Second Quarter 2023 Letter

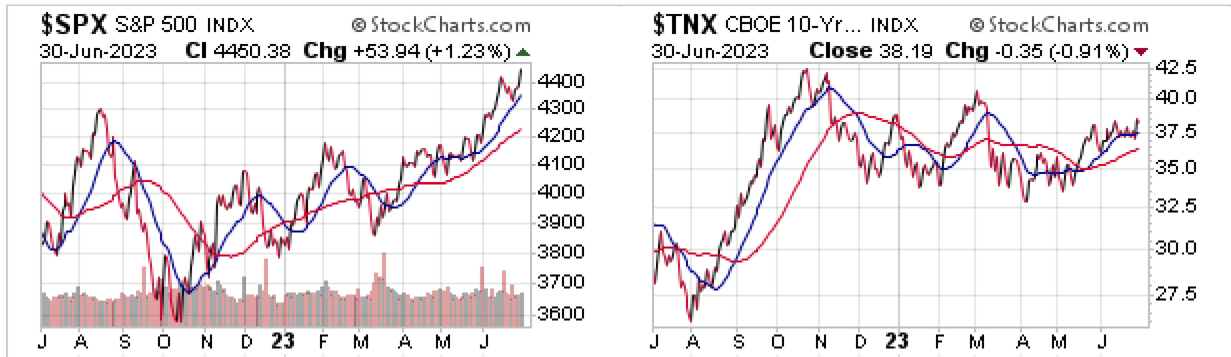

Figure 1 – S&P 500 **Figure 2 – U.S. 10-Year Treasury Yield**

Market Recap

Markets rose again in the second quarter of 2023 continuing the recovery that began at the end of 2022. The S&P 500 index (**Figure** 1) led markets higher again, with a total return of 8.7%, and is now up 16.9% for the year. Mid and small cap indices also posted solid gains. The S&P MidCap 400 rose 4.9% and the Russell 2000 Small Cap gained 5.2%. International exchanges notched more modest gains. Developed countries outside the U.S. as a group added 2.9%, while emerging markets inched higher 0.9%. U.S. growth stocks rose 10.6% boosted by excitement over the potential of artificial intelligence, while value stocks gained 6.6%. Bonds gave up some ground as interest rates recovered in the quarter with the Bloomberg U.S. Aggregate Bond index fell 0.8%%.

Financial markets appeared to return to stability in the second quarter, after the bank rescues that were needed in March. Lower long-term interest rates early in the (**Figure 2**) quarter helped stock prices, which were also supported by first quarter corporate earnings. Overall, it was a quiet quarter for major headlines. Economic uncertainty remained, but the Federal Reserve helped the rally in May by hinting at a pause in interest rate hikes. Market optimism was validated, at least temporarily, when interest rates were held steady in June. Late in the quarter the June consumer confidence survey showed strong improvement, giving stocks another boost.

Market leadership for much of the quarter was very narrow, dominated by the technology sector. Approximately 20% of individual S&P 500 stocks beat the index in the first half of the year, a historically low number. The market concentration has also reached unusual levels. The top five stocks currently comprise 25% of the index. By comparison, when the NASDAQ bubble began to burst in 2000, the top five represented about 17%. In June, however, market returns broadened, with small and mid cap stocks outpacing the S&P 500.

First quarter earnings dropped 3.4% as revenue rose 4.4%. It was the second consecutive year-over-year decline, but somewhat better than the -9.0% expected at the beginning of the quarter. Once again companies generally fared better than expected, which has led some analysts to increase estimates for the coming quarters. The consumer discretionary and transportation sectors had the largest percentage gains, partially due to a strong recovery in airline earnings. Estimates for the technology sector, which provides 26% of the S&P 500's earnings, are -5.0%, an improvement over the first quarter's -10.3% results. The anticipated bottoming of tech earnings, along with solid company guidance, has been a big driver of stock gains this year. Analysts are currently expecting that earnings for the S&P 500 will trough in the 2nd quarter (-9.4%) and rise sequentially in the following three quarters. As other sectors return to growth, more stocks may share in the market's gains.

Economic Perspective

U.S. gross domestic product (GDP) grew 2.0%, slower than the previous quarter's 2.6% annual growth rate, but better than the 1.5% that had been forecast. Services spending was strong, but manufacturing fell slightly from the previous year. Government expenditures (+2.7%) were a source of strength, as infrastructure spending quietly spreads through the economy. 2nd quarter GDP is currently expected to grow 2.1%. Manufacturing sector purchasing manager surveys have remained weak this year. New orders slowed and backlogs shrunk as companies

worked through inventories, some of which had increased too much while dealing with supply chain problems. In contrast, service sector activity, which comprise more than three-fourths of the U.S. economy, rebounded sharply in June on increased business activity. Some market watchers are calling for slowing in the 2nd half of the year, including possibly the start of a recession. As we have noted before, this may be the most forecast and eagerly anticipated recession ever. However, with new home sales +20% and new auto sales +13% in the first half of the year, we may be waiting a little longer for the next contraction in the economy.

Employment has remained a bright spot in the economic picture. Employers added more jobs than expected in April and May before June's report fell slightly short. The unemployment rate rose slightly in the quarter but remained low (3.6%). The much-followed Employment Cost Index trended down marginally to 5.07%, as wages continue to pressure inflation. Strong wage growth has helped consumers maintain their spending in the face of rising prices, but poses a problem for the Federal Reserve, as they debate further interest rate hikes to bring inflation closer to their long-term target of 2%.

May's consumer price index (CPI) report provided mixed news on inflation. The headline reading of +4.0% from the previous year was the slowest growth in two years and seemed to vindicate the Fed's decision to pause rate hikes in June. However, the core CPI index, which excludes the volatile food and energy components, remained stubbornly high at 5.3%. Lower energy prices may provide some welcome relief to strapped consumers, allowing them to maintain spending elsewhere. OPEC has announced multiple production cuts this year to try to maintain high oil prices, but global demand has not been strong enough to provide a boost. If commodity price inflation remains tame, it will make the Fed's task that much easier.

Looking Ahead

The first half of the year has been frustrating for many investors. The headline S&P 500 is up strongly, but gains have been concentrated in the largest seven stocks in the index. Consequently, diversified portfolios have looked anemic by comparison. Historically, periods of extreme market concentration have generally been followed by catch-up from the laggards. Small cap stocks (**Figure 3**), which were battered earlier in the year, may be among the biggest beneficiaries as interest rates stabilize and confidence improves. At the same time, we would not bet against U.S. consumers, who remain in relatively good shape, supported by solid wage growth and slowly moderating inflation. Consumer discretionary stocks (**Figure 4**), including the travel sector, may continue to help lead the market.

Figure 3 – S&P 600 SmallCap Index

Figure 4 – Consumer Discretionary SPDR Fund

Bond prices pulled back slightly as yields rose towards the end of the quarter. However, with yields above 5%, and few additional rate hikes expected, investment grade bonds should offer solid total returns. And for those investors who prefer to hold cash, money market funds provide competitive yields, but it may be necessary to move funds from your bank checking or savings account.

Index returns taken from Morningstar.com

The market's rise this year may have surprised many. Last year's bear market was difficult, and there has been plenty of bad news to digest since the start of the year. But our economy and stocks have a great track record of recovery and growth. Patient investors who maintain their holdings generally prosper over time.

We hope that your summer is going well, and we look forward to speaking with you soon.

Best regards,

Kenneth M. Bernard, CFA

Index returns taken from Morningstar.com