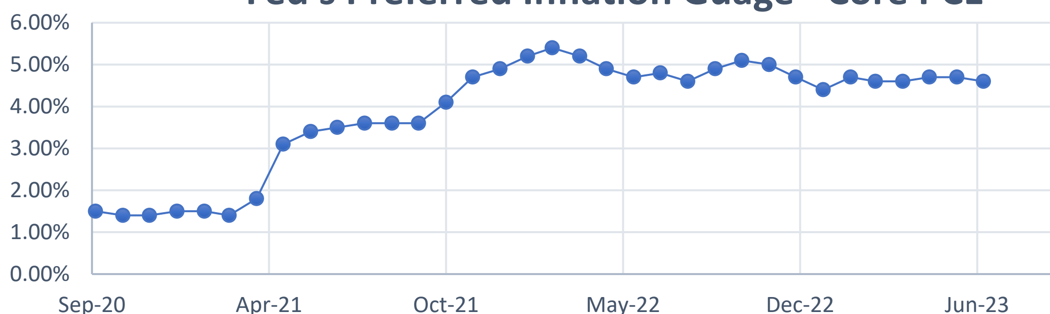
2023 Second-Half Outlook

A Mixed Picture

- The S&P 500 has put in impressive gains this year despite a litany of worries on the minds of investors and Wall Street strategists. These include persistently high inflation, higher interest rates, several high-profile bank failures, and ongoing expectations that a recession is "just around the corner".

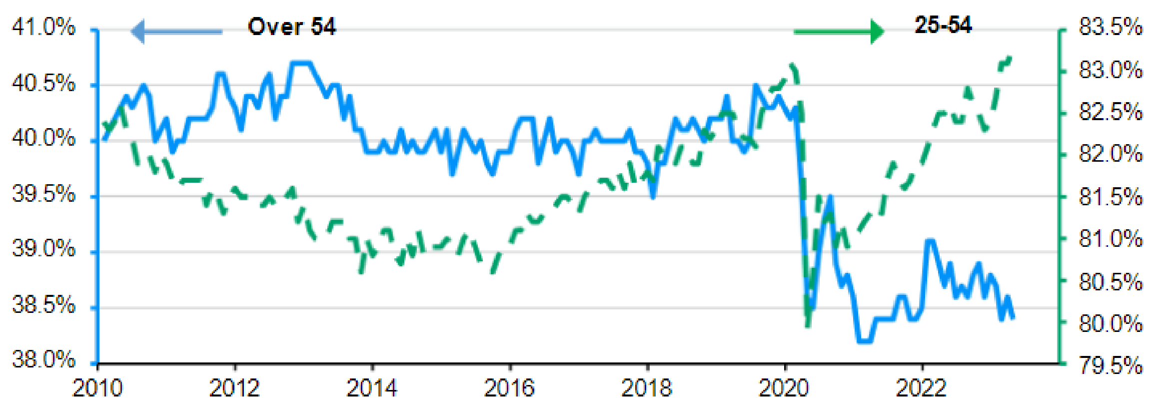


Source: Investing.com

- Given these worries - and against a backdrop of money-market instruments like CDs and money market funds offering high yields - many investors have likely been under allocated to stocks.
- The latest Bank of America Fund Manager Survey from June had cash levels for funds (equity mutual funds and ETFs) above 5% for the 15th straight month - the largest such stretch since the 32-month bear market of 2000-2002. "Cash-on-the-sidelines" may be one reason why markets are scaling a wall of worry – fewer sellers are available as money comes back into stocks this year.
- Also likely supporting the stock market is the fact that bond yields have not exploded higher in 2023 like they did last year. The 10-year Treasury Note finished 2022 with a yield of around 3.90%, not too far from where it is today at about 4.0%. And the shorter-term 2-year Treasury finished 2022 at a yield of about 4.40% and it is now trading at about 5.0%. Further increases in yields from here, however, may start to significantly limit stock market gains.
- As we enter the second half of 2023, the stock market has decent momentum and improving breadth. Thumbs-up for the technicals! But an uncertain earnings picture, a mixed economic backdrop, and somewhat stretched valuations detract from the outlook for stocks.

- Of course, momentum alone could carry the large-cap growth stocks higher as we move further into the summer. But such a move would likely need to be "digested" via a modest correction or at least a flattening-out of gains at some point later in the year.
- If growth stocks flatten-out or correct modestly, but "hand-off the baton" (rotation, in market parlance) to left-behind-sectors of the market, then the overall market could continue to do well. In that case we should expect to see cyclicals and small-caps perform better in the second-half. For now, breadth for small-caps remains weaker than breadth for large caps.
- Despite the ongoing-but-so-far-unfulfilled "imminent recession" worries, the economy has proven to be resilient, with the labor market continuing to create jobs, home construction remaining robust, and overall consumption expenditures hanging in there – especially for services. Our previous call for a "soft-landing" is thus far looking ok.
- With wages up, labor force "participation" has been spiking for the important working age category of 25-to-54-year-olds, suggesting that people are flooding back into the job market. This should help to keep a cap on wage growth going forward, and could give the Fed some leeway to slow rate hikes.

Labor force participation rate (%)

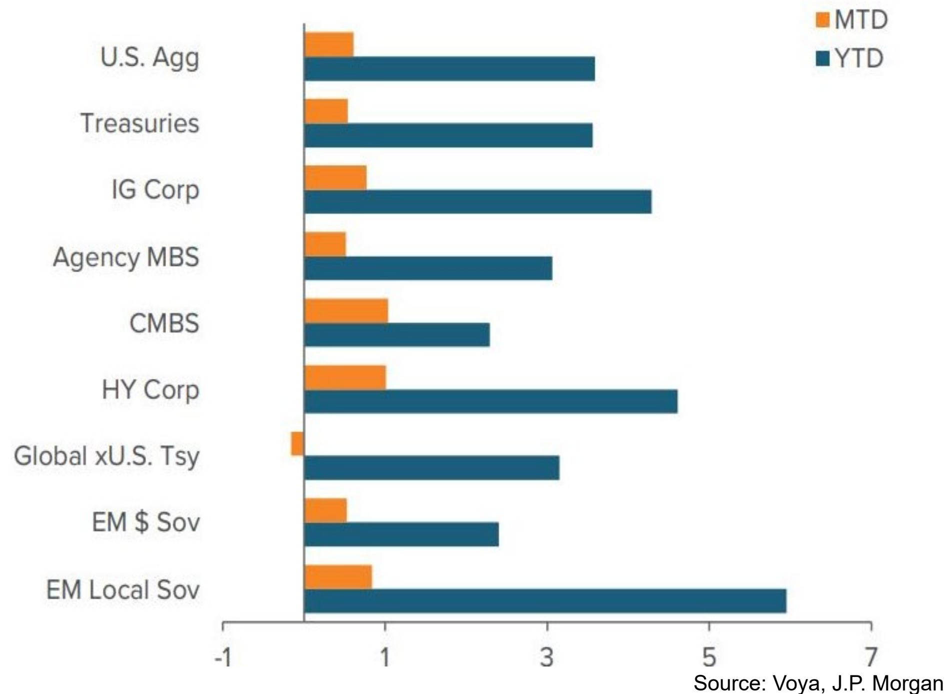


Source: Bureau of Labor Statistics

- It remains a tough call as to whether or not the economy falls into a recession later this year. For now, as we mentioned, it looks like the no recession "soft landing" scenario remains intact. But, while "the consumer" seems to be hanging in there, business fixed-investment has slowed and is likely to decelerate further given tighter credit conditions. This could in turn lead to layoffs, a weakening job market, and slower consumer spending.
- How much business spending decelerates will depend on the path of interest rates and banks' propensity to lend. The most recent senior lending officers' survey conducted by the Fed suggests that banks have been pulling back on lending amid deposit flight uncertainty, lower loan demand, higher interest rates, worries about their existing loan book, and an expectation by bank management that the economy will slow.

- Worries about lending and commercial real-estate are probably behind the June FOMC decision to not raise interest rates. This comes after hikes at each of the last 10 meetings totaling about 5.0%. Despite the pause, FOMC members, on average, believe that more rate hikes will be needed in order to tame inflation which, as measured by core PCE inflation (ex-food and energy), is still close to 5%. The median of the "dot plot" (Fed members expectations for the Fed Funds rate) is now 0.25% higher than it was a few months ago. Market based expectations for the Fed Funds rate by the end of the year, however, are still lower that where the Fed median projection is, suggesting that the market thinks that either inflation will moderate faster than the Fed does or that economic growth will begin to cool off significantly.
- Factors that will impact markets in the second half of the year include two unique Fiscal items:
    - the Treasury Department "refilling" the Treasury General Account after Congress has raised the debt ceiling. The Treasury plans on issuing roughly one trillion dollars in paper over the back half of the year. Accordingly, liquidly will likely be drained from the banking system. All else equal, this should tend to put negative price pressure on both stocks and bonds.
    - Student loan debt payments are scheduled to resume at the end of August. This will likely lead to a small drag on consumption, especially among purchases by younger cohorts.
- At 19 times forward earnings (the forward P/E Ratio), the S&P 500 is relatively expensive from an overall index perspective. International stocks, "value" stocks, and small-cap US stocks offer a more reasonable valuation with the small cap Russell 2000 forward P/E ratio closer to 14 times, the EAFE international index forward P/E about 13 times, and emerging markets at about 12 times.
- While we shifted some client equity allocations from small-caps to large caps earlier in the first quarter, we are looking for an attractive entry point to add back some small-cap exposure should the economy reaccelerate. Additionally, we added a bit to international equity allocations recently in case the U.S. market levels off in the second half but international markets keep rallying. We are also running shorter-than-normal duration in fixed-income portfolios but would likely be comfortable extending duration if 10-year Treasury yields get above 4.25%.
- Fixed-Income provides an attractive alternative to stocks now that rates are significantly higher - and we are currently allocating a small portion of our equity "sleeve" to very short-term fixed income funds yielding close to 5.0%. Despite worries about credit, Investment Grade Corporates, High-Yield Bonds, and Emerging Market Local Currency Bonds have been outperforming Treasuries thus far this year through May.

Bond Sector Total Returns for 2023



Source: Voya, J.P. Morgan

- Stock vs. bond correlation may have also reverted back to normal this year. Last year, both stocks and bonds fell in value – a rare event. However, now that the Fed is much closer to the end of its hiking cycle, we have seen signs that bonds are acting like a more traditional portfolio hedging component.
- Overall, while we are cautiously optimistic that markets will finish the year with good returns, we are closely monitoring bond yields, market momentum, and market breadth for signs that the rally could be running on fumes.

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