Second Quarter Market Review and Comment
July 2023

Updated Market Performance

Returns	2nd Quarter 2023	YTD	One Year	Annualized 3 Year	Annualized 5 Year	Annualized 10 Year
S&P 500	**8.74%**	**16.89%**	**19.59%**	**14.60%**	**12.31%**	**12.86%**
DJIA	**3.97%**	**4.94%**	**14.23%**	**12.30%**	**9.59%**	**11.26%**

Performance: April continued March's gains, returning 1.56%. May was flat after April's gains, eking out a return of 0.43%. June returns shot upwards returning 6.61%. This left us with a 2nd quarter 2023 total return of 8.74%.

After the 1st quarter 2023 posted a gain of 7.50%, the 2nd quarter 2023 started off flat and finished with a strong June. We ended the quarter positive mainly attributed to Mega Cap Tech stock gains, leaving us with a return of 8.74%. The Dow Jones Industrial Average (DJIA) underperformed the SP500, posting a 3.97% gain over the same period. For the previous twelve months the SP500 returned 19.59%, outperforming the DJIA which returned 14.23% over the same period. The annualized three-year returns for the SP500 were 14.60%, the DJIA three-year returns trailed the average increasing 12.30%. Over the last five years the annualized returns are right around historical norms (around 10.15%), with the SP500 returning 12.31% and the DJIA posting 9.59%. The ten-year annualized numbers are running above long-term averages (around 10.15%), with the S&P500 returning 12.86% versus the DJIA which turned in 11.26%.

Breaking down the returns for Q2 2023, we note that there were three outperforming sectors and eight underperformers. **The best sectors were Information Technology (16.93%), Consumer Discretionary (14.31%), and Communication Services (12.82%). The underperformers during the quarter were Utilities (-3.26%), Energy (-1.79%) and Consumer Staples (-0.20%).** The best sectors over the last year were Information Technology (38.82%), Consumer Discretionary (23.45%), and Industrials (22.98%). Following behind were Real Estate (-7.47%), Utilities (-6.63%), and Healthcare (3.63%).

Economy: Growth in the economy increased in 2022 by 2.1% compared to an increase of 5.9% in 2021. 2022 began the deceleration in growth leaving us with growth below historical trends (Historical growth is ~3.13%). Expectations are that we will continue to see growth slow. 1st Quarter 2023 GDP increased at 2.0%. Inflation is still running above historical averages, although it has been continuing to ease. The Fed has been aggressively tightening monetary policy to get inflation under control. Normally when the federal reserve tightens monetary policy and raises short term rates, they usually result in hindering growth and causing the economy to go into a recession. Recession risks are currently high. We had a technical recession in the first half of 2022 which is defined as two negative quarters of GDP. We think a more meaningful recession will occur sometime in the second half of 2023 or in 2024. At the current moment, the recession looks to be shallow and short.

The third estimate of 1st quarter 2023 Gross Domestic Product (GDP) is 2.0% according to the report released at the end of June by the Bureau of Economic Analysis (BEA). The latest estimate suggests that overall economic growth in the 1st quarter decreased 0.60% from the 4th quarter 2022 third estimate of 2.6%. GDP for 2022 came in at 2.1% compared to 5.7% in 2021, -3.5% in 2020, 2.2% in 2019, 2.9% in 2018 and 2.2% in 2017. Currently Trading Economics estimate (Forecast of U.S. GDP Growth) has forecasted 2023 Q2 GDP growth at 1.60%. The Federal Reserve Board of Atlanta's GDPNow is forecasting 2nd quarter GDP at 2.1%, which is below the consensus estimate of ~0.9%. By comparison, China says their GDP increased 4.5% in the 1st quarter of 2023. Increasing from 4th quarter 2022 reading of 2.9%. China's 2022 GDP was 2.9%, 8.1% in 2021, 2.3% in 2020, 6.1% in 2019, 6.6% in 2018 and 6.8% in 2017. Growth rates for the European Union (EU) and the Euro Area were 1.0% and 1.0% respectively in the 1st quarter 2023. For 2022, GDP grew 3.5% for the EU and 3.5% for the Euro Area. For 2021, GDP grew 5.3% for the EU and 5.3 for the Euro Area. For 2020, GDP fell -6.1% for the EU and -6.37% for the Euro Area. For 2019, GDP rose 1.5% for the EU and 1.2% for the Euro Area. This is down from the 1.9% growth achieved by the EU and the 1.8% achieved by the Euro Area in 2018. GDP Growth forecasts for the end of the 2nd QTR 2023 are 0.60% for the EU and 0.40% for the Euro Area.

Unemployment is continuing to trend below historical norms (~5.76%). Even with increased layoffs in the headlines, unemployment remains resilient. According to the Bureau of Labor Statistics, May unemployment increased to 3.7% from April's 3.4%. Unemployment for 2022 came in at 3.65% which is 1.71% below 2021's rate of 5.36%. Unemployment was 8.11% and 3.67% in 2020 and 2019, respectively. The number of unemployed rose by 440,000 to 6.1 million in May. The labor force participation rate held at 62.6% in May. In May, job gains occurred in professional and business services, government, health care, construction, transportation and warehousing, and social assistance.

Inflation increased 4.00% in May continuing to run above the average trend. After averaging 5.8% in the 1st quarter 2023, inflation as measured by the Consumer Price Index (CPI) decreased to an average of 4.45% for the first two months of the 2nd Quarter 2023. The average rate of inflation for 2022 was 8.01% and was above average by historical standards (~2.59% over last 30 years and 3.27% from 1914-2023). The energy index decreased 11.7% for the 12 months ending in May, and the food index increased 6.7% over the last year.

Consumption is an important driver of the economy as it represented 68.3% of 2nd quarter 2023 nominal GDP. The U.S. Census Bureau announced in June that retail sales for May 2023 were 0.30% from April and were up 1.6% above May 2022. Non-store retailers were up 6.5% from last year, while food services and drinking places were up 8.0% from May 2022.

The manufacturing economy contracted in June. Economic activity in the manufacturing sector contracted for the month of June, with the overall economy contracting for the 8th consecutive month. This follows a 28-month period of expansion. The Purchasing Managers Index (PMI®) registered 46.0; a decrease of -0.90 from May's reading of 46.9. Of the five subindices that directly factor into the Manufacturing PMI®, none were in growth territory. Of the six biggest manufacturing industries, only one (Transportation Equipment) registered growth in June. The New Orders Index logged a 10th month in contraction territory. This month, none of the 10 subindices were above 50 for the month. A reading above 50 indicates that the manufacturing sector is generally expanding; below 50 indicates that it is generally contracting. Based on historical relationships between PMI and GDP, a PMI of 46.0 corresponds to a -1.0% decrease in real gross domestic profit (GDP) on an annualized basis.

Home prices continued to increase in April. According to the S&P Case-Shiller Home Price Indices home prices in April decreased -0.20% over the last 12 months, which is down -0.90% from the previous month's 0.70%. Miami, Chicago, and Atlanta had the largest year-over-year increases with 5.20% for Miami, followed by 4.10% for Chicago, and 3.50% for Atlanta. According to the National Association of Realtors, the year-over-year change in existing home sales was –11.80% in May for Single family homes between $250,000-$500,000. Housing supply continued to remain tight in May with 2.8 months of supply.

Markets: The markets have continued to trade in a range after hitting an all-time high on the S&P 500 January 3rd, 2022, at 4,796.5. We went from being in a Bull market to being in a Bear market back in January of 2022. At this time, the market will continue to be driven by hawkish monetary policy, inflation, recession fears, decreasing corporate earnings, geopolitical risks, and the current banking situation.

What will move the markets moving forward:

- **Earnings: Earnings growth for the SP500 is expected to decrease -6.8% for the 2nd quarter 2023. For Q2 2023, the estimated earnings decline for the S&P 500 is -6.8%. If -6.8% is the actual decline for the quarter, it will mark the largest earnings decline reported by the index since Q2 2020 (-31.6%).** Looking at future quarters, analysts project earnings growth for the 3rd QTR 2023 to be 0.40% and 7.90% for the 4th QTR 2023. Earning growth for 2023 is projected to be 0.90% and 11.7% for 2024.
- **Valuations: Valuations came down meaningfully last year but have expanded meaningfully the first half of 2023.** The Price to Earnings at the beginning of 2023 was 16.7. It increased in the first half of the year to the current P/E of 19.1. The 20 Year average P/E is 15.5, which is 3.6 below our current levels. There is not a lot of room for P/E expansion currently, but there is the potential for contraction without meaningful growth.
- **Monetary Policy/Interest Rates: Short Term Interest Rates are continuing to increase and are right above historical averages. The average effective Fed Funds rate since July 1954 is 4.60%. The average over the last 10 years is 1.01%.** The Federal Reserve left rates unchanged at a range between 5.00%-5.25% in its latest meeting in June and is expected to raise rates at least .25% twice for the remainder of the year. The Fed will continue reducing its holdings of Treasury securities, agency debt, and agency mortgage-backed securities, as described in the Plans for Reducing the Size of the Federal Reserve's Balance Sheet. The Committee is strongly committed to returning inflation to its 2 percent objective. The spread between the 2-year and 10-year Treasury yields is -0.94% as short-term rates have risen faster than long-term rates amid expectations for Fed monetary policy tightening. The yield curve is currently inverted (2-year yield is higher than the 10-year yield) and financial conditions are tightening. **Eight of the last Nine recessions since 1955 have occurred during a rising interest rate environment when short term rates were higher than long term rates (Inverted Yield Curve), which leads to our ongoing concern of the Fed raising rates too far. It is not if, but when.**
- **Inflation: Inflation has continued to remain elevated, however we are continuing to see signs of inflation easing.** Inflation is easing albeit slowly. Currently the Fed has committed to increasing interest rates and decreasing their balance sheet to continue to fight inflation. This comes at a time when growth is slowing. If growth slows too much and inflation stays elevated/high, we may end up with stagflation.

- **Russia-Ukraine Conflict and other Geopolitical risks: The current conflict is continuing to weaken the European economy more than the US economy, with some speculation of a recession in some countries (especially Germany).** At this time, it is hard to determine the total impact this conflict will have on the US. US-China relations remain tense.
- **The current banking situation:** The banking events were swift and severe: Silicon Valley Bank and Signature have both been taken over by the Fed and placed into FDIC receivership. Washington needs to come up with a new and improved cure. Banking issues, at this point in time, do not appear to be systemic, but continued withdrawals may lead to more failures. The two "issues" were separate. Silicon Valley Bank seems to be a traditional risk/maturity issue, which appeared to be a management failure and now also appears to be a regulatory one. Signature appears to be a portfolio issue. With the intent to not downplay the event/damage, the market has looked the other way, and it has moved back to its old issues consumer spending, inflation, the Fed, and profits. This is not the 2008-2009 banking crisis and the market impact going forward at this point is expected to be tighter loan requirements, new regulations for regionals, lower margins for all deposit-related issues and an increased chance of a recession. The Fed stepped in and prevented contagion. They created the Bank Term Funding Program (BTFP) allowing banks to exchange treasury and other assets and receive full face value for 1 year. They have also accelerated their review of large bank balance sheets. We do foresee issues in the commercial real estate market, especially office buildings. Almost $1.5 trillion of US commercial real estate debt comes due for repayment before the end of 2025. These loans will need to be refinanced. They will be refinanced at higher rates with lower occupancy leading to the potential for defaults. The majority of this debt is held by regional banks which could have a significant impact on their balance sheets and potentially lead to more bank failures if default rates spike.
- **Student loan moratorium lifted:** After a three-year moratorium, Congress recently passed a law preventing further extensions of the payment pause. Student loan interest will resume starting on Sept. 1, 2023, and payments will be due starting in October. The largest impact could be seen in consumer spending since borrowers will have less disposable income. This could potentially have a drag on GDP causing growth to slow and increasing the probability of a recession.

Forecast:

We think the biggest threats to the stock market are interest rates continuing to increase accompanied by elevated inflation, the Fed tightening monetary policy, and economic contraction. We think the SP500 will end Q3 2023 between 4200 and 4400. At this juncture, we venture a guess that stocks will end the year somewhere between 8% and 10% for the year.

For the next six to twelve months, the Federal Funds rate will most likely increase from its current range of 5.00%-5.25% to 5.25-5.50%. **The 10-year Treasury, which is currently priced at ~4.03% should remain in a range between 3.80%-4.00% through the end of the 3rd quarter.**

As always, we appreciate your continuing confidence in our firm. Please let us know if you have questions.

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