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Dear Fellow Investors,

The first half of 2023 illustrates the impossible challenge of trying to time the market. We've been bombarded with constant predictions about a severe recession for the last year now. As the Fed has embarked on its fastest hiking cycle in history, consensus has been that something will break, sinking us into a severe contraction. There has been plenty of proof points to back up this fear:

- significant layoffs in the tech sector
- several of the largest bank failures in history
- mortgage rates more than twice what they were a few years ago
- groceries and gas still cost a lot
- credit card debt at an all-time high

However, despite these events and some of the most pessimistic sentiment surrounding the market that we've ever seen, neither a market crash nor economic contraction materialized in the first half of 2023. Not only has the market not crashed, but the first half of 2023 has been exceptionally strong with the S&P 500 up 14% and the NASDAQ up nearly 30% (albeit from depressed levels at the end of 2022).

Markets are filled with "experts" speaking in absolutes as to what will happen in the future. There is a staggering amount of overconfidence when proclaiming to know what the future holds. Remember, as investors, we are not fortune tellers. We have not built our investment strategy on pretending to know where stock prices will be in a few months. Imagine the folly in assuming you could preempt, let alone fully understand the countless actions and reactions that people and businesses make when faced with various challenges or opportunities. Residential real estate provides a perfect example. We just received the strongest reading on new home construction since 1990. The past year was filled with countless experts predicting a real estate collapse given today's 7% mortgage rates. Instead, current homeowners locked into low-rate mortgages are not selling and the void of housing supply is being met by new construction. We can't find a single prediction of a new construction boom as we entered 2023.

If our job isn't about predicting what stock prices will do, then what is it? To answer this, we believe some first principles thinking helps set our foundation. Some "ground-floor" truths related to modern history and investing are:

- great ideas and bright, ambitious people can create tremendous value
- the world's standard of living has and continues to improve
- the democratization of knowledge has turbocharged progress
- global economic output has surged in modern history

TV hosts and their guests are entertaining and typically speak with heavyweight-like conviction. As investors, when we speak with conviction it's typically boring. However, our conviction is grounded in the truth that investing in human ingenuity has proven to be a fantastic way to build wealth. History has proven that as the value of a business grows it is eventually reflected in the stock price. Therefore, our job as investors isn't to focus on pretending to know how the market will price a stock in the short-term but rather to:

- find those businesses that currently create significant value
- find those businesses with the potential to create significant value
- follow these businesses to make sure they're maintaining their competitive edge
- keep shareholders invested in these qualified businesses for as long as possible

Far too often investors are convinced that they need to take action when it comes to managing their portfolio. That they should be "making moves" with each economic or corporate press release. Though we often find this advice entertaining, it's typically useless. In investing, making more decisions will not lead to greater success. As a matter of fact, successful investing is more about getting a handful of wonderful decisions correct than getting the majority of your decisions correct. To put it in baseball terms, it's more about slugging percentage than batting average.

We know this is not easy. It takes discipline to be a good saver, stick to a plan even when it looks like it's not working, stay invested when your portfolio has experienced a significant decline, and tune out the around-the-clock coverage of financial markets urging you to act. Coaching you through these challenges is the greatest value we bring to our relationship (Vanguard even quantified it). Just as with an investment in a business, your investment in us can take time for this value to be realized. As we've managed investments now for over a combined 60 plus years, we believe the compounding effects of our value are apparent especially to our long-time clients. Just think back on all the conversations we've had about market crashes, political events, wars, acts of terrorism, government debt, the next big thing, etc., each one prompting you to act with urgency. It has all largely turned out to be nothing more than noise that takes away focus from the ground-floor truths of investing. Life, markets, and economies are dynamic and far too complex to reduce into simplistic outcomes. As the first half of 2023 has shown, tuning out the noise, staying disciplined, and having faith in humanity to deliver a future better than the past remains the core of our investment strategy and advice.

FORECASTS

As we're halfway through 2023, let's check in on our forecasts for the year. Our forecasts from the beginning of the year are in **bold** with current updates in *italics*.

- **Economy: By the 3rd quarter of 2023 we are forecasting that the US economy will continue to show a year-over-year increase and eclipse $26.50 trillion.** *GDP was $26.49 trillion as of Q1 2023 nearly meeting our expectations a full 6 months ahead of schedule.*
- **S&P 500: a respectful expectation of 7.2% total return from stocks for 2023. For the S&P 500, this translates to a target of just over 4,000 by year-end.** *As of 6/27/2023 the S&P 500 closed at 4,378 far better than the majority of expectations. Future growth expectations are being fueled by proof that innovation such as AI is very real.*

- **Short-term rates: the Fed will be resolute in their battle and continue to raise the Federal Funds rate to at least their target of 5%. Further, as a 5% Federal Funds rate is not much above the long-term historic average, we would not be surprised to see it stay above 5% through the end of the year. If we are wrong, it may be because the rate is higher than 5%, but we are not forecasting it to be eased below 5%.** *Fed funds rates stands at 5% with a few more rate hikes expected throughout the second half of 2023.*
- **Long-term rates: the yield on the 10-year US Treasury will stay below the Fed Funds rate but the yield curve will flatten and see the rate approach 5% by year-end.** *10-year yields have climbed from 3.13% a year ago to approximately 3.76% as of today.*
- **Oil prices: may be driven more by geopolitical pressures than by actual demand. OPEC could then become swing producers yet again and most likely limit production to maintain the average $80 price for the year.** *Oil has remained well below an $80 average price for the vast majority of 2023.*
- **Inflation: we see the wage / price spiral being kept in check by technology driven productivity enhancements and job openings across many of the highest employment sectors in the economy being met by a continued wave of immigration. These factors should mean we have indeed seen "peak inflation" and possibly see the rate approach 5% sometime during 2023.** *CPI has continued its downward march and recent numbers give us confidence in believing we're beyond peak inflation. As year-over-year comparisons drop off, the headline number may start with a 2% handle. However, we believe it is far too early to declare victory over inflation. We should see much more meaningful inflation numbers as extreme year-over-year comparisons drop off and we have a more normalized baseline to measure from.*
- **Commercial real estate: a slight positive total return from REITs and would position portfolios into the sub-sectors that still have a fundamental need in the economy – manufactured housing, industrial warehouses, data centers, and health care (but not hospitals).** *This certainly appears to be what is driving commercial returns. Certain properties and geographic regions are in demand while others are struggling. Over-leveraged properties in poor performing areas are already seeing ownership changes as lenders take back control.*
- **Residential real estate: for the first time since the over-leveraged real estate bubble popping in 2007 – 2009, the S&P Case-Shiller index will decline year over year.** *Rising rates have put a cap on price appreciation. Further, used home transactions are down with many owners enjoying their historically low-cost mortgages. Demand is being met with new construction, but rates and lower volumes have put a cap on real estate prices.*
- **Disney – Iger will focus on a mega merger / acquisition.** *Not sure if the cameo at Apple's headset event will prove to be anything, but being mentioned as a strategic partner with the biggest company in the world is a good thing.*
- **Twitter is moving at Elon-speed and we believe the transformation will be so dramatic that talks of an IPO will be happening by year-end.** *More has happened at Twitter in the past 6 months than the previous 6 years. Tools for content creators continue to be rolled out and they now have a dedicated CEO. Although this call was ambitious, should sentiment surrounding markets continue to improve, we believe a Twitter IPO remains possible in 2023.*

As always, we welcome your feedback and would love to talk about these and other topics that may be important to you. We thank you for your continued confidence and the opportunity to manage your investments. We take very seriously our responsibility. ***Montecito Investment Portfolio's Mission: To provide diversified, disciplined long term investment solutions, service and guidance to help our clients achieve, and maintain, their "Financial Independence".***

Sincerely,

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