MIDDLETON & COMPANY, INC.

Investment Update

July, 2023

2023 Second Quarter Update

Review: The S&P continued to rally in the quarter and has now returned 16.9% in 2023, significantly outperforming most asset classes. International equities lagged in the quarter due to weaker than expected economic growth, particularly in China. Fixed income indices were slightly negative due to higher yields, which stemmed from better than expected economic growth in the U.S. and a Federal Reserve outlook that implies higher rates for longer than the market had been expecting.

	2Q23	1Q23	2022
S&P 500	8.7%	7.5%	-18.1%
MSCI EAFE[1,2]	3.2%	8.6%	-14.0%
MSCI Emerging Markets[2]	1.0%	4.0%	-19.7%
Bloomberg U.S. Aggregate Bond	-0.8%	3.0%	-13.0%
Bloomberg Municipal Bond	-0.1%	2.8%	-8.5%

[1]Europe, Australasia, Far East
[2]MSCI returns are in U.S. Dollars

A Strong but Narrow Rally. Can It Continue?

After a very challenging 2022, the strong performance of the S&P 500 is a welcome surprise. Part of the outperformance is being driven by a US economy that has been more resilient than expected. However, another part of the outperformance comes from the outsized returns from a handful of mega cap stocks. Roughly 75% of the year-to-date (YTD) S&P 500 return has been driven by seven stocks. This is best illustrated by the chart on the next page that shows the YTD total return of the S&P 500 index (which is market cap weighted) versus the total return of the equal-weight S&P 500, which is a more modest 6.9%. Can the rally continue to be driven by a handful of companies, or will a broader rally, supported by fundamentals, materialize?

Digging into the drivers of the returns of the seven mega cap stocks, one finds that the majority of their YTD returns are coming from expanding valuation multiples (i.e., Price to Earnings ratios) rather than earnings growth. Part of the multiple expansion came from investors viewing these names as relative safe havens in the wake of the banking turmoil in March, and more recently, artificial intelligence has provided another boost. For the other 493 stocks in the S&P 500, however, the median YTD change in valuation multiples is negligible. Some level of multiple expansion could be justified by the higher growth offered by the seven mega cap stocks versus the other 493 stocks. However, they have seen their P/E

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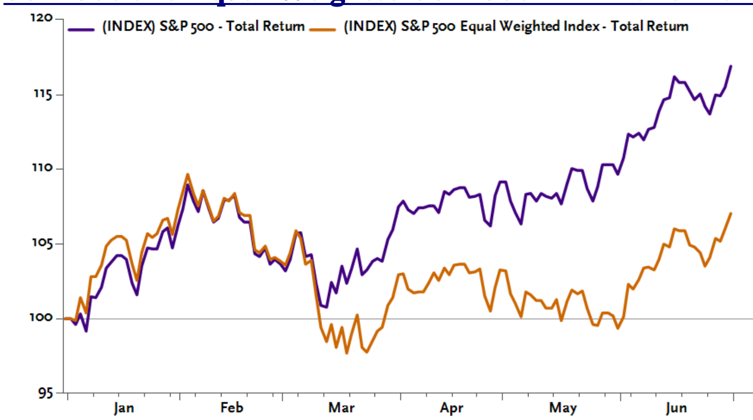
multiples expand by a median of 42% versus 1% for the rest of the S&P 500, which seems unbalanced relative to their earnings growth—median of 9.6% estimated growth in 2023 for the seven mega caps versus 4.3% for the rest of the S&P 500. At least one more rate hike seems to be quite likely, and the first rate cut is unlikely to come until at least 2024. All else being equal, this higher for longer rate environment could be negative for equity valuations and lead to more challenging equity returns in the second half of the year, particularly for companies whose performance has been more dependent on multiple expansion than earnings growth.

S&P 500 and Equal-Weighted S&P 500 YTD Performance



Source: FactSet

Outlook: US economic growth has continued to hold up better than expected, with Q1 GDP growth coming in at 2.0%. Growth for the full year is expected to be 1.3%, higher than the 0.8% expected as of our last quarterly update. Though there are pockets of weakness—e.g. industrial activity—a strong job market has continued to support US consumers. As we noted in the last update, this is obviously positive, but it also gives the Federal Reserve the justification for further rate hikes as it tries to tame inflation. Certain inflation metrics, particularly core services, continue to be elevated (+6.6% year-over-year in May) and are influencing the Fed's rate decisions. While it is still possible that the economy will see a soft landing, higher rates for longer make that more difficult to achieve. Also, the resumption of student loan payments later this year will be an incremental drag on consumer spending.

International growth has disappointed, particularly in China, where an expected rebound from their long-awaited COVID reopening has been weaker than expected. That fact, coupled with a US dollar that has outperformed expectations this year, has led to underperformance of international equities in recent months.

Strategy: The equity rally makes fixed income relatively attractive. Real yields (bond yields minus inflation) are positive across the full range of maturities, providing investors with reasonable alternatives to equities. If the Federal Reserve indeed does not cut rates until at least 2024, the ability to earn >5% in US Treasurys will likely pressure equity valuations, since the current S&P 500 earnings yield is 5.2%. Within equities, we continue to prefer higher quality growth companies at reasonable valuations due to the potential valuation headwind and the possibility of slower than expected economic and earnings growth.