Barrett Capital Partners

2nd Quarter 2023 **Newsletter #8**

	Q2	YTD
S&P 500 TOTAL RETURN	+8.7%	+16.9%
US AGGREGATE BOND TICKER: AGG	-1.27%	+1.73%

Unprecedented scenarios

Great year so far, but with a caveat

It has been a **big** year so far for the markets, but the headline numbers are a little misleading. Just seven companies account for about **75%** of the gains this year: Amazon, Google, Microsoft, Meta (Facebook), Nvidia, Apple, and Tesla[1].

That means the remaining 493[2] S&P 500 companies account for only 4% of the gain for the year. Still a great six-month return, but it puts into perspective how the market is sometimes driven by just a handful of the biggest companies.

The tagline of our January newsletter was, "**Predicting the future is…difficult**". In December 2022, Bloomberg surveyed Wall Street analysts about their expectations for 2023. The average analyst called for a *decline* in the stock market. Halfway through the year, the market is up 16.9%. Go figure.

We are all bored of the Fed, but we need to talk about it

The Federal Reserve has indicated that they will likely raise interest rates two more times before the end of year, totaling at least 0.50%. In our view, we think the current rates should be enough to slow inflation, but not in the time period that the Fed would like. The base case is another two rate hikes this year, and maybe even a third if the economy keeps firing.

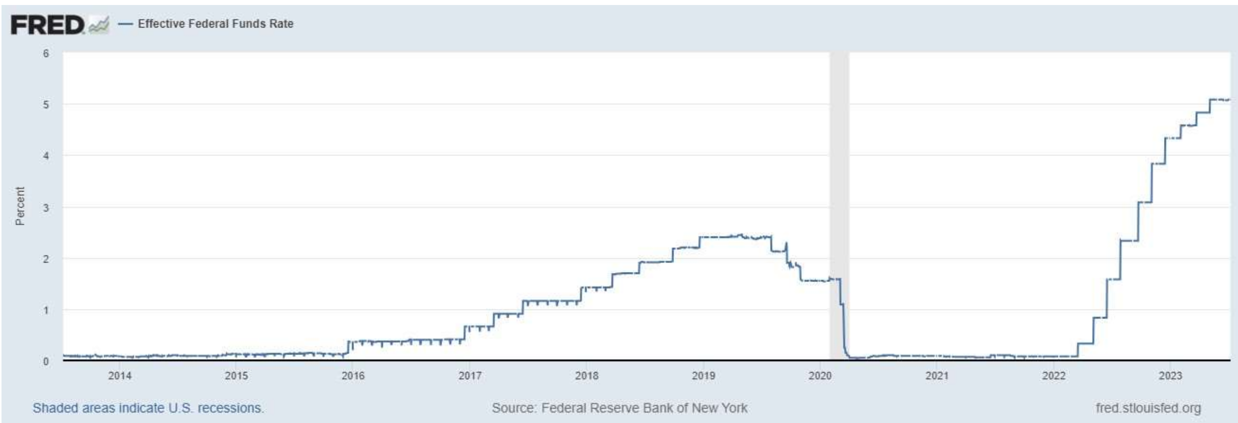
Unemployment is under 4%, employment numbers are *still rising,* consumers continue to spend, and the economy continues to run hot despite the higher rates. *Historically, this is an unprecedented scenario.*

[1] Morningstar.com
[2] The S&P 500 is actually comprised of 505 stocks because 5 of the companies have two share classes.

Barrett Capital Partners LLC
1109 Washington Street, Weymouth MA 02189
Patrick@BarrettCapitalPartners.com 339-499-6282 Joe@BarrettCapitalPartners.com

The inflation reading in May was 4.6%, which is great compared to last year, but still 2.6% *above the stated goal of 2%*. ***Pre-Covid, 4.6% inflation would have been unheard of!*** The last time it was above 4% was in 1991… the year after I was born.

Below is the Federal Reserve rate for the last 10 years.



Soft landing, or mild recession

Bear with me for a minute. I'm envisioning inflation as a campfire. The fire has gotten out of hand, and no matter how much you try to slow it down, it keeps getting bigger. The only option is to fully douse the fire and start from scratch. Does the Fed *need* to douse the economy into a recession in order to finally stop inflation?

For the past year, our base case was a soft landing. We believed that the Fed could raise rates enough to bring inflation down without the economy going into a recession. Right now, it does look like the odds of a recession have risen. Mostly because the interest rate hikes aren't slowing the economy down the way we initially thought they might. *Long story short, it's going to take more rate hikes than anyone expected.*

This looks like a "bend till it breaks" situation, where the Fed is going to raise rates until one day it chokes the economy and we start over.

One of the positives to this elongated rate cycle is that companies began preparing for an economic downturn *last year*, so if there *is* period where the economy slows, corporate America should be in a pretty good position to weather the storm with very little blood spilled.

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Banking used to be boring

How banking used to work in the good old days:

1. You deposit $10,000 in Bank A.
2. Bank A lends that money in the form of loans and government bonds.
3. The interest the bank generates is used to pay expenses and the rest is passed on to the depositors and as earnings to pay shareholders.

How banking is working *now*:

1. You deposit $10,000 into Bank A.
2. Bank A lends out that money in the form of loans and government bonds.
3. *You move your money from Bank A to Bank X because they pay more interest.*
4. Bank A sells $10,000 in loans for $9,000 to meet your withdrawal.
5. The bank *loses $1,000 and keeps doing this until they run out of money.*

This is not a sustainable model. It contributed to several bank failures in the first quarter, and regional bank stocks have been crushed. The Regional Bank Index has dropped 30% this year, and there is still ***a lot*** of risk that has not been sorted out yet.

Items of interest

- There has been a lot of talk about AI this year, and it is very quickly becoming a powerful force in our world. There is a *60 Minutes* episode where they spent some time talking to the people who are working on it, including Google CEO Sundar Pichai.

- Worthwhile read: "Let My People Go Surfing", written by the founder of Patagonia, Yvon Chouinard, about his journey building his company, while also encouraging his employees—and the world—to live a full life. Last year, he *gave away* the company to a non-profit trust who will use the profits to fight climate change and help preserve undeveloped land.

As usual, feedback is appreciated! See you soon,

Patrick and Joe

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