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Mid-Year Update

July 5, 2023

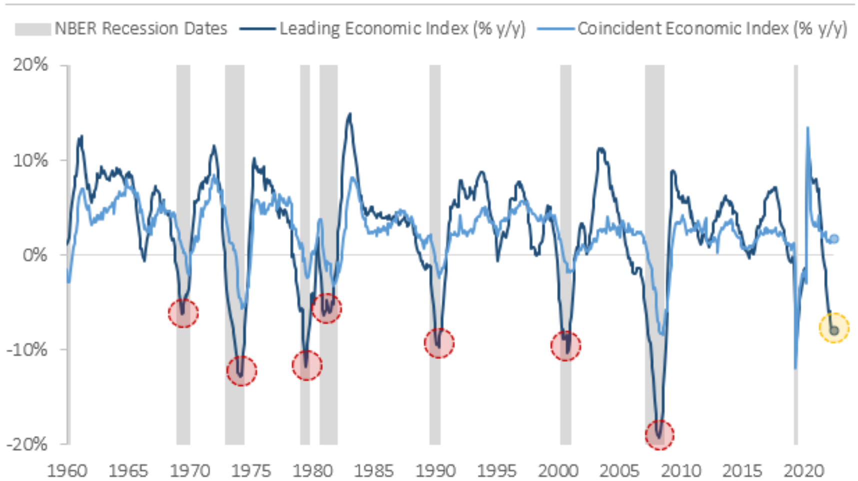
Markets Bring Relief. Recession Off the Table?

A year can make a big difference. One year ago, the market was trying to catch its breath after a chaotic start to 2022. The Federal Reserve had raised interest rates by 1.5% in a little over three months. Inflation touched 9% as Russia's invasion of Ukraine upended commodity markets and competition for employees resulted in wage inflation. The S&P 500"s first half 2022 return was its worst start to a calendar year since 1970. Fast forward 12 months, and the backdrop is markedly different. Oil prices are –33% lower, inflation is running at a 4.1% pace, and the S&P 500 is up +16.7% this year. This letter reviews the second quarter, recaps the strong start to 2023, and discusses the outlook for the second half of the year.

Recession Probability

While the backdrop has significantly changed, second quarter economic data highlighted the U.S. economy's continued resilience. In the housing market, new home sales rose more than 10% year-over-year in both April and May as tight inventories pushed homebuyers to the new construction market. Personal income, which measures an individual's total income from wages, investments, and other sources, continued to grow along with wages and interest income. While unemployment rose slightly to 3.7%, companies added ~ 300,000 jobs in both April and May. Revised data showed the economy expanded at a faster pace in Q1 than previously estimated. First Quarter U.S. GDP Growth was revised up to a 2% annualized pace from the initial 1.3% estimate, reflecting upward revisions to exports and consumer spending. The data underscores the economy's momentum, but it's backward-looking rather than forward-looking. How much longer can the U.S. sustain it's economic strength? An index of leading economic datapoints suggests the U.S. may be near a turning point.

FIGURE 1 – Leading Economic Index vs Coincident Economic Index



Source: U.S. Conference Board, National Bureau of Economic Research US (NBER). Time period is from December 1960 to May 2023. Data as of June 30, 2023.

Please see disclosures at end of document.

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Recession Probability (cont.)

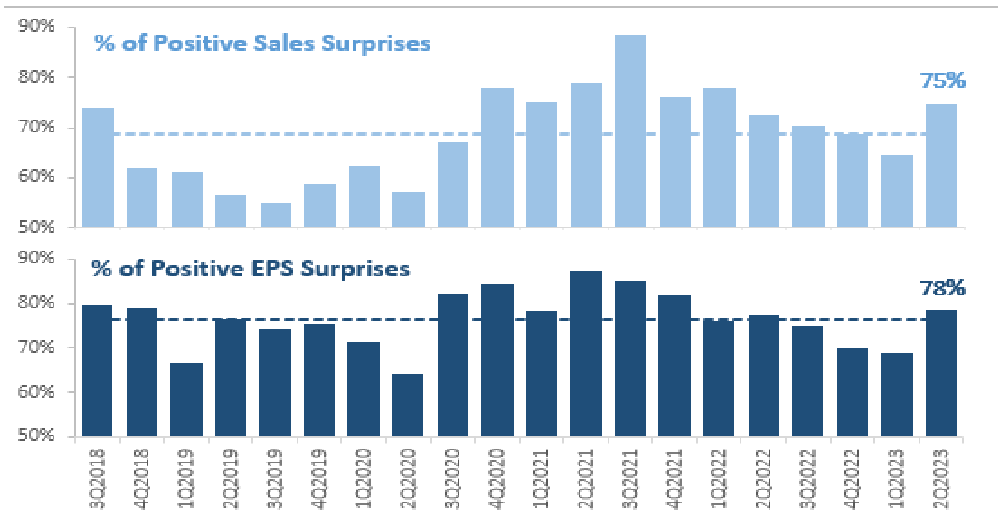
For context, the LEI is an index of ten economic datapoints whose changes tend to precede changes in the overall economy, such as unemployment claims, building permits, and manufacturing hours worked. The CEI is an index of four datapoints that tend to move with the economy and provide an indication of the current state of the economy, such as industrial production and personal income. The gray shades represent past U.S. recessions.

The chart shows the LEI declined -8% during the past 12 months, an indication the economy may be approaching a turning point as the Fed's interest rate hikes take effect. In contrast, the CEI rose +2% over the same period, an indication the economy currently remains strong. What does LEI/CEI divergence imply? Positive CEI doesn't necessarily mean the economy has avoided a recession, but CEI's rise does provide additional evidence showing the U.S economy's resilience despite higher interest rates. On a related note, the chart shows it's not uncommon for the LEI to decline even as the CEI remains positive. The red circles highlight prior instances like today, where LEI declined first and then CEI declined later. However, the gray shades show the U.S. economy has been near the start of the recession each time the LEI fell by more than -5% in 12 months.

Corporate Profits Remain Healthy

Corporate earnings tell a similar story to economic data. While the S&P 500's earnings declined –2% year-over-year in the first quarter, an increasing number of companies reported results that exceeded analyst's estimates. Figure 2 graphs the percentage of S&P 500 companies beating sales and earnings estimates during Q1 earnings season. The top chart shows 75% of companies beat their sales estimate in Q1, up from 65% the prior quarter and above the 5-year average of 69%. From an earnings perspective, 78% of the companies beat their estimate, up from 69% the prior quarter and slightly above the 5-year average of 76%. Like the economy, investors appear to be underestimating corporate earnings strength.

FIGURE 2 – Percent of S&P 500 Companies Beating Quarterly Estimates



Source: MarketDesk. Data represents the percentage of S&P 500 companies with actual results greater than the market's consensus estimate.

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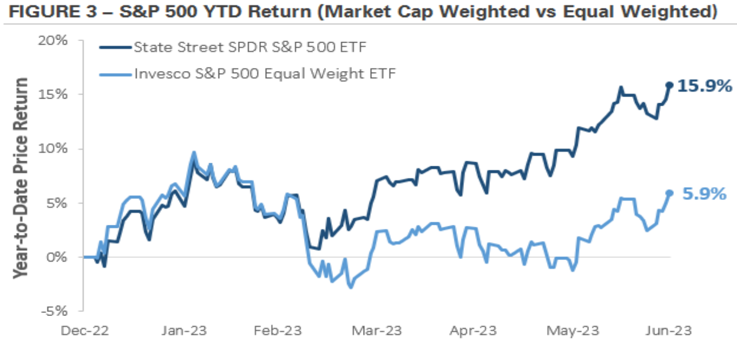
Stocks Bring Investor Relief

Equity markets are off to a strong start this year. After a steep sell-off in the first half of 2022, the S&P 500 returned +16.7% in the first half of 2023. The year-to-date gain ranks as the fifth strongest first half return since 1989. The biggest Technology stocks performed even better, with the Nasdaq 100 returning +15.3% in Q2 after its +20.7% Q1 return. The Nasdaq 100's +39.1% return is the strongest first half year return since 1989, ranking ahead of both 1998 and 1999 during the dot-com bubble. Small cap stocks also participated in the rally, returning +8.1% through the end of June. The year-to-date equity market gains have lifted portfolios after a difficult 2022.

While the S&P 500's headline return is impressive, a look underneath the surface tells a different story. Figure 3 compares the performance of the S&P 500 Index against an equal weight version of the S&P 500 Index. Why is this relevant? The S&P 500 Index is weighted by market cap, which means the biggest stocks can significantly impact the index's headline return. An equal weight index neutralizes the impact of the biggest stocks and allows investors to track how the average stock is performing. The chart shows the two versions of the S&P 500 Index traded together in January and February, an indication market cap didn't significantly impact performance.

However, the market cap and equal weight versions of the S&P 500 diverged in March when the first signs of regional bank turmoil appeared. The S&P 500 traded higher in April and May, while the Equal Weight S&P 500 traded sideways. The split indicates the biggest stocks drove a large portion of the S&P 500's gain in Q2. While the S&P 500 ended the first half of 2023 with a strong return, the average stock's return was noticeably smaller and indicates the first half rally was top-heavy. Investors will be watching to see if the first half S&P 500 rally broadens in the second half of the year.

FIGURE 3 – S&P 500 YTD Return (Market Cap Weighted vs Equal Weighted)



Source: MarketDesk. Analysis uses State Street's SPDR S&P 500 ETF as a proxy for the S&P 500 and Invesco's S&P 500 Equal Weight ETF as proxy for the S&P 500 Equal Weight Index. Past performance does not guarantee future results. Time period is from 12/31/22 to 6/30/23.

Third Quarter Outlook—Can the Good Times Continue?

The first half of 2023 was marked by continued economic resilience and a rebound in the equity market. The U.S. economy outperformed expectations despite the Fed's aggressive 2022 rate hikes, with new home sales rising, personal income growing, and continued job creation. Corporate earnings exceeded expectations, and the S&P 500 gained more than 15%. In the credit market, the riskiest corporate bonds outperformed as investors collected higher yields.

As the market enters the second half of 2023, investors are left asking whether the good times can continue. The LEI indicates the U.S. economy may be nearing a turning point, and the economic data may start to show the cumulative effect of the Fed's interest rate hikes. Plus, there is the potential for additional rate hikes in Q3. While the S&P 500 rally was impressive, it was also top-heavy, with larger stocks driving a significant portion of the gains. Corporate earnings are forecasted to decline, and bankruptcy filings could rise further if borrowers struggle to refinance and/or profit margins decline.

While the first half of 2023 was relatively calm, the economy and market face potential challenges in the second half of the year. Our team will continue monitoring conditions as they evolve and will be prepared to adapt portfolios if needed as the second half plays out.

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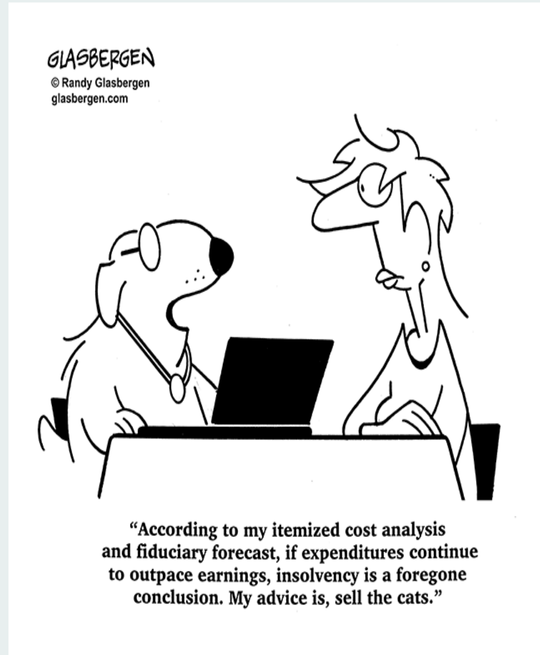

Save the Date!

Office Closure
July 19, 2023
12:00 pm—4:30 pm
LIG Staff Meeting

Office Closure
Labor Day
September 4, 2023
NYSE will also be closed on this day

LIG Annual Client Picnic
September 27, 2023
12:00pm - 3:00pm
Cape Henlopen State Park
Invitation Required

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