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Second Quarter Market Watch

The major US indices emerged from a bear market in the second quarter, with the Nasdaq Composite closing out June 2023 with a 32% gain year to date, its best first half of the year since 1983. The S&P 500 locked in a gain of 16.9%, its best first-half return since 2019. The Dow Jones Industrials Average was a laggard, returning just 4.9%. Bonds enjoyed some reprieve as well, with most fixed income indices posting modest gains after their historic selloff in 2022. Time and time again, the worst-case scenarios predicted by market participants failed to materialize.

A concerted effort by the regulators and large banks in March 2023 prevented the failures of Silicon Valley Bank and First Republic Bank from turning into a systemic crisis. In late May, lawmakers managed to strike an agreement on government spending, just in time to avoid a US default on its debt. More importantly, the recession that many had anticipated has so far remained out of sight, despite the interest rate hikes by the US Federal Reserve to rein in inflation. Typically, higher rates leads to higher costs for commercial and consumer loans, which in turn cool the economy. Yet the latest Commerce Department data showed that the US GDP increased 2% annually, significantly faster than the 1.3% forecasted by economists. In addition, the labor market has continued to add jobs at a pace well above its pre-COVID average.

Despite the overall positive economic backdrop, some cracks have begun to emerge. Year to date, 286 US companies filed for bankruptcy protection, including Silicon Valley Bank, Bed Bath & Beyond and Vice Media. That is the highest count year to date since 2010. Another sign of weakness is the manufacturing sector, which has been declining for months.

US Treasury bond yields increased in the second quarter, a sign of rising risk appetite as the market powered through the turbulence. The yield on the 10-year Treasury note ended Q2 at 3.81%, up from 3.49% on March 31st. It briefly tested 4% in March before the banking crisis sparked a rally that dragged down yields, which fall when bond prices rise. The US Treasurys are influenced by central bank policy. While June's Fed meeting ended without an interest rate hike, the central bank left the door open for more hikes while they assess the cumulative impact of the 500 bps of hikes already taken. Market pricing suggests better than 50% odds of a hike in July, while dramatically reduced bets for rate cuts by year end. Taken together, the outlook for the economy and inflation remains uncertain.

Two-year yields have remained consistently above 10-year yields for a year. Such an inversion of the yield curve typically precedes a recession. Despite an overall improvement outlook by investors, a slowdown remains a possibility.

	Date	YTD		1 Year Ago	
	6/30/2023	12/31/2022	% chg	6/30/22	% chg
DJIA	34,407.60	33,147.25	4.9%	30,775.43	14.2%
S&P 500	4,450.38	3,839.50	16.9%	3,785.38	19.6%
NASDAQ Composite	13,787.92	10,466.48	32.3%	11,028.74	26.1%
Russell 2000	4,693.98	4,377.14	8.1%	4,244.79	12.3%

	Date	YTD		1 Year Ago	
	6/30/2023	12/31/2022	% chg	6/30/2022	% chg
Japan Nikkei 225	33,189.04	26,094.50	16.1%	26,393.04	-8.2%
MSCI EM (Emerging Markets)	989.48	956.38	5.1%	1,000.67	2.2%
MSCI EAFE	2,131.72	1,943.93	12.1%	1,846.28	19.4%
MSCI AC World	682.84	605.38	14.3%	596.77	17.1%
FTSE 100	7,905.25	7,657.48	9.1%	7,242.59	1.5%
SSE Composite Index	3,202.06	3,089.26	-0.8%	3,398.62	-22.8%

US Equity Sector

	YTD	1-yr ret.
Consumer Discretionary	33.1%	22.3%
Consumer Staples	1.3%	5.1%
Energy	-5.5%	17.1%
Financials	-0.5%	8.0%
Health Care	-1.5%	4.1%
Industrials	10.2%	24.0%
Information Tech	42.8%	39.9%
Materials	7.7%	14.4%
Communication Services	36.2%	16.5%
Utilities	-5.7%	-6.0%

US Equity Style

	YTD	1-yr ret.
Russell 1000 Value	5.1%	10.1%
Russell 1000 Growth	29.0%	25.8%
Russell 2000 Value	2.5%	4.4%
Russell 2000 Growth	13.6%	17.6%

Commodity Prices

	Jun 2023	Dec 2022	Jun 2022
Gold	1,929.	1,826.20	1,807.30
Crude Oil	70.64	80.26	105.76
US Dollar Index	102.59	103.27	104.46
Commodity Index	101.48	112.81	117.05

Interest Rates

	Jun '23	Dec '22	1 Yr. Ago
USD Prime Rate (TPI)	8.25	7.50	4.75
USD Federal Funds (TPI)	5.07	4.34	1.58
US 2Y T-Note Yield (TPI)	4.87	4.42	2.93
US 10Y T-Note Yield (TPI)	3.81	3.88	2.98
30YR FIXED MORTGAGE	6.71	6.42	5.70

Exchange Rates

	Jun 2023	Dec 2022	Jun 2022
Euro per U.S. Dollar	0.917	0.937	0.957
British Pounds per U.S. Dollar	0.787	0.831	0.823
China Renminbi per U.S. Dollar	7.264	6.952	6.694
Indian Rupee per U.S. Dollar	82.036	82.730	78.973
Japanese Yen per U.S. Dollar	144.535	131.945	135.855

Economic Sentiment

	Jun 2022	Dec 2021	Jun 2021
Unemployment Rate	3.70	3.50	3.60

US Bond Performance

	Q2	YTD	1-Year Return
BAR CAP Govt. Interm. TR	-1.1%	1.1%	-1.5%

Along with the recent banking sector stress, commercial real estate has been under tremendous pressure, especially in the office sector. A crash in values of office buildings could start a doom loop with bank commercial real estate loans, with falling property prices leading to less financing and thus further reducing value. Some analysts think that could spread across the multitrillion-dollar commercial real estate sector, draining funding liquidity out of the real estate market as banks and investors turn cautious. Still, bulls argue that the worst is priced in, and the latest deal by Japan's Mori Trust taking over 245 Park Avenue from real-estate investment trust SL Green marks a turning point for high-quality offices.

Along with the year-to-date stock market rally, investor risk appetite has been surging. Companies with weaker balance sheets are beating those with stronger balance sheets, based on recent research by Société Générale. A part of this lower quality stock rally could be explained by market exuberance in the face of economic strength. The weakest borrowers benefited because the widely expected recession simply has not arrived. In contrast, more credit-worthy companies, outside the top-performing mega-cap tech companies, have not enjoyed a similar boost to their share prices. Another evidence of the uptick in investor risk-appetite is the performance of high volatility stocks. Stocks with higher volatility have far outperformed low-volatility stocks even as the S&P 500 has entered a new bull market. Some of the highly levered and the most economically sensitive companies, such as cruise operators and airlines, soared in the recent months. Companies with significant amounts of debt during the era of easy money now face a reckoning. Rising rates make it a mounting pressure to service the debt, thus creates challenges to the underlying businesses.

The 32% gain of the Nasdaq was a sharp divergence from expectations at the beginning of 2023. This surprising rally has some investors questioning its durability. Beneath the surface are two market dynamics: the mega cap technology stocks, which account for a significant portion of the market rally, and everything else. The top ten stocks account for 31.7% of the S&P 500, a record concentration over the past 30 years. However, the earnings contribution to the S&P 500 of these top 10 stocks is just 21.5%.

Some asset managers are cautious whether the market's rally is here to stay. Fund managers surveyed by Bank of America still have less exposure to equities in their portfolios than usual, and the firm's survey result of investor sentiment has stayed relatively low as well. Such caution is justified, given the fact that the market's gains have been relatively narrow. Given this backdrop, professional money managers are faced with considerable challenges in deciding future winners and losers.

Enthusiasm for Artificial Intelligence (AI) has resulted in a rapid multiple expansion among mega cap technology stocks, but this AI theme will take years to play out. Even for the current winners, it is difficult to predict monetization potential of the many applications of AI, as well as the regulatory risks. At 1911, our investment professionals seek to find and maintain other sources of exposure for your portfolios outside mega cap stocks, such as international stocks, small and mid-cap equities, and bonds. Importantly, private equity, a strategic asset class in 1911, provides a compelling investment opportunity. More companies have been staying private for longer, resulting in greater opportunities in the private markets. Based on a JP Morgan study, private equity and venture capital funds have triple the exposure to information technology than the Russell 2000, which could yield many emerging opportunities in AI and beyond.

The S&P 500 has exceeded our expectations thus far in 2023 and we are cautious about the next 6 months for equities. The credit markets are providing nice entry points for private credit, offering double digit returns as well as safe attractive returns for your cash and tax-free bonds. Once again, diversification will provide lower risks and strong total returns.

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