrieved July 5, 2023, from https://fred.stlouisfed.org/series/M2SL.
10. "An Early Look at the Labor Market Impact Potential of Large Language Models", OpenAI, OpenResearch and University of Pennsylvania, March 2023.
11. The S&P 500 confirmed a new bull market on 6/8/2023 using the standard definition of a 20%+ rally that was preceded by a decline of 20%+ on a closing basis. The prior bear market experienced a peak to trough decline of 25.4% and lasted from 1/3/2022 to 10/12/2022.
12. The Magnificent Seven include Apple (AAPL), Alphabet (GOOGL & GOOG), Amazon.com (AMZN), Meta Platforms (META), Nvidia (NVDA), Microsoft (MSFT), and Tesla (TSLA). Apple's market cap is now the same as the entire Russell 2000 Small Cap Index.
13. Diversification doesn't guarantee investment returns or eliminate risk of loss including in a declining market.
14. The Magnificent Seven is a 1960 American Western film and it is a remake – in an Old West–style – of Akira Kurosawa's 1954 Japanese film Seven Samurai. Watch "We Know What Fear Is" movie clip here.
15. Christopher, B., & Gedye, G. (2023, May 31). State Farm won't sell New Home Insurance in California. Can the state shore up the market? CalMatters. https://calmatters.org/housing/2023/05/state-farm-california-insurance/
16. Blood, M. R. (2023, June 5). California insurance market rattled by withdrawal of major companies. AP News. https://apnews.com/article/california-wildfire-insurance-e31bef0ed7eeddcde096a5b8f2c1768f

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