

# outlook

We are near the end of an interest rate cycle

## Economic Tailwinds

On Wednesday June 28<sup>th</sup> the Federal Reserve published results from its most recent annual stress test of America's largest banks. The scenario simulated in this year's exam included a rise in unemployment to 10% along with a drop in residential and commercial real estate prices of 38% or more. All 23 of the banks included in the test were deemed capable of weathering a severe recession while continuing to lend to consumers and businesses. In other words, they all passed the test. The good news was a far cry from the lamentations that dominated headlines just over three months ago when Silicon Valley Bank announced it would cease operations and liquidate assets.



Mark Frombach  
Chief Investment Officer

JPMorgan quickly followed the Federal Reserve announcement with a 5% increase in the quarterly dividend. The company pays out nearly a third of its profits, totaling about \$12 billion cash returned to shareholders annually. On a per share basis the dividend has increased over 10% on average for each of the past ten years. Another 1/3 of the company's profits this year will go towards

stock buybacks, reducing the outstanding share count by 3%. Despite the recent fear of systemic bank failures and the debt ceiling crisis on top of that, shares of JPM have risen nearly 7% in 2023 compared to the 4.9% advance in the Dow Jones Industrial Average. There was other interesting news in the Fed's report.

Shares of Charles Schwab were punished earlier this year when it became clear that depositors at Charles Schwab Bank were withdrawing cash. Always looking for a story, the media reported this as a run on the bank and compared Schwab Bank's situation with the three bank failures of 2023. While the press spent a lot of ink and airtime covering the story, what went missing was the fact that money wasn't actually leaving Charles Schwab altogether, instead it was moving from low-yielding bank deposits into Schwab's own money market funds which were paying higher rates. In fact, Schwab Bank's results in the recent Fed stress test showed the lowest loan losses among all the banks tested in the simulated crisis.

Still, the rise in rates puts stress on the bottom line: what is good for the firm's customers is not always good for the company, and Schwab will be less profitable this year due to the higher interest expense it is paying to savers and depositors. Speaking to Schwab CEO Walt Bettinger at a recent conference, he admitted the impact would bring operating margins from the 50% area down to the 40s... hardly a reason to feel bad for the company.

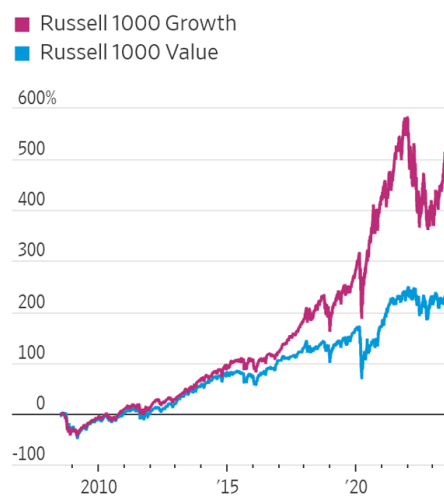
The recent rise in interest rates was historic, increasing faster to this level than any time over the past four decades. The purpose for driving rates aggressively higher was to curb inflation and stabilize wage growth and employment. Persistently higher rates may ultimately slow the economy and level off stock prices again, but I believe the higher rates are a boon for investors in both the long and short term. Although the rate curve is currently inverted, with long-term rates lower than the short-term rates, savers and investors are seeing returns on cash and quality investments of roughly 5% today, something we had not seen since before the financial crisis of 2008. Higher rates on investment grade bonds provide better risk-adjusted returns, perhaps allowing investors to achieve their longer-term goals with more predictability.

The average return of S&P 500 stocks at mid-year was 7.03% including dividends. That figure is not making headlines because the returns of the biggest components are much more dramatic to report: Apple +49%, Microsoft +42%, Amazon +55%, Google parent company Alphabet +35%. With a 40% average return for those four stocks, it means the other 499 constituents of the index\* saw an average return of just over 3% for the first six months of 2023. Somehow it feels that the market has done better than that, but different indexes give different indications. Roffman Miller has always focused less on indexes and more on setting reasonable portfolio goals and then selecting investments based on their individual characteristics and the role they can play in a diversified portfolio. From the chart on page two you can tell that pure value investors have not kept up with pure growth recently, but we continue to believe that a diversified mix of those and other characteristics will serve investors well over the longer term.

(\*there are 503 stocks in the S&P 500)

Artificial Intelligence is a concept that people have spoken about, written about, and even made films about for many years. Anyone who has used Amazon's Alexa, Google's Assistant, or Apple's Siri has interacted with AI. But over the past nine months a new reality has set in; with the introduction of ChatGPT, a generative AI software program, millions have seen that the benefits resulting from machine learning are here today and will have impact beyond simply asking our phones to set a reminder or play our favorite songs. ChatGPT, if you have not tried it, is akin to having a digital assistant capable of carrying on conversation and solving problems at a pace that seems human or beyond. Let the hype begin.

Is there an AI 'mania' going on in the markets? For sure. Is it all hype and no substance? Probably not. Some are suggesting that the incorporation of AI in everything we do will rank up there with the industrial revolution and the internet. No one can confirm that today, but practical applications abound. Moving beyond being a competitor on Jeopardy, I can remember IBM talking about Watson providing doctors with diagnoses based on an encyclopedic knowledge of healthcare experiences. Now perhaps it can help to write computer code or run computations necessary to make breakthroughs in energy or pharmaceutical research or fraud detection. Microsoft became a \$1 trillion company on the back of software-as-a-service, and then a \$2 trillion company by taking advantage of cloud computing. Will AI push Microsoft over the \$3 trillion mark? Almost certainly.



Most often it is the established companies that apply a new technology, not the pioneers, that continue to build long and sustainable businesses. In the case of the internet it was those who harnessed its power that benefitted most – would Apple be a \$3 trillion company if not for the internet? Without the internet there would have been no online shopping boom to generate the cash needed for Amazon to then invest in cloud computing, its largest profit driver. The AI revolution needs microprocessors and memory chips and programmers and large server farms. Stocks of those companies have lead the market this year. But in the coming years those who incorporate AI in their businesses will provide sustainable, long-term returns for their shareholders. Still, risks to our economy remain.

The slowing of China's economy is more worrisome to me than the recent economic sparring between our countries. A slowdown in one of the world's largest economies can have a disinflationary effect felt around the globe. Just look at the price of oil this year, down 30% off its 2022 highs despite cuts by OPEC and the state of politics in the world's oil-producing nations. Today's falling oil prices are related to China's less-than-anticipated GDP growth. Actually, if not for the rise of China over the past twenty years we would have felt more global impact from the gradual decline in Japan. Both countries have experienced a stall or decline in population, a bad sign for global economic activity. But it's not all bad news, there are some positive economic tailwinds here in the U.S.

We are near the end of the rising short-term interest rate cycle. Crippling inflation here in the U.S. has slowed, and the tight employment markets show signs of loosening. Even though some measures remain elevated, the important observation is not the current level but the trend, and we seem to be heading in the right direction in many areas. Wages remain high, and that's a good thing (right?). The U.S. pursuit of technological sovereignty, or control over its secrets, and advocacy for more resilient supply chains will both provide a boost to GDP. An increase in domestic manufacturing could cost more, but the incorporation of AI will provide efficiencies that offset those inflationary effects.

Two thoughts come to mind as I approach the end of this letter. One comes from Wall Street veteran Bob Farrell's 10 rules of investing: #7, Markets are strongest when they are broad and weakest when they narrow to a handful of blue-chip names. Unfortunately, the first half of 2023 was the latter description, driven by the handful of companies I mentioned earlier. In the past thirty days the market rally has been broadening out, a sign that investor sentiment is strengthening and the market may not be as fragile as indicated. I feel the proper investment approach is to be well-balanced with opportunities for growth but also well represented by investments with sound fundamentals and good cash returns like dividend stocks. The second thought I had was about the gap between your financial risk tolerance and your emotional risk tolerance. 2022 was a difficult year for investors, but markets are rising in 2023. 3- and 5-year trailing returns are good. If you felt uneasy with 2022's market dislocation, this may be a good time to talk with us about your current allocation and possibly taking advantage of today's higher interest rates, as Ryan suggests in his article *Lock it in For Longer*.

I am fortunate to have such wonderful partners and coworkers here at Roffman Miller. I'd like to thank them all for their many years of dedication to our clients and our values. I'm sure I'll speak to many of you over the second half of the year, but for now I'll wish everyone a safe and adventurous summer. Please give us a call if you'd like to review your allocation or financial plan, and as always I appreciate the trust and confidence you place in us every day.

A history story with local roots

## The Philadelphia Stock Exchange

In 1790 a group of Philadelphia merchant financiers came together and formed an organization called the Board of Brokers, to be known later as the Philadelphia Stock Exchange (PHLX), the first established stock exchange in the country. Their meeting place was the Merchants Coffee House, the site of today's City Tavern on the corner of Second and Walnut Streets. When it opened for trading on April 5th, 1790, business was limited to debt securities only. The Board of Brokers benefited from the city being the capital of the country at that time, as well as being in the home city of the nation's only two large commercial banks. The location helped the Board of Brokers play a supporting role in financing some of the earliest corporations and infrastructure projects including banks, insurance companies, railroads, and utilities. Philadelphia was an industrial epicenter for years to follow.

Two years after the rise of the PHLX, the New York Stock Exchange (NYSE) was founded and trading in stocks began at 82 Wall Street in the Tontine Coffee House, a few blocks from the current home of the NYSE. Ultimately, New York's financiers successfully transitioned away from railroads and into the financing of other large industrial corporations. As New York City became a major center of commerce, the NYSE began to surpass all other stock exchanges in trading volume. Over the course of the 19th century, many of the largest firms migrated to the NYSE due to its depth and liquidity. The PHLX did not enjoy the same degree of success, but it continued to compete and evolve alongside the NYSE by engaging in numerous tactics.

For instance, PHLX started to list and trade the securities of younger and smaller firms that could not meet the listing requirements of the NYSE. As a result, the volume of trading on the PHLX, as on many other regional exchanges, increased dramatically. However, PHLX took a hit as the Great Depression resulted in a loss of listings and trading volumes and the newly founded SEC prompted exchanges to impose stricter listing requirements. Nevertheless, PHLX evolved by trading securities listed on the NYSE and the AMEX, and soon the vast majority of stocks traded on the PHLX were ones listed on the NYSE. Still, PHLX continued to face an uphill battle.

PHLX encouraged membership by brokerage firms that could

not afford membership in the NYSE. It absorbed the Baltimore Stock Exchange in 1949 and the Washington, D.C. Stock Exchange in 1953.

Decades later, deregulation of brokerage commissions in 1975 almost pushed the PHLX to its breaking point. Customers began to return to the NYSE which was investing in technology that put a premium on fast and reliable executions of their trades. Once again, PHLX rallied by introducing PACE, a computerized order-handling and execution system enabling the instantaneous execution of security orders and more accurate price quotes. As a result, PHLX again experienced a significant increase in the dollar value of its equity trading. PHLX then introduced options trading and saw rapid growth between 1975 and 1985, tripling its market share.

In 2008 PHLX was acquired by Nasdaq for \$652 million. This marked a critical step in the advancement of trading platforms as PHLX was on the cutting edge of technology and investor tools.

Ultimately, the perseverance and resiliency of the PHLX is not only a story of competition among financial institutions, but parallels the story of Philadelphia itself. This historic organization with local roots significantly influenced the development and progress that led to the efficient exchanges we enjoy today.

Juliana Covino & Gerald Hewitt, 2023 Summer Interns



The Merchants Exchange Building in Philadelphia, home to the Board of Brokers following a fire in 1834 that destroyed the Coffee House

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Lock it in For Longer

## Fixed Income Corner

If you told most investors just a couple of years ago that they could get 5% on their cash or money-market, most would have said you were crazy, and I might have been one of them. It seemed like a fantasy at the time, having just come out of a period of zero-interest-rate (ZIRP) and even negative-interest-rate (NIRP) policies globally. Estimates show the amount of negative yielding global sovereign debt as recently as December 2020 had reached \$18 trillion. This represented about one quarter of all government debt at the time and what wasn't negative wasn't paying much more. That paints the picture of just how unreasonable the interest rate environment felt at that time. Shortly after that an even more unfathomable reality fell upon the globe when the pandemic ushered in another round of drastic economic policies, both monetary and fiscal. How much credit those policies should get in the subsequent economic recovery can be debated, but it would be hard to argue that the shift in consumer demand, supply chain constraints in both manufacturing and services, and easy money policies were not responsible for creating an inflationary environment not seen in over forty years. Additional policy response came, and when it did, although not necessarily the largest cumulative increase (so far) it has been the fastest series of Fed rate hikes in history with a 5% increase in 10 consecutive FOMC meetings starting in March 2022. Last month's meeting resulted in a "pause," although future rate increases were alluded to.

So where does this leave us as investors, and what can we be doing to make sure we take advantage of this higher rate environment, not

just now but for the foreseeable future? A quick look and refresher on the "yield curve" may be in order. The yield curve is simply the series of rates that correspond with the maturities of the regularly issued treasury bills, notes and bonds, from 1 month to 30 years, connected by a line on a chart. The first thing to note is that the FOMC does not directly control the entire yield curve, only what's considered the 'overnight lending rate.' This is the rate paid by banks and other financial institutions to manage their immediate cash and cash reserve requirements. It is somewhat intuitive that the rates with a shorter time to maturity are going to correspond with the overnight policy rate.

However, as we gradually move further out to longer and longer maturities, there is more uncertainty about the economic scenario that will exist at that time, and investors are typically paid more for that uncertainty in what would be considered a "normal" yield curve. Currently, we have the opposite scenario, an inverted yield curve, where short rates are higher than the long ones (see table at left) - this reflects the market's assumption that the Fed's policy movements will do as intended and slow down growth in the economy, reducing inflation, leading to lower short and long-term rates. Getting to the point, earning 5% in a money-market or short-term CD is a great, but let's remember where we've just been and make sure we enjoy these rates for longer. A 7-year bond compounded at 5% adds up to a cumulative return of 40.7%. A 1-year CD at 5% is just that, plus 6 years of wondering what's next. Let's make sure we are planning for your future instead of playing to the market...or letting it play us.

U.S. Treasurys	
	Yield (%)
30-Year Bond	3.923
10-Year Note	3.800
7-Year Note	3.904
5-Year Note	4.001
3-Year Note	4.325
2-Year Note	4.734
1-Year Bill	5.320
6-Month Bill	5.481
3-Month Bill	5.405



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