Review & Outlook

Second Quarter 2023

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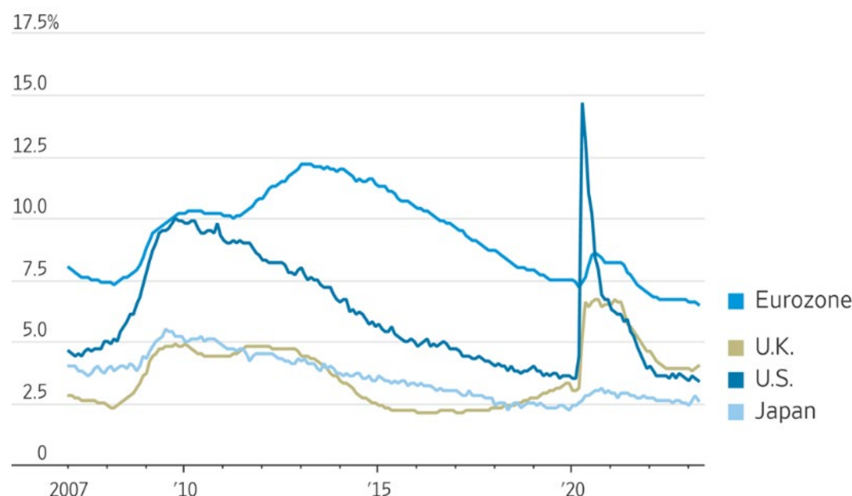
Review and Outlook

Looking back at this past spring makes us think of waiting for Godot, though instead of Godot, we waited for something to happen. Several times we thought we heard footsteps approaching, but nothing arrived. Whether it was the recession everyone said was coming, or the banking crisis that wasn't, or the debt ceiling drama, it seemed like something was going to happen - but nothing did. Investors braced for trouble, moving money to safe havens, only to have the stock market move upwards.

Index Performance Data
Total Return as of 6/30/2023

Indices[1]	Q2 2023	Trailing 12 Months
CRSP U.S. Total Stock Market Index	8.41%	18.94%
iShares MSCI Global ex-U.S. Total Stock Market Index	3.95%	-1.59%
Bloomberg Barclays U.S. Aggregate Bond Index	-0.84%	-0.94%

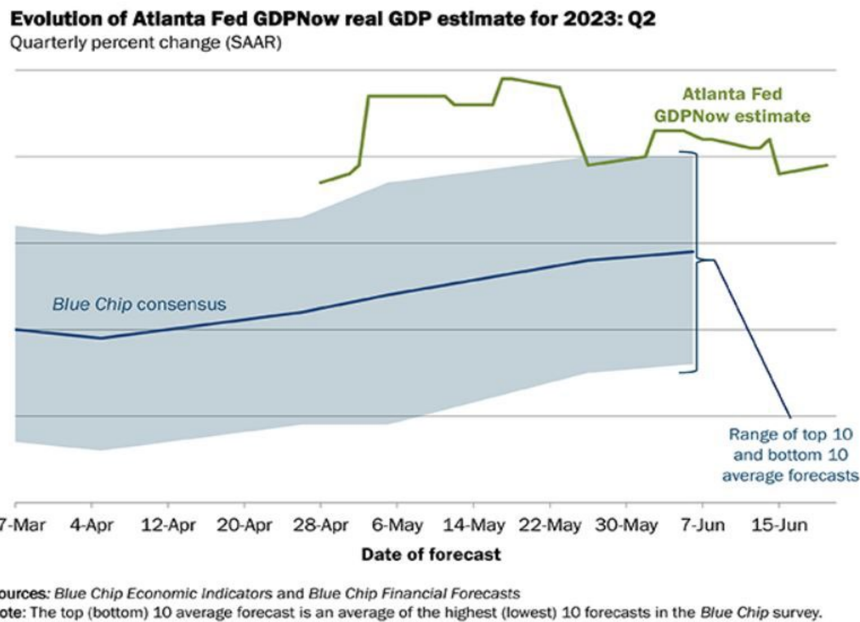
All year we have heard about the pending "earnings recession". The worry is that corporate earnings, and ultimately profits, have not been increasing enough to support the higher stock prices, and concerns are that declining profits could mean lower stock prices in the future. It is easy to find articles that describe the weakness in corporate profits.[2] Some companies have been able to increase prices to offset higher operating costs, and consumers continue to spend in some areas (notably travel and entertainment). As such, many companies have reported earnings above expectations. However, many people will have to start making payments on their student loans again in the near future, which could lead to less spending. And some of the spending has been supported by increasing credit card debt, which isn't sustainable. All this suggests that investors should be cautious, as stock prices could move down. And investors were cautious. The amount of cash moved to money market funds reached a record in June.



One reason for the positive performance in stocks is that the labor market remains strong. Companies are having to compete for workers and that means paying them more. The strong labor market means household finances remain in good shape, which allows people to continue to spend. Moreover, savings for many people remain elevated as COVID stimulus money continues to ripple through the economy. To be sure, many people in the lower half of the income spectrum are struggling. They have felt the impacts of inflation, and no longer have the stimulus cushion. Credit card debt has risen and spending is slowing. But many in the upper portions of the income spectrum continue to spend, supporting the stock market.

Unemployment sits near historic lows in the U.S. and Europe. However, the economic data is not what it used to be. Many data series come from surveys conducted by the Bureau of Labor Statistics and other groups. Response rates are down; seasonal adjustments have become complicated by the swings in the data during COVID; and changing demographics present a mix of challenges. One data series does not tell the complete story, so we need to look at multiple series, then take into consideration the strengths and weaknesses of each.

It may also be important to note that when stock indexes like the S&P 500 move up, it doesn't mean that all stocks are moving up. In the second quarter, the S&P 500 increased 11%, led by the largest companies: Apple, Microsoft, and a few others, including Nvidia (based on optimism about their computer chips and artificial intelligence applications). A majority of the companies in the S&P 500 did not do nearly as well. Consider, for example, that the price of Apple stock increased 18% in the second quarter. Given the outsized influence it has on the S&P 500, for the index to have increased only half as much means many of the remaining companies had no price increase or even price declines.



As with financial markets, when we look at the economy, we find some positive surprises. Early in the year, and even early in the second quarter, most outlooks called for a recession by the end of 2023. While many economists continue to make that call, the consensus view has been steadily improving. The following diagram shows how the consensus view now calls for growth for the current quarter. Moreover, estimates for growth in the first quarter have been revised up, and many economists are now thinking the U.S. can avoid a recession in 2023.

The Federal Reserve did not hike interest rates at its last meeting in mid-June, choosing instead to let more data come in before acting. Financial markets responded positively, imagining a soft landing where higher interest rates reduce inflation, without causing a recession. However, Jerome Powell also suggested the Fed may raise the federal funds rate two more times by the end of the year. And expectations about what may happen with inflation and/or what the Fed may do with interest rates are foundational for any outlook at this time.

Many of the factors that drove inflation last year, including supply chain constraints and excess demand for certain goods, have subsided. Rents have even fallen in many cities in the U.S., helping to reduce inflation. But the message is simply that the rate of inflation is slowing. Inflation is not low and is not at 2%, where the Fed would like it to be. Jerome Powell even said in the last week of June that inflation may not get to 2% until 2025. That means the Fed is likely to raise interest rates again later this summer and perhaps again in the fall. Higher interest rates will put additional pressure on a very tenuous commercial real estate market, and will present challenges for consumers. The question as we look at the second half of the year is whether consumers can continue to spend until the challenges subside. We wonder whether consumers will have that kind of stamina, and we worry about the economy and financial markets given what usually happens at the end of a credit cycle.

In Focus

Money market mutual funds have seen inflows of more than $614 billion this year.[3] We don't think those flows are surprising, even given the fact that the major stock indexes have moved up this year. We mentioned above that the surprising performance of the stock market is actually attributable to the performance of just a few large companies. The following diagram shows the how stocks in different categories performed over the last quarter.[4] The large growth category includes companies like Apple, Microsoft, and Amazon.

Equity Style Snapshot			6/27/23
QTD	Value	Blend	Growth
Large	2.15%	7.10%	11.56%
Mid	2.34%	3.03%	3.75%
Small	2.79%	3.18%	3.68%

Standard practice calls for a degree of diversification, where you hold a mix of stocks or funds across the different categories. It might seem a little surprising that value-oriented companies have performed so poorly, even though they are often considered to be a little safer when uncertainty arises. Instead, investors have turned to money market funds. When you realize that simple money market funds currently have an annual yield of 4.75%, or roughly 1.2% per quarter, you start wondering if 1.2% with little to no risk might be better than 2-3% with considerable risk. Or more specifically, you start wondering how much of your account you should have in the different stock categories in case things go well, and how much to put in something like money market funds where you get a modest return even if things don't go well.

We know many businesses could be at risk if consumption expenditures peak while rates are still increasing. The Fed did not increase interest rates in early June because it wants to see what the effects might be from the increases over the past year. (The impacts are only visible over time, as there is a lag between when rates go up and when we see the resulting dampening effects on the economy.) At the same time, investors are holding a lot of cash. That cash could move into the market with any dips, and possibly just on the view that tech is now a part of everything. To the extent that large tech companies are the modern blue chip companies, providing something of a safe, defensive option, then those companies may continue to do relatively well. We embrace this dichotomy by having exposure to the market, and to large tech in particular (which happens automatically if you hold capitalization-weighted indexes like the S&P 500), while also holding positions in money market funds. The latter provides a defensive stance, getting a modest return with very low risk while also providing cash should stock prices drop and attractive opportunities arise. Big tech has done very well, but also looks to be quite expensive at this point in time.

Currently, the interest rate environment is quite challenging. Short-term interest rates are notably higher than long term rates, resulting in an inverted yield curve, which has persisted for months. The figure below shows long term yields minus short term yields, with negative numbers showing when the yield curve is inverted. An inverted yield curve has preceded each recession (the shaded areas in the figure) for the last 50+ years. That's no guarantee we will have a recession soon, but the extent and duration of inversion at present paints a challenging picture for businesses. Large tech companies have weathered the storm remarkably well thus far, but current conditions suggest that a degree of caution is prudent.

1. Index performance data provided by ICE Data Services, and calculated by Black Diamond, an SS&C Advent company.
2. Duggan, W. (2023, June 1). July 2023 stock market forecast. Forbes. https://www.forbes.com/advisor/investing/stock-market-outlook-and-forecast/
3. McCrank, J. (2023, May 24). US Money Market Fund assets hit record highs despite debt-ceiling fears. Reuters. https://www.reuters.com/markets/us/us-money-market-fund-assets-hit-record-highs-despite-debt-ceiling-fears-2023-05-24/
4. Chart data provided by YCharts.

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