Insights: August 2023

Market Overview and Performance

As we look back on the investment environment through the first seven months of 2023, one thing is clear: equities are strongly positive, commodities are solidly positive, bonds have generated mildly positive returns and even cash allocations have delivered gains for investors. In short, virtually all asset classes have delivered encouraging results thus far in 2023. This is in strong contrast to the consensus outlook of a challenging year with an anticipation of negative results across asset classes that was widely entrenched at the end of 2022. While caution was certainly merited as questions surrounding the strength of economic growth and the trajectory of the deceleration rate in inflation were murky at best, history has taught us that that a prevailing view in one direction rarely holds to be true. As legendary trader Jesse Livermore famously stated, "To anticipate the market is to gamble. To be patient and react only when the market gives you the signal is to speculate". We are certainly believers in that discipline and have been basing our allocation decisions on market evidence rather than prognostication. Broadly speaking, economic growth has exceeded expectations globally, inflation has fallen at a rapid pace globally, corporate earnings have remained robust, and consumer spending, particularly the US, has proven to be remarkably resilient. The market has clearly recognized these trends and embraced the momentum especially given comments like this from Federal Reserve Chairman Jay Powell. "The 2% target will not require a prolonged series of rate hikes. Once inflation shows a credible and sustainable decrease, the Fed will no longer need to maintain a restrictive level…You'd stop raising [rates] long before you got to 2%." The danger going forward is that both Wall Street and Main Street get more comfortable with the notion that things "aren't so bad" just as risk markets embark on what is seasonally a difficult period in August, September, and October. Time will tell. As always, thank you for taking time to read our market Insights.

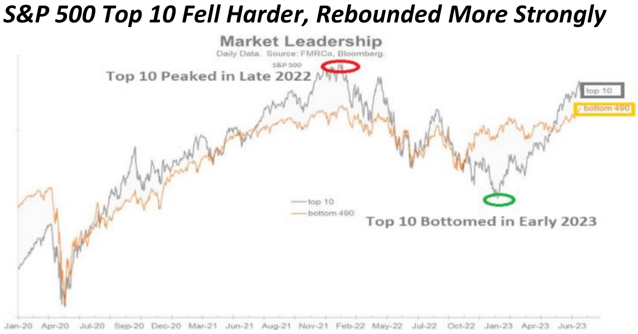
	Month to Date July 31	***Year to Date July 31***
Equity	***Total Return % (USD$)***	***Total Return %***
S&P 500 Index	3.21	**20.65**
Russell 2000 Index	**6.12**	14.70
MSCI EAFE Index	3.24	15.28
MSCI Emerging Markets Index	**6.23**	11.42
Fixed Income		
Barclay's U.S. Aggregate Bond Index	-0.07	**2.02**
Barclay's U.S. Aggregate Credit Index	-0.15	4.82
Barclay's U.S. Aggregate Corporate High Yield Index	1.38	6.83
Barclay's Municipal Bond Index	0.40	3.08
Macro Measures		
Gold	2.24	**6.71**
Crude Oil	**15.80**	6.12
CBOE Volatility Index	0.29	**-29.34**
USD Dollar Index	-1.02	**-1.60**

Current Theme – Strong Year to Date Returns Across Asset Classes Defy Extreme Negative Sentiment at the Start of 2023

Equities Rise for 5 Straight Months While Bonds and Commodities Also Experience Gains Thus Far in 2023

The S&P 500 return of +20% through the first 7 months of the year has confounded many who feared that 2023 would present a challenging environment for risk assets. This is perhaps not surprising given that the roughly -35% 2022 decline seen in the Nasdaq was still fresh in many investors' minds. However, as one can see below, the Top 10 positions within the S&P 500 that suffered the worst losses have now experienced the strongest gains thus far in 2023.

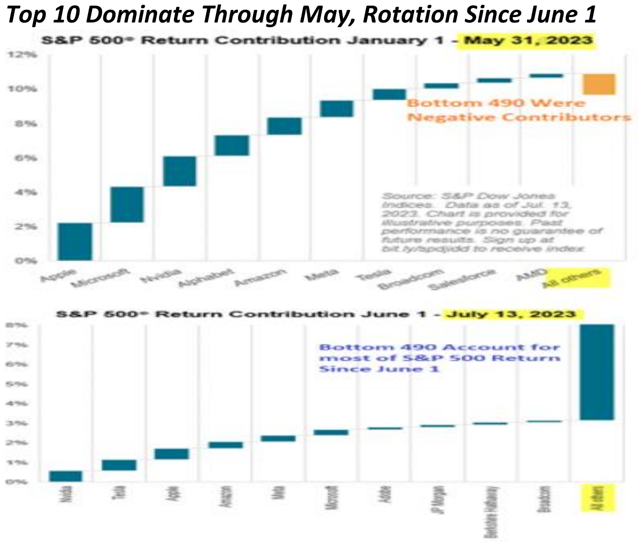
S&P 500 Top 10 Fell Harder, Rebounded More Strongly



Source: Fidelity

In fact, as one can see below, the Top 10 names which are primarily comprised of large cap technology names, have dominated market performance through the first 5 months of the year.

Top 10 Dominate Through May, Rotation Since June 1



Source: The Daily Shot

During that period, the other 490 names within the S&P 500 actually *detracted* from the Index performance with negative returns. Since June 1st however, the remaining 490 names have overwhelmingly carried the Index higher. This type of rotation within market dynamics is exactly the kind of healthy broadening out of gains which often times allows a bullish market to climb higher.

US Dollar Decline Since October 2022 Boosts US Equities

Source: All Star Charts

Clearly, one of the important factors driving the roughly +28% bounce in the S&P 500 since October of 2022 has been the continued decline in the US dollar. This helps to make US goods and services more attractive internationally which then bolsters profitability for US companies. But has it proven to be too much? Many investors become fearful after large market moves, but there is reason to be optimistic about prospective future returns.

2023 is 13th Best Start to a Year; Suggests More Strength

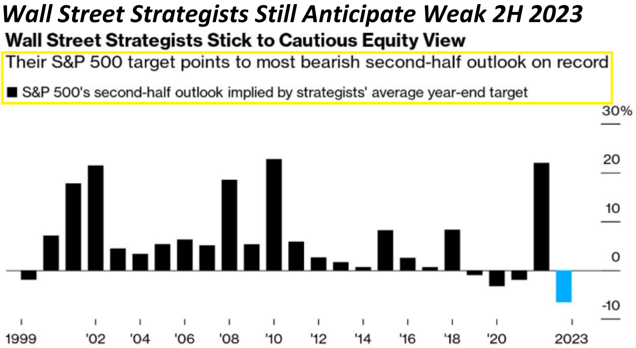
S&P 500: Best Performance through First 143 Trading Days (1928 - 2023)

Rank	Year	Price Return: First 143 Trading Days	Price Return: Day 144 to Year-End	Price Return: Full Calendar Year
1	1933	45.2%	-0.8%	44.1%
2	1975	30.2%	0.5%	30.9%
3	1987	28.3%	-20.2%	2.3%
4	1997	26.7%	3.4%	31.1%
5	1954	22.3%	17.8%	44.1%
6	1995	22.3%	9.7%	34.1%
7	1989	21.7%	4.5%	27.3%
8	1943	21.6%	-1.8%	19.4%
9	1983	21.1%	-3.2%	17.2%
10	1955	21.1%	4.4%	26.4%
11	2019	20.7%	6.8%	28.9%
12	1938	19.6%	4.1%	24.5%
13	2023	19.3%		
14	2013	18.6%	9.3%	29.6%
15	1936	17.9%	9.1%	28.6%

Source: Charlie Bilello

As seen in the table above, 2023 is the 13th best start to a calendar year in history. And despite the natural tendency towards caution, most strong start years (barring 1987) went on to experience solid returns during the remainder of the calendar year. It's important to note that the average drawdown in the back half of these strong years averages about -7% before gains into year end. Perhaps this will prove to be true in 2023 as well, but for the time being, Wall Street is not convinced that will be the case.

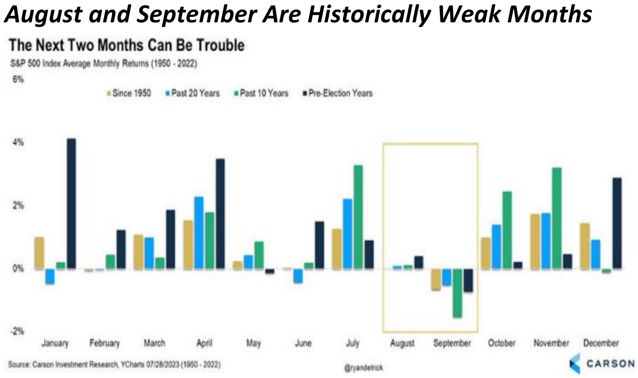
Wall Street Strategists Still Anticipate Weak 2H 2023



Source: Bloomberg

As one can see in the chart above from Bloomberg, Wall Street strategists are generally not believers in the strength of this year's equity rally and remain convinced that markets will falter between now and year end. As the S&P 500 just concluded its 6th positive month out of 7 in July, some notably Bearish firms have begun to raise their year-end expectations. However, this type of optimistic "catch-up" behavior comes with perhaps less than ideal timing.

August and September Are Historically Weak Months



Source: Carson Investment Research

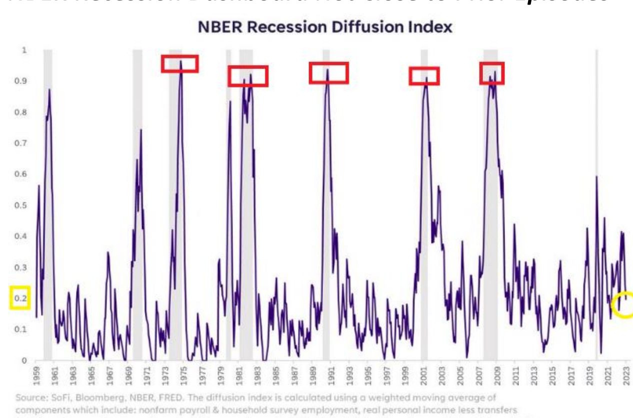
As one can see above in the chart from the Carson Group, whether looking at the past 70 years, 20 years, 10 years or Pre-Election years, both August and September tend to experience declines in equity markets. As we mentioned previously, while strong years tend to finish higher, this point in the calendar would not be an unexpected window for risk assets to take a pause. Thankfully the markets do not trade on sentiment alone. Fundamentals drive prices over time and right now, the information coming from the economy is better than it's been in some time.

Citi Economic Surprise Index Strongest Since Early 2021

Source: Bloomberg, Citigroup

The previous chart highlights the elevated reading of the Citi Economic Surprise Index. This is a measure of whether or not various economic data are being reported as better or worse than expected. At present, data are surprising to the plus side to a degree not seen since March of 2021. This bodes well for the future path of the economy as a whole and suggests that the well-anticipated weakness has not developed.

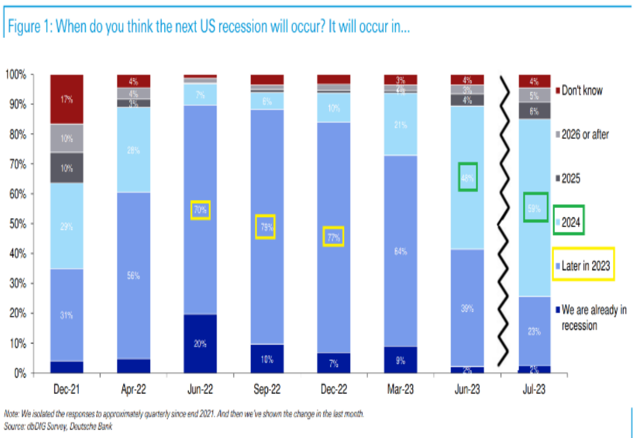
NBER Recession Dashboard Not Close to Prior Episodes



Source: Liz Young, Sofi, Bloomberg, NBER, FRED

As a result, the composite measure of indicators utilized by the NBER, which is the official determiner of recession within the US, has fallen quite notably in 2023. Importantly, at just around a 20% probability, their Index is nowhere near the 90% type readings that were experienced during the last 5 recessions. These encouraging developments have not gone unnoticed by market participants either. The strategy group at Deutsche Bank led by Jim Reid, conducts a number of investor surveys throughout the year. The results of their most recent recession questioning are seen below. In June through December of 2022, roughly 80% of investors foresaw a recession in late 2023. By July 2023, that figure had fallen to just 23% and most (59%) have pushed their views out to 2024.

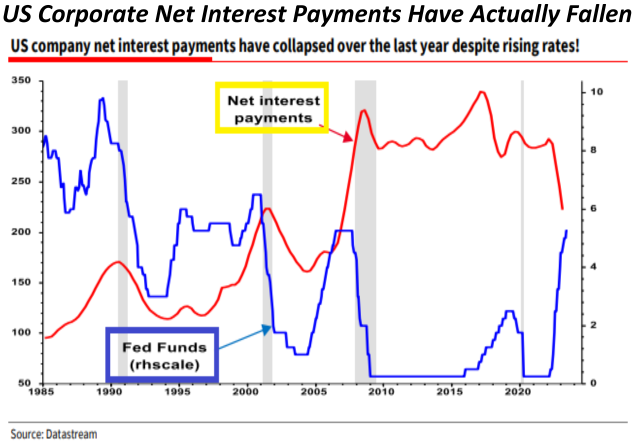
Investor Expectations for Recession in 2023 Have Faded



Source: Deutsche Bank

In listening to various earnings conference calls recently, it also becomes clear that many corporations do not see a recession on the near-term horizon either. This is in part due to the fact that their balance sheets are in solid shape. One of the more interesting developments in 2023 has been the trend in corporate net interest costs actually declining despite the rapid rise in interest rates. Corporations were able to lock in very low borrowing rates during the crisis and now have used their increased profitability to pay down older more expensive debt from their balance sheet.

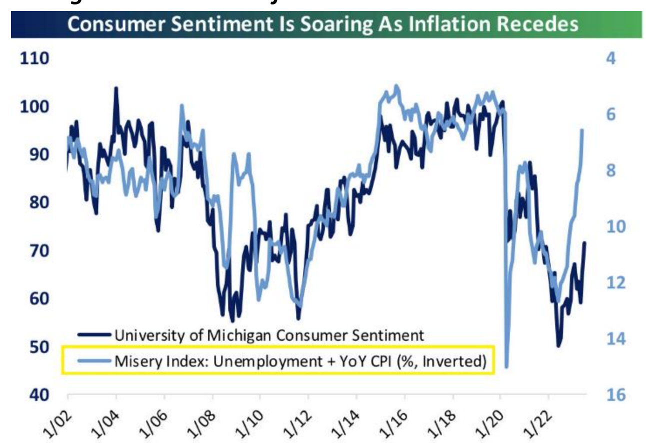
US Corporate Net Interest Payments Have Actually Fallen



Source: Societe Generale SA; DataStream; Bloomberg

This unusual set of circumstances provides corporations with more confidence to invest current profitability toward future endeavors which in turn helps economic development. And consumers are feeling better about the economic situation as well. As seen below, the "Misery Index" is a measure that attempts to capture the stress felt by consumers given economic conditions. When employment is strong and inflation (CPI) is falling, consumers feel better about the environment. As one can see in the following chart, when the measure falls (light blue line inverted), consumer sentiment historically has improved with a very tight correlation over the past 20 years.

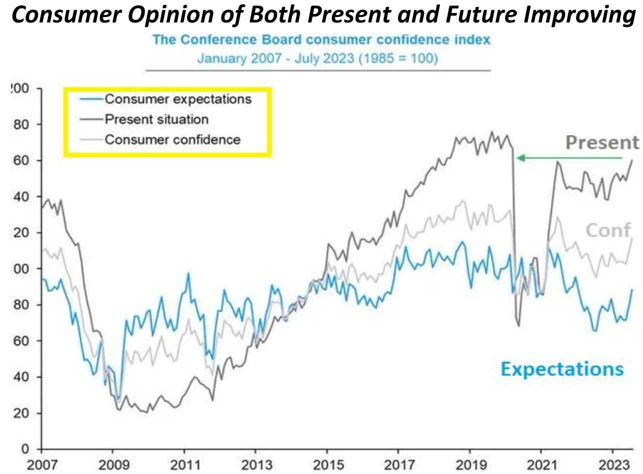
Strong Labor + Lower Inflation = +Consumer Sentiment



Source: Bespoke Investment Group

And we are seeing evidence of that now. Below is the Conference Board's July reading of consumer confidence. Individuals are feeling better not only about the present, but also about future expectations. This is a notable change from the end of 2022.

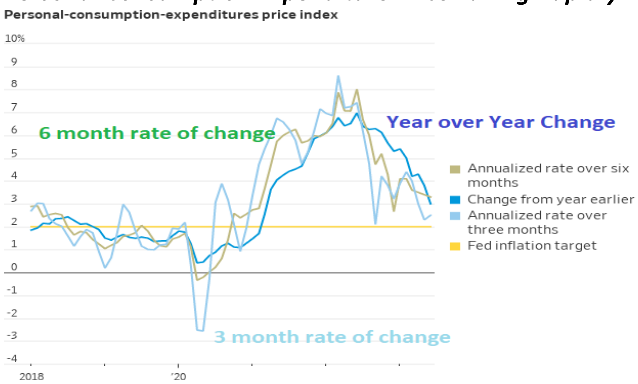
Consumer Opinion of Both Present and Future Improving



Source: The Conference Board; EY-Parthenon

Without question, the rapid decline in inflation measures has much to do with these perceptions. As seen below, the rate of change for the personal consumption expenditure, the Fed's preferred measure, is rapidly falling toward their 2% target.

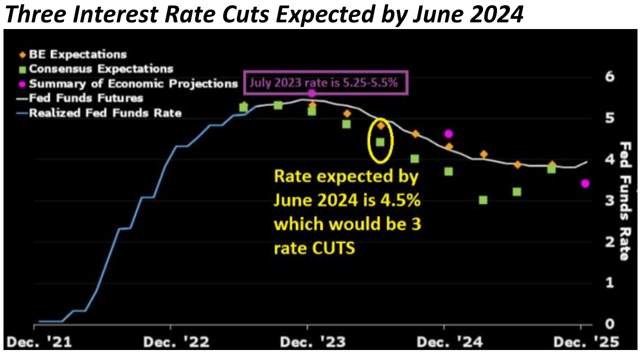
Personal Consumption Expenditure Price Falling Rapidly



Source: Commerce Department

As a result, the market now believes that the Fed is done raising interest rates and will in fact be cutting interest rates by the summer of 2024 and beyond.

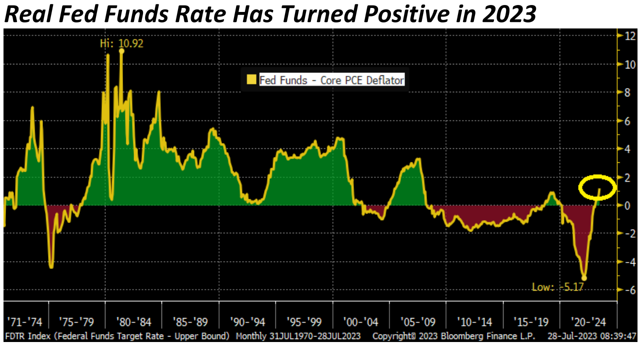
Three Interest Rate Cuts Expected by June 2024



Source: Federal Reserve; Bloomberg

While three rate cuts over the next 12 months may seem aggressive given the current improvement in the economic backdrop, there is reason to believe that that the Fed may be satisfied with current policy.

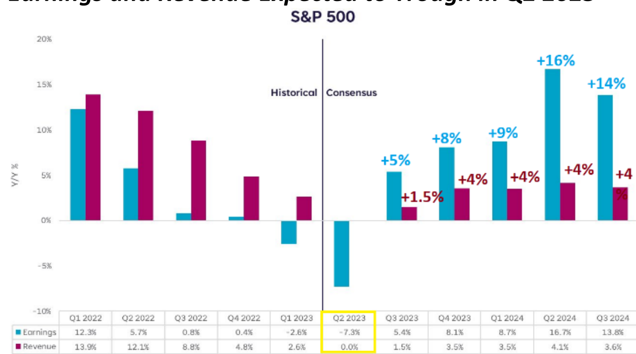
Real Fed Funds Rate Has Turned Positive in 2023



Source: Bloomberg; Richard Bernstein Advisors

As the previous chart highlights, the Real Fed Funds rate, or the Fed Fund level minus PCE (inflation), is now positive for the first time since late 2019. The interpretation of this change is that Fed policy is now "restrictive" rather than "accommodative" which serves their purpose of ideally containing inflation.

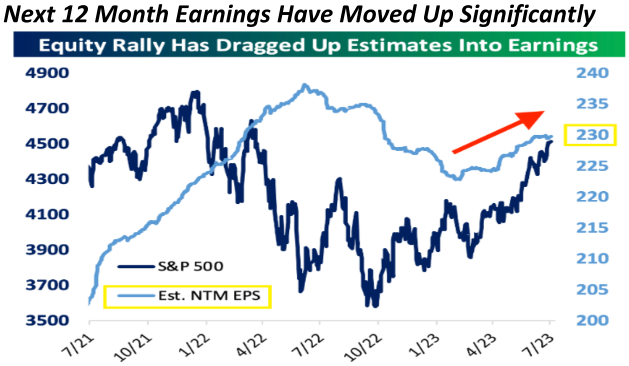
Earnings and Revenue Expected to Trough in Q2 2023



Source: Sofi; Refinitiv

Again, this has much to do with the decline in inflation and the market appears increasingly convinced that this decline is credible. As the chart above highlights, the consensus view is that a transition is occurring with a bottoming this quarter in both earnings and revenue growth. Beginning in Q3 of this year earnings growth is expected to rise by roughly 5% accompanied by a small increase in sales. By late next year, earnings are anticipated to grow by double digits and revenues by more than 4%.

Next 12 Month Earnings Have Moved Up Significantly



Source: Bespoke Investment Group

The trend within earnings estimates revisions has also been improving. With the bulk of corporate earnings complete for the second quarter, roughly 80% of companies have beaten their estimated results. As a consequence, the blended earnings for the S&P 500 over the next 12 months has moved from approximately $222 to $230. As earnings drive price over the long term, this is a welcome development.

Going Forward

One of the more remarkable aspects of markets this year has been the level of discomfort on the part of many investors. Virtually everyone suggested at the end of 2022 that the global headwinds were just too great to expect positive returns in 2023. As the banking stress witnessed in March unfolded, this sense of unease only became more heightened. But a banking crisis didn't develop. And inflation didn't devolve into a run-away problem. And consumers didn't stop spending. And corporations didn't fire large swaths of employees. However, these positive developments failed to sway many. We are reminded of the old investing adage, "Trade the market you are given, not the one you want."

It seems odd, but many apparently didn't want a +20% return for equities over the first seven months of the year based upon the pessimism and defensive positioning so prevalent in the market. As always, we attempt to not take an entrenched view on the market, but rather, adjust allocations and risk as the environment evolves. As such, we have benefitted from our decision to increase exposure to the market leading elements which have produced strong returns since the positive pivot experienced by markets in October of 2022. However, we have certainly been focused on taking profits along the way as merited. This leaves us with what we would consider to be a prudent allocation allowing for cash to be available as we head into what is traditionally the most volatile few months of the year.

As we discussed, one of our concerns is that signs are emerging that many of the reluctant investors who have missed a portion of the strong gains in 2023 are now playing "catch-up" in an attempt to chase profits into the end of the year. Our preference would be to monitor the "choppiness" likely to come over the next few months before a potential rally in the late months of the year emerges as it has done many times before in past strong equity return years.

With the strong outperformance of large cap tech to start the year, some names have provided areas to harvest gains, however, we still retain a sizable exposure to the large cap technology space and will continue to do so as many of those companies consistently deliver exceptional profitability.

Given that small and mid-cap stocks companies generate almost all of their sales domestically, they are poised to benefit from an improving inflation and rate scenario. Valuations for both small and mid-cap stocks are very attractive when compared to their large cap counterparts and fund flows have therefore been attracted to these areas at the start of 2023. While many investors have sought the perceived safety of larger capitalized companies at the cost of small and mid-cap exposure, flows have gone back into smaller names over the last several months.

Regions outside of the US which were challenged by a very strong US Dollar throughout 2022 have seen a change in the headwinds. Valuations outside of the US are very compelling on a historical basis after a difficult 2022. Additionally, the US Dollar appears to have peaked for the near term declining about -12% since September 2022. If that trend continues, along with the improving fundamental data we have seen globally, non-US markets could potentially do well in 2023 and in fact, some are outperforming their US counterparts thus far in 2023.

Within fixed income, we continue to place our emphasis on shorter duration exposures and unconstrained strategies. More recently however, we have taken advantage of the climb in treasury yields to allocate a portion of our exposure into laddered short-term treasuries as a way to capture risk-free yield for fixed income portfolios. As rate increases by the Federal Reserve are projected to end, we would anticipate taking advantage of slightly longer duration exposure that stand to benefit from a more stabilized rate environment combined with falling inflation.

We believe that commodity exposure, primarily via gold, but also including agriculture and energy, will continue to be additive due to the nature of the current supply constraints. Gold in particular has served its purpose as a diversifying asset quite well, returning +7% thus far in 2023.

Thank you for taking the time to read our thoughts on the markets and we look forward to speaking soon.