Where Are We Now - Part II: After a Strong First Half, It Gets Harder, But Opportunities Exist

How strong were financial markets during the first half of 2023?

- *2023 financial markets performance started strong and rebounded from a challenging 2022*
- *Growth outperformed value, reversing much of what was experienced last year*
- *10th best first half performance for the S&P 500 since WWII.*

2023 got off to a strong start with a solid January, and despite concerns about a potential crisis in regional banks in March, the market continued to strengthen through the first half of the year. It seems that equities hit their low point in October of the previous year and have shown impressive performance since then.

During the first half of 2023, domestic equities saw a return of approximately 16%, mainly driven by strong relative performance in the technology, communication services, and consumer discretionary sectors. These three sectors accounted for about 97% of the S&P 500's first-half return. To sustain the upward movement of domestic equities throughout the remainder of the year, it's essential a widening in breadth across more sectors occurs.

Interestingly, only 30 stocks were responsible for about 95% of the S&P 500's return in the first half, while the remaining 470 stocks contributed only 5% of the overall return. Despite some claims that just seven stocks were driving the market gains, there were actually several others that also had a meaningful impact.

Growth stocks outperformed value stocks by approximately 7.5%, reversing much of the trend experienced during 2022. This was particularly evident in larger capitalization names, with the S&P 500 market capitalization weighted index outperforming the S&P 500 equal weighted index by about 10%.

Year-to-date results through June 30th were the 10th best performing first half for the S&P 500 since WWII, providing optimism for continued strength in equity markets in the coming months and into next year as momentum drives investment managers continue to continue to reallocate portfolios back into equities. This may be balanced by prudent risk-minded investment managers rebalancing portfolios away from asset classes that have outperformed to those that have not fully participated. We anticipate this point-counterpoint scenario inherent in all markets, financial or otherwise, likely to result in moderately increased levels of volatility in the back half of this year and into 2024.

International stocks also performed well, with developed markets returning +12% and emerging markets gaining 5%. However, the higher than anticipated interest rate environment and a strong U.S. dollar had a dampening effect on some international investments, particularly in emerging economies.

Fixed income investments experienced ups and downs throughout the first half. Initially rebounding, then selling off before recovering into the end of Q1, only to then decline again in Q2. High yield was a standout category during the first half, benefiting from a broader risk-on sentiment and a compression in high yield spreads. The category also

Are the results experienced in the first half of 2023 justified and is the broader economy on better fundamental ground than the narrative suggests?

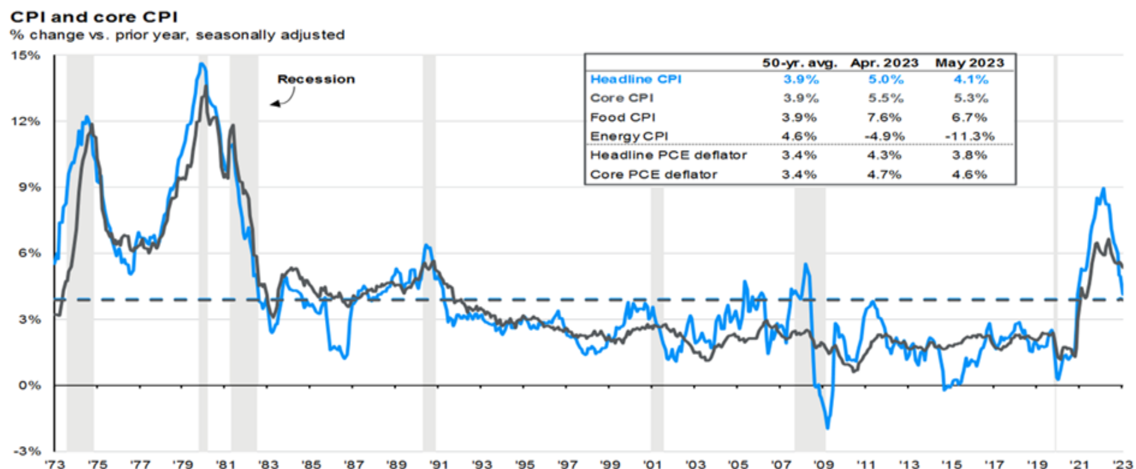
- *Underweight investors began to reallocate cash to equity and fixed income markets, driving performance*
- *Domestic economic activity remains resilient during unprecedented times*
- *GDP data suggests that the recession may have occurred last year.*

After a challenging 2022 that impacted almost every asset class, there was hope for a rebound as long as economic activity didn't deteriorate beyond expectations. Surprising to many, the macroeconomic picture remained relatively strong and resilient, which led to robust performance in most cases during the first half of the year. The big question that has yet to be answered is whether this performance was justified. We firmly believe it was, and that opportunities will continue to present themselves in the forward with the broader economy on solid footing.

Compared to the beginning of the year, many economic indicators have improved or been more durable than anticipated. Additionally, corporate earnings have remained strong, illustrating further resilience in the economy. Many portfolio managers and retail investors were underweight in both equities and fixed income at the beginning of 2023, which they began to reallocate to risk assets and add fuel to the strong first half performance. Although gains could continue to build into the second half of the year, it is unlikely they will continue at the same velocity and with such low volatility. As such, we believe it is advisable to maintain a neutral bias between equities and fixed income.

Despite these unprecedented times, domestic economic activity continues to defy the expectations of many and has shown remarkable strength. The residuary stimulus provided in response to the COVID pandemic, along with various associated issues, has created a unique environment to be sure. Although the Federal Reserve (the Fed) initially labeled inflation as transitory, inflation persisted and reached levels not seen in decades, forcing the Fed to pivot and aggressively raise the benchmark Fed Funds Rate (FFR) 5% over a fourteen-month window. This sharp policy change put the broader economy to the test.

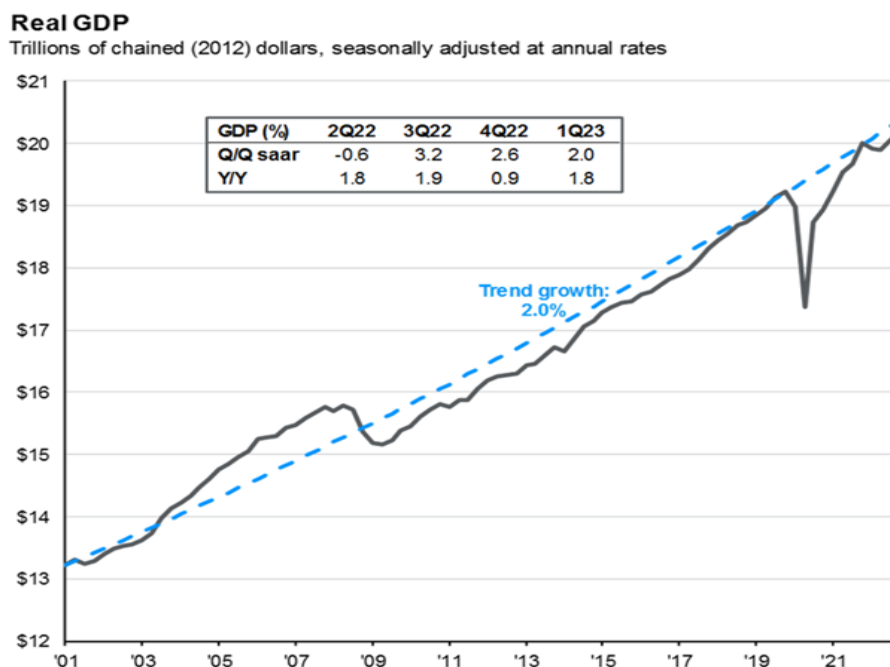
Employment, housing, and consumer behavior have shown real resilience, and the inflation situation has gradually trended back toward historical norms. Of particular note is the manufacturing which has been holding better than expected but it may hold risk as higher interest rates impact economic activity.



Source: JP Morgan Guide to the Markets 3Q 23

Perhaps the recession actually took place in 2022 when the Gross Domestic Product (GDP) experienced negative growth for two consecutive quarters (Q1 at -1.6%; Q2 at -0.6%). However, it seems the decision-makers may not have considered enough historical factors to confirm the recession, and now we find ourselves on the other side of it. In the subsequent four quarters, GDP has rebounded impressively, reaching +3.2%, +2.6%, +2.0%, and +2.4%, respectively.

Several positive indicators support the notion that the economy is in a much better position now. The employment situation is solid, with an average of over 250,000 jobs gained each month year-to-date. Consumers continue to spend, although the savings rate is gradually returning to pre-pandemic levels. Housing has experienced a positive rebound and business investment spending (particularly beneficial to the technology and industrials sectors) is beginning to trend higher after years of sluggish performance. Despite the skepticism of some pundits in the financial media, these factors collectively suggest a strong and more stable economic outlook than much of the reporting.



GDP (%)	2Q22	3Q22	4Q22	1Q23
Q/Q saar	-0.6	3.2	2.6	2.0
Y/Y	1.8	1.9	0.9	1.8

Source: JP Morgan Guide to the Markets 3Q 23

What should we expect from financial markets in the second half of the year?

- *Domestic equity markets provided strong returns during the first half, likely leading to a pause and increased volatility at some point during the back half of the year.*
- *We see an opportunity for equity markets to broaden participation during the back half of the year and for fixed income to benefit as the Fed likely stops hiking interest rate.*
- *Outlook remains neutral with respect to allocation to equities and fixed income as we believe risk/reward remains favorable even after the first half's solid performance*

Our allocation bias between equities and fixed income remains neutral, as we still believe that the risk/reward balance is favorable, although not to the degree it was at the beginning of the year. The Federal Reserve's transition towards a neutral interest rate policy throughout this year and into 2024, along with an improving global macro backdrop, creates the potential for a welcomed return to normalization in asset class performance and correlations.

In 2023, growth stocks roared back relative to their value counterparts which dominated much of 2022. We anticipate equity market participation will broaden in scope during the latter half of 2023 and into 2024. Our portfolio strategies incorporate both growth and value attributes; avoiding extreme bias towards one or the other which can lead to periods of substantial performance deviation. We prefer a balanced approach while focusing on quality security selection to drive outcomes.

Consequently, we believe that both domestic and foreign equities are entering a phase where skilled stock selection will be crucial to balance risks and rewards in a transitioning market. This trend has the potential to be more pronounced in the U.S. versus abroad, where markets are expected to exhibit greater correlation due to relatively lower valuations. Within fixed income, opportunities are clear on the short end of the yield curve with the increase in yields, high yield bonds with fewer than anticipated defaults and municipal bonds with stable state and local budgets. We believe a steepening yield curve will begin to present opportunities in other areas of the fixed income arena and provide an opportunity for longer maturities, increased portfolio duration and greater diversification within fixed income and portfolios as a whole.

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