The Emergence of AI and Fed Skipping a Rate Hike Drive 2Q23 Surge
July 2023

Dear Client:

The second quarter of 2023 began with investors on high alert for a recession and believing that the Fed could soon cut interest rates. Yet the first half of 2023 was the best first half of a year for the stock markets since 2018, before the economic, social, and political disruptions caused by the pandemic.

The quarter ended without an economic downturn, inflation sticky yet heading lower, and the Fed firmly stated it would keep rates higher for longer. So far, 2023 has been the re-emergence of the growth trade and the reversal of much of the damage in Technology stocks that led to the 18% market selloff in 2022.

The economic forces in the U.S. and worldwide have produced an inflationary environment unlike any we have seen in recent times. This environment has also prompted the Federal Reserve and other central banks worldwide to raise rates faster than at any additional time.

Usually, this would have plunged the U.S. and world economies into a deep recession, but this has not happened. The U.S. consumer, buoyed by multiple rounds of Covid-related federal funds and corporations receiving financial benefits from the federal government and the Fed, continue to spend and sow profits.

The positive returns of 1H23 in the public markets didn't come without volatility for investors. Quick action from regulators and bankers in March helped prevent the collapse of several regional banks from morphing into a systemic credit crunch, and an agreement by lawmakers on the government spending and debt ceiling impasse averted what would have been an unprecedented U.S. default on its debt.

U.S. large-cap equities continued to charge higher in the second quarter, leaving behind most asset classes. The S&P 500 Index soared 8.7% in the second quarter, contributing to a substantial gain of 16.9% for the year's first half. Similarly, the tech-focused Nasdaq had an impressive performance, surging 13.1% in the second quarter and achieving a remarkable 32.3% gain for the first half, marking its strongest first half since 1983.

The impressive gains in the indices were propelled mainly by a select few mega-cap tech stocks, driven by the enthusiasm surrounding Artificial Intelligence (AI). Many, view AI as a potentially transformative technology, offering companies additional sources of growth, much like the internet did. More diminutive and mid-cap stocks and international equity indices, with less emphasis on technology, delivered more modest returns.

Data showed a robust U.S. labor market, firm consumer spending, and an improving inflation rate (though one still well above Fed targets). While inflation appears on the right downward track, the Fed still seeks to balance a hawkish stance to stabilize price pressures without forcing the U.S. into a recession. The Fed's preferred inflation measure, the personal consumption expenditures ("PCE") index, rose 3.8% in May from a year earlier, marking its lowest reading in two years.

June headline CPI was 3.0% (as compared with April's 4.9%), making 12 consecutive months of declines. The biggest driver of inflation continues to be housing costs, which economists expect to cool in the coming months. (Apartment-rent growth has cooled, but this will take time to show up in the inflation data due to the lag in calculating rent.) Core prices rose 5.3%, down from 5.5% in April.

The Federal Reserve took a hiatus in June, leaving the Fed Funds rate at the target range of 5% to 5.25% after ten previous meetings of consecutive hikes. Fed Chairman Jerome Powell signaled that it was prepared to raise rates again in July and beyond if the economy and inflation do not cool significantly.

Domestic Equity Market

The second quarter again saw Growth style outpace Value style stocks at every market cap size in U.S. markets.

As measured by the Russell 3000, the broad stock market was up 8.4%. Small stocks, as categorized by the Russell 2000, did well, though substantially trailed Large Caps. The Russell 1000 Growth Index, which measures Large Caps, was up 12.8% for the quarter; Value stocks (per Russell 1000 Value) returned 4%. Small Cap growth measured by Russell 2000 Growth was up 7%, and the Russell 2000 Value index was up 3.2% this quarter.

Technology (15.4%), Consumer Discretionary (13.9%), and Communication Services (12.5%) were still by far the leading sectors this quarter. Cyclical sectors Industrials (6.9%), Financials (5.3%), and Materials (3.3%) had good quarters, which explains the improvement in value stocks. In comparison, Health Care (3%) and Real Estate (1.8%) were the other positive sectors for the second quarter. Consumer Staples (-.02%), Energy (-1.1%), and Utilities (-2.5%) were all negative for the period.

The risk-on appetite increased stock markets, especially in the U.S., despite a banking crisis, the threat of a U.S. default, continued interest rate increases from the Federal Reserve, and ongoing recession fears. Even with these factors, the Dow Jones Industrial Average, Standard & Poor's 500, and Nasdaq posted gains of 3.8%, 15.9%, and 31.7%, respectively, through the year's first half. During June, the DJIA, S&P 500, and Nasdaq gained 4.6%, 6.5%, and 6.6%, respectively. The big tech "magnificent seven" (Apple, Microsoft, Alphabet, Amazon, Meta, NVIDIA, and Tesla) drove most of the rally as AI became the focus for stock market bulls.
Most importantly, as shown above, in the S&P sector performance, the market broadened in June and was led by cyclical sectors, which had all the S&P gains until March. That's when NVIDIA announced a massive increase in future AI revenue estimates, rocketing it to the fifth-largest company in the S&P 500.

The narrow concentration at the top of the S&P 500 is now at historic levels again, with 31.5% of the Index market cap in the top 10 stocks: the magnificent seven plus Berkshire Hathaway, UnitedHealth, and Exxon Mobil.

AI is significant, yet its near-term tangible revenue benefits, beyond those for NVIDIA, could be more robust in companies. The market is embracing a small group of high-performing companies that should benefit in the future. It is betting that little can stop them even when the rationale (earnings) for outperformance has yet to materialize.

International Markets

The global economy remains fragile. Headline inflation is above-target in almost all major economies, and core inflation is sticky and elevated. Regionally, the brighter spots in the global economy are the fast-growing major Asian economies, including China, India, Southeast Asia, and a strengthening Brazil. Contrary to the motion of U.S. stocks, Growth style stocks in these markets underperformed Value style stocks in internationally developed and emerging markets as measured by the MSCI Indices.

International developed markets, measured by MSCI EAFE Index, climbed 2.6% for the quarter, and the MSCI Emerging Markets Index was up 1.8%. Economic growth in some major economies was more robust than predicted at the beginning of this year, with resilient consumption in the U.S. and a faster-than-anticipated initial post-pandemic reopening in China.

Inflation in Europe nudged back up to 7% in May, the labor market remains nearer to full employment, and core inflation rates, which exclude more volatile energy and food costs, stay at or close to multi-decade highs. All of which are problematic. The European Central Bank (ECB) raised interest rates by 25 basis points to 3.5%, the highest interest rate over two decades. Taming inflation while avoiding a recession is Europe’s biggest challenge in the months to come as the continent also continues to digest the impact of the war in Ukraine on its economy.

The World Bank forecasts the global economy to slow in 2023 to 2.1% and edge up modestly to 2.4% in 2024. The world economy is experiencing a synchronized slowdown, and most countries will likely face slower growth this year than last.

A China decelerating from Q123 and not producing as significant or as broad an impact from its last Covid reopening, combined with the near-term ECB inflation fighting and the U.K. post-Brexit malaise, explains why non-U.S. assets are cheaper – yet with risks.

Bond Markets

At its June meeting, the Fed chose not to hike interest rates (leaving the Fed Funds rate at 5.25%) for the first time after ten consecutive meetings with a raise. Powell asserted that this pause in hikes did not mean the tightening was complete or that easing (pivoting) was imminent. He and a host of Fed governors reiterated the utility of future hikes as the Fed monitors economic conditions.

As measured by the Bloomberg US Aggregate Bond Index, the bond market was down 0.84% for the quarter.

Treasury yields rose, with the 10-year yield climbing 19 basis points (bps) for the month and 37 bps for the quarter to end at 3.84%, back where it started this year. The 2-year spiked 49 bps in June and 87 in 2Q23 ending at 4.9%, just 17 bps shy of its 5.07% cycle peak.

The 2-year to 10-year curve inversion moved to -106 bps at the end of the quarter, just shy of the -108 bps maximum it reached in March before the SVB & Signature Bank failures. All fixed-income subsectors except U.S. High Yield and Emerging Market Debt (+2.3%) were negative for the period.

A self-inflicted apocalypse—the debt ceiling debate/drama—was successfully averted. President Biden signed the debt ceiling legislation in June, and the Treasury began what it expects to be a heavy round of issuance to rebuild cash balances. The market expects at least $1.25T of short-term issuance over the next several months, most of which will be in T-bills maturing in three months or less, targeting money market funds that can finance the purchases by reducing overnight repo balances held at the Fed.

Strong economic data seemingly validated the Fed's position that restrictive policy remains appropriate, including the strong labor market (+339,000 jobs in May), solid growth (GDP +2% in the first quarter and revised higher), impressive housing market resilience (new home sales at +763,000 vs. an earlier prediction of 676,000) and sticky inflation.

Core inflation rates are being viewed as a gauge for underlying price pressures, and their stickiness has sparked concern that central banks will need to work to hit their inflation targets without wiping outgrowth. Yet a large part of Mr. Powell's inability to convince the market that higher for longer is real relates to the Fed he inherited: Before the panic of 2008: The banking system was a *scarce reserve* monetary policy where banks lent and borrowed federal funds (reserves) amongst themselves. The Fed guided this marketplace by adding or subtracting reserves to move the overnight interest rate. Today markets are somewhat addicted to this and perpetually expect rate cuts and Fed-supplied excess reserves.

Our colleague Brian Westbury at First Trust says it best:

> *Since the financial panic of 2008, and the introduction of Quantitative Easing, the Fed has flooded the system with reserves. Reserves are so abundant that banks no longer borrow or lend them. The Fed pays banks to hold them. As you can imagine, the Fed would like to pay almost nothing to banks, as it did for nine out of the last fifteen years. Under the new system, there is no direct link between interest rates and the money supply.*
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> *Instead, the Fed just decides what rates should be. And this explains why market expectations about interest rates jump around with every piece of economic data. It's all about what the Fed "might" or "might not" do. Earlier this year, the market was pricing in multiple rate cuts in the second half of 2023.*
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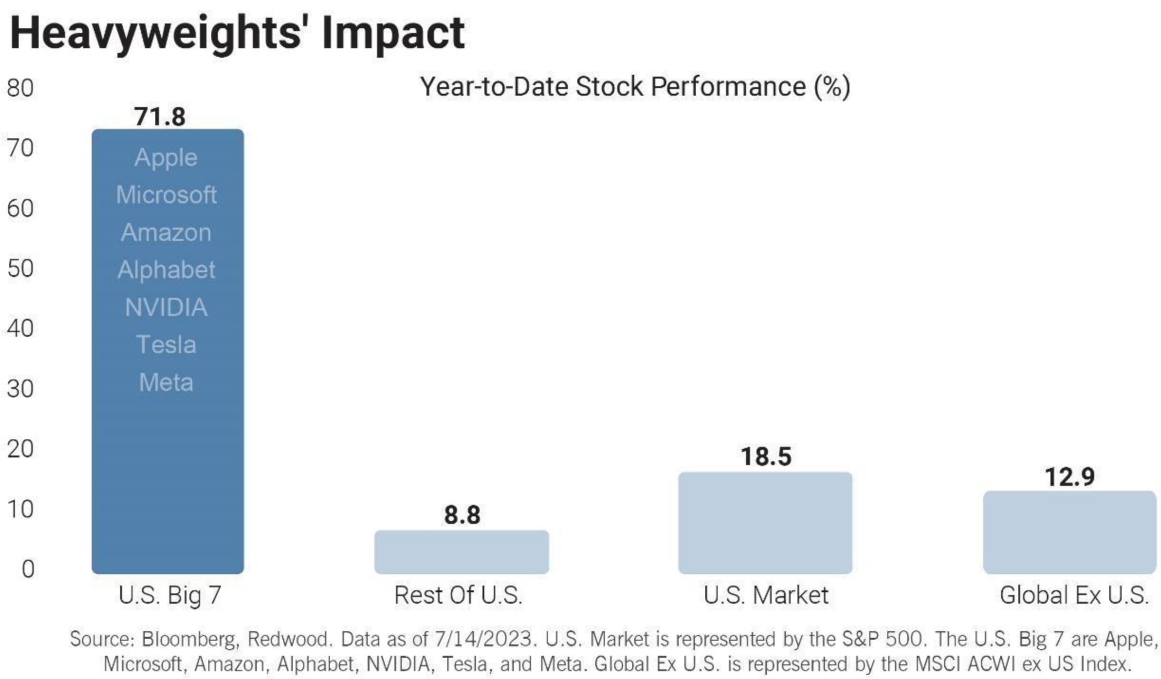
> *But after last week's employment report, which showed continued solid job growth, the futures market finished the week with the odds of a July rate hike at almost 90%. We think the market is underestimating the odds that the Federal Reserve will raise short-term rates again this year after July. Recent economic reports have been stronger than expected, and inflation remains stubbornly high around the world.*

A Look Ahead

Markets seem to be pricing in the best of all worlds—inflation moderating, policy rates falling, and recessions avoided and or at least softly landing. The steep rise in interest rates, which historically has posed a risk to businesses with long-term profit projections, didn't impact growth equities in the U.S. The market largely disregarded a negative longer-term economic view. One may wonder if we are entering an AI-driven stock market bubble.

However, this market rally has been extraordinarily concentrated at the top: The returns of those magnificent seven companies were responsible for *72%* of the overall gains by the S&P 500.



As another reflection on the skewed nature of the current returns by the market year to date, only 23% of the companies in the S&P 500 had returns outperforming the index.

This is the best example of the purpose of maintaining a diversified portfolio, always staying invested at some level, and identifying risks—in this case, concentration risk. And keep this in mind: Only one year, 1998, had a 29% outperformance concentration.
My portfolio recommendations for your asset allocation have a few changes from last quarter. Maintain a risk-balanced focus and multi-asset class approach, evaluate opportunities, and be ready (with cash) to invest when more significant short-term declines occur—*and* as declines are happening, distress situations are likely on the horizon.

Further:

- Maintain adjustments to asset allocation targets.
- Cash inside your portfolio remains a great idea when assets aren't cheap, with Treasury bills and money markets able to earn a risk-free 5%+ until risk assets get cheaper.
- Focus on high-quality, fixed-income holdings with short duration (1-to 3-year) and proven opportunistic private credit strategies for yield; still needs some time for high-yield bonds.
- Reduce overall U.S. equity allocation to the lower range of portfolio targets; tilt towards Value over Growth, Small over Large, and International over the U.S.
- Increase cash by reducing U.S. Large Cap growth stocks and keep private equity distributions on hand.
- Continue to increase allocations to Small Cap Value and Mid Cap Value, emerging and international stocks within your portfolio target ranges.

- Wait for well-priced alternatives, including venture capital, growth equity, co-investments, opportunistic strategies, and secondary private investments (don't pay premium prices).
- Look to invest in cashflow-generating real estate and real asset investments, both equity and debt, in private and public space (logistics, warehouses, data centers, infrastructure, commodities/natural resources, multi-family, and farmland).

Maintain a disciplined focus on your investment strategies – especially during volatile periods. Many investors' interests in the "E" for the environment (as well as in "S" for social and "G" for governance) of ESG continue to grow. Please know that this has been and always will be a deeply embedded part of our firm's philosophy that we can happily talk about at length.

It is a pleasure to serve you, and I look forward to continuing our work together. Stay safe and healthy.

With appreciation,

Walid L Petiri

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Sources: Bloomberg Barclays, MSCI Barra, Russell Investments, Standard & Poor's, Federal Reserve Board, Redwood, First Trust July 2023.