Second Quarter 2023

For much of the last decade, but perhaps most acutely during 2020 and 2021, the acronym TINA (There Is No Alternative) was used to explain the seemingly relentless bid under and accompanying elevated valuations of U.S. equity markets. With interest rates pinned at zero, investors were forced out of bonds and into equities to generate adequate returns. This was both a function of yield (cash generated by portfolios) and the flow through of lower interest rates to lower discount rates used in equity valuation models, pushing "fair value" multiples higher. In 2022, as the Fed rapidly raised interest rates in an effort to contain inflation, another acronym TARA (There Are Reasonable Alternatives) emerged as bond yields climbed, providing investors both reasonable yield opportunities in bonds and lowering "fair value" multiples for stocks. In addition to TARA lowering the price component of P/E multiples investors also worried, quite rationally given history, that tighter monetary policy would lead to a recession and bring the earnings component of P/E multiples lower as well. Exacerbating investors' worries were concerns that high inflation and a resilient labor market curtailed or eliminated the Federal Reserve's ability and willingness to cut interest rates in the face of an economic slowdown, the reaction function often referred to as the "Fed Put."

In many respects, the first half of 2023 has been a continuation of themes from 2022: inflation remains above target, unemployment remains historically low, bond yields offer a reasonable (and in some cases more compelling relative to 2022) alternative to equities, and analysts continue to lower forward earnings estimates. In contrast to 2022, equity markets have rallied despite concerns over bank failures, ballooning Federal debt, and the resulting Congressional funding standoff. In this quarter's edition of the Market Comments, we examine the mixed signals coming from the Federal Reserve, equities, and fixed income and the implications for risk and portfolio management going forward.

The Federal Reserve: Inflation and monetary policy

The Federal Reserve's campaign against inflation continued through the first half of 2023, with twenty-five basis point interest rate hikes implemented at each of the Fed's February, March, and May policy meetings. The Fed did not raise rates at its recent June meeting, opting to hold the benchmark rate at 5.25%, 350 basis points above where it was a year ago and up 75 basis points from the end of last year. The most recent year over year reading for the Fed's preferred inflation measure, Core Personal Consumption Expenditures (CPCE) came in at 4.6%, 80 basis points below the 2022 peak of 5.4%, but still well above the Fed's 2% target. The Consumer Price Index (CPI), which is less central to the Fed's policy decisions, but is an important part of the public perception of inflation, shows more meaningful progress, falling to 4%, compared to 9.1% a year ago. The decline in inflationary pressure is largely attributable to a significant decline in energy prices and the normalization of supply chains for goods and food. Service inflation has moderated somewhat but remains elevated relative to pre-pandemic levels.

While there have been significant, high-profile layoffs in the technology and financial services sectors, the labor market has remained strong in the face of tighter monetary policy, with the most recent reading of the unemployment rate coming in at 3.7%. Though wage growth (as measured by the Atlanta Fed's median wage growth index) has moderated somewhat to 6% year over year, it remains elevated compared to the 3-4% range that characterized the five years leading up to the pandemic. There is evidence that even with low unemployment and healthy wage growth, the U.S. consumer is starting to come under pressure. Credit card balances and delinquencies are ticking higher in recent months, even as lenders appear to be tightening standards for extending consumer credit.

In March of this year, when market stress surrounding the failures of Silicon Valley Bank and Signature Bank was at its peak, Federal Funds futures markets indicated that the Fed would be cutting rates by June of this year. However, as that crisis was contained and its memory receded, expectations of rate cuts this year also faded. Markets are now pricing at least another fifty basis points of rate hikes in the second half of this year, and a potential cut in the first or second quarter of 2024. Markets and the Fed currently seem to be aligned regarding the future path of monetary policy. With unemployment low, the consumer still strong, and inflation remaining uncomfortably high the Federal funds rate is likely to go somewhat higher from here and remain elevated for some time. The precise meaning of "some time" is open to debate, but it seems quite clear that there would need to be significant deterioration in the economy (i.e., substantially higher unemployment) and not simply a downdraft in markets for the Fed Put to be reactivated and interest rates lowered.

Equities

U.S. equity markets enjoyed continued strength in the second quarter. The S&P 500, NASDAQ composite, and the small cap Russell 2000 gained 8.7%, 13.1%, and 5.2%, respectively. Year to date the S&P 500 is up 16.9%, the NASDAQ has gained 32.3%, and the Russell 2000 has returned 8.1%. The run up in markets has been powered by the "big seven" mega cap tech stocks: Apple, Microsoft, Amazon, Nvidia, Alphabet, Tesla, and Meta. These seven behemoths now represent ~27% of the capitalization of the S&P 500. The importance of these companies to the S&P 500's return can be illustrated by comparing the performance of the capitalization weighted S&P 500 to the equal weight version of the index, which was up 4% in the second quarter and is up 7% year to date. The narrow breadth of the market is cause for caution. In the near term it possibly sets up an opportunity for areas of the market that have not performed as strongly to "catch up" as investors, against the backdrop of a "risk on" tone in markets, seek opportunities on a relative value basis. In the medium to longer term, it likely indicates that imbalances are building up in the economy and that markets will need to be recalibrated in the future.

The rally in technology stocks has been driven by two intertwined factors. First, catalyzed by regional banking stress in the first quarter, concerns about the economy revitalized the "safety trade" into the balance sheet strength and revenue durability of big cap tech that characterized the pandemic markets of 2020 and 2021. Second has been investors' focus on Artificial Intelligence (A.I.) as a revolutionary technology. The investment case for A.I. is that much like the widespread adoption of the internet in the early 2000's and the proliferation of smartphones in the 2010's it will change the way that we work, innovate, and play by quickly processing vast amounts of data. With a labor market that appears to be structurally short of workers the appeal of A.I. to the business community is clear, and with the substantial investments being made by large technology companies it seems likely that more and more commercial applications will be developed. That said, implementing A.I. at scale is going to require substantial investment by businesses to purchase and implement A.I. technology, re-engineer business processes, and train staff. In the event the labor market loosens and/or the economy enters recession, the scale and pace of these investments will likely be downsized or delayed.

The fundamental question for equity investors is "what is in the price?" For stocks generally, and for the technology sector specifically, the answer seems to be: "a lot of good news." The S&P 500 finished the quarter trading at ~20x and ~18.5x estimated 2023 and 2024 earnings, respectively. The consensus estimate is that S&P 500 earnings will decline 1% year over year in 2023 and then grow 8.5% in 2024. The NASDAQ Composite is currently trading at ~36.5x estimates for this year's earnings and ~29x estimated 2024 earnings. These lofty multiples reflect consensus expectations that EPS will decline ~10.5% in 2023 and then grow ~25% in 2024. Phrased another way, equities broadly, and technology particularly, are pricing in a soft landing for the economy in the wake of the Fed's monetary policy tightening. In general, if the most anticipated recession of all time does finally arrive equity valuations do not offer a significant margin of safety. With all of that said, we continue to seek out opportunities to take positions in companies that meet our criteria for balance sheet strength, free cash flow generation, competitive moats, and reasonable valuations.

Fixed Income

Bond markets continue to paint a somewhat less optimistic forward view than equities. The yield curve remains deeply inverted in both the 3 month-10 year and 2 year-10 year pairs. Historically, yield curve inversions have been harbingers of a recession on the horizon, although they are not particularly useful as timing tools. There has also been a fair amount of volatility in the Treasury market. The two-year Treasury, the maturity most sensitive to the perceived trajectory of monetary policy, has had an average yield of 4.33% through the first half 2023, with a peak yield of 5.07% on March 8th and a trough yield of 3.77% coming on March 24th during the height of the regional bank stress. Since then, the two-year yield has climbed steadily, finishing the quarter at 4.90%. Ten-year Treasuries followed a similar pattern, though with a smaller peak to trough range. The ten-year yield averaged 3.63% through the first 6 months of the year, peaking in early March at 4.06% and hitting the year to date low of 3.31% on April 6th. At the long end of the curve, thirty-year Treasuries have traded in a tighter range, with a high yield of 3.99% in early May and low yield in mid-January of 3.54%. Though Yogi Berra supposedly said, “predictions are hard, especially about the future,” it seems there are some inferences that can be made from the price action in the Treasury market. First, the two-year Treasury note’s yield swings convey a message that after a brief period of wishful thinking about rate cuts in the early spring, the Federal Funds rate is likely going somewhat higher from here and will remain there for a period that is likely to be measured in quarters rather than months. Second is that long-run inflation expectations, expressed in the narrower trading ranges further out the yield curve, remain reasonably well anchored, though somewhat more ominously they hint that long run growth expectations are somewhat muted.

Given the concerns about the path of the economy and equity valuations, investment grade fixed income looks attractive on a risk-adjusted basis provided that inflation continues to moderate, even if the Fed fails to reach its 2% target. With yields in the high 4%’s to low 5%’s available for investment grade corporate and taxable municipal bonds, and taxable equivalent yields in the mid 4%’s to low 5%’s for high tax bracket investors, fixed income can serve a role in many portfolios, particularly those looking to generate income and have predictable liquidity for distribution needs. Furthermore, with rates having reset higher, bonds should also offer a degree of portfolio diversification in the event that the economy does weaken, and the Fed begins to cut interest rates. We continue to deploy our strategy of building laddered bond portfolios, with final maturities of approximately 10-12 years and overall duration of 5-6 years. We have been adding to portfolios across the maturity spectrum, which allows investors to capture currently available yields while also being reasonably well hedged against interest rate risk. If rates move higher from here bonds maturing in the near term can be reinvested at higher rates. Conversely, if rates come down and the yield curve assumes a more normal upward slope, investors have locked in reasonably attractive yields on high quality credits.

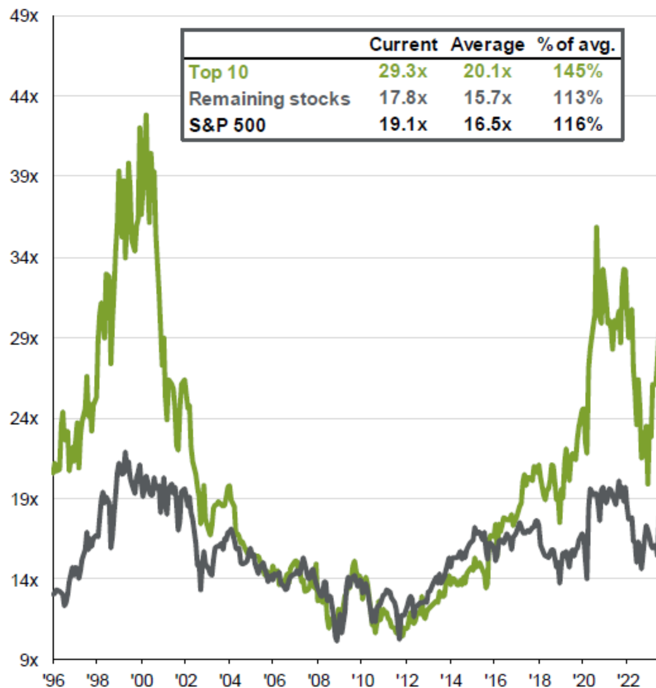
Summary

At the halfway point of 2023, investors face a complex landscape, with conflicting messages coming from equity and bond markets. Despite higher interest rates, decelerating corporate earnings, and above target inflation, equity markets broadly, and the technology sector particularly, have rallied and are now trading with valuations that are pricing in a soft landing for the economy. With the yield curve still deeply inverted (historically a recessionary indicator) bond markets are sending a conflicting signal. The Fed’s interest rate hiking campaign over the last 15 months has made some progress in containing inflation with energy and goods price increases coming off the boil. However, service sector inflation, driven by low unemployment and rising wages, remains stubbornly high. The Fed has clearly articulated that it intends to raise interest rates somewhat higher from here and then hold them there until inflation meaningfully subsides. All of this seems to imply that the price for containing inflation is likely going to be higher unemployment, and, with the U.S. economy driven by consumer spending, an accompanying recession at some point in the future. Against this backdrop, we continue to follow our time-tested research process in both equities and fixed income, with a focus on high quality companies and credits to help manage risk and provide downside protection in difficult markets. Over the long run we believe that equities will continue to be the driver of compounding returns in portfolios. However, given the uncertain environment, higher yields on high quality fixed income investments mean that bonds can play an important role in many portfolios as a means to generate income, provide predictable liquidity, and provide a degree of diversification. Asset allocation and portfolio construction are driven by each client’s time horizon, investment goals, liquidity needs, and risk tolerance. We welcome the opportunity to meet with clients to make sure these variables are aligned.

Valuation and weighting risks of the top 10 S&P 500 stocks

P/E ratio of the top 10 and remaining stocks in the S&P 500

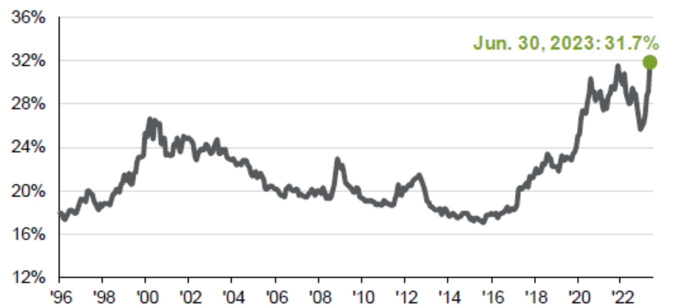
Next 12 months, 1996 - present



	Current	Average	% of avg.
Top 10	29.3x	20.1x	145%
Remaining stocks	17.8x	15.7x	113%
S&P 500	19.1x	16.5x	116%

Weight of the top 10 stocks in the S&P 500

% of market capitalization of the S&P 500



Earnings contribution of the top 10 in the S&P 500

Based on last 12 months' earnings

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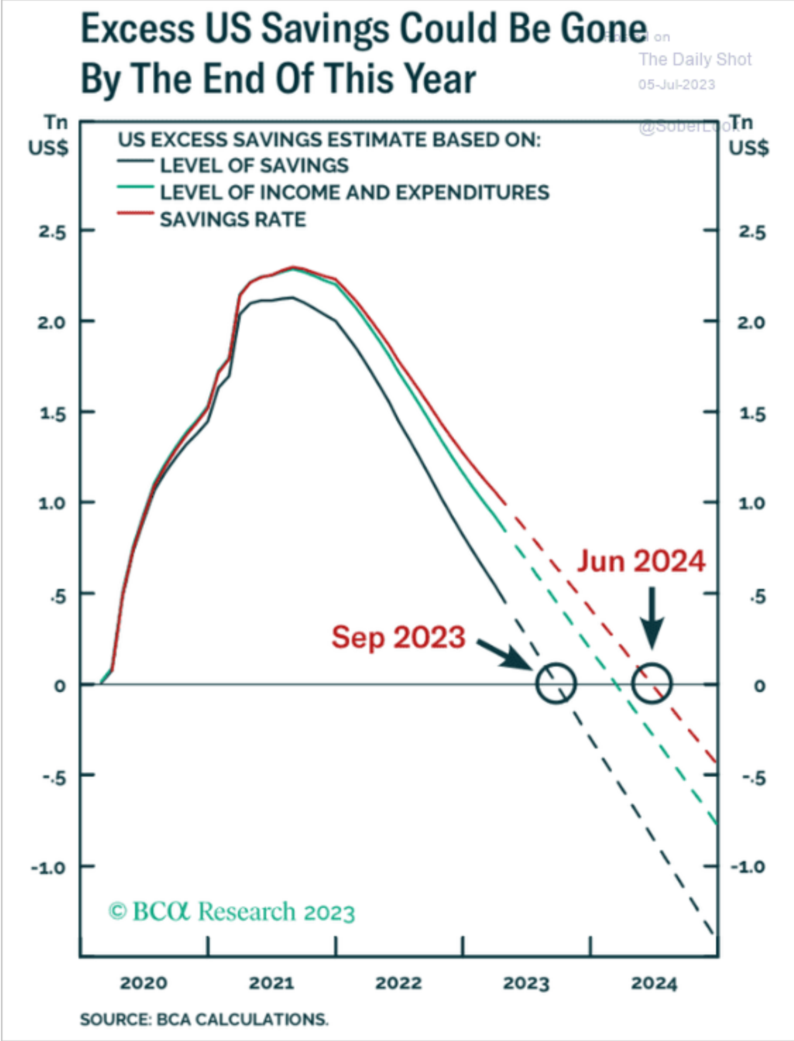
A headwind for consumer spending



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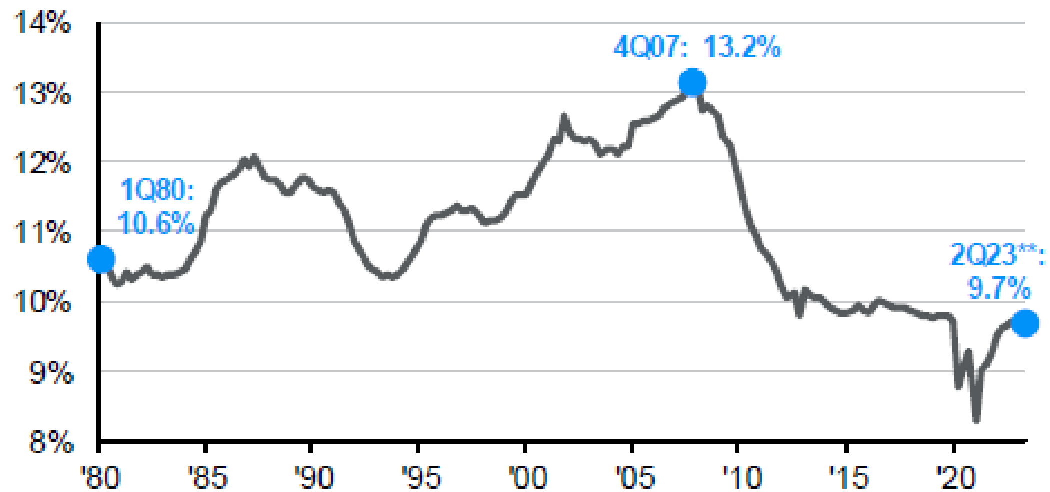
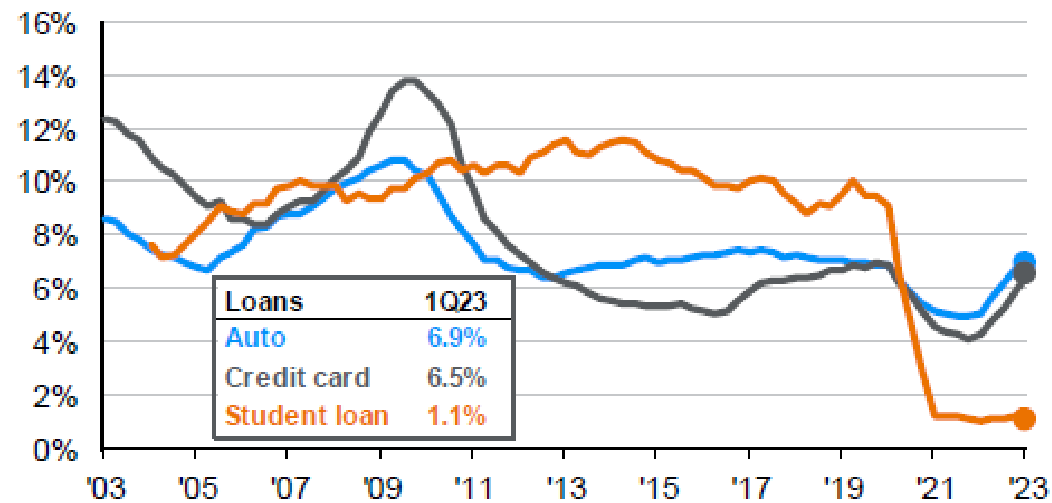
Along with debt service and delinquencies





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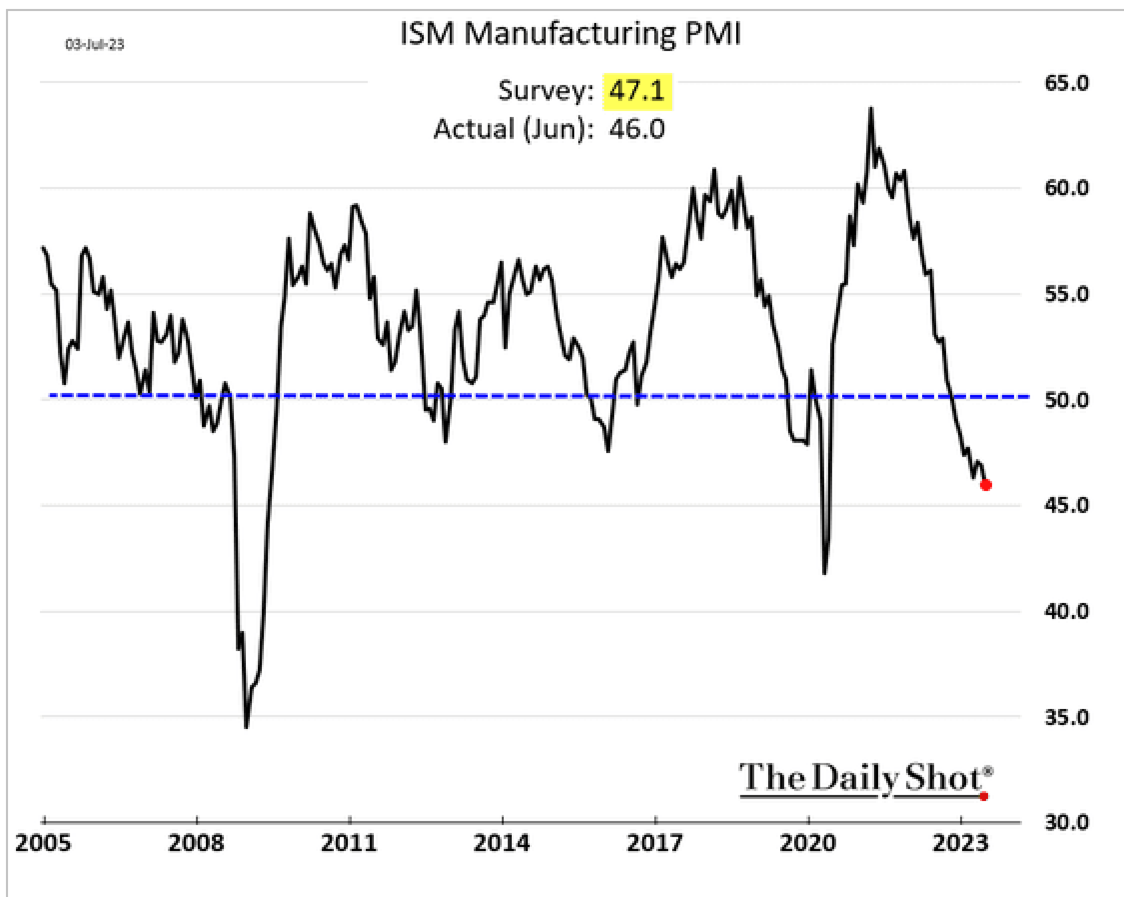
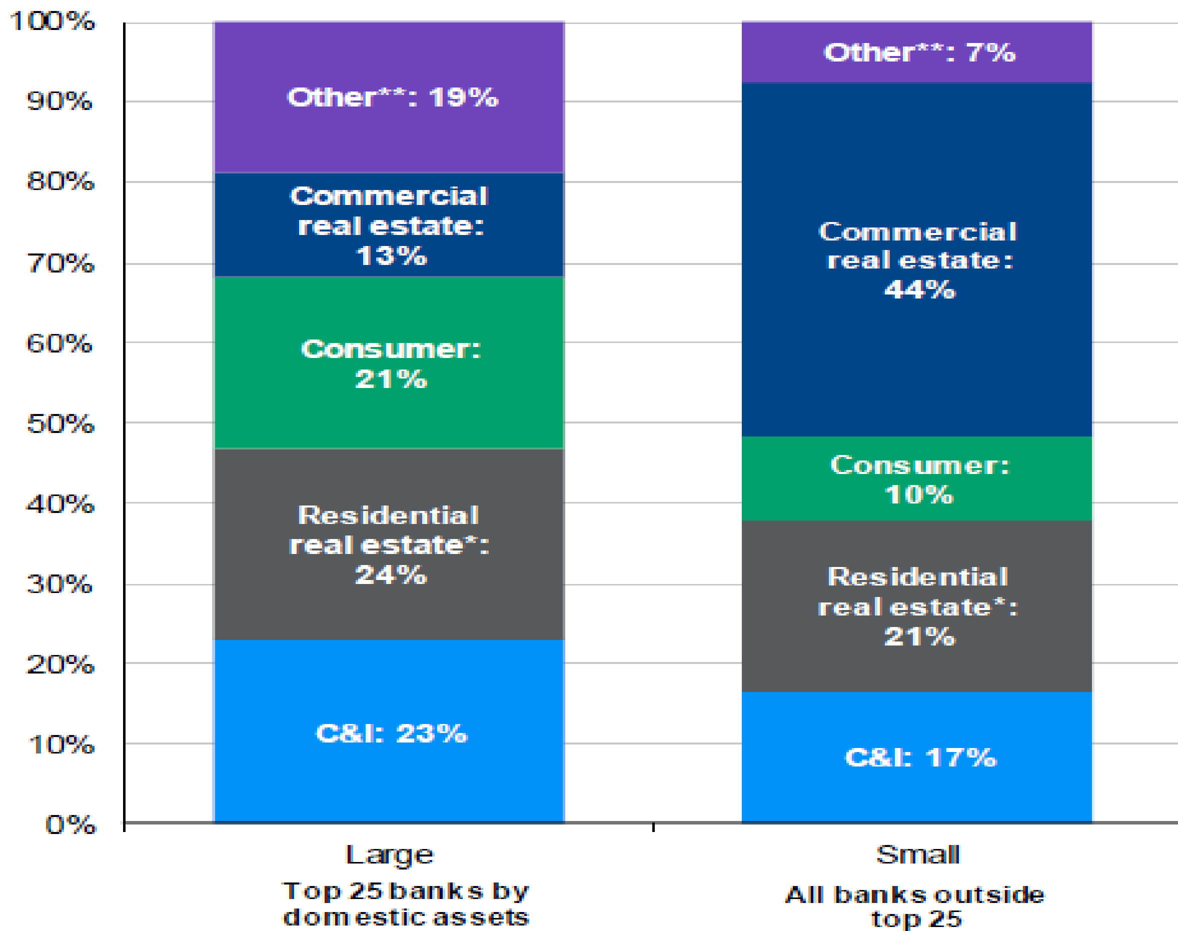
Historically a PMI datapoint below 50 has signaled a slowdown



Office occupancy remains a concern in key markets

Office real estate is a risk for banks



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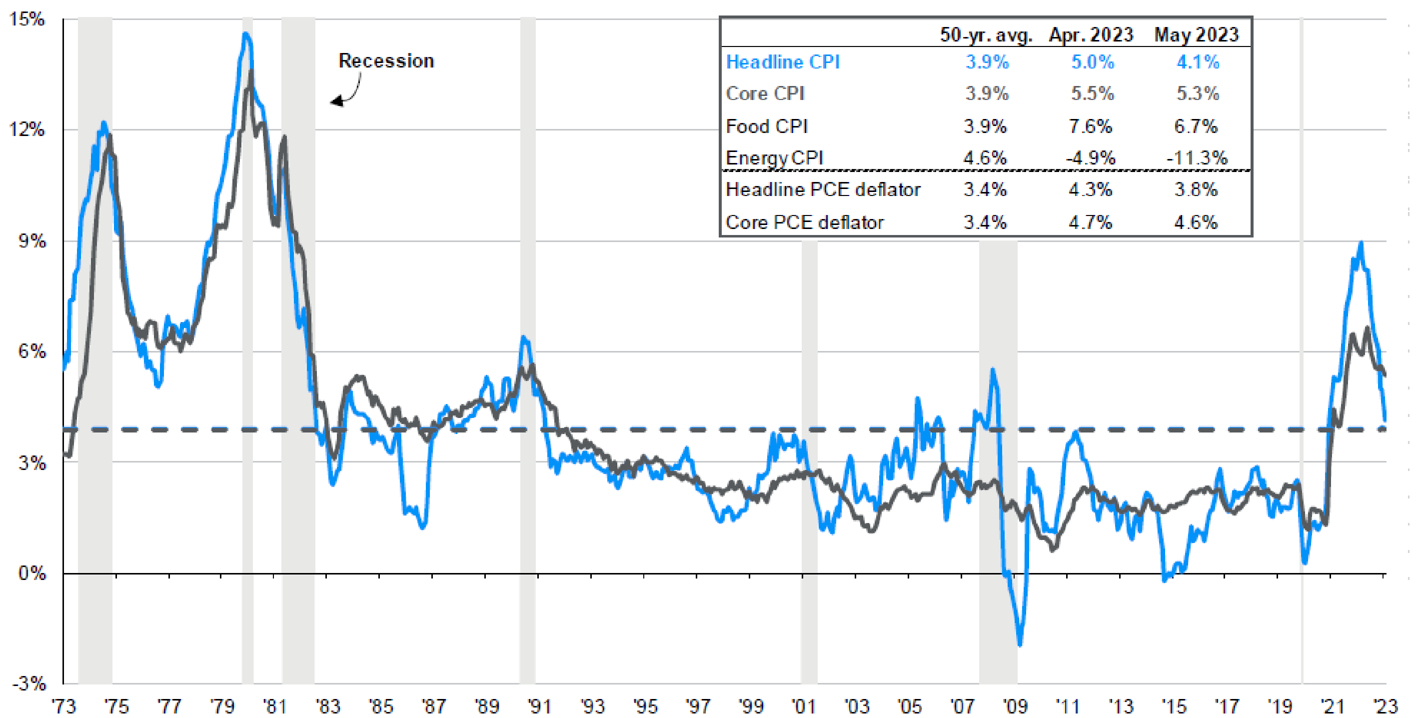
Inflation trending down



	50-yr. avg.	Apr. 2023	May 2023
Headline CPI	3.9%	5.0%	4.1%
Core CPI	3.9%	5.5%	5.3%
Food CPI	3.9%	7.6%	6.7%
Energy CPI	4.6%	-4.9%	-11.3%
Headline PCE deflator	3.4%	4.3%	3.8%
Core PCE deflator	3.4%	4.7%	4.6%

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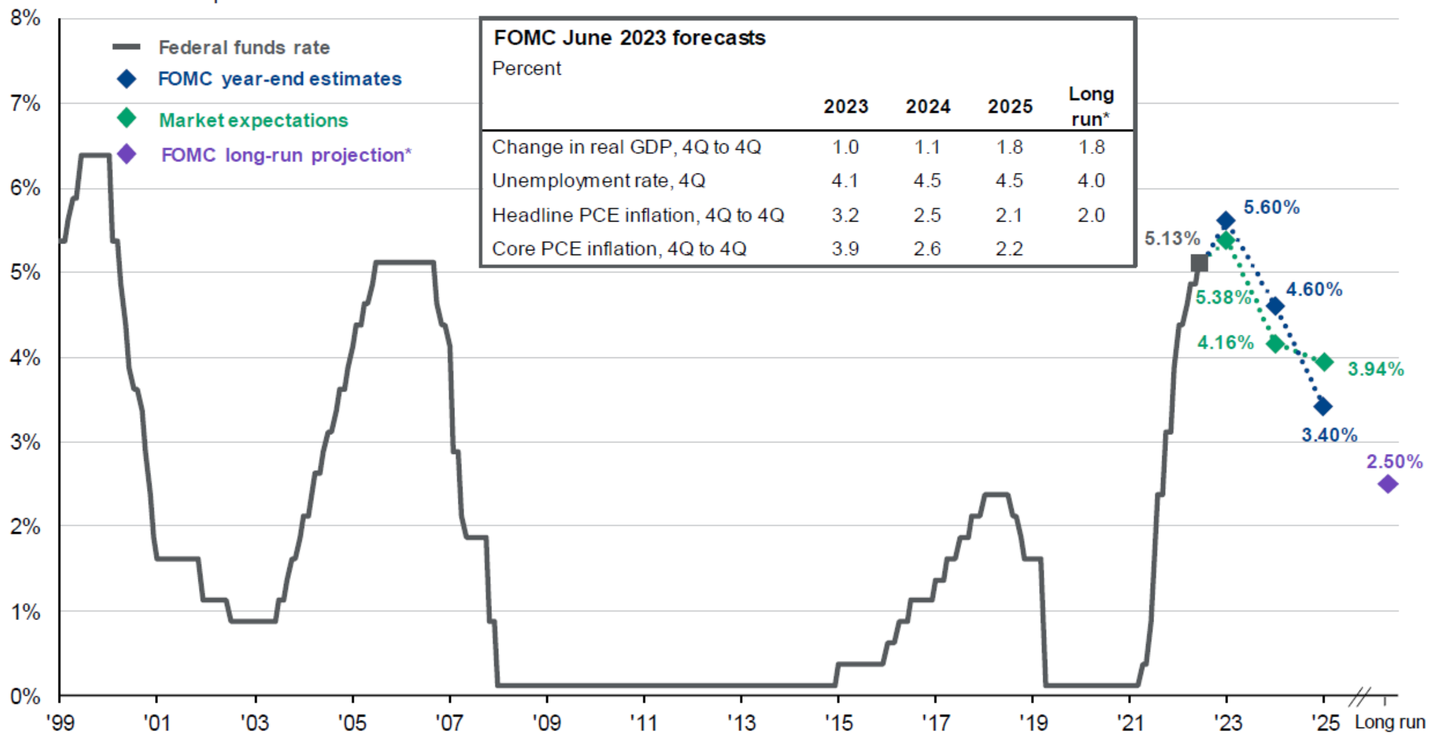
The Fed and interest rates

Federal funds rate expectations

FOMC and market expectations for the federal funds rate



FOMC June 2023 forecasts

Percent

	2023	2024	2025	Long run*
Change in real GDP, 4Q to 4Q	1.0	1.1	1.8	1.8
Unemployment rate, 4Q	4.1	4.5	4.5	4.0
Headline PCE inflation, 4Q to 4Q	3.2	2.5	2.1	2.0
Core PCE inflation, 4Q to 4Q	3.9	2.6	2.2	

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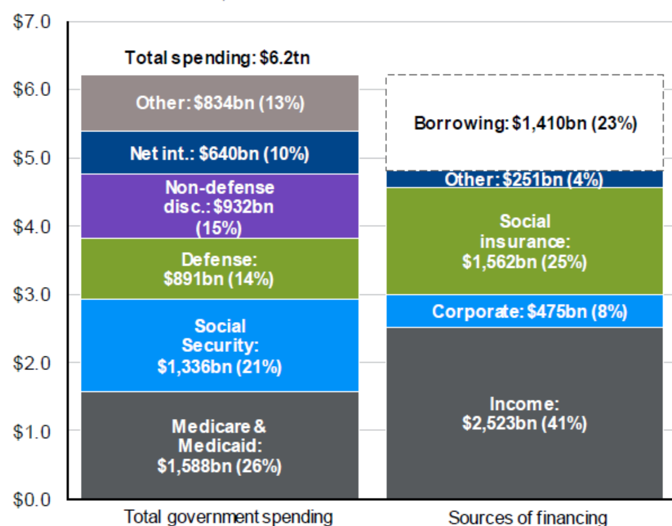
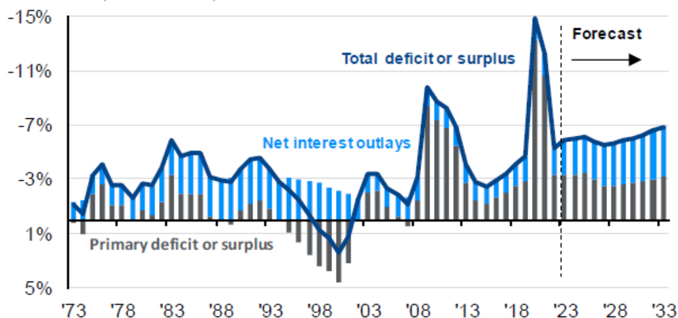
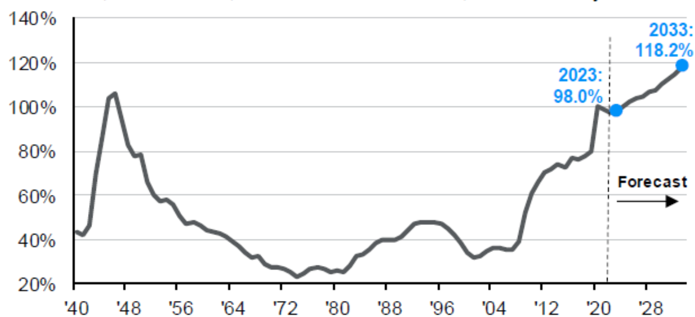
So much for deficit reduction



CBO's Baseline economic assumptions

	2023	'24-'25	'26-'27	'28-'33
Real GDP growth	0.3%	1.9%	2.4%	1.9%
10-year Treasury	3.8%	3.8%	3.8%	3.8%
Headline inflation (CPI)	5.7%	2.8%	2.1%	2.2%
Unemployment	4.3%	4.9%	4.5%	4.5%





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