Q2 MARKET INSIGHTS

Summer 2023

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The first half of 2023 has brought some much-needed relief to investors, with equity markets posting positive returns despite the "sticky" inflation that prompted the fastest rate hiking campaign by the Federal Reserve (the "Fed") since the 1980s. The S&P 500® Index ended the first half of 2023 at a 14-month high, and most major stock indices logged solid gains in the second quarter following a pause in the Fed's rate hike campaign, stronger-than-expected corporate earnings, and the relatively drama-free resolution of the debt ceiling. For the three months ending June 30th, the S&P 500 returned 8.74% and is now up 16.88% year-to-date. Internationally, foreign markets lagged the S&P 500 due to investor concerns about the health of the European and British economies as persistent inflation continues to put pressure on the Central Banks to keep raising rates. Foreign developed markets, represented by the MSCI EAFE Index, rose 3.19% during the second quarter (+12.16% YTD). Emerging markets underperformed the S&P, led by weakness in China, which faces sluggish consumer spending, an overbuilt property market, slumping exports, and high levels of local government debt. The MSCI Emerging Markets Index finished the quarter up 0.97% (+5.02% YTD). Switching to fixed income markets, the leading benchmark for bonds, the Bloomberg Barclays US Aggregate Bond Index, was down 0.84% for the second quarter of 2023 (+2.09% YTD) as hopes for a pivot in Fed interest rate policy were thwarted by the realization that the Fed intends to keep interest rates "higher for longer."

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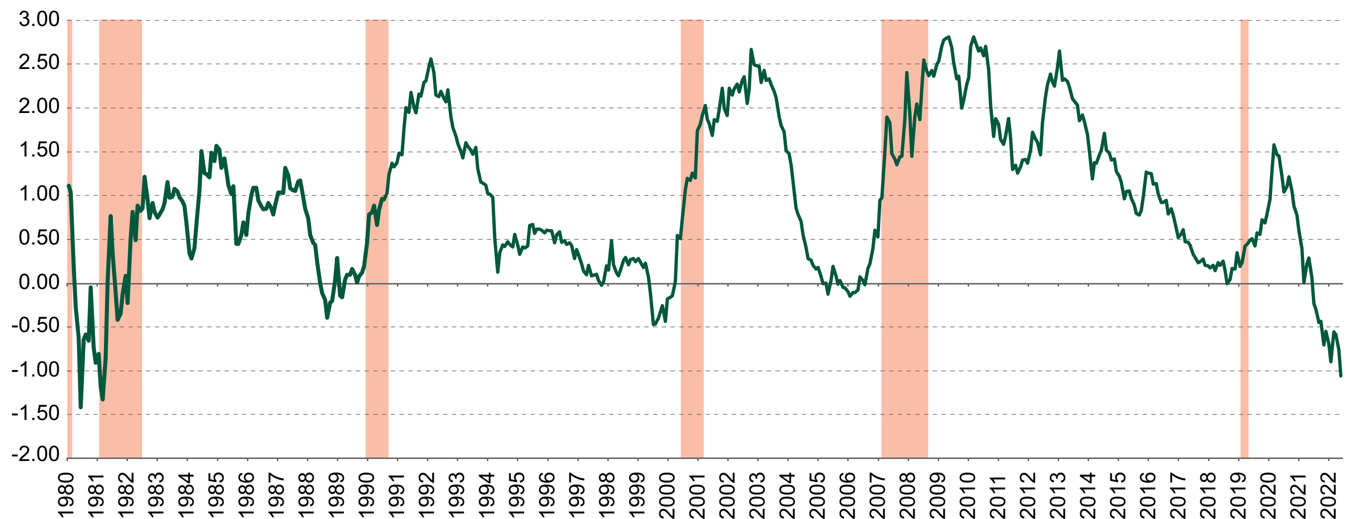
WARNING SIGNS ON THE ROAD AHEAD

As we highlighted last quarter, we believe the Fed faces the challenging task of trying to tame inflation without causing a severe slowdown in economic activity. The Fed has embarked on one of the most aggressive tightening campaigns in history in terms of both the size and speed of rate hikes. After taking rates up 5.00% since March of 2022, the Consumer Price Index ("CPI") has fallen from a high of 9.1% in June of last year to 4.0% in May. The decline was helped in large part by energy prices which are down 17% from their recent highs, and a renormalization in the prices of goods and food. Given the magnitude of the rate hikes done, and the lagged effects of monetary policy changes and their impact on the economy, the Fed decided to pause its rate hiking campaign and hold rates steady in June. However, CPI is still well above the Fed's target of 2%, and as a result, Fed Chairman Powell has indicated that, despite the recent pause in raising rates, more hikes may be on the horizon. He also reiterated that rates will likely stay "higher for longer", meaning that it may be quite some time before the Fed will reverse course and cut interest rates.

> **"This suggests that the market as a whole is reflecting investor pessimism about the economic prospects for the near future."**

Since monetary policy typically operates with a lag, the full effects of policy tightening have yet to be felt in the economy. However, incoming economic data suggests that the economy is already feeling the impact of these rate hikes, and that the odds of a recession occurring here in the U.S.

U.S. Treasury Yield Curve Inversions 1980 to June 2023: 10-Year Note vs. 2-Year Note (Recessions in Red Shaded Areas)

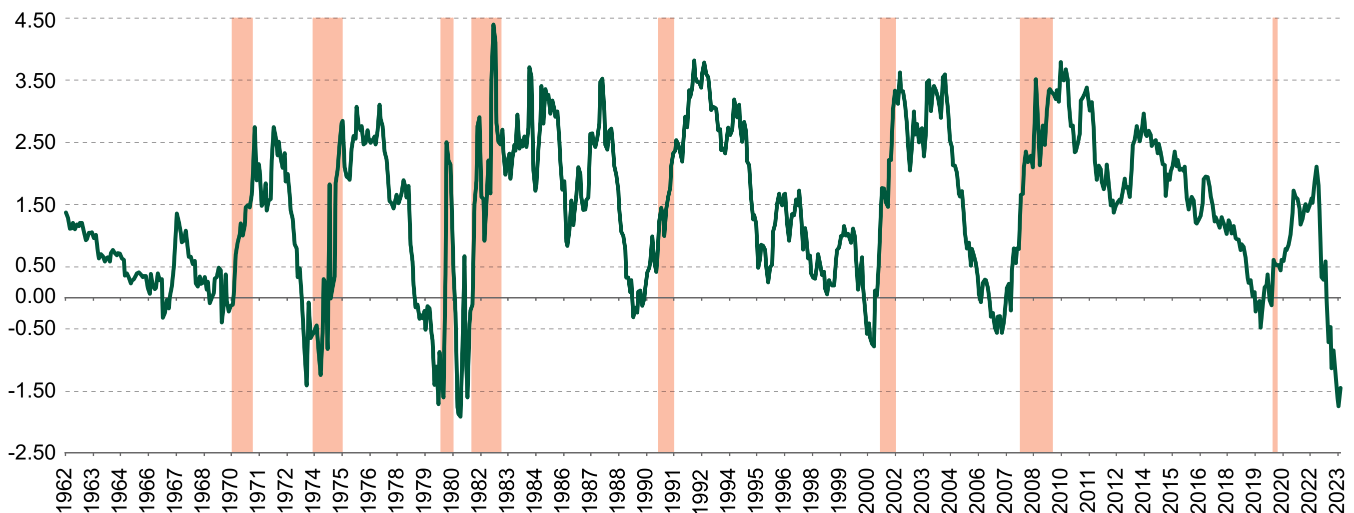


Source: Bloomberg

is rising. Forward looking indicators such as the inverted Treasury yield curve, weak manufacturing activity, declining Leading Economic Indicators ("LEI's"), tighter bank lending standards, and depressed consumer confidence readings are all flashing warnings signs. The chart above shows the yield spread between the 10-Year U.S. Treasury Note and the 2-Year U.S. Treasury Note going back to 1980. As you can see, the spread between the 10-Year and the 2-Year notes is currently negative (meaning the yield on the 2-Year note is higher than that of the 10-Year note), which implies that the yield curve between these two tenors is inverted. A yield curve inverts when long-term interest rates drop below short-term rates, indicating that investors are moving money away from short-term bonds and into long-term ones. This suggests that the market as a whole is reflecting investor pessimism about the economic prospects for the near future. Historically, an inverted yield curve has been a reliable indicator of prior recessions (the red shaded areas on the chart).

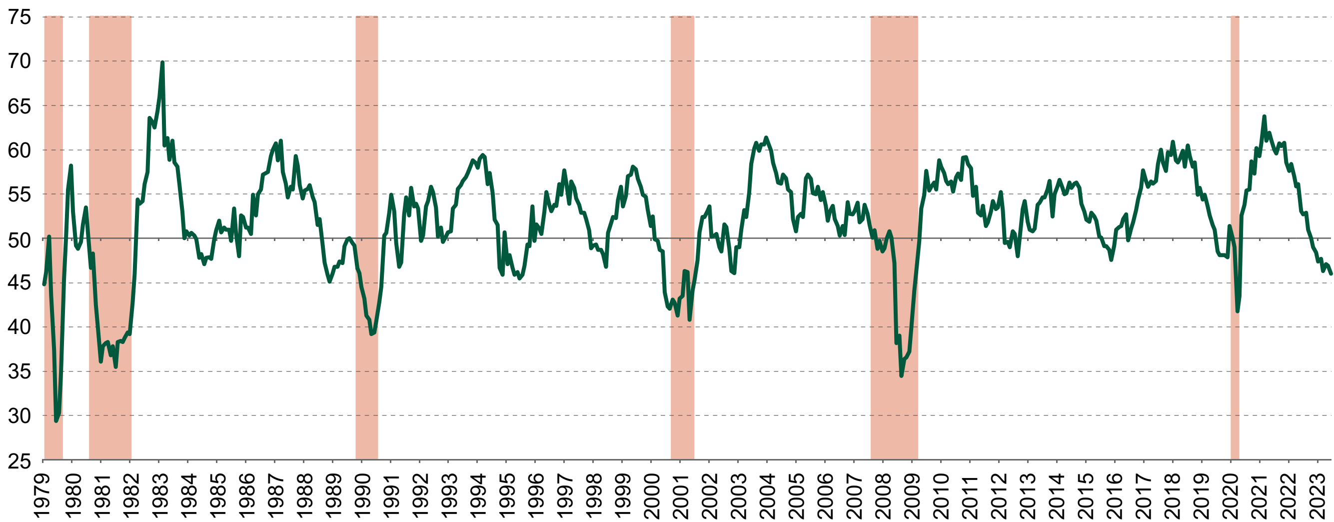
The below chart shows the inversion between the 10-Year

U.S. Treasury Yield Curve Inversions 1961 to June 2023: 10-Year Note vs. 3-Month Bill (Recessions in Red Shaded Areas)



Source: Bloomberg

ISM Manufacturing PMI Index 1980-June 2023 (Recessions in Red Shaded Areas)



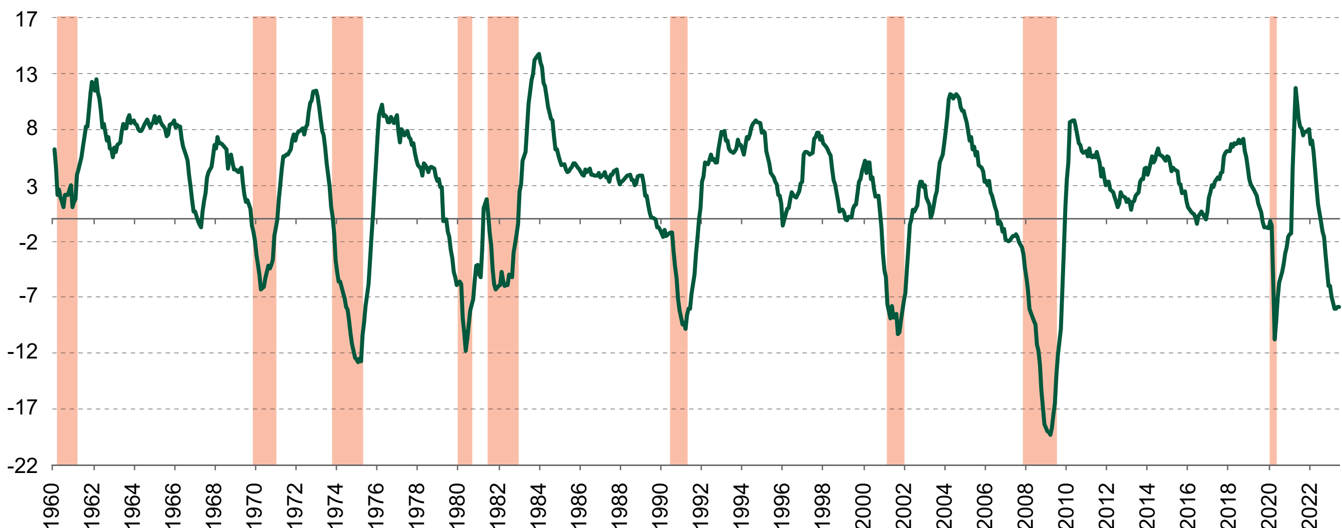
Source: Bloomberg

U.S. Treasury Note and the 3-Month U.S. Treasury Bill going back to 1961. Again, this indicator has been a good predictor of future recessions here in the U.S. (red shaded areas).

The chart above displays the Institute for Supply Management's (ISM) U.S. manufacturing index, typically referred to as the ISM Manufacturing PMI Index, which is a gauge of manufacturing activity here in the U.S. going back to 1980 (a reading above 50 in the ISM Manufacturing Index indicates an expansion in factory activity, while a reading below 50 indicates a contraction). June marked the eighth consecutive month in which manufacturing activity contracted with a reading of 46. Again, recessions are highlighted in the red shaded areas. The lowest ISM Manufacturing reading to occur without a recession emerging within 12 months thereafter was 45.9, so this metric is very close to flashing a recessionary signal.

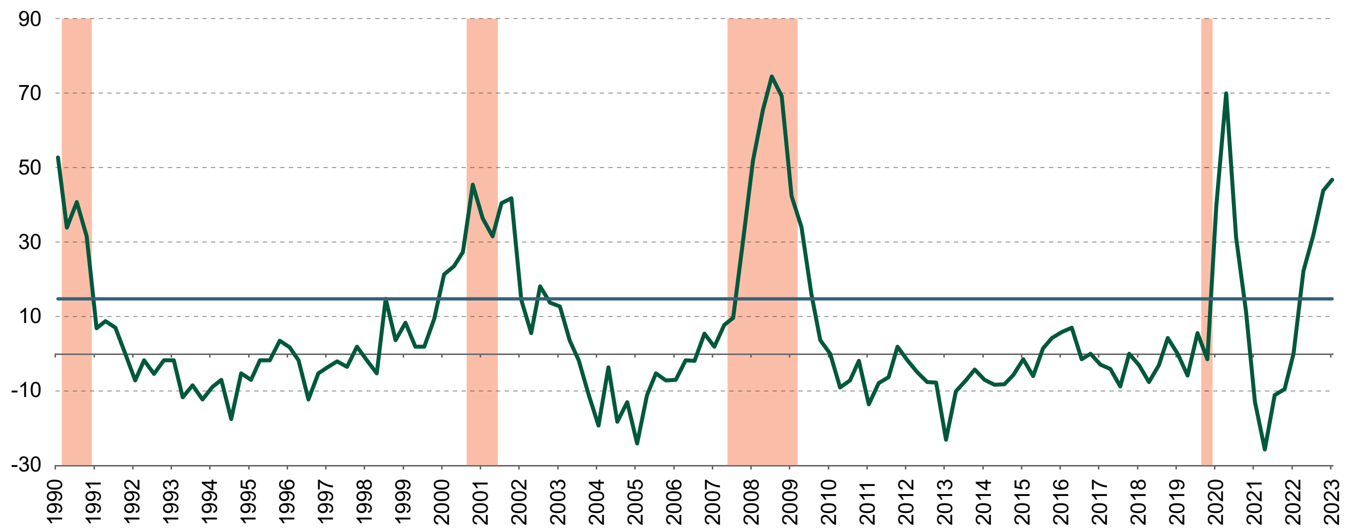
The following chart shows the current LEI reading of -7.94%. As a reminder, LEI's are a composite of economic data points

Leading Economic Indicators 1960-June 2023 (Recessions in Red Shaded Areas)



Source: Bloomberg

Senior Loan Officer Opinion Survey: Respondents Tightening Loan Standards (Recessions in Red Shaded Areas)

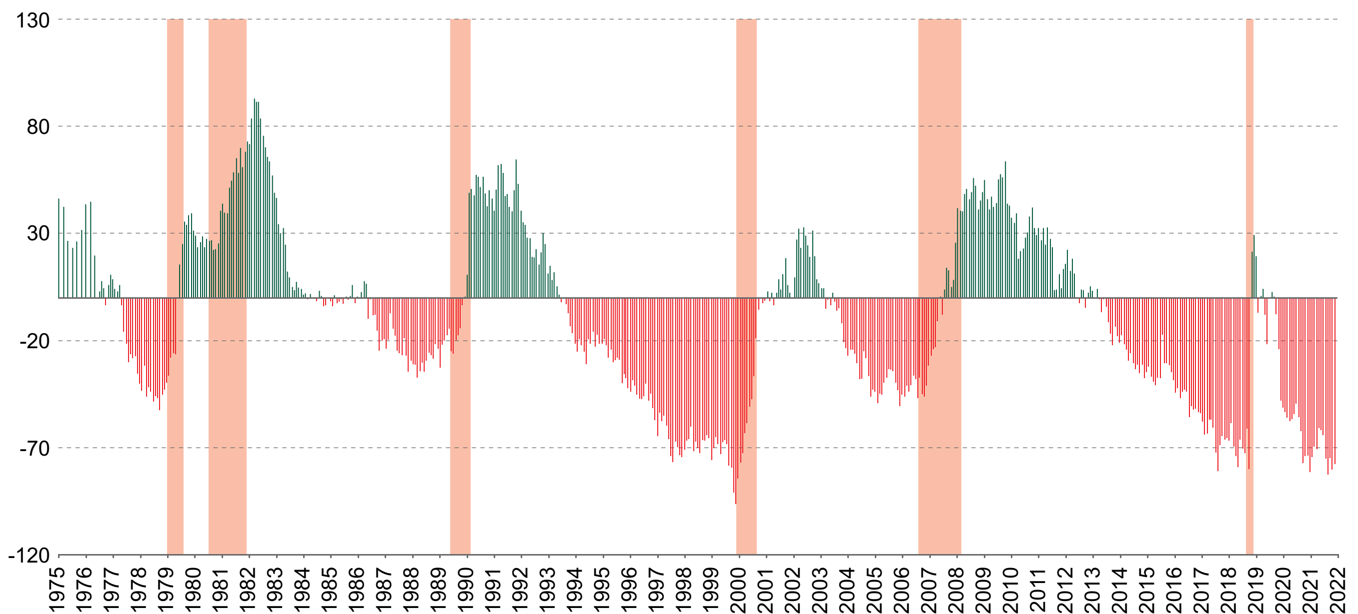


Source: Bloomberg

designed to signal peaks and troughs in the business cycle, and recessions have historically occurred when LEIs are negative (red shaded areas).

The chart above highlights the percentage of bank loan officers who are tightening loan standards for commercial loans to small firms. This data is taken from the Senior Loan Officer Opinion Survey on Bank Lending Practices conducted by the Fed. This survey includes 80 large domestic banks and twenty-four U.S. branches and agencies of foreign banks. As you can see 46.7% of respondents have said they are tightening loan standards. This means that it will be much more difficult for businesses to expand and invest (thereby slowing economic growth). Whenever 15% or more of the respondents say that lending standards are getting tougher

U.S. Consumer Confidence Expectations vs. Present Situation 1975- June 2023 (Recessions in Red Shaded Areas)



Source: Bloomberg

> "The fact that the Fed appears committed to keeping interest rates "higher for longer", leads us to believe that a recession is more likely to occur than not."

(accentuated by the blue line), it is usually a precursor to a recession.

The chart on the previous page focuses on consumer sentiment utilizing the Conference Board's Consumer Confidence Expectations Index and Consumer Confidence Present Situations Index. The lines on this chart represent the U.S. consumer's future outlook (1 year out) relative to their current situation. When the lines are green, that means that consumers are more optimistic about prevailing business conditions in the year ahead (this takes into account consumer attitudes, buying intentions, vacation plans, as well as expectations for inflation, stock prices and interest rates). When the lines are dark red, that means that consumers are more pessimistic about conditions in the year ahead. Again, recessions are highlighted by the red shaded areas. It is interesting to note that recessions have generally started when the red lines begin to contract, meaning that consumers are expressing that near term conditions are starting to get worse when compared to 1 year out. While this indicator may suggest that a recession is not currently imminent, the conditions are in place to imply that a recession may be in our future.

Taken together, these datapoints underscore the impact that the Fed's rate hiking campaign have had on the economy. Things are definitely slowing down, and the full implications of Fed's tight monetary stance have yet to take full effect. The fact that the Fed appears committed to keeping interest rates "higher for longer", leads us to believe that a recession is more likely to occur than not. However, what's more difficult is to forecast the timing as to when a recession may materialize.

THE SEARCH FOR EARNINGS GROWTH LEADS TO NARROW MARKET LEADERSHIP

Despite growing economic headwinds, equity markets have had a solid year so far, supported by a better-than-expected first quarter earnings season as well as excitement about the potential of artificial intelligence ("AI"). Earnings per share for the S&P 500 fell 2.0% in the first quarter (which are reported during the second quarter of the year), however, that was much better than the 6.7% decline that analysts were expecting. Overall, 78% of companies beat earnings expectations, which was above the 10-year average of 73%. In addition, net profit margins came in at 11.5%, which was slightly ahead of the 5-year average of 11.4%. While investors were pleased with the better-than-expected results, this still marked the second consecutive quarterly decline in earnings. With earnings contracting, the strong performance of the U.S. equity market was led by a narrow group of stocks seen as big winners from the AI revolution. Case-in-point: a majority of the S&P 500 gains so far this year have been delivered by stocks linked to AI. During the first half of 2023, seven companies accounted for 72% of the S&P 500's gain (see table at right—note that we included both share classes of Google's parent company Alphabet, Inc.), as this group is widely seen as direct beneficiaries of AI's potential to transform business productivity. If these seven companies were excluded from the index, the actual year-to-date return

YTD Contribution of the Top Seven Companies in the S&P 500 Through June 30, 2023

Name	S&P 500 Weighting at 1/1/2023	Total Return	S&P 500 Contribution
Apple Inc.	6.02%	49.7%	2.99%
Microsoft Corp.	5.54%	42.7%	2.36%
Amazon.com Inc.	2.31%	55.2%	1.27%
Alphabet Inc.	1.63%	35.7%	0.58%
Alphabet Inc.	1.46%	36.3%	0.53%
NVIDIA Corp.	1.13%	189.5%	2.14%
Tesla Inc.	1.02%	112.5%	1.15%
Meta Platforms Inc.	0.84%	138.5%	1.16%
Sum of Top 7 Stocks Return Contribution to S&P 500			**12.20%**
S&P 500 Total Return			**16.88%**
Top 7 Stocks YTD Contribution			**72.20%**

Source: Bloomberg

from the other 493 companies in the index would be 4.68%, rather than the actual index return of 16.88%. Going even further, the S&P 500 Equal Weighted Index (an index where

> "These aforementioned AI-related companies are especially popular because they are perceived to have the structural fundamentals to achieve sustained earnings growth during periods of economic difficulty."

each stock in the S&P 500 is given equal importance in calculating the value of the index as opposed to being based on the market capitalization of each individual stock) has trailed the market cap weighted S&P 500 by 9.85% through June 30th. Since the beginning of February, the difference was even bigger with the Equal Weight Index down 1.36% while the S&P was up 8.83%, underscoring the massive impact these companies have had on recent returns.

Why have these stocks outshined the rest of the market so dramatically? We believe the reason is related to investor concerns about the Fed's policy response (again, keeping rates "higher for longer") and its adverse impact on the economy, which has raised anxiety about the sustainability of corporate earnings after two quarters of consecutive declines. These aforementioned AI-related companies are especially popular because they are perceived to have the structural fundamentals to achieve sustained earnings growth during periods of economic difficulty. This is because that profit growth becomes increasingly scarce when the economy slows or contracts. When the profit cycle decelerates, markets become increasingly "Darwinistic" (i.e., performance is determined by survival of the fittest). Fewer and fewer companies can maintain their earnings growth rates as the overall economy and profit environment get worse, and investors gravitate to the fewer and fewer companies with growth opportunities. These AI-related companies have exhibited strong characteristics such as high barriers to entry, strong balance sheets, above average revenue growth, robust free cashflow generation, while benefiting from current secular growth trends. We believe AI offers compelling long-term opportunities, however, the narrow market performance, driven by a handful of higher quality names, has historically been a warning sign that market momentum is likely to fade. This narrow market breadth, combined with the waning economic data, makes us cautious about equities as we look to the second half of the year.

MARKET TIMING: IT'S NOT EASY

It's important to remember that recessions are a normal part of the business cycle, and while the current economic data suggests the risk of recession has risen, it is almost impossible to predict exactly when one will occur. In fact, there is an old joke that economists have predicted nine out of the past five recessions. Given the difficulty in forecasting the exact timing of a recession, it remains important that investors not panic, and remain appropriately positioned based on their investment timeline and risk-management framework. The table on the next page (which was compiled by Affiliated Managers Group) shows the 12 recessions that occurred in the post-World War II era. The first column shows the price changes of the S&P 500 during the recession with, perhaps, a surprising conclusion. The stock market actually rose during 50% of the recessions, with an average loss over all periods of only 0.2% (the clear outlier was the Global Financial Crisis of 2008-2009, which we will discuss shortly). Even with perfect foresight of the start and end of a recession, selling stocks at the beginning of a recession and buying them back at the end resulted in the preservation of capital only 50% of the time.

What if you perfectly anticipated the start of a recession three months before it began, and then bought stocks back when the recession ended? Column 2 in the table shows the S&P 500 price performance over those periods and, again, 50% of the time the market rose over the period. However, the average and median gains over the periods suggest that there would have been at least some potential benefit from having such foresight.

But what if you were late in identifying the end of a recession? Column 3 in the table shows the result of anticipating the start of a recession by three months but then identifying the end of a recession three months after it ended. The market rose two-thirds of the time in these periods, with an average

> "While the S&P 500 has declined from peak to trough by a median of 24% during the past 12 recessions, it's important to note that stocks typically recover before recessions officially end."

S&P 500 Price Changes During Post-World War II Recessions

Recession		S&P 500 Price Change			
Start	End	During Recession	3 Months Before Start to Recession End	3 Months Before Start to 3 Months After Recession Ends	Recession Start to 3 Months After Recession Ends
11/30/1948	10/31/1949	8.7%	0.4%	6.8%	15.6%
07/31/1953	05/28/1954	17.9%	18.6%	21.2%	20.5%
08/30/1957	04/30/1958	-3.9%	-8.4%	-0.5%	4.4%
04/29/1960	02/28/1961	16.7%	14.1%	19.7%	22.4%
12/31/1969	11/30/1970	-5.3%	-6.4%	3.9%	5.1%
11/30/1973	03/31/1975	-13.1%	-20.0%	-8.7%	-0.8%
01/31/1980	07/31/1980	5.7%	19.5%	25.2%	5.7%
07/31/1981	11/30/1982	5.8%	4.3%	11.4%	13.1%
07/31/1990	03/28/1991	5.4%	13.4%	12.2%	4.2%
03/30/2001	11/30/2001	-1.8%	-13.7%	-16.2%	-4.6%
12/31/2007	06/30/2009	-37.4%	-39.8%	-30.8%	-28.0%
02/28/2020	04/30/2020	-1.4%	-7.3%	4.1%	10.7%
Average		**-0.2%**	**-2.1%**	**4.0%**	**5.7%**
Median		**2.0%**	**-3.0%**	**5.5%**	**5.4%**
% Positive		**50.0%**	**50.0%**	**66.7%**	**75.0%**

Data from 9/2/1945–4/30/2023
Source: FactSet

gain over all periods in the mid-single digits. Finally, what if you identify the start of a recession but are three months late in identifying its end? Column 4 shows the market rose 75% of the time in these periods, with an average gain over all periods, again, in the mid-single digits.

These results may seem somewhat surprising. While the S&P 500 has declined from peak to trough by a median of 24% during the past 12 recessions, it's important to note that stocks have typically recovered before recessions officially ended. The stock market is a leading indicator of future investor expectations, and as a result, equity markets tend to bottom during recessions and rebound as investors recognize that the economy is going to improve.

The object of this exercise is to demonstrate that it is extremely difficult to use predictions about recessions (even if they are accurate) in order to time the stock market. To be sure, if an investor had been able to predict the 2008–2009 recession with even partial accuracy, they would have reaped significant benefits. However, this is an exception rather than a rule. The 2008–2009 recession was global in its effects. It resulted in a significant breakdown of the financial system, and it was both the deepest (in terms of GDP decline) and longest of the recessions since World War II. Most recessions have been far less severe than the Global Financial Crisis of 2008–2009.

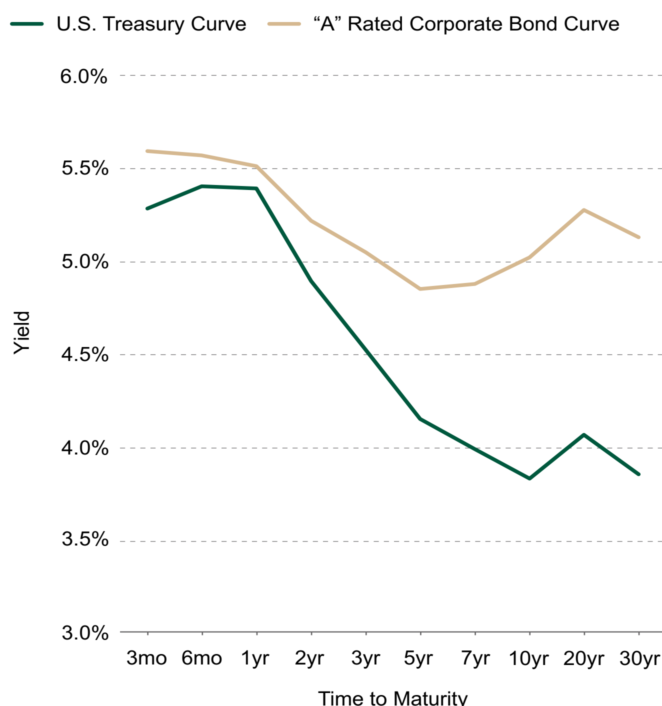
It will be undoubtedly stressful for stock market investors if a recession unfolds later this year or next, but history suggests that making market timing decisions based on recession predictions is not likely to add much value.

BONDS: TIME TO EXTEND DURATION

In our opinion, higher yields have created attractive opportunities in fixed income. After years of artificially low interest rates, this is the highest yielding environment we've seen in over fifteen years. With the Fed nearing the end of its rate hiking cycle (combined with the likelihood that the Fed would lower interest rates if the U.S. were to enter a recession), we believe now is the time to extend duration within fixed income allocations. Remember, that duration is a measurement of a bond's interest rate risk, and bonds with longer maturities and higher coupon payments have a

higher duration than those with shorter maturities and lower coupons. The higher the duration of a fixed income portfolio, the more sensitive its value is to changes in interest rates. This means if you have two separate fixed income portfolios, the one with the higher duration will rise in value by a greater amount when interest rates fall (the opposite is true if rates rise, the portfolio with the higher duration will decline in value by a greater amount). Today, we see opportunities in owning high quality investment grade corporate bonds as a suitable way to extend duration. In past letters, we have highlighted the positive inflation adjusted return potential of owning shorter-term U.S. Treasuries. We still suggest owning these bonds if you wish to keep a shorter duration as short-term corporate bonds don't offer much of a yield advantage over U.S. Treasuries with similar maturities (see chart at right which exhibits the U.S. Treasury yield curve and the Bloomberg Single-A U.S. Corporate Bond yield curve as of June 30, 2023). You'll notice that if you go out to one year, there isn't a big yield advantage to owning single-A rated corporate bonds (gold line) versus owning a U.S. Treasury Note (green line). Investors really aren't being compensated for taking on the additional credit risk of owning a short-term single-A corporate bond versus owning a similar dated U.S. Treasury. However, as the maturity lengthens, single-A rated corporate bonds look much more attractive relative to U.S. Treasuries. In fact, as of June 30, 2023, a 20-year single-A rated corporate bond paid 1.21% more on an annual basis than a 20-year U.S. Treasury bond (5.28% versus 4.07%). Given our view, that the risk of a recession is rising, we suggest staying with bonds rated single-A or better as the higher credit quality should provide protection in a deteriorating credit market.

Opportunities in Long Duration Investment Grade Corporate Bonds



Source: Bloomberg

IN CLOSING

After a challenging year for markets in 2022, the strong start to the first half of 2023 has been a welcome development for investors. Nonetheless, the red flags (inverted yield curve, tighter credit conditions, weak manufacturing data, declining LEI's) that have historically emerged prior to recessions are waving. Could this time be different? Absolutely. Anything is possible, as there are fiscal and monetary supports still in place today (as a result of the government's COVID response), that were not available in the past. Monetary liquidity in the economy still runs very high as a percentage of GDP, which could allow the economy to muddle through.

Given these unknowns, it is always prudent to maintain a well-planned, long-term-focused, and diversified asset allocation based on your financial position, risk tolerance, and investment timeline.

We thank you for your ongoing confidence and trust. Please reach out to your relationship manager with any questions, or if you wish to discuss your portfolio allocation.

Happy Summer!

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All performance data is as of 6/30/2023 unless otherwise stated. Diversification does not ensure a profit or guarantee against loss. An investment cannot be made directly in an index. As with all investments, there are associated inherent risks, including loss of principal. Sector investments concentrate in a particular industry and the investments' performance could depend heavily on the performance of that industry and be more volatile than the performance of less concentrated investment options and the market as a whole. Foreign markets, particularly emerging markets, can be more volatile than U.S. markets due to increased political, regulatory, social or economic uncertainties. Fixed Income investments include risks such as exposure to interest rate fluctuation, credit changes and inflation. Positions held in cash are subject to inflation risk.

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The MSCI Emerging Markets Index captures large and mid-cap representation across 24 Emerging Markets (EM) countries*. With 838 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country. Performance numbers for the index are total return with dividends reinvested in the index.

The Bloomberg Barclays US Aggregate Bond Index provides a measure of the total return performance of the U.S. dollar denominated investment grade bond market, which includes investment grade government bonds, investment grade corporate bonds, mortgage pass through securities, commercial mortgage backed securities and asset backed securities that are publicly for sale in the United States.

The Consumer Price Index (CPI) is issued by the U.S. Bureau of Labor Statistics and is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services. Indexes are available for the U.S. and various geographic areas.

Institute for Supply Management® (ISM®) is the first and largest not-for-profit professional supply management organization worldwide. Founded in 1915, ISM has over 50,000 members across 100 countries. It's Manufacturing (PMI®) and Services (PMI®) are two of the most reliable economic indicators available, providing guidance to supply management professionals, economists, analysts, and government and business leaders. The reports are issued by the ISM Manufacturing and Services business survey committees. An index reading above 50 indicates expansion in activity, while a reading below 50 represents contraction.

Leading Economic Indicators (LEI), a composite of economic data points put together by The Conference Board designed to signal peaks and troughs in the business cycle. The Conference Board is a global independent business membership and research association working in the public interest.

The Senior Loan Officer Opinion Survey on Bank Lending Practices is conducted by the Board of Governor of the Federal Reserve System. The current reporting panel consists of up to 80 large domestically chartered commercial banks and up to 24 large U.S. branches and agencies of foreign banks. The purpose of the survey is to provide qualitative and limited quantitative information on bank credit availability and loan demand, as well as on evolving developments and lending practices in the U.S. loan markets. The respondents' answers provide information that is critical to the Federal Reserve's monitoring of bank lending practices and credit markets.

The Conference Board is a non-profit business membership and research group organization. It counts over 1,000 public and private corporations and other organizations as members, encompassing 60 countries. The Conference Board convenes conferences and peer-learning groups, conducts economic and business management research, and publishes several widely tracked economic indicators. It's Consumer Confidence Survey reflects prevailing business conditions and likely developments for the months ahead. This monthly report details consumer attitudes, buying intentions, vacation plans, and consumer expectations for inflation, stock prices, and interest rates. The Present Situation Index is based on consumers' assessment of current business and labor market conditions. The Expectations Index is based on consumers' short-term outlook for income, business, and labor market conditions.

Artificial intelligence (AI) is a wide-ranging branch of computer science concerned with building smart machines capable of performing tasks that typically require human intelligence. While AI is an interdisciplinary science with multiple approaches, advancements in machine learning and deep learning, in particular, are creating a paradigm shift in virtually every sector of the tech industry.

Please contact us at 781-400-2800 for more information on how we can assist you with your financial needs.

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