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ASSET MANAGEMENT

2023 – 2nd Quarter Review & Outlook

Economic and Investment Review

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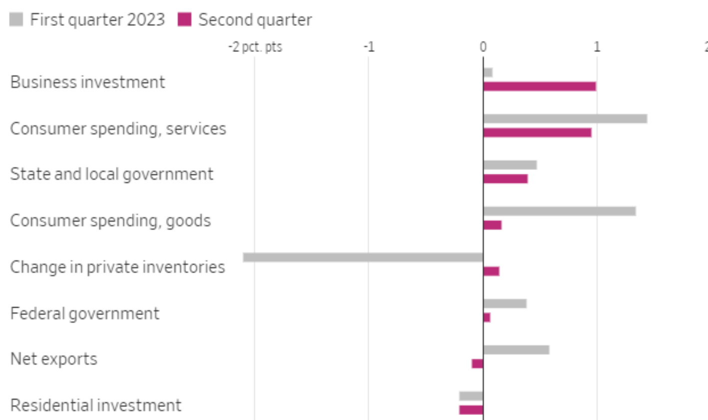
Economic Growth: The U.S. economy continues to surprise to the upside and has so far avoided falling into a recession that many economists and strategists have forecasted would be the result of the Fed increasing interest rates. Jan Hatzius, Chief Economist for Goldman Sachs, cut the probability that a U.S. recession will start in the next 12 months from 25% to 20%. This compares with the median forecast of 54%. It seemed highly unlikely earlier in the year, but the prospect of a soft landing is being given more of a chance.

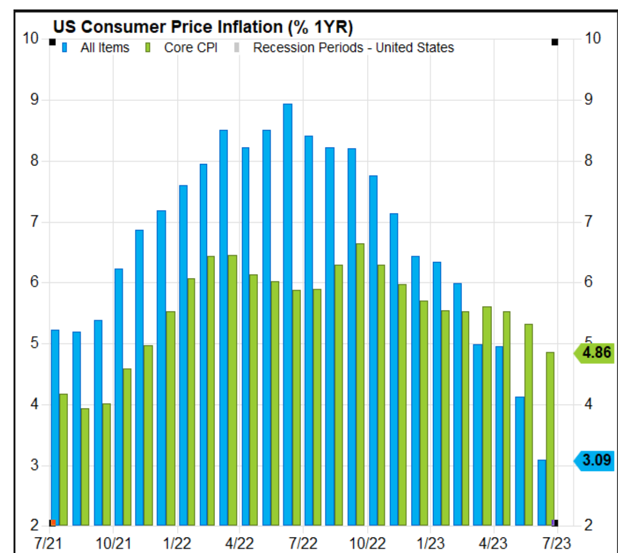
Gross domestic product grew at an annual rate of 2.4% in the second quarter, above the consensus forecast of 2.0% and slightly up from 2.0% in the first quarter. However, the better-than-expected number may be a bit misleading. Consumers account for more than two thirds of GDP and consumer spending grew by just 1.6% in the quarter, down from 4.2% in the first quarter. Business investment punched well above its weight with an annual growth rate of 7.7%. Business investment accounts for only 13% of GDP but contributed 1.0% of the 2.4% total. The Wall Street Journal states that “a surge in federal spending on chip-manufacturing plants and electric-vehicle factories is offsetting some other cutbacks.”

Higher interest rates have caused consumers to reduce spending on big-ticket items after a strong start to the year. However, consumers remain supported by a strong labor market and wage growth. Overall, workers saw their paychecks increase faster than the rate of inflation for the first time in two years in June. Consumers may have reduced their spending in some areas but they continue to spend on services such as travel.

Inflation continues to trend down in the direction of the Fed’s 2.0% target. The consumer price index declined from 4.0% in May to 3.0% in June.



Note: Seasonally and inflation adjusted at an annual rate
Source: Commerce Department



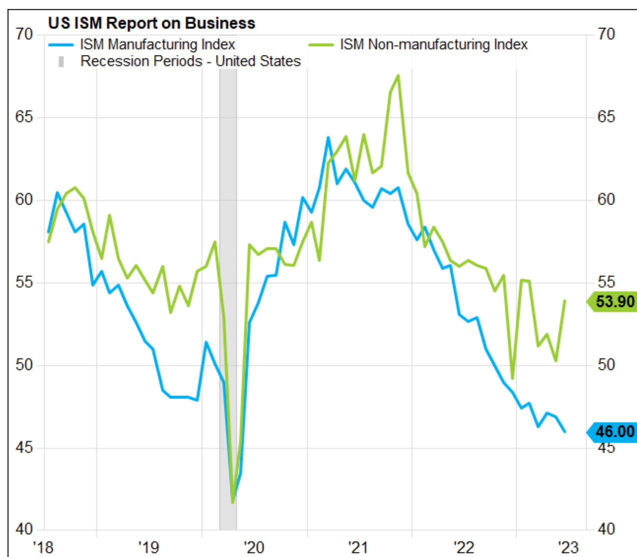
Source: FactSet

However, core CPI remained somewhat higher at 4.8% in June, down from 5.3% in May. The Fed's preferred inflation measure, annualized core PCE, dropped by 0.5% to 4.1% y/y. The strong labor market and wage growth may act to slow the downward path of inflation towards the inflation target rate and keep the Fed in tightening mode. Also, deglobalization could slow the path if companies move manufacturing to higher-cost locations.

The Fed increased the Fed Funds target rate by 0.25% to a 22-year high of 5.25%-5.50% during their recent July meeting. Chairman Powell stated that the central bank would decide on continued rate increases based on additional economic and inflation data made available in the months to come.

Even with Fed rate increases and the possibility for a recession, consumer confidence reached its highest level since January 2022 in June based on declining inflation and a strong job market.

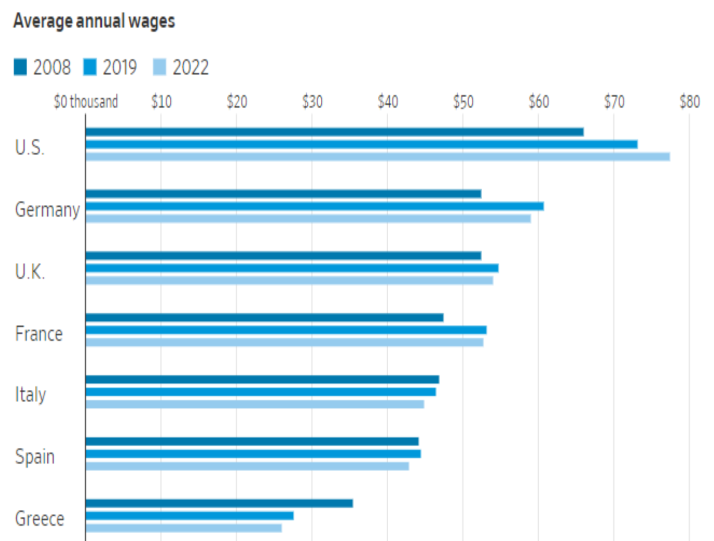
The ISM report continues to indicate the U.S. manufacturing is contracting. The most recent down cycle began in Q4 2022. However, there may be some sign of bottoming as some manufacturing sectors including industrial rail volumes, container exports, and steel production have improved recently.



Source: FactSet

Global manufacturing is also contracting in nearly every developed market. Kristalina Georgieva, the managing director of the International Monetary Fund stated that "while prospects are mixed in the near term, the medium-term outlook for the global economy remains bleak." However, there are still a few bright spots in emerging markets, including India and Indonesia. The U.S. and its allies are seeking alternatives from China to reduce dependance for manufacturing and the supply chain. Alternatives may include reshoring some manufacturing to the U.S. as well as increasing activity in other emerging Asian markets including India.

While wage growth has been strong in the U.S., that has not been the case in Europe. The largest economies in Europe have all experienced wage declines from 2019 to 2022. Combining wage



declines with punishing inflation has caused consumers to feel poorer and see their purchasing power melt. The decline in consumer demand tipped Europe into a recession at the start of the year. High energy and labor costs have strained a European economy that is heavily dependent on exports. Exports account for about 50% of the eurozone GDP compared with only about 10% for the U.S.

The unemployment rate remains at a surprisingly low 3.6%. However, private market employment and related job openings are beginning to slow.

Equity Markets

Equity markets continued to move higher in Q2. The S&P 500 moved up 8.74% in the quarter and was up 16.89% YTD, nearly erasing the entire loss in 2022. The 1 year return of 19.59% more than

2023 Q2 Returns				
EQUITY	**Q2 2023**	**YTD 6.30.23**	**1 Year 6.30.23**	**3 Years Annualized**
S&P 500	8.74	16.89	19.59	14.60
S&P 500 Value	6.64	12.15	19.99	16.79
S&P 500 Growth	10.59	21.25	18.25	11.80
Dow Jones Ind Avg	3.97	4.94	14.23	12.30
NASDAQ Composite	13.05	32.32	26.36	12.02
S&P Mid Cap 400	4.85	8.84	17.61	15.44
S&P Small Cap 600	3.38	6.03	9.75	15.19
MSCI EAFE	2.95	11.67	18.77	8.93
MSCI Emerging Mkts	0.90	4.89	1.75	2.32

Source: FactSet

recovers last year's loss of -18.11%. Growth continued to lead value and the technology heavy NASDAQ Composite continued to move even higher.

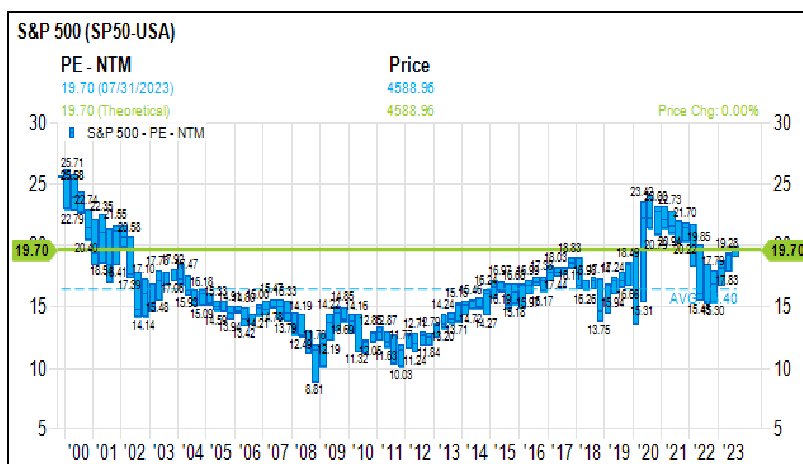
The strong move higher in the equity markets was far from expected at the beginning of the year. The exceptionally fast recovery has many investors questioning whether or not it can hold up. Two primary areas of concern are valuation and concentration.

After removing the aberration of COVID, the S&P 500 is trading at the highest valuation level based on next-twelve-months PE ratios since the internet bubble in the early 2000's. Investors appear to be looking past current Fed tightening and flat earnings growth, focusing instead on expected rate cuts and forecasted strong earning growth in 2024 and 2025.

A narrow group of stocks largely driven by the perceived prospects for artificial intelligence has had an outsized impact on the broader market. JPMorgan reports that the top ten stocks, which are predominantly megacap tech, are 45% more expensive than their long-term average, compared to the rest of the S&P 500, which is 13% more expensiveve compared to its long-term average. The

Source: JPMorgan

good news is that the market has recently begun to broaden out to small cap stocks.



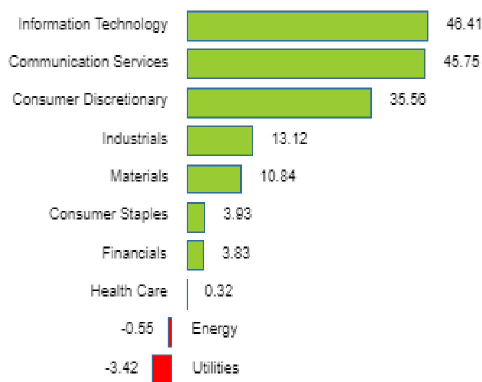
Source: FactSet

Small cap stocks lagged their large cap counterparts in the quarter and YTD but have picked up steam and are now up over 13% for the past three months through July.

Developed International stocks (MSCI EAFE) lagged the S&P 500 in Q2 and YTD but have nearly matched the domestic benchmark over 1 year. The S&P 500 is still well ahead in the race for 3 years annualized. Emerging market stocks (MSCI EM) have lagged considerably. The related benchmark is up just 1.75% for 1 year and

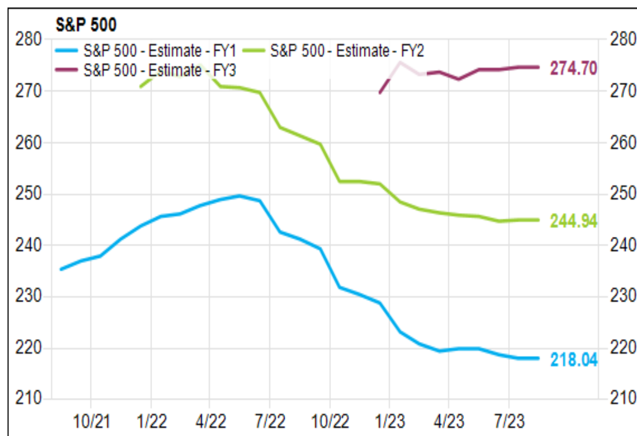
2.32% annualized for 3 years through June. The biggest drag on the index is China. The index ex-China is up 12.0% for 1 year and 32.03% annualized for 3 years.

The top three performing economic sectors in the S&P 500 in Q1 are the same and are in the same order YTD through July. Those three sectors continued to significantly outpace the rest of the large-cap market. Information Technology, Communication Services and Consumer Discretionary sectors are leaving everything else in the dust. However, Industrials and Materials have shown some life recently.



Source: FactSet

Earnings for the S&P 500 are only expected to grow by 1% in 2023 but are forecasted to grow by more than 12% in 2024 and 2025. Earnings estimate revisions have begun to level out after a year of decline.



Source: FactSet

Goldman Sachs forecasts just 1.0% earnings growth for 2023 and 5.5% for 2024. JPMorgan and Raymond James continue to expect earnings growth to be flat-to-down for 2023.

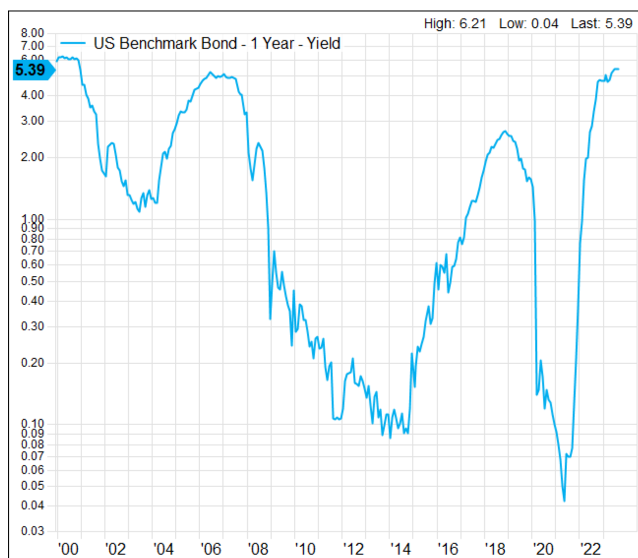
The S&P 500 is currently at 4,575, trading at 21.0x the 2023 consensus earnings estimate of 218.04, 19.7x for the next 12 months and 18.7x the 2024 estimate of 244.94. Goldman Sachs maintains a forecast of 4,300 for 3 months, 4,500 for 6 months and 4,700 for 12 months. Raymond James has a year-end target of 4,400 and a 12-month target of at least 4,600. Justification for PE multiple expansion is primarily based on the belief that the Fed will be successful in its battle against inflation, that the Fed will come to the end of its tightening cycle, that interest rates will begin to decline in 2024 and that strong earnings growth will return. However, the market may be building in too many rate cuts too quickly.

There does not appear to be much upside in the U.S. equity market for the remainder of the year and into the next as we forecast the S&P 500 to end the year near 4,550 and near 4,600 for 12 months. The forecast is based on 1.0% earnings growth in 2023, compared with the consensus estimate of 1.0% and a rebound of 11%+ earnings growth in 2024 and 2025 compared with consensus estimates of 12%+ for each year. At the same time the P/E multiple is expected to regress slowly towards the long-term mean.

We have reached the mid-point of the Q2 earnings season. The number of S&P 500 companies reporting positive earnings surprises is above the 5 and 10-year averages. However, in aggregate, companies are beating consensus estimates by less than 5 and 10-year averages. Also, the index is reporting its largest year-over-year decline in earnings since Q2 2020. The percentage of companies issuing negative guidance is near 5 and 10-year averages.

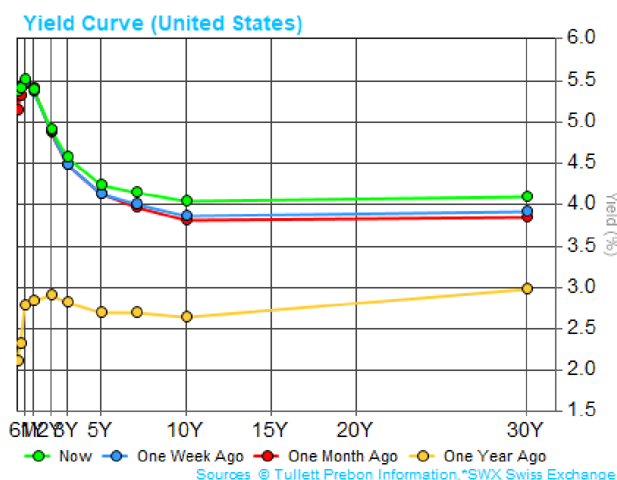
Fixed Income Markets

The 1-year U.S. Treasury yield is now at its highest level since 2000. The yield will likely move slightly



Source: FactSet

higher if the Fed follows through with an additional rate increase later in the year. The inverted yield curve indicates that investors expect inflation and yields to decline over time.



The 10-year U.S. Treasury yield is near the high end of the trading range of the past year but well below the shorter-term rates. Based on the shape of the curve it is tempting to just pile into the short end of the maturity range with taxable bond investments. While it may make sense to take advantage of the higher rates for short maturities it is still important not to forget the longer-term strategy for bond holdings.

The Bloomberg US Aggregate Bond index (U.S. taxable bonds) declined -0.84% in Q2 but rose 2.09% YTD through the end of June. Returns remain negative for 1 and 3 years due to the increase in interest rates over the past year.

2023 Q2 Returns				
FIXED INCOME	Q2 2023	YTD 6.30.23	1 Year 6.30.23	3 Years Annualized
Bloomberg US Agg Bond	-0.84	2.09	-0.94	-3.96
ICE AMT-Free Nat'l Muni	-0.11	2.53	3.09	-0.39
Markit iBoxx USD Liquid High Yield Index	1.60	5.46	9.08	2.47

Source: FactSet

Municipal bonds declined less than taxable bonds in Q2 and had higher total returns YTD and for 1 year while being only slightly negative for 3 years annualized. The Municipal bond yield curve is much flatter than the taxable bond curve and is upward sloping from the intermediate to longer term maturities. The taxable equivalent yield comparison

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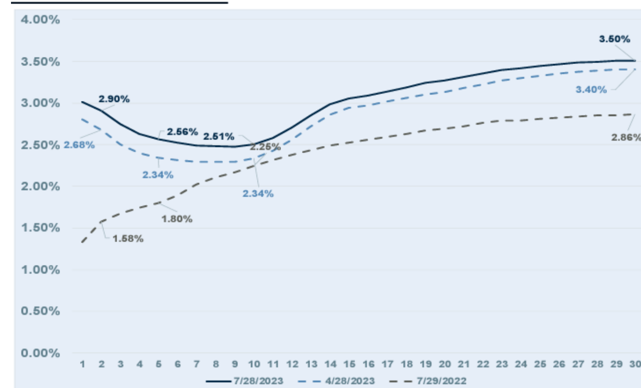

Source: Bloomberg, Raymond James

with taxable bonds becomes more attractive in the upward sloping part of municipal bond maturities.

For investors in a higher tax bracket, municipal bonds are a great high-quality investment that can provide tax exempt cash flow. This becomes even more important for investors in high tax states.

It is somewhat surprising that high yield bonds have had better returns in Q2 as well as YTD and for 1 year given the overhang of recent bank failures and

the potential for a recession. None-the-less, high yield bonds are up 5.46% YTD and 9.08% for 1 year.

We reiterate that the opportunity should be taken to bring fixed income allocations to target due to high equity valuations and likelihood that bond prices will respond positively to lower inflation.

We continue to recommend focusing on high credit quality but look to extend duration from the shorter posture that was maintained last year.

Real Assets

Real Estate, as represented by the Dow Jones U.S. Real Estate Index, increased by 2.45% in Q2 and 4.06% YTD through June. The index is still negative for 1 year but considerably less than the end of Q1. The office segment continues to struggle with high vacancy rates but industrial and multi-family properties continue to provide positive return.

Commodities, lead by energy, moved down -2.73 in Q2 and -7.45% YTD. However, a reversal in energy prices has led the index appreciably higher in July.

Asset Allocation

Balanced allocations have produced positive returns so far this year mostly due to strong equity performance. With equity valuation extended, it is important to not forget about the importance of the defensive nature of fixed income and alternatives allocations in investment portfolios.

Disclosures

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