An Awful(ly) Good Quarter

What worked, and what didn't in second quarter 2023

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Against a concerning economic backdrop, global equities climbed the Wall of Worry to notch a third consecutive quarter of positive returns. This performance brought the S&P 500® into a technical bull market, as the index has moved more than 20% off its lows in October 2022 (Figure 1). It is quite a contrast from this point last year when the S&P 500 was down more than 20% through June 30, 2022.

Despite these positive returns, current market characteristics give us pause, making it an awful(ly) good second quarter for investors. As we enjoy the fruits of better returns, we will be keeping a watchful eye on the fundamental backdrop within financial markets.

Figure 1. Total Return Comparison, %
Economic resilience improves sentiment and fuels a rally

	2Q23	1Q23	YTD	1Yr
U.S. Equity				
Russell 3000®	8.4	7.2	16.2	19.0
S&P 500	8.7	7.5	16.9	19.6
S&P 500 Value	6.6	5.2	12.2	20.0
S&P 500 Growth	10.6	9.6	21.2	18.3
S&P MidCap 400®	4.9	3.8	8.8	17.6
S&P SmallCap 600®	3.4	2.6	6.0	9.8
MSCI USA IMI Real Estate 25/50	1.4	1.5	2.9	(5.0)
International Equity				
MSCI ACWI Ex USA IMI	2.4	6.6	9.1	12.5
MSCI World Ex USA	3.0	8.0	11.3	17.4
MSCI World Ex USA Small Cap	0.5	5.0	5.5	10.0
MSCI EM	0.9	4.0	4.9	1.7
Fixed Income				
Bloomberg US Aggregate	(0.8)	3.0	2.1	(0.9)
Bloomberg US Corporate High Yield	1.7	3.6	5.4	9.1
Morningstar LSTA US Leveraged Loan	3.1	3.2	6.5	10.7
Bloomberg EM USD Aggregate	1.1	2.1	3.3	5.6

As of 6/30/2023. Source: Morningstar, Inc.

LEADERS

U.S. QUALITY
MSCI USA Sector Neutral Quality Index **8.91%**

U.S. LARGE CAP
S&P 500 .... **8.74%**

U.S. SMALL CAP GROWTH
Russell 2000 Growth **7.05%**

LAGGARDS

EMERGING MARKET EQUITY
MSCI Emerging Markets Index **0.90%**

INTL DEVELOPED SMALL CAP
MSCI World ex-USA Small Cap Index **0.49%**

CORE FIXED INCOME
Bloomberg U.S. Aggregate Bond Index......................... **-0.84%**

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Key positive developments:

Markets experienced a number of positive catalysts throughout the second quarter. There are several notable developments that together helped stave off a contraction — for now — and extend the current slowing expansion phase of the business cycle.

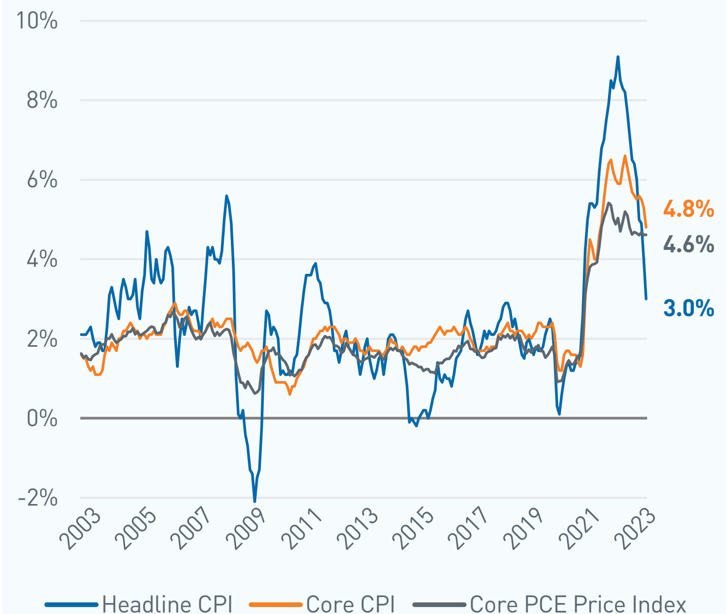
1. **Labor market strength:** The U.S. labor market created 732,000 new jobs during the second quarter, the highest number since last quarter! Strong labor data continues to surprise the market. As a result, the timing of a potential business cycle contraction is further out than initially expected.
2. **Lower inflation readings:** The Consumer Price Index (CPI) continues to decline since reaching a peak in June 2022. Headline CPI started the second quarter at 5.0%, but by June 30, had dropped to 3.0%. Core CPI, which excludes food and energy costs, remains higher at 4.8% (Figure 2). Both core and headline CPI remain above the Fed's 2% target. Furthermore, the latest reading of the Fed's preferred inflation measure, Core Personal Consumption Expenditures, was 4.6%. However, the reduced inflation readings were welcomed by investors as an indication that the Fed's tightening policy is working.
3. **The Fed "pause":** In recognition of the progress against high inflation, the Fed declined to raise interest rates at its June Federal Open Market Committee (FOMC) meeting. The target fed funds rate is now 5.00%-5.25%. However, the Fed indicated further rate increases are expected as inflation remains elevated (Figure 3). Nonetheless, markets responded positively to the pause after 10 consecutive rate hikes.

Healthy returns do not always equal a healthy market

While equities performed well during the quarter, we noticed several trends that may signal weakening health of the underlying market. While nothing in particular is worrisome on its own, as issues accumulate, we are mindful of possible downside risks.

Figure 2. U.S. Headline CPI, Core CPI and Core PCE Price Indices

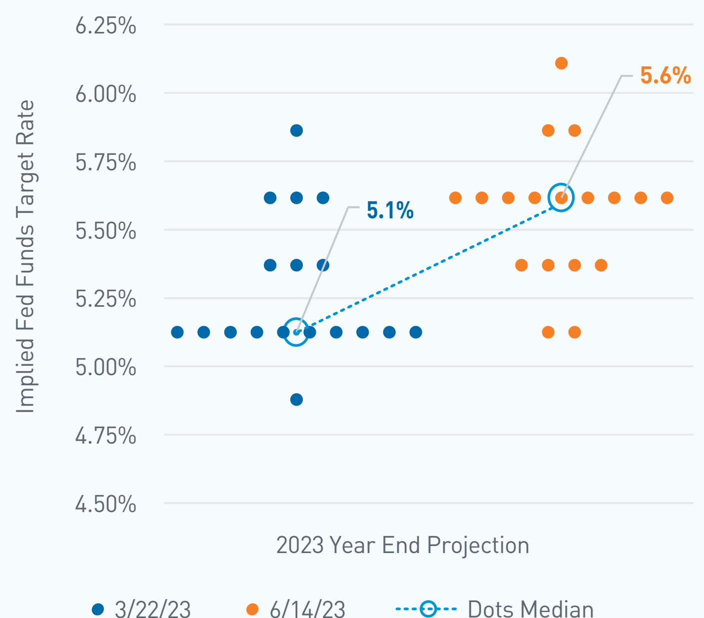
Services components continue to drive inflation



As of 6/30/2023. Source: Bloomberg L.P.

Figure 3. Updated FOMC Projections "Dot Plot"

Projections for future rate hikes increased following the Fed's "hawkish pause"



As of 6/30/2023. Source: Bloomberg L.P.

What Worked, and What Didn't

1. **Narrow market leadership**
   As of June 30, the top 10 companies in the S&P 500 by market-cap weight comprised 31.7% of the index (Figure 4). In fact, the top five companies alone make up 24% of the index. Of the S&P 500 return for the year, the top 10 holdings account for 12.5% of the total 16.9% return. Viewed another way, 74% of the S&P 500 return was driven by a very narrow subset of stocks.

   Another interesting aspect of this narrow leadership is the timing. Coincidently, the dramatic move higher among top holdings started mid-March, which corresponds to the start of the U.S. banking industry stress. In our view, this trend potentially signals that broader market weakness has been masked by the strong performance of a select few.

   For the S&P 500 Equal Weighted Index, which does not consider company size in the index weighting, returns are more muted for the year at 7.0%. This indicates to us that certain parts of the market may be overvalued, and investors may be chasing returns in a fear-of-missing-out (FOMO) trade.

2. **Large cap vs. small cap**
   Another market indicator we are watching is the rotation from small-cap stocks to large-cap stocks. The S&P 500 outpaced its small-cap counterpart, the S&P SmallCap 600, by 5.36% in the second quarter and 10.86% year to date.

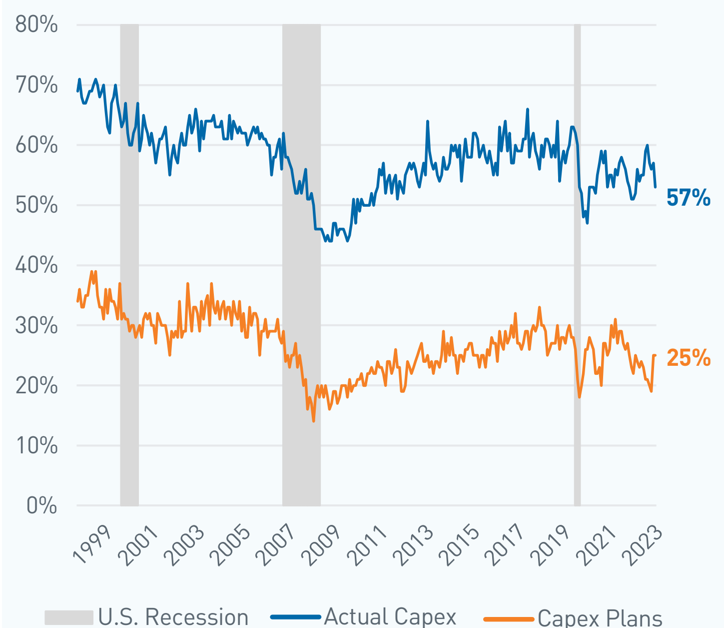
   Investors often rotate toward larger-capitalization stocks prior to a business cycle contraction as these companies tend to be better able to manage through downturns. This can be especially true in environments with higher interest rates and tighter lending standards, as smaller companies could struggle with higher levels of debt or securing lending (Figure 5). Because investors appear to be favoring large-cap companies due to macro forces as opposed to business-specific opportunities, we believe this signals expectations for a possible broader drawdown.

Figure 4.Top Holdings in S&P 500
Year-to-date performance of the S&P 500 has been driven by the largest growth companies

Top Holdings in S&P 500 Index	6/30/2023 Weight	YTD Return
Apple Inc.	7.7%	50%
Microsoft Corporation	6.8%	43%
Alphabet Inc. Class A & Class C	3.6%	36%
Amazon.com, Inc.	3.1%	55%
NVIDIA Corporation	2.8%	190%
Tesla, Inc.	1.9%	113%
Meta Platforms Inc. Class A	1.7%	138%
Berkshire Hathaway Inc. Class B	1.6%	10%
UnitedHealth Group Incorporated	1.2%	-9%
Exxon Mobil Corporation	1.2%	-1%
Top 10 Holdings	**31.7%**	**12.5%**
S&P 500 Index	**100.0%**	**16.9%**

As of 6/30/2023. Source: FactSet®, FactSet® is a registered trademark of FactSet Research Systems, Inc. and its affiliates.

Figure 5. NFIB Small Business Capital Expenditures and Plans
Small business outlook on capex



As of 6/30/2023. Source: Bloomberg L.P.

3. **Bull / Bear Market Sentiment**
The AAII Bull and Bear Market Index is intended to capture the sentiment of investor expectations. As one might expect, feelings are not a great investment strategy. As such, this index is often viewed as a contrarian indicator (Figure 6).

Obviously, this index does not predict future market performance. However, it is an interesting datapoint that, along with other key observations, indicates investors' expectations for the future could be at a cyclical high — potentially ignoring fundamental data.

As investors take sides on the current bull versus bear debate, we believe it is helpful to review various historical characteristics to provide additional context. A recent analysis from Strategas Research Partners helps illuminate whether this is truly the next bull market, or if a cautionary outlook is warranted (Figure 7). Based on this data, bull markets historically do not start:

- near full employment;
- during an aggressive Fed rate hike cycle;
- when the yield curve is inverted; or
- when market liquidity is declining.

Earnings optimism and valuations

Earnings expectations, in our view, are still too optimistic for 2023 (Figure 8, page 5). We are already in an earnings recession, as earnings growth for fourth quarter 2022 and first quarter 2023 were -4.7% and -2.1%, respectively. While last quarter was better than expected, estimated earnings growth for the current earnings season is now -6.9%, a decline from the initial estimate of -4.7% as of March 31.

At the same time we expect earnings to decline, valuations are reaching new highs for the year. The next-12-months (NTM) price-to-earnings (P/E) multiple for the S&P 500 is 19.1 times (x). Multiple expansion has been the driving force behind price appreciation so far this year. While it is possible for multiples to go higher in the near term, earnings and valuations are historically good indicators of the market's path forward. Right now, both are signaling caution.

Figure 6. AAII Bullish / Bearish Sentiment Survey
The wisdom of crowds usually doesn't work

Sentiment Peak	Bull/Bear	Return Time Period	S&P 500 Price Return
9/2007	Bull	2008	-38.5%
12/2017	Bull	2018	-6.2%
12/2018	Bear	2019	28.9%
3/2020	Bear	2020	16.3%
12/2021	Bull	2022	-19.4%
9/2022	Bear	Since October Lows 2022	24.4%
7/2023	Bull	Future return	???

As of 6/30/2023. Source: Bloomberg L.P.

Figure 7. U.S. Economic Data at the Start of a Bull Market
The "bull market" since October 2022, is unique relative to history

Indicator	Historical Avg.	10/12/2022	Latest
Unemployment Rate	**5.7%**	**3.5%**	**3.7%**
Initial Claims	367,200	191,000	234,000
ISM New Orders	48.3	47.3	42.6
Housing Starts	1.3M	1.5M	1.6M
CPI Y/Y	4.3%	8.2%	4.0%
Fed Funds Effective	5.6%	2.6%	5.1%
Fed Funds Y/Y (BP Change)	**-72.6**	**248**	**429**
Fed Funds - CPI Y/Y	1.3%	-5.6%	1.1%
Long-Term Treasury Com-posite	6.1%	3.8%	3.9%
3-Mo. T-Bill	4.9%	3.1%	5.1%
Yield Curve (LT - 3m, BP)	**123**	**63**	**-122**
M2 Y/Y	**5.9%**	**2.7%**	**-4.6%**

Note: Average is 1957-2020, monthly data.
As of 5/31/2023. Source: Strategas Research Partners, Inc.

Let's consider a real-time example. If we assume the S&P 500 consensus NTM earnings per share estimate of $233 is correct, to see 10% market appreciation from here, the earnings multiple would need to expand to about 21x (Figure 9). Alternatively, to see roughly the same appreciation from earnings growth, NTM earnings would need to increase to $256. The combination of above-average P/E multiples and overly optimistic earnings expectations leads us to approach equity markets with caution.

What does the next phase look like?

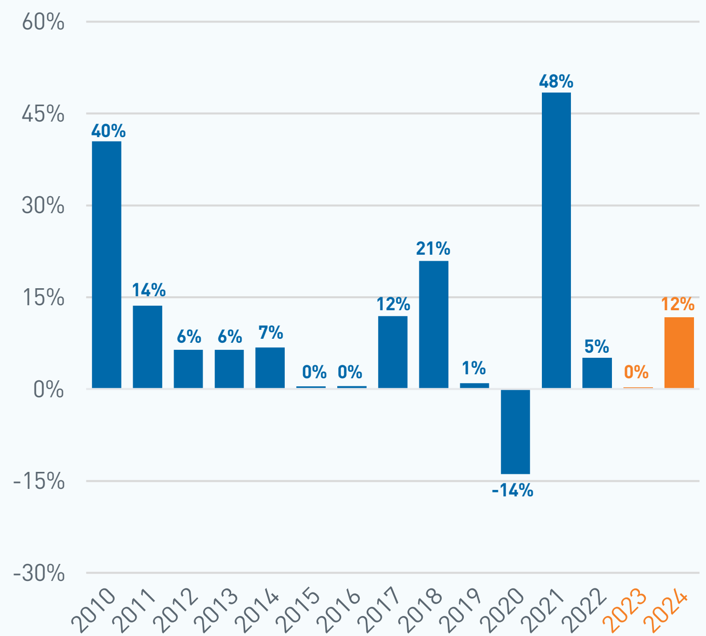
Although it seems like a lifetime ago, at this point last year, the Fed was still early in its rate-raising regime. As of June 30, 2022, the fed funds rate range was "only" 1.50% - 1.75%. Because monetary policy has a lagged effect on the economy, we are finally beginning to see its impact.

As the full effect of tighter monetary policy develops, we anticipate a chain reaction of sorts as higher interest rates pressure various aspects of the economy. Continued strength in the labor market is likely to continue pressuring wages higher, supporting elevated inflation. As a result, we expect the Fed to pursue a higher-for-longer interest rate policy. Higher interest rates will weigh on corporate profits in the form of higher labor costs as well as higher interest expense. The higher-for-longer policy will also eventually weigh on consumer spending. Finally, as demand wanes and corporate revenues decline, companies may turn to expense management in the form of layoffs.

The path forward is likely to encounter surprises and not play out in this exact scenario. However, one thing seems certain: With inflation still above the Fed's 2% target, additional monetary tightening seems unavoidable.

We attribute the market's recent strong gains to a function of investors ignoring or pricing out risk, namely inflation. If markets were to be driven higher by improving economic and earnings conditions, we would certainly reconsider this view.

Figure 8. S&P 500 Annual Earnings Growth (YoY)
Earnings estimates reflect a "no landing" scenario



As of 6/30/2023. Source: FactSet®

Figure 9. Implied S&P 500 Price Level using Earnings per Share (EPS) and Forward P/E Ratio
Valuations look stretched, even for a mild recession scenario

NTM EPS	Hypothetical Scenario	P/E NTM				
		17.0x	18.0x	19.0x	20.0x	21.0x
$175	25% downside	2,975	3,150	3,325	3,500	3,675
$210	10% downside	3,570	37,80	3,990	4,200	4,410
$233	Current consensus est.	3,961	4,194	4,427	4,660	4,893
$256	10% upside	4,352	4,608	4,864	5,120	5,376
$291	25% upside	4,947	5,238	5,529	5,820	6,111

As of 6/30/2023. Source: FactSet®

What Worked, and What Didn't

What Asset Classes Led in Q2?

U.S. Quality (8.9%)

- **Our thesis:** We expect the market to favor high-quality equities given our expectation for a business cycle contraction later in 2023, with the added possibility of a mild recession. The quality style focuses on consistent earnings growth, higher profitability and lower leverage, which should be valuable in a slowdown, as these companies typically have greater earnings sustainability and stronger competitive advantages.
- **What worked:** The quality investment style broadly outperformed given its exposure to companies with higher profitability characteristics. Investors have been tilting toward these larger growth companies given their healthy net cash positions, which should provide a margin of safety as we head toward a potential contraction. Additionally, quality's exposure to mega-cap companies that are levered to artificial intelligence (AI) was also a key performance driver.
- **Looking ahead:** High-quality companies tend to have consistent earnings growth protected by strong competitive advantages. We believe investors should focus on quality stocks with strong balance sheets, consistent profitability and low leverage. We believe large-cap stocks could become more attractive as economic growth weakens further and inflation remains elevated. Quality has historically performed better on a relative basis during the contraction phase of the business cycle.

U.S. Large-Cap (8.7%)

- **Our thesis:** We believe large-cap equity is the long-term growth and innovation engine of the public equity asset class universe given its sustainable, high-quality fundamental characteristics.
- **What worked:** This quarter's market rally was driven by the largest growth companies. Market breadth has been very narrow, with the 10 largest companies within the S&P 500 accounting for 74% of year-to-date performance. Notably, investors' enthusiasm over the potential of AI has helped fuel gains, as well as the expectation that the Fed is nearing the end of its tightening cycle.
- **Looking ahead:** We continue to believe large-cap companies are the workhorse of corporate earnings. Amid a shifting macro backdrop, we want to maintain broad exposure to these leaders across several sectors and industries. As the U.S. economy slows and the Fed nears the end of its tightening cycle, we expect large-cap stocks will find support from earnings growth and easing multiple compression.

U.S. Small-Cap Growth (7.1%)

- **Our thesis:** We believe in the long-term benefit of small-cap stocks and associated growth prospects. As such, we maintain an overweight asset allocation view toward small cap. Small-cap growth, in particular, has exposure to several industries focused on long-term megatrends, such as the emerging growth of AI, alternative energy and biotechnology.
- **What worked:** Moderating interest rates helped ease pressure on valuation multiples, benefiting growth equities, particularly longer-duration small-cap growth. Non-earners were the top-performers in the quarter, with the Russell 2000® Growth also gaining from the growing enthusiasm surrounding AI.
- **Looking ahead:** The forward P/E for small-cap companies has increased to 36.9x, well above their 20-year average of 22.9x. The combination of a looming recession, elevated interest rates and higher inflation has lowered our views on profitability and potential outperformance in the near term. We believe earnings estimates look vulnerable to continued pressure on operating margins as companies contend with higher inflation pressures.

What Worked, and What Didn't

What Asset Classes Trailed the Most in Q2?

Emerging Markets Equities (0.9%)

- **Our thesis:** Emerging markets (EM) account for about 40% of global GDP, 35% of global consumption and 75% of global economic growth, yet EM only makes up 8% of the global equity index. We continue to believe EM demographic trends, long-term economic growth potential and the multi-year earnings outlook remain strong supporting trends for the asset class.
- **What didn't work:** Equities in China were notable laggards, as the post-COVID economic reopening has been much less robust than expected. While activity continues to normalize, consumer spending and the property sector remain lackluster, and a deflationary trend has emerged over the last few months. This is now reflected in earnings revisions, with the rate of change having recently turned negative.
- **Looking ahead:** More than 80% of the MSCI Emerging Markets index is composed of five countries, led by China. Although performance outside China was strong, China's equity performance dictates how the asset class will perform. Although macro data from China has disappointed in recent months, the country's equity market is one of the few with double-digit positive earnings estimates for 2023. As economic activity continues to normalize, combined with targeted policy support and an improving credit impulse, we expect a rerating of the market's exceptionally low valuations may follow.

International Developed Small Cap (0.5%)

- **Our thesis:** Unlike developed international large cap, small-cap companies are typically found outside core Europe and offer much stronger growth prospects, acting as the innovation engine for countries such as Japan, the U.K. and Canada.
- **What didn't work:** The asset class was pressured by negative economic data in the Eurozone and the U.K. as both regions continue to face persistently high inflation and weaker economic growth relative to the United States. Tightening credit conditions and a disappointing demand recovery in China have kept equity returns subdued. Dollar strength, particularly against the Yen, has turned into a headwind for developed ex-U.S. small caps.
- **Looking ahead:** From a valuation and earnings growth perspective, we believe international small cap remains attractive relative to international large cap, as it has much higher weightings in sectors with high growth potential.

Core Fixed Income (-0.8%)

- **Our thesis:** Core fixed income tends to be the primary ballast in multi-asset portfolios given its broad diversification across Treasury, Corporate and Securitized markets.
- **What didn't work in the quarter:** Long-term interest rates moved higher as concerns about an imminent recession were delayed. As long-term Treasury yields rose, credit yields fell and spreads narrowed, causing core fixed income to underperform.
- **Looking ahead:** Over the long term, we remain confident that core fixed income can still provide stability in portfolios and generate positive real total returns. In the near term, our expectation for an economic contraction warrants increased exposure to the most conservative areas of fixed income.

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