Market & Economic Commentary

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INVESTMENT SERVICES

Market Performance Recap

We are halfway through the year and equities have staged a strong comeback after last year's struggles. The sector laggards of 2022 are the leaders of 2023 with technology, communication services and consumer discretionary all blazing the trail. Those sectors tend to be filled with growth stocks, meaning little in the way of current earnings but high expected earnings sometime in the future. The bank failures at the end of last quarter seemed to have had no lasting impact on the overall trajectory of the market, while the much-ballyhooed recession has failed to materialize. Resilient is the best way to describe US equities. Despite the steady drumbeat of negative headlines, the market continues to shrug off the naysayers and climb higher. The S&P returned 8.7% in the quarter with growth continuing to outperform value across all market caps. The Russell 1000 Index is comprised of mid- and large-cap US equities while the Russell 2000 Index reflects small-cap stocks. Chart 1 illustrates large caps beating small caps in the quarter and on the year, while growth dominated value during the same periods.

Chart 1: US Equity Index Returns

	2nd Quarter	Year to Date
S&P 500	8.7%	16.9%
Russell 1000 Growth	12.8%	29.0%
Russell 1000 Value	4.1%	5.1%
Russell 2000	5.2%	8.1%

Source: OIS, FactSet

Outside of the US, the results were similar but more muted as international markets have more challenges to contend with. Developed markets rallied on optimism around cooling inflation data, especially in the Eurozone. Another tailwind to developed markets was stabilization in energy prices and supplies, which have shifted from Russia to other sources and seem robust enough to weather even a cold winter in Europe. However, the currency tailwinds from first quarter subsided as the dollar stabilized across most major currencies and even gained ground on the Japanese Yen. Fundamentals remained strong for many countries, especially Japan where the local equity market returns are over 20% for the year (as measured by the Tokyo Stock Price Index). A modest uptick in inflation is welcome in Japan, which has been waiting decades to see it happen. Corporate reform in Japan is in full effect as companies are shedding unprofitable units and returning capital to shareholders fueling that market rally.

Emerging market equities have fared less well than non-US developed markets (as measured by the EAFE Index). Emerging markets are dominated by China, which not only is the largest weight in the index but also the largest trading partner of most of the countries in the index like South Korea and Vietnam, as well as less obvious countries like Saudi Arabia, Brazil and Chile. Starting the year, high optimism abounded for the reopening of the Chinese economy as it emerges from years of hard lockdowns forced by the government. Unfortunately, the reopening has not had the economic spark and consumption boost anticipated and China has needed to enact stimulative measures to get its economy growing again. This weakness in consumption bleeds through the broader emerging market economies as China has less demand for the goods and services produced by other nations. This results in lower earnings for companies

reliant on exporting to China for their growth, impacting everything from oil exporters to agricultural producers. The result is weaker, but still positive, returns in the quarter from the MSCI Emerging Market Index as shown in Chart 2.

Chart 2: Non-US Equity Index Returns

	2nd Quarter	Year to Date
MSCI Emerging Markets	0.9%	4.9%
MSCI EAFE (Developed)	3.0%	11.7%
MSCI ACWI-Ex US	2.4%	9.5%

Source: OIS, FactSet

Most, if not all, market pundits missed calling the rally in equities this year. They also called for this to be the 'year of the bond' or some equally catchy tagline indicating their bullish stance on fixed income. So far in 2023, that has not materialized as The Federal Reserve has continued to increase the benchmark Fed Funds rate, keeping pressure on fixed income. The second quarter was negative for all investment grade fixed income segments, while the riskier high yield segment of the market was the only one to post positive returns as seen in Chart 3. The high yield segment tends to have a higher correlation to equity markets and as equities were rising the risk premium (known as 'the spread') for high yield reduced during the quarter, leading to positive returns. High yield is also the segment of the market most susceptible to economic slowdowns, and despite the positive returns in the segment there has been an uptick in bankruptcies among high yield issuers. International investment grade bonds have had tepid interest and underperformed their US counterparts. Until there is an evident end to higher inflation and the interest rate hiking cycle globally, there won't be a clear catalyst for a prolonged rally in fixed income securities. While investors have moved toward fixed income to take advantage of higher yields, the looming perception of even higher yields has tempered enthusiasm.

Chart 3: Fixed Income Returns

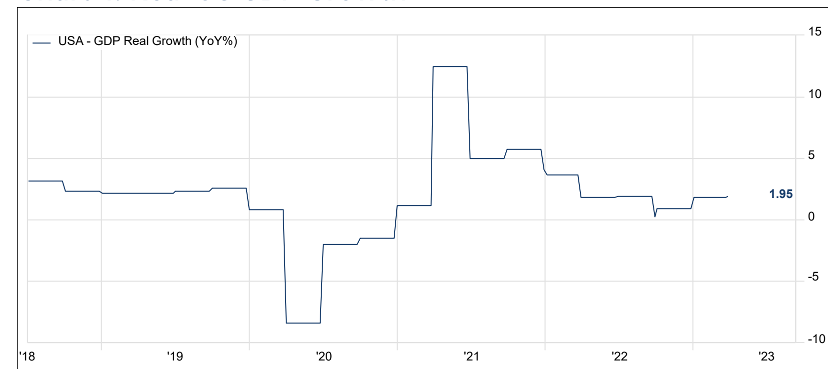
	2nd Quarter	Year to Date
FTSE WGBI (USD)	-1.8%	1.7%
Bloomberg US Aggregate	-0.8%	2.1%
Bloomberg Municipal Bond	-0.1%	2.7%
ICE BofA US High Yield	1.6%	5.4%

Source: OIS, FactSet

Economy

The US economy continues to outperform expectations as the consumer has proven to be surprisingly resilient. While perhaps paying more for less, increased spending still translates to higher GDP, even when subtracting inflation from growth, as seen in Chart 4.

Chart 4: Real US GDP Growth

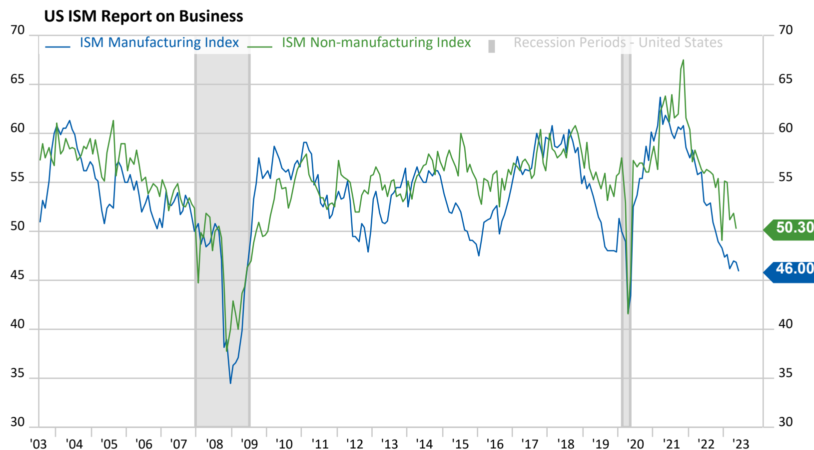


Source: OIS, FactSet (May 2018 – May 2023)

The US consumer needs to stay resilient if the economy is to avoid recession, as consumption drives about 70% of the overall US economy. Higher interest rates (from the fight against inflation) and declining credit availability (from banks pulling back after a deposit flight leading to bank failures) will put pressure on the consumer in the coming months. Some credit card interest rates are closing in on 30%, while, at the same time, credit card balances are increasing.

There is reason for optimism as unemployment remains incredibly low at 3.7% and wages are still rising (though not as fast as inflation has been). The services sector is still very strong with elevated demand across everything from airfare and cruises to dining out and concerts. The services demand may help offset the slumping manufacturing sector of the economy (the blue line in Chart 5) which has fallen to lows only seen during recessionary periods.

Chart 5: US ISM Purchasing Managers Index



Source: OIS, FactSet (May 2018 – May 2023)

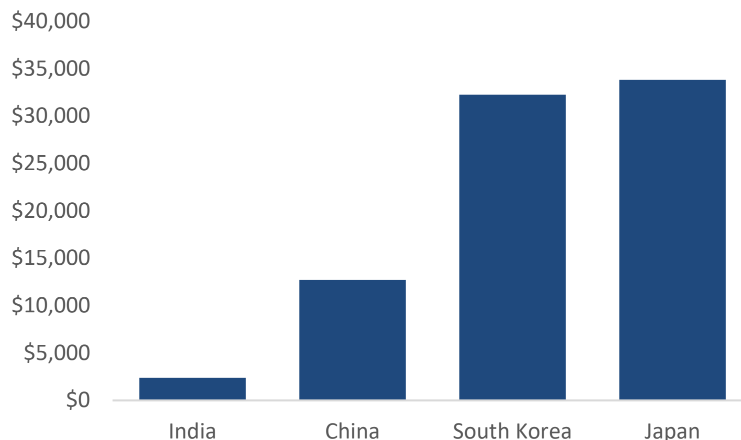
A reading of the ISM Manufacturing Index below 46.5 has historically indicated a recession. Yet, manufacturing as a percentage of our overall economy has continued to shrink so there is a case to be made that an expanding services sector can overcome the slumping manufacturing sector.

Across Europe, the economy is still chugging along with 1% real GDP growth over the last year. The overall number clouds the reality that Germany has slipped into a recession while Spain and Italy are seeing some of their best growth in decades. The two-speed economy in Europe is not uncommon as Germany led the bloc with strong growth for years while Italy and Spain suffered from the strong euro and saw economic malaise. As fortunes have reversed, the robust southern economies are net beneficiaries from the increasing demand for travel and leisure activities.

Asian economies are growing at different speeds as well, with Japan nearing 2% real GDP growth, while South Korea is hovering around 1%. Both countries have declining populations due to low birth rates and restrictive immigration policies, so any positive growth is good and has an outsized impact on per-capita GDP (less people and higher GDP results in feeling wealthier). Both Japan and South Korea have per-capita GDP in the top 10 of countries across the world making them among the wealthiest nations. The most populous country in the world, also the largest democracy and sporting a rapidly growing population, is India and real GDP growth there is over 6% thanks to economic reforms and a highly educated workforce. India has a long way to go though in per-capita GDP, which sits just above $2,380 per person, meaning most of the country lives in poverty. Putting that into perspective,

the average Indian GDP per-capita is less than 20% of the average for a Chinese citizen and about 3% of the average US citizen. This perspective is useful in understanding the enormous amount of potential growth in the Indian economy. To get the Indian population out of poverty and towards the middle income countries like China, requires India's GDP to increase by more than four times. While seemingly quite high, this growth is not impossible as China has recently demonstrated lifting over one billion people out of poverty. As India makes progress on this journey, it will create unique investment opportunities as the economy becomes more dynamic.

Chart 6: GDP Per Capita



Source: The World Bank, data as of 12/31/22

Overall, the global economy may be moderating growth a bit from the strong rebound after the pandemic, but it is far from recessionary. Keep in mind that economic growth does not correlate to short-term moves in the equity market which can trade off sentiment and short-term boosts in operating efficiency as much as economic swings.

Complacency

Similar to life, one must guard against complacency when investing. Going with the flow or the consensus is the easiest route, but often not the best one. In equities this year, the consensus has been leaning into the largest companies. The bulk of the return in the S&P 500 Index has come from just eight securities, Nvidia, Meta (formerly Facebook), Microsoft, Apple, Netflix, Alphabet (formerly Google), Tesla and Amazon. In one sense this is a safety trade as these companies have strong cash positions coupled with high revenues and high growth. However, this has pushed valuations to very high levels where Nvidia is trading at 221x current earnings and Meta at 36x, versus the broader market around 22x. The rally has pushed market caps higher too, with Apple now worth over $3 trillion – the first time ever for a listed company. It would be easy to hop on this bandwagon, which many investors have done during the second quarter after the easiest money has likely been made. Rather than chasing the leaders, will the rally broaden out and lift up small caps? Or, does the rally stall and those expensive market leaders take the brunt of the downturn? These are questions all investors should ask themselves as they think about their portfolios.

Complacency is evident in commodities, as well. After a strong 2022, the first good year for commodity returns in a decade, prices drifted lower to start the year. Sellers took their profits from 2022 and moved on. There are fewer long-term holders of commodities after a decade of sub-par returns, so the transient holders were happy to move on.

Commodities, like stocks, can trade on sentiment, however they are subject to much stronger supply and demand forces not prevalent in other markets. For example, the price of natural gas fell to close to $2 per Metric Million British thermal units (MMBtu) in early April. That price is below the cost of production on offshore rigs, so those rigs closed down taking as much as 15% of supply off the market in just a few weeks. This ability to respond almost immediately to changes in pricing is unique to certain commodities, and in this case has boosted natural gas prices back above $2.60 per MMBtu. Other commodities take longer to respond to shocks and changes, such as wheat where the initial shock of the war in Ukraine pushed prices up 70% in the early days of the conflict. However, the prices fell steadily as Ukraine and Russia both committed to keeping the grains flowing. What the sentiment didn't consider this year is a drought in the midsection of the US, specifically around Kansas, during the planting season. The resulting wheat harvest in the autumn will be light setting up less supply for a similar demand, which is just now starting to be appreciated by the market.

If you have questions or would like to discuss any of these topics in greater detail, please reach out to us.

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