

An update of performance, trends, research, and topics for the long-term investor

Relevant rates of return a/o: **12/31/2022 vs. 6/30/2023**

**Russell 1000® Growth Index:** -29.14% +29.00%  
Stocks within this index include:  
Amazon, Facebook, Google (Alphabet)  
Home Depot, Visa

**Russell 1000® Value Index:** -7.54% +5.10%  
Stocks within this index include:  
Berkshire Hathaway B, Exxon  
Johnson & Johnson, JP Morgan

**Bloomberg U.S. Agg Bond Index:** -13.01% 1.10%

**S&P 500 Index:** -18.11% +16.90%

**Russell 2000® Value Index:** -14.48% +2.50%

**MSCI EAFE® Index:** -14.45% +12.10%

Long Term Historic Returns, compounded annually  
(1970-2021)<sup>1</sup>

- Small Value +13.90%
- Large Value +10.50%
- Small Growth +9.70%
- Large Growth +9.70%

Growth and value stocks in this example are represented by the Ibbotson Associates Growth and Value Indexes for 1970–1997 and the Morningstar Style Indexes thereafter. Ibbotson Associates Growth and Value Indexes calculated based on data from CRSP US Stock Database and CRSP US Indices Database, Center for Research in Security Prices (CRSP®). The data assumes reinvestment of income and does not account for transaction costs or taxes.

*We are thrilled to announce that Jonathan Gorton has been accepted into the Wells Fargo Advisors Financial Advisor Training program which will begin on July 31<sup>st</sup>. With Jonathan's transition into his new role, we'd like to introduce Cori Valdez. Cori is joining our team as a Client Associate and will be taking on Jonathan's previous responsibilities. Cori will be working in tandem with Emma to ensure day-to-day operations run smoothly and that your needs are timely met.*

— Brian Gallagher



**“You’re not going to get very far in life on the basis of what you already know. You’re going to advance in life by what you’re going to learn.” —Charlie Munger<sup>2</sup>**

**Trying not to break something**

We’re halfway through the year! Where has the time gone? The first six months of 2023 have been eventful; the Fed finally pressed pause on rate hikes after five increases this year. A recession is still widely expected by the end of the year. We had three bank failures. The U.S. government avoided a debt default. Russia and Ukraine are still at war and the U.S. and China are still at odds over key issues. Did we miss anything?

In this midyear letter, we’re focusing on the following topics:

1. *Investing Ahead: Top Trends to watch for the remainder of 2023*
2. *Cautious Currents: Top concerns and Challenges in the Financial Markets*
3. *Unforeseen Twist: The top surprises in the first half of 2023*
4. *Debunking the Debt Ceiling Drama: Why the US Debt ceiling wasn't a Major concern.*
5. *AI: A beginner's guide to how AI operates*

**Investing Ahead: Top Trends to watch for the remainder of 2023**

These are the trends that we are following in the markets and economy. This will give you a small glimpse into our thinking that goes into making portfolio decisions. The following is a list of the top 6 trends we are watching.

1. **Bonds** –After years of historical low rates it may be time to discuss adding them back into more conservative portfolios with rates back in the 4-5% range.
2. **Inflation** – Seems to be coming down.... 2% target, last print 3% We are hoping with this new print the fed decides to pause again as another raise may not be necessary.
3. **Energy** – We plan to continue to overweight energy as we see supply/demand in its' favor, continuing to look for alternative energy opportunities

**Investment and Insurance Products are:**

- **Not Insured by the FDIC or Any Federal Government Agency**
- **Not a Deposit or Other Obligation of, or Guaranteed by, the Bank or Any Bank Affiliate**
- **Subject to Investment Risks, Including Possible Loss of the Principal Amount Invested**

4. **International investments** – Still deciding if we want to increase our exposure here, but not in a hurry. Still looking towards Asia as Europe has too many problems to work out.
5. **Deglobalization** – Speed and breadth of deglobalization and what opportunities it brings.
  - o Private non-residential construction spending, +20%+ ytd and +30% in April. Even with a slowdown in real estate and the economy, there is a lot of building going on here, mostly comes from industrial properties: New factories production is brought back to the U.S., as well as logistic centers to distribute that production. Even with the severe downturn in office properties, there are still opportunities elsewhere.<sup>3</sup>
6. **Artificial Intelligences** – Will AI revolutionize the way we live? How will businesses use AI as a tool moving forward. Which companies will be successful in integrating it into their business.

### Cautious Currents: Top Concerns and Challenges in the Financial Markets

It's essential to recognize that financial markets are influenced by a wide range of factors. These factors range from the health of the economy, political events, wars, terrorist attacks, global health issues and investor sentiment. We need to remain informed on challenges that may impacted the market and how to potentially position portfolios. Below are our biggest concerns for the markets moving forward.

**Recession** – This has been one of the most anticipated recessions of all-time. It was predicted to start as early as the 3rd quarter of 2022 but keeps getting pushed back by economists.

Will there be a recession? How deep will it be? Will it result in higher unemployment?

Our focus is always long-term investing, buying good quality companies at a fair price. Recession predictions don't tend to affect this philosophy as we always look at how a company is poised to weather poor economic conditions.

**Russia** – Doing something desperate

- o Recent March to Moscow may have shown Putin's weakness

**China** – Recent global reactions have partially allayed these concerns since our last newsletter. NATO has responded to world events with increased unity and Strength. Finland has joined and Sweden, a long-time ally of NATO, submitted its application in May of 2022. This response sends a strong message to non-NATO members.

**Middle East** – A region that has always been unstable, as the US backs away from trying to control and cool the region what issues will pop up effecting trade and markets.

### Unforeseen Twist: The top surprises in the first half of 2023

As we mentioned earlier a lot has happened in the market over the last 6 months. Here are the surprises in the first half of 2023.

1. **Regional Banks** – The regional banking crisis and failure of First Republic, Silicon Valley bank and Credit Suisse. A Major factor was a quick rise in interest rates, combined with a mismatch in maturities of their lending and investments. As news broke about the potential lack of liquidity, individuals grew nervous about their deposit's safety. They begin to withdraw funds from accounts to move them to larger institutions or into higher paying money market funds. The banks were forced to sell their portfolios at massive losses which eventually led to their collapse.
2. **Tech Sector** – The quick rebound in the oversold tech stocks year-to-date and the valuations of some of the companies leading the AI field.
  - o This industry group had sold off heavily in 2022, a rebound became probable, but this has been a rebound-on steroids.
3. **S&P 500 Divergence** – A quick glance at the S&P 500 index and one would assume the market has performed incredibly this year. However, if you take a deeper look into what has driven the S&P to this point you will find it has only been seven stocks driving market returns. It certainly gives an impression that the economy's health is strong, but the S&P 500 is now the most concentrated it's been since the 1970's.<sup>4</sup>

There was a real divergence in returns through May. As we review the rest of the 493 stocks in the S&P500 the majority are down or flat on the year. (Data as of 6/30/2023)

- a. S&P equal weight: +5.97%
- b. Vanguard Dividend Appreciation: +8.01%
- c. Vanguard S&P 500: +16.84%

### **Debunking the Debt Ceiling Drama: Why the US Debt ceiling wasn't a major concern.**

*"Those who have knowledge, don't predict. Those who predict, don't have knowledge." - Lao Tzu*

We are always cautious to be too bold in our predictions. We have mentioned several times no one knows the future. We are always looking out for "what will blindside us next". This year we had many clients ask about the debt ceiling and if there was anything they should be doing differently in their portfolios. While we did not want to predict what would happen, instead we presented the following:

The debt ceiling has been raised 78 times since 1917 and markets continued to march ahead. You may remember 2011, as the deadline for increasing the debt limit approached, both the U.S. domestic and international financial markets became chaotic. The S&P 500 fell by 17% and bond rates spiked. Two days prior to the US running out of money, the debt ceiling was raised, and markets rebounded, continuing its' long-term upward trend.

In addition to that debt ceiling crisis, there have been 22 federal government shutdowns. These were due to the federal budget not being passed. We are all still here...

Why we don't try to predict the future and trade on that prediction: As of, June 30 The S&P 500 is up 16.9%. Had the debt ceiling issue caused you to move your portfolio to cash, you would have missed the market run up and likely have been stuck with a hefty tax bill.

### **AI: A beginner's guide to how AI operates**

People can't stop talking about Artificial Intelligence (AI) and its potential impact on our lives. Some believe it will revolutionize our world, while others think it may destroy it (Shades of HAL 2000 in 2001 a space odyssey and The Matrix) and some feel it's over hyped and will be a "nothing burger". Regardless it's already had a large impact on the markets this year as we mentioned earlier there's been seven stocks this year driving the S&P500 returns and most of those companies are, developing AI technology.

Given AI's potential, this may go down as one of the most significant moments in history for new technology. Below we briefly discuss how AI works, some of its important applications along with the challenges and limitations it faces. To explain what AI is, we decided to ask Chat GPT:

**"Input:** *Can you explain in three paragraphs or less how artificial intelligence works. Please explain it in a way that someone who understands technology but hasn't researched AI before."*

**"ChatGPT:** *Certainly! Artificial Intelligence (AI) is a field of computer science that aims to create smart machines that can perform tasks that typically require human intelligence. AI works by using computer programs and algorithms to process and analyze vast amounts of data to recognize patterns and learn from them. It's like teaching a computer how to think and make decisions based on the information it receives.*

*There are two primary types of AI: Narrow AI and General AI. Narrow AI is designed to perform specific tasks, like playing chess or recognizing faces in photos. It focuses on solving one problem really well but doesn't have a broader understanding of the world. On the other hand, General AI aims to be as versatile as human intelligence, being capable of learning and understanding multiple tasks and adapting to different situations.*

*AI algorithms can use various techniques, such as machine learning, deep learning, and natural language processing. Machine learning allows AI systems to improve their performance over time by learning from data without explicit programming. Deep learning involves using artificial neural networks, which are inspired by the human brain's structure, to process complex data and make predictions. Natural language processing enables AI to understand and interact with human language, like in virtual assistants or chatbots.*

*As technology advances, AI is becoming more prevalent in our daily lives, powering virtual assistants, recommendation systems, autonomous vehicles, and much more. While AI holds immense potential for improving various aspects of our world, it also raises important ethical considerations regarding privacy, bias, and the impact on jobs and society."*

AI is great at analyzing data, recognizing patterns, and coming to a general conclusion based on inductive reasoning. Humans are capable of deductive reasoning. Our ability to use deductive reasoning and draw a conclusion allows us to think deeper than AI models and allows us to have a better understanding of the world. They are currently working on deep learning for AI to help create something that operates more like our deductive reasoning.

AI's lack of deductive reasoning means that machines struggle to work backwards and find the correct answer. For example, an AI using Inductive reasoning could come to this conclusion "Penguins are birds. Penguins can't fly. Therefore, all birds can't fly." Because of this flaw, AI models can generate fake information that might sound right but is ultimately wrong. This was recently demonstrated in a court case where a lawyer used a popular AI chatbot to build his case and cited at least six cases to the judge that were fake to help with his defense. As a result, he unknowingly presented the court with phony legal documents and now is facing possible punishment.

We feel that AI models are likely far from being able to replace human workers. However, AI has already proven useful and beneficial. Companies will continue to look for ways to incorporate AI into their business to help them become more efficient and profitable moving forward.

It is hard to think it won't change our world in both our personal and professional lives. There is clearly upside potential for companies that can develop AI systems and for companies that can integrate AI into their business. As with any new technology there will be benefits and negative impacts, winners, and losers. Although it is too early to tell who the winners will be, many of our portfolios are already invested in companies that have become leaders in the development of AI. We expect these companies to survive and thrive with or without success in their AI endeavors. AI requires a great deal of electricity and computing power and is therefore very capital intensive, it is doubtful that two people in a garage will drive this revolution. It may be one of these large companies in our current holdings that booms in the AI industry, but we will wait and see as the AI market develops to dedicate any additional capital.

# THE GORTON

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### Description of Indexes

An index is unmanaged and not available for direct investment.

S&P 500 Index - a market capitalization-weighted index, composed of 500 widely held common stocks, including reinvestment of dividends, that is generally considered representative of the US stock market.

Russell 1000 Growth Index - offers investors access to the large-cap growth segment of the US equity universe. The index is constructed to provide a comprehensive and unbiased barometer of the large-cap growth market. Based on ongoing empirical research of investment manager behavior, the methodology used to determine growth probability approximates the aggregate large-cap growth managers' opportunity set.

Russell 1000 Value Index - measures the performance of those Russell 1000 companies with lower price-to-book ratios and lower forecasted growth values. These stocks are selected from the 1000 largest companies in the Russell 3000 Index.

MSCI EAFE Index - the MSCI EAFE Index is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the US and Canada.

Russell 2000 Value Index - measures the performance of those Russell 2000 companies with lower price-to-book ratios and lower forecasted growth values.

Barclays U.S. Aggregate Bond Index - an index comprised of approximately 6000 publicly traded bonds, including U.S. Government, mortgage-backed, corporate, and yankee bonds with an approximate average maturity of 10 years.

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