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2023 Mid-Year Update **July 9, 2023**

"No one is so brave that he is not disturbed by something unexpected." – Julius Caesar

When we wrote our thought piece at the beginning of the year, we generally predicted that equity and debt markets would recover during 2023. Specifically, we opined that, despite an uncertain economic and investment climate, the stock market in 2023 could present investors with a long-term opportunity to allocate assets with a focus on quality and growth at a reasonable price. We also, however, expected investment-grade bonds and dividend-paying stocks to provide income and risk-mitigation attributes for what, we believed, would be a sputtering economy and a volatile market.

Some of what we laid out at the beginning of the year did indeed transpire. A number of developments that have unfolded in the first half of 2023, though, have confounded many institutional investors.

The Economy:

With substantially higher inflation and interest rates over the past 18 months, conventional wisdom suggested that US gross domestic product (GDP), employment, and corporate profits would all dip in 2023. What's actually occurred, however, is that the economy has continued to remain resilient. Personal income, disposable income, personal saving, and corporate profits were all revised upward for Q1 2023 in the US Bureau of Economics' recent data release on June 29, 2023. This chart shows the favorable changes in previous estimates of certain metrics.

Q1 2023 US GDP and Prices

	Advance Estimate	Second Estimate	Third Estimate
	(Percent change from preceding quarter)		
Real GDP	1.1	1.3	2.0
Current-dollar GDP	5.1	5.4	6.1
Real GDI	...	-2.3	-1.8
Average of Real GDP and Real GDI	...	-0.5	0.1
Gross domestic purchases price index	3.8	3.8	3.8
PCE price index	4.2	4.2	4.1
PCE price index excluding food and energy	4.9	5.0	4.9

Source: US Bureau of Economic Analysis @ June 29, 2023

Inflation

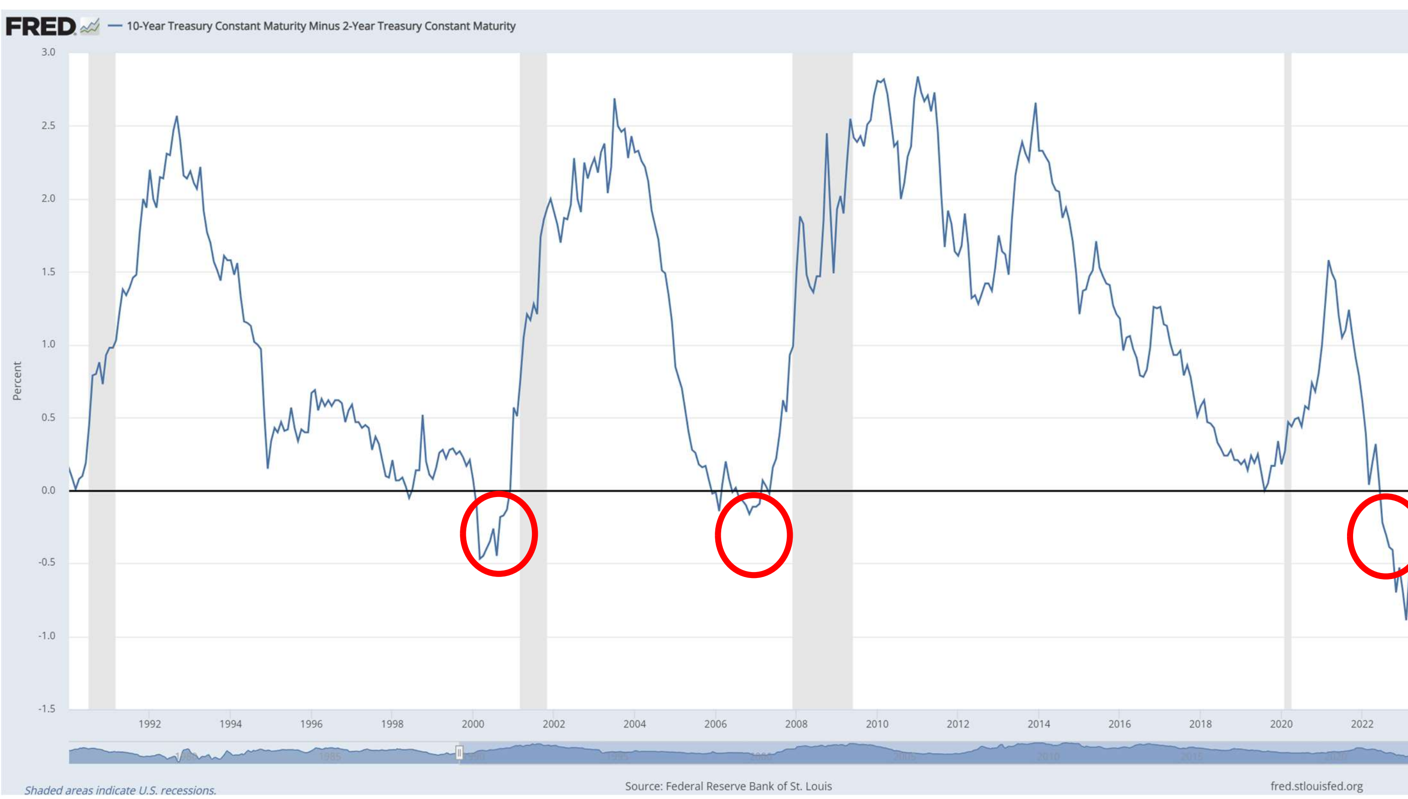
Inflation figures have begun to decrease faster than expected from elevated 2022 levels to approximately a 4%-5% annualized rate. Specifically, core CPI came in at 5.3% in May – which is well below the 7.7% annualized rate registered a little more than a year ago, but still about 1.4 percentage points higher than the 50-year average of 3.9% and far above the Federal Reserve's target of 2%.

Unemployment

The most-recently-released data show that the jobless rate in the US actually *fell* to 3.6% in June (from 3.7% in May). This implies a continuation of an extremely tight labor market, especially when compared to the 75-year average unemployment rate of 5.72%.

Yield Curve

With rates on the 10-year Treasury bond starting the year at 3.88%, we thought that long-term rates would peak at 4.5% in Q2 2023. However, as of June 30, 2023, the yield on the ten-year U.S. government bond was 3.86%, while the yield for a two-year bond was 4.94%. This phenomenon, known as an *inverted yield curve*, occurs when bonds of longer maturities provide a *lower* income yield for investors than those of short-term maturities. The force behind this dynamic is decreased appetite for long-term risk-taking from market participants, and an expectation that the Federal Reserve will lower rates from current levels in the near future – possibly due to weakening economic conditions. Market watchers generally take heed of this sort of rate environment as it can sometimes portend an upcoming recession. The chart below shows several instances where the 10-year treasury bond yielded *less* than a 2-year treasury bond - with the gray sections showing subsequent periods of an economic recession. While a yield-curve inversion *does not always* precede a recession, it is noteworthy that the current yield-curve inversion is as severe as any time in the last 30 years.



<u>US Stock Market:</u>

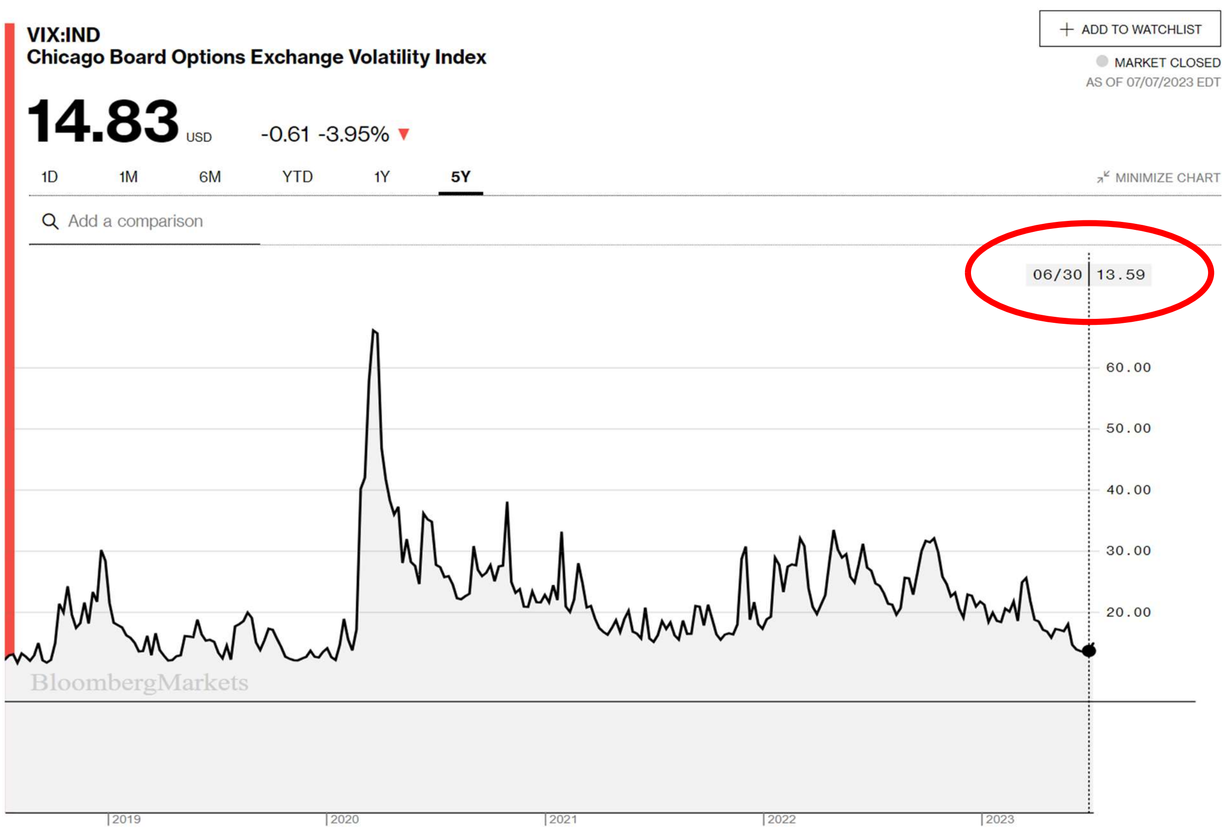
With interest rates flashing a bright-red *check engine* light for an imminent recession, one would expect risk assets to be somewhat volatile and for investors to be bidding up investment-grade bonds, right? Wrong!

Volatility

One of the biggest surprises so far in 2023 is that market volatility has fallen through the floor.

In 1993, the Chicago Board Options Exchange created an index which attempts to measure market sentiment. The now widely-used Volatility Index is based on a complicated equation which takes into account the volume of bets investors make in the options market that the S&P 500 index will go up or down in the near term. A VIX reading above 30 is generally considered to be a market panic, 20 and above is associated with a volatile market, and levels below 15 are typically related to calm markets.

After a tumultuous 2022 with the VIX registering over 30 as recently as this past October, the index ended the year at 21.67. However, volatility has declined dramatically during 2023 – hitting a post-pandemic low in June and ending Q2 at 13.59. To put this all into perspective, markets have gone from panicked to complacent in less than a year.



Valuation

According to the Wall Street Journal, as of July 7, 2023, the **S&P 500 Index was trading at a forward Price-to-Earnings Ratio of 20.10x with a 1.58% dividend yield**. That is currently well above the **150-year average of 16.02x**, and nearly a full standard deviation **above the 25-year average of 16.79x**. Its dividend yield is also less than a third of what an investor can generate from simply owning a 1-year Treasury bill. This does not necessarily mean that stocks are obscenely overvalued, but it does suggest that they are not historically cheap currently.

Bad Breadth

Many investors do not realize that the S&P 500 is not as diversified as the name implies. As a *market-cap weighted* index, the constituents with the highest market valuation have outsized weights and the smaller companies have a much lower impact. So far in 2023, the performance of US Megacap growth stocks have far exceeded that of any other sector as demonstrated in this chart below.

YTD S&P 500 Return Attribution

Sector	Weight at start of 2023	YTD return	Basis points of S&P 500 return
Info Tech	**26 %**	**43 %**	**1101 bp**
Cons. Discretionary	10	33	324
Comm. Services	7	36	264
Industrials	9	10	88
Materials	3	8	21
Real Estate	3	3	9
Consumer Staples	7	1	9
Financials	12	(1)	(6)
Utilities	3	(6)	(18)
Health Care	16	(1)	(23)
Energy	5	(6)	(29)
S&P 500	**100 %**	**17 %**	**1689 bp**

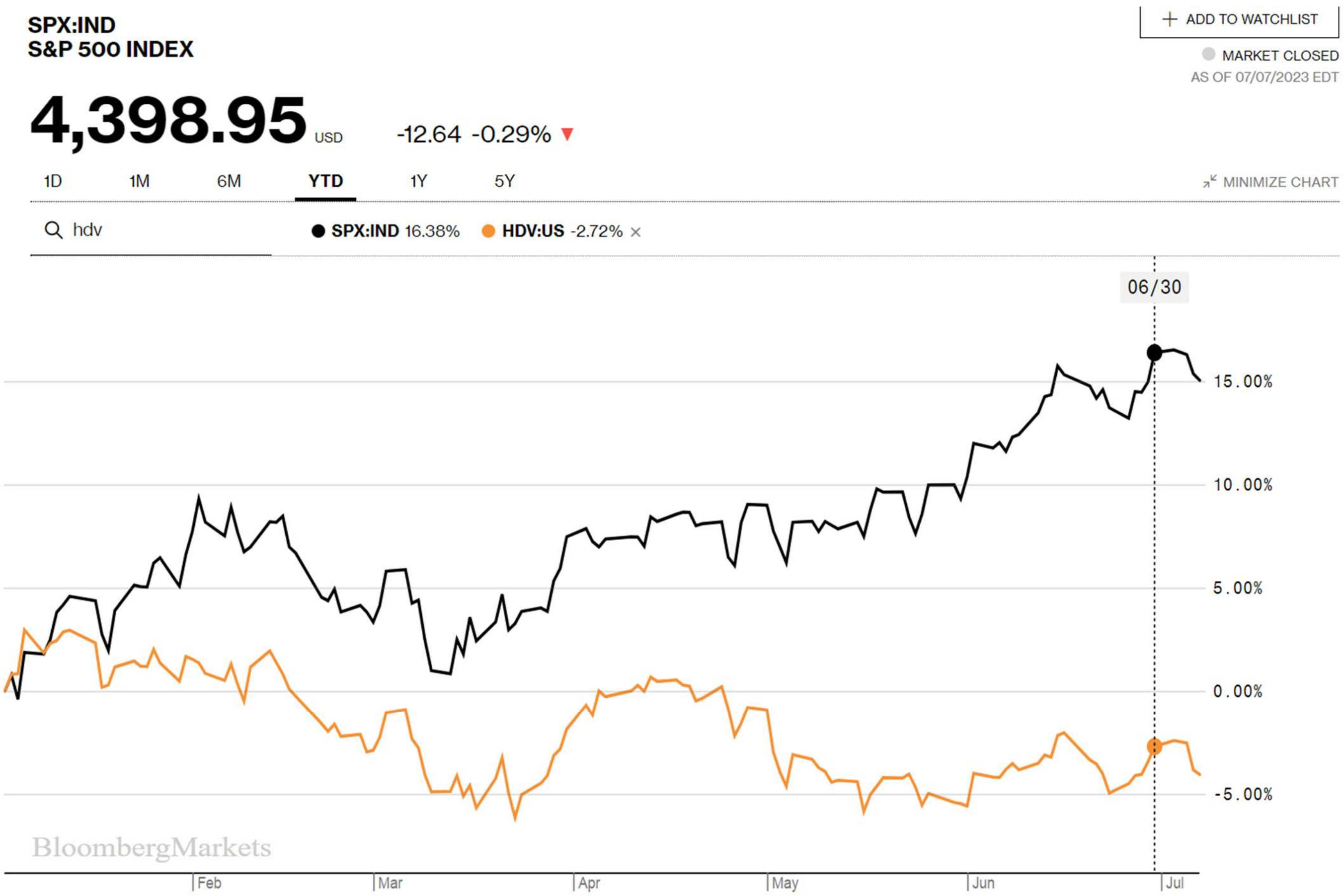
Source: FactSet, Goldman Sachs Global Investment Research

Because the largest tech companies have market values in the trillions of dollars, their share performance has an outsized influence on the overall performance of the S&P 500 index. As of June 30, 2023, the top 10 holdings of the S&P 500 (most of which are tech companies) represented 31.7% of the index, yet those same companies only contribute 21.5% of the index' earnings. Furthermore, those same 10 holdings are trading at a combined multiple of 29.3x their forward earnings versus an average of 20.1x for the index' top 10 holdings since 1996.

To graphically illustrate the point, David Kostin from Goldman Sachs recently created this chart showing how the majority of the return in the S&P 500 for 2023 has come from just a handful of stocks.

A Goldman Sachs chart shows how a few companies have led the major indexes higher in 2023.

Let's further evaluate the performance of the S&P 500 index relative to a portfolio of *dividend-paying* stocks. Below is a comparison of the S&P 500 index versus the iShares Core High Dividend ETF. Unlike the S&P 500 index, this ETF's dividend-oriented portfolio is largely made up of companies in the energy, healthcare, financial, consumer, utility, and telecom sectors. Since these areas of the market are sometimes considered *defensive* equity plays in an uncertain economy, perhaps the momentum in growth stocks is depressing valuations in these areas of the market. As one can see from the chart below, the disparity in performance so far this year has been dramatic.

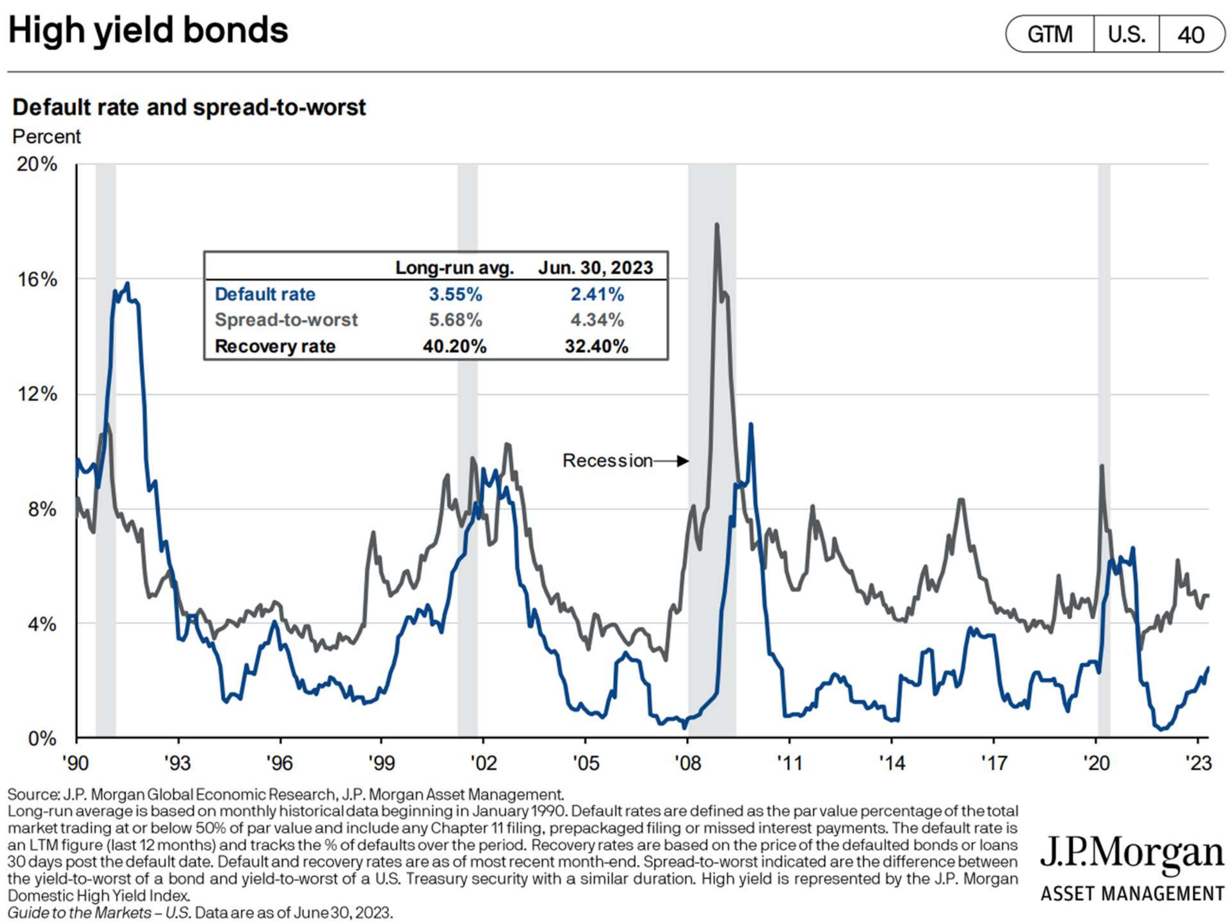


This outcome was another surprise compared to what many market analysts expected. The outperformance of technology may, in part, be the result of the strength of tech firms' minimally-leveraged balance sheets. It could also be attributable to the enthusiasm around tech companies' ability to market new products and services in the area of Artificial Intelligence. We are not disparaging tech companies at all. In fact, we currently own a number of them in client accounts. However, when the 6-month performance in growth stocks exceeds our *multi-year* potential-return assumptions, we suspect that further returns in 2023 for that sector may be harder to come by. If the market is to go higher from here, then we think the breadth of companies participating in the rally will probably need to expand.

The US Bond Market

Intermediate-term investment-grade bonds (typically tracked by the Bloomberg Aggregate Bond Index) have produced a positive return in 42 of the past 47 years. After losing roughly 13% in 2022 (the worst return for that asset class in more than 5 decades), the index has not rebounded much in 2023. In fact, the index has produced a total return of only 2.09% through June. Even though such bonds tend to outperform treasuries by a wide margin at the end of a rate-tightening cycle, their performance has not even beaten that of many money-market funds thus far in 2023. While many industry participants have been calling this year *The Golden Age Of Fixed Income Investing*, the actual market results for traditional bonds with longer durations have been anemic (whether those bonds be corporates, governments, munis, or otherwise.)

On the other end of the risk spectrum, further defying institutional managers' expectations, non-investment grade junk bonds (as tracked by the Bloomberg US Corporate High Yield Index) have produced a 5.38% return through Q2. Perhaps this outperformance is due to the continued strength of the US economy, the below-average rate of corporate defaults year-to-date, and relatively attractive yields relative to investment grade credit.



Our expectations for the balance of 2023

The first half of 2023 was marked by the outperformance of *high-Beta* parts of the equity and fixed income markets such as large cap growth and junk bonds, as well as low levels of overall market volatility. In our opinion, this seems to be due to the enthusiasm around the potential for Artificial Intelligence as a new economic growth engine, the avoidance of a recession thus far (despite higher rates), and a lack of anticipated corporate defaults.

For the back half of 2023, we think that continued higher rates should ultimately begin to have both an economic effect and a market outcome. In recent days, comments from the Federal Reserve and stronger-than-expected employment figures seem to suggest that the interest-rate tightening cycle is not yet over. This past week, the 10-year Treasury bond ticked over 4% and the 2-year Treasury bond moved to a 16-year high of 5.12%. As rates continue to climb and then peak, we think the disparity between growth stocks and defensive dividend stocks should move towards more traditional valuation metrics as interest expenses impact corporate profits, consumer spending, and capital expenditures. Using the 25-year average S&P 500 earnings multiple of 16.79x and projected 2024 earnings of $250, our base case is for the S&P 500 to end the year at 4197. (That would represent roughly a 10% increase versus year-end 2022, but a move roughly 4-5% lower than the S&P's level as of this writing.) We envision a blue-sky scenario where stocks end higher than that base case if corporate profits remain robust and a recession is avoided. Logically, we also have a grey-cloud scenario where the equity market moves lower than our assumptions because the opposite occurs. Regardless, as the US large-cap market's rally matures, we will continue to search for equity opportunities in different market caps and areas of the globe in an effort to uncover value and diversify portfolios. Furthermore, we believe traditional bonds should begin to attract more investment fervor in the coming 12 months as the economy begins to cool and the tightening cycle winds down at some point. In the meantime, as the market for bonds of longer durations sorts itself out in the coming months, we note that short-duration US Treasury bills currently provide yields above 5% for relatively low risk. And finally, we would not be surprised to see market volatility (i.e. the VIX) move up to levels more reflective of the current environment's true economic and geopolitical realities.

In terms of risks and opportunities, the themes we outlined in our original 2023 thought piece largely continue to exist – and they can be reviewed here: https://investmentpartners.com/wp-content/uploads/2023/01/IPAM-OUTLOOK-2023-FINAL.pdf . As the current year wears on, we will be updating our longer-term thoughts and sharing them in our 2024 Outlook thought piece.

As a parting note, you may be interested to know that we gave ChatGPT an opportunity to write the conclusion to this mid-year update using AI. We were very excited to see its results, but unfortunately the verbiage it produced was unclear and its interpretations were difficult to follow. Maybe AI still has a long way to go before it can be used to summarize complicated financial concepts… or perhaps it correctly learned that using confusing language is the hallmark of most economists and market prognosticators.

We are honored and privileged that you have entrusted us to guide you in your pursuit of achieving your long-term financial goals. Speaking of which, it's always a good time to reassess your risk profile and objectives. If they have changed, or you would like to modify risk in your portfolios, please let us know.

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yriearningsforecast.pdf (yardeni.com)
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