Investment Newsletter

Second Quarter 2023

The adage 'the stock market climbs a wall of worry' was on full display this quarter. Despite multiple concerns and negative sentiment, the S&P 500 index posted a total return of +8.6%, resulting in a first-half total return of +16.6% - one of the stronger performances ever recorded. The MSCI All-Country World ex-U.S. index posted a total return of +2.4% for the quarter and +9.5% for the first half. The following were key drivers of performance: the continued easing of inflation; the recent pause in interest rate hikes by the Federal Reserve after 10 consecutive hikes; the explosive advent of the generative artificial intelligence (A.I.) market, which catalyzed technology stock outperformance; and the extraordinary sturdiness of the U.S. labor market.

Fixed income, however, came under moderate pressure in the quarter, with the Bloomberg U.S. Intermediate Government/Credit index returning -0.8% and the Bloomberg Municipal Bond Blend 1-5 Year index returning -0.4%. Yields were volatile with the 10-Year U.S. Treasury trading in a range of 3.29% to 3.85%. Yields rose across all maturities, resulting in negative returns for all maturities except one-year and under. The move up in yields reflected a change in investor sentiment regarding monetary policy, as stronger economic data reinforced the Federal Reserve's intent to continue raising interest rates despite pausing in June.

We expect continued volatility as the expected decline in inflation and slowing of economic activity takes longer to unfold. A variety of factors – stubborn inflation, rising U.S. debt service costs, and pockets of economic strength – will likely keep yields range-bound. As such, we are maintaining our fixed income investment strategy of selectively increasing portfolio duration and yield by locking in intermediate maturity, higher coupon bonds as existing holdings mature. Our objective is to structure portfolios with high-quality bonds that generate a higher income stream than what we have seen over the past several years.

With the stock market's surprisingly resilient performance, investors re-learned four critical investing lessons:

1. Consensus expectations are often wrong. For example, coming into this year, most equity strategists were calling for a U.S. recession. In fact, at the beginning of the year, the consensus forecast for 2023 U.S. real GDP growth was a paltry +0.3%. By the end of June, that figure was revised up to +1.1%.
2. Innovation powers stock outperformance. For example, the incredible lift-off in the generative A.I. market was first triggered by the groundbreaking debut of OpenAI's ChatGPT product, and then by A.I. semiconductor market leader NVIDIA's (NVDA) shocking revenue forecast for its upcoming quarter that was +53% above consensus – an unprecedented event for such a large company. These events helped ignite the NASDAQ to its best first-half performance in 40 years.
3. The stock market is focused mostly on the future, not the present. For example, the S&P 500 has performed well because it could 'see' inflation was falling, the Federal Reserve would pause interest rates hikes, the banking crisis would be contained in the short term, and the debt ceiling would get temporarily resolved.
4. Stay invested for the long term. No one can predict near-term or mid-term equity performance.

Notwithstanding the stock market's robust performance, the following are concerns going forward:

- Core inflation remains sticky. The Personal Consumption Expenditures Index (PCE) has a headline reading and a core reading (ex-food and energy). The core PCE has been higher than the headline PCE for many months. For example, the May headline PCE was +3.8%, but the core PCE was +4.6%. In addition, monthly PCE readings will have tougher comparisons beginning in November. Consequently, the Federal Reserve might continue raising interest rates and has signaled two more possible hikes.
- Wage growth – which drives inflation – has remained elevated in the +6.0-6.7% range since March 2022.

- The $20 trillion U.S. commercial real estate market is suffering from low post-pandemic occupancy rates, higher online shopping, and higher interest rates – all of which lower cash flows and property values. If property owners default on their mortgages, banks could suffer losses.
- Banks could come under renewed pressure. They have lost deposits, are entering a period of rising credit losses, and have restricted credit to businesses and consumers. Higher interest rates could also sustain pressure on their balance sheets like earlier this year during the banking crisis.
- The Federal Reserve reported that 37% of non-financial firms are in financial distress (i.e., close to default), a level higher than during most previous monetary tightening periods since the 1970s.
- Twenty-five percent of the combined corporate debt in the U.S. and Europe will mature within the next three years. This debt will get refinanced at higher interest rates, pressuring earnings growth.
- Consumer spending will be pressured. Federal student loan payments restart on October 1. An estimated 40.5 million people owe a total of $1.4 trillion. With an average monthly payment of $389, student loan payments are estimated to cut -8% from consumer monthly income and $190 billion annually from the economy.
- The stock market's performance has come solely from valuation multiple expansion, not from earnings growth. In fact, the consensus estimate for 2023 EPS growth for the S&P 500 has fallen to +0.6% currently from +4.5% at the end of last year. The S&P 500's forward price-to-earnings ratio now sits at 19.2x versus its 10-year average of 17.4x (a +10% premium) and versus 15.2x in October 2022.
- Narrow stock market breadth. Eighty percent of the S&P 500's first-half total return performance attribution was concentrated among just ten stocks – all technology companies.
- Monetary policy operates with a one-year lag. The Federal Reserve made its first 75-basis points hike in interest rates last June, which means the full effect of its hiking campaign is only starting to be felt.
- U.S.-China relations are worsening, and China's post-pandemic economic recovery has been disappointing. China's indebted property sector is still struggling to recover, its export market is slowing, its population is in decline and was recently overtaken by India, its currency is near a 15-year low, and its stock market was one of the few that posted negative first-half performance. Its government has also been reluctant to add more fiscal stimulus out of fear of stoking inflation.

These concerns, however, will be balanced out by the following positive factors:

- Continued innovation. Energy and computing power are both getting cheaper, which will support growth in many new technologies. Over the long term, only innovative companies outperform.
- S&P 500 earnings growth is forecasted to accelerate to +11.7% in 2024 from +0.6% in 2023 based in large part on easing quarterly comparisons that begin in the third quarter of this year.
- Strong government infrastructure investment programs are still in their early stages – the $1.2 trillion Infrastructure Investment and Jobs Act (broadband access, clean water, electric grid renewal, and transportation), the $783 billion Inflation Reduction Act (clean energy, energy security and climate change), and the $280 billion CHIPS and Science Act (R&D and semiconductor manufacturing). In the first quarter, manufacturing spending was nearly 0.5% of GDP – the most since 1991.
- A strong U.S. labor market featuring a 3.7% unemployment rate and 10.1 million job openings.
- Continued easing of U.S. inflation. The headline PCE peaked at +6.8% last June. The full effect of the Federal Reserve's higher interest rates should continue to pressure inflation lower.

The two concurrent global transitions of monetary policy shifting to restrictive from easy and COVID-19 shifting to endemic from pandemic, all against a backdrop of government and corporate indebtedness, have spawned the most complex, challenging, and volatile investment environment in decades. Despite this, our equity investment strategy remains both consistent and compelling, strongly rooted in the discovery of companies with market-leading innovation tied to durable sector trends. Our strategy also entails the employment of prudent diversification across individual securities and product end markets – especially given the extreme concentration of stock winners seen so far this year – as well as the patient and vigilant focus on long-term performance.

Sources: FDIC, BEA, Commerce Department, Barclays, Nareit, Federal Reserve Economic Data (FRED) and FactSet

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