Wealth Management Newsletter

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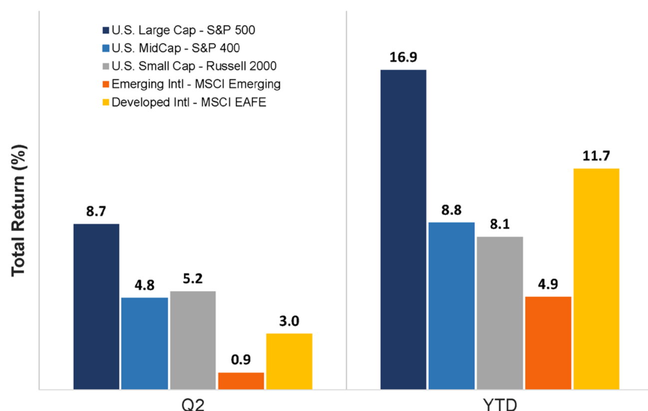
KEY POINTS

- Inflation has peaked but is the pace of decline fast enough to placate the Fed
- Despite expectations of a recession, economic data proved more resilient than many anticipated
- Risk assets performed well in Q2 despite higher rates and a hawkish Fed; bond yields are in line with Fed guidance
- The economic environment and financial markets remain challenging and therefore, we remain vigilant with respect to the current risks and continue to maintain a defensive investing posture overall

Q2 2023: BY THE NUMBERS

The first half of 2023 was marked by a surprising but welcome investment performance rally across most major asset classes. When looking at news headlines alone, thus far, 2023 has felt equally as challenging as 2022 given the debt ceiling drama, continued geopolitical uncertainty, global central banks tightening policy, and the collapse of multiple banks. Despite these headlines, as previously noted, global equity markets have powered ahead (See figure 1) and have once again provided a powerful reminder that the stock market and the economy can often be two different things.



Data Sources: Bloomberg Financial LP, Bangor Savings Bank

The S&P 500 finished the first half of the year up nearly 17% and posted an 8.7% return during the quarter. That marks the fourth-best first half of the year in 25 years, with gains primarily driven by outsized performance within growth sectors of the market as a broad interest in artificial intelligence (AI) and the hope that it would improve productivity as well as profit margins pushed stocks higher. Beneath the surface, however, it was a tale of two markets: mega-capitalization technology stocks vs everything else. For instance, just seven mega-capitalization stocks have accounted for ~83% of the S&P 500 Index performance year-to-date. Similarly, just 1% of the S&P 500, or the five highest-weighted companies in that index have contributed 56% of 2023's returns. In a new milestone, this year's top contributor, Apple, eclipsed a market capitalization of $3 trillion which exceeds the aggregate market capitalization of the entire Russell 2000 Index of small-capitalization stocks. The extreme divergence in performance across size, sectors, and style for the quarter and year continues to be a complete reversal of what we witnessed last year. For example, large-capitalization value stocks, which proved very resilient during last year's market weakness, underperformed large-capitalization growth stocks by nearly 24% during the first half of 2023. While the majority of the economic sectors that comprise the S&P 500 were up during the first half given the almost 17% composite return, the best performing was Information Technology (+42.1%), Communications Services (+35.6%), and Consumer Discretionary (+32.3%). Meanwhile, the Energy and Utilities sectors were both down a little more than 7% over the same period. Additionally, U.S. middle-capitalization and small-capitalization stocks finished the first half of the year up 8.8% and 8.1%, respectively.

International equity markets were also positive during the first half, with developed markets outperforming emerging markets. The MSCI EAFE Index was up 11.7% through June 30th and the MSCI Emerging Index was up 4.9% (See figure 1). Emerging market equities have thus far been held back by fading optimism over China after its initial reopening-driven rally.

Commodities, which were last year's star performer, finished the quarter down -2.6% and have returned -7.8% year to date. Oil has fallen from its June 2022 high of $120.67 to $70.64. Gold fell -2.5% during the quarter as the Fed slowed rate increases at least momentarily, though is still up 5.2% for the year. After a challenging 2022, real estate securities finished the quarter up 2.4% and are up 4% on the year.

REVERSAL IN BOND MARKET – DON'T FIGHT THE FED

After posting positive returns in the first quarter US Treasury bonds sold off consistently through Q2 as markets repriced Fed rate path expectations to remain higher for longer. The US Treasury index

returned -1.4% for the quarter partially reversing the previous quarter's gains. Short-dated maturity bonds underperformed on the yield curve and retraced the sharp rally experienced in Q1, further inverting the yield curve. Treasury bills finished the quarter yielding nearly 5.5% which is the highest rate in over 20 years. Global bonds also struggled as the developed international bond index declined -2.2% for the quarter. High yield and emerging market bonds were the lone bright spots in bonds returning 1.7% and 1.1% respectively.

Looking forward, fixed income performance will be driven by Fed policy which will take its cues from inflation. CPI is materially lower than its peak over a year ago, but remains well above the Fed's 2% target. Leading indicators have been flashing recession risks for all of 2023 though the economic data has been resilient. Short-dated Treasury yields are at the highest levels since before the Great Financial Crisis and would be expected to perform well in any kind of economic slowdown. We are likely in the later innings of the hiking cycle and bond yields are at the highest levels in decades which provides an attractive hedge to riskier assets and offers diversification to portfolios.

THE ECONOMY – WHAT RECESSION?

The U.S. economy surprised most market participants to the upside as the labor market, consumer spending, and the housing market remained buoyant despite tightening financial conditions and an additional 75 basis points of Federal Reserve interest rate increases to 5.25% which is the highest that rate has been since August 2007. The US economy grew by an annualized rate of 2% in Q1 and is expected to remain around the same level for Q2 which surprised most economists who have been forecasting a recession this year. Over 700K jobs were added in the second quarter and the unemployment rate hovered near all-time lows at 3.6%. Inflation continued to decline off the highs with headline CPI dropping to 3.0% year-over-year, although excluding food and energy, core prices declined at a lesser pace to 4.8%. The Federal Reserve chose to pause at their June FOMC meeting but are expected to resume hiking another 25-50 basis points in 2023 to combat higher prices and then remain on hold for quite some time while continuing to reduce the size of their balance sheet.

MARKET VIEW AND PORTFOLIO CHANGES

2023's welcome yet surprising rally has left many investors questioning whether the current advance is durable. The narrow market leadership has resulted in the top ten stocks in the S&P 500 representing 32% of the index, a concentration level not seen for at least three decades. Meanwhile, these ten companies only represent 22% of the index's earnings power. As a result, valuation expansion has been the main driver of investment performance year-to-date. Thus far, better than feared economic data and the recent spotlight on artificial intelligence (AI) have vaulted valuations and future expected earnings, specifically within AI related names. The last earnings season saw a heightened focus on the topic, with 110 companies mentioning AI on conference calls. According to FactSet data, this was a 41% increase from the prior quarter. Additionally, Goldman Sachs, a prominent investment bank, said that over the next 10 years, AI could increase productivity by 1.5% per year and could increase S&P 500 profits by 30% or more.

Accordingly, in retrospect, it is not surprising that investors favored mega-cap technology companies during the quarter, as these companies are the most appropriately positioned to benefit from AI. However, the top ten companies are currently 45% more expensive than their long-term average. As a result, the S&P 500 looks rich at nineteen times forward earnings estimates which is 16% more expensive than its long-term average. We are optimistic about future productivity increases that will come from AI, but we are also exercising caution at this time given valuations as the theme will likely take years to play out in earnest.

Looking ahead, the backdrop for equities remains challenging. Expectations for policy easing may be too optimistic and current equity market valuations make it difficult to be overly bullish at this time. Therefore, we currently remain defensively positioned with an emphasis on quality companies with durable cash flows. With that said, the first half of 2023 has highlighted the importance of remaining invested and not letting how you feel about the economy dictate your long-term investment strategy. With many U.S. large-cap equities currently priced for perfection, diversification continues to remain critical moving forward to help reduce overall portfolio risk. International equities appear attractively valued relative to the U.S. Additionally, fixed income continues to look attractive as the rise in interest rates has raised the potential for future returns from this asset class as inflation begins to normalize over time and the Federal Reserve ultimately lowers interest rates at some point in the future.

Once again, market history has shown that the best defense against an uncertain investing landscape is having – and sticking with – a long-term financial plan. Therefore, please do not hesitate to reach out to our wealth management team to review your customized financial plan, and to ensure that your accounts are properly aligned with your investment goals and timeframe.

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