Market Review & Outlook

July 2023

To the surprise of many professional prognosticators, stocks outperformed all expectations for the first half of 2023, following a dismal 2022 that saw the traditional 60% stock, 40% bond portfolio suffer its worst calendar year performance since 1871. Indeed, the benchmark S&P 500's first half performance was the best since 2019 (and second-best since 2000), while the tech-heavy Nasdaq Composite enjoyed its best first half since 1983. For over a year, many economists have been forecasting that Fed interest rate hikes and fading fiscal stimulus would tip the economy into recession in 2023. Despite deteriorating economic conditions, the US has thus far avoided a recession largely on the strength of a historically tight labor market. For a more detailed look at how various asset classes performed in recent periods, please refer to the table above.

Index	June 2023	2nd Quarter	Year-to-date	One Year	Description (what the index is comprised of)
S&P 500	6.61%	8.74%	16.89%	19.59%	Large Cap US Stocks
DJ Industrial Average	4.68%	3.97%	4.94%	14.23%	Large Cap US Stocks
Nasdaq Composite	6.65%	13.05%	32.32%	26.14%	Large & Mid-Cap US Tech Stocks
Russell 1000 Growth	6.84%	12.81%	29.02%	27.11%	Large Cap US Growth Stocks
Russell 1000 Value	6.64%	4.07%	5.12%	11.54%	Large Cap US Value Stocks
Russell 2000 Growth	8.29%	7.05%	13.55%	18.53%	Small Cap US Growth Stocks
Russell 2000 Value	7.94%	3.18%	2.50%	6.01%	Small Cap US Value Stocks
MSCI EAFE	4.55%	2.95%	11.67%	18.77%	Foreign Developed Market Stocks
MSCI EM	3.80%	0.90%	4.89%	1.75%	Emerging Markets Stocks
Credit Suisse High Yield	1.69%	1.87%	5.84%	9.35%	US High Yield Corporate Bonds
Bloomberg US Aggregate Bond Index	-0.36%	-0.84%	2.09%	-0.94%	US Treasuries, mortgage-backed, investment grade corporate bonds

Undoubtedly, the stock rally since last fall has been impressive, especially for the headline averages. Witness the S&P 500 rally of 24.3% since its cycle low on October 14 of last year, or the 35% Nasdaq rally since its cycle low on December 28, with both indices now sitting near 15-month highs. For much of this rally, gains were highly concentrated in seven widely-held stocks – Alphabet (Google), Amazon, Apple, Meta (Facebook), Microsoft, Nvidia, and Tesla. As recently as late May, stock market bears were pointing out that this small group of stocks accounted for ~90% of the YTD return for the S&P 500, and that such narrow breadth does not a healthy market make. Moreover, as of 6/30, four out of eleven sectors (utilities, health care, energy, and financials) were still down YTD, while consumer staples were up only 1.3%.

However, stocks have not cooperated with the bearish view, and the rally broadened out in June, with the equal-weighted S&P 500 index outperforming the capitalization-weighted S&P 500 by 108 basis points (7.69% vs. 6.61%) on the month. What only a few weeks ago had looked like a momentum-driven rally powered by a handful of tech stocks and AI-related hype is starting to look more constructive, despite the major averages looking short-term overbought. This has happened despite aggressive Fed rate hikes (with the threat of more to come), the most inverted yield curve in 40+ years, a regional banking crisis, another congressional debt ceiling fight, elevated geopolitical risks, and a NY Fed recession odds probability model sitting at 96%.

To be fair, though a broad range of data continues to show growth slowing, the Bloomberg US economic surprise index leapt into positive territory this past quarter and has continued rising the past two months as some economic data releases have come in "better than expected." As an example, last week annualized GDP in the US for Q1 was revised higher on the final estimate to 2.0% from 1.4%. Along with the strength in the equity markets, this positive inflection in the data has emboldened the bulls and thinned the ranks of the bears. Increasingly, recession forecasts are being pushed out to late this year or into 2024, and some bullish commentators predict a recession will be avoided altogether. According to the minutes of the June FOMC meeting released this week, the Fed still expects a "mild" recession later this year.

Is the positive shift in investor sentiment warranted? Looking beyond the undeniable price momentum, the fundamental backdrop for stocks has continued to worsen. According to Zacks Equity Research, 2023 Q2

earnings for the S&P 500 index are expected to decline -9.4% from the same period last year on -0.5% lower revenues, with margin declines for the 6th consecutive quarter driving the earnings drop. This will be the 3rd consecutive quarter of earnings declines for the S&P 500 index, as it would follow a -3.4% decline in 2023 Q1 and -5.4% drop in 2022 Q4.

Look to the Philadelphia Semiconductor Index for a more pronounced example of this trend, as the index has risen more than 45% YTD even though the Semiconductor Industry Association reported last month that chip sales had declined by 22% year-over-year in April. Apple stock rose 49.7% during the first half, despite revenue growth turning negative earlier this year, and forecasts predicting negative revenue growth will remain negative during the 2nd and 3rd quarters. At the same time, Apple's valuation has blown out to 30x forward earnings, or 67% above its 10-year average of 17.9. Apple's market valuation topped $3 trillion in recent days, with the stock comprising 7.7% of the S&P 500 and worth $500 billion more than the next most valuable company, Microsoft. The company is now worth more than the entire Russell 2000.

These examples illustrate that fears about overvaluation and speculation are not unfounded. Several market veterans have drawn comparisons to the tech-fueled 1999-2000 rally, which ultimately ended with the Nasdaq plunging 83% during the 2000-2002 bear market. The broader S&P 500 declined 49%. People forget, but the economy was strong in 2000 before entering a mild recession that lasted just eight months from March through November of 2001. Not only was it shorter than average, but according to the St. Louis Fed, real GDP rose by 0.2% during those eight months. The point is that even during a so-called "mild" recession, stocks can decline meaningfully, despite what pundits peddling the soft-landing narrative might say.

The soft-landing thesis rests on trust in the Fed's ability to deftly slow the economy enough to tame inflation without causing a broad recession. To be charitable, the Fed has "engineered" perhaps two soft landings during its existence, with the only clear example being in 1996. This thesis ignores the most relentless campaign of interest rate hikes in modern history, hikes with lagged effects that are "long and variable," i.e., 6-24 months, and which will continue to impact business activity in the coming quarters. It also ignores the most inverted yield curve since 1981.

Back then, the inverted curve presaged a double-dip recession that at the time was the worst recession in the US since the Great Depression. Finally, the Conference Board's Index of Leading Economic Indicators (LEI) declined again in May for the 14th consecutive month, something that's never happened outside a recessionary period. Not only that, but the decline accelerated during the six months from November 2022 through May 2023 compared to the previous six-month period. And guess what? Stock market performance is a major component of the LEI, so the decline accelerated despite the strong rally in stocks.

We are not predicting a market sell-off akin to the dot.com crash. Arguably, technology stocks are not nearly as overvalued as they were in March 2000 at that era's market peak. In a recent interview, a notable venture capitalist said stocks already priced in the recession during 2022's sell-off, that the market "bottomed" in October, and that this year's rally has been looking beyond the recession to the recovery and Fed rate cuts next year.

Perhaps this time is different. Maybe the unprecedented fiscal/monetary stimulus of the COVID era distorted the economy such that previously accepted metrics aren't measuring trends the same way they once did. Perhaps even with all the headwinds stocks can rally back to new all-time highs rather than revisit last year's lows. Those who advised caution coming into the year have been wrong, as the defensive sectors of the stock market have been the worst performers YTD. After a good first quarter, bonds and gold have languished. We will only reiterate the same message as previous missives – if you are near retirement age, we still believe playing defense (e.g., being underweight stocks) is prudent. Otherwise, adherence to your long-term investment strategy is always the best course.

If you have a general administrative question about your account, please contact our customer service at 800-535-4253 option 1. If you would like to set up an investment consultation, please contact our customer service line or send us an email at advisors@wespac.net. We would be happy to schedule a call or Zoom meeting to discuss your portfolio.