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Economic & Market Update

SECOND QUARTER 2023 REVIEW & FORECAST

- The U.S. economy showed resilient growth, posting a GDP increase of 2.0% in two consecutive quarters, largely driven by robust consumer spending and defying predictions of a recession due to Federal Reserve tightening measures.
- In Europe, economic growth has been slow, with Southern countries like Spain compensating with better performance, while China's expected surge in spending and production following relaxation of COVID-19 restrictions fell short of predictions.
- The U.S. equity markets experienced a strong quarter, attributed to positive GDP growth, decreasing inflation, and stable interest rates, with international equity performance varying; Japanese equities outperformed due to lenient monetary policy, while Chinese equities declined due to disappointing recovery and lack of aggressive financial stimulus.

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REVIEW OF THE QUARTER

- Surprising many analysts and economists, the U.S. economy has yet to fall into the recession that many had expected following 500 basis points of Federal Reserve (Fed) tightening over the last 15 months. After gross domestic product (GDP) growth of 2.0% in the first quarter, the second quarter is expected to have grown at roughly the same rate, which is close to the longer-term potential growth rate of a mature developed market economy like the United States. The primary driver of this better-than-anticipated growth is the strong consumer, as overall consumption has grown at a real rate of roughly 4.0% year to date. Continued strong jobs and wage growth in the second quarter drove spending, with a further boost in confidence at the end of the quarter coming from a notable decline in goods price inflation, particularly gasoline prices. There was some concern that consumers may have been too aggressively working down their excess savings, but the large amount of wealth accumulated by the baby-boom generation and the natural tendency to spend that wealth as they collectively enter their retirement years may produce a growing "wealth effect" on overall consumer spending.
- Surveys of the business community, whether it be chief executive officers, chief financial officers or purchasing managers, portrayed continued slowing in the manufacturing sector and even forecasted some slowing in the previously strong services sector. Actual spending statistics held up rather well in the quarter, however, as businesses needed to spend to keep up with continued healthy consumer demand. Durable goods orders and capital spending on technology equipment both showed notable growth. Housing was the first, and so far, only sector to fall into recession, beginning in the middle of last year. There were signs of a bottoming in the housing downturn as the quarter began, with May statistics apparently presaging an early rebound as mortgage rates have declined slightly and pent-up demand, particularly from the first-time homeowner segment, has driven the inventory-starved industry to increase the rate of new construction.
- European economies have not fallen into recession, but growth in the first half of the year was rather anemic as Germany, the largest economy on the continent, suffered from higher energy prices and a slower-than-expected rebound in China, which hurt some of Germany's manufacturing industries. It has been the southern-tier countries that have historically relied more on tourism and other services to drive their economies that picked up some of the slack. Spain was a standout in the first half of the year with annualized GDP growth of roughly 3.0%.
- China relaxed its severe COVID-19 restrictions at the beginning of the year, but the anticipated surge in spending and production failed to materialize. The economy did see an uptick in GDP growth, but it was limited by relatively restrained consumers and a hesitancy of businesses to significantly add to their employee payrolls. This had a dampening effect on neighboring countries that export to China, although Japan showed solid economic growth on the back of strong domestic capital spending by businesses and decent consumer spending.
- Headline inflation continued its seemingly inexorable decline as the effectively complete unclogging of supply chains has been met with lower goods demand. The decline in energy prices also helped cool goods price inflation. Input prices at the producer level are beginning to show actual deflation in certain goods sectors. There is a strong possibility that when the June Consumer Price Index is reported in the middle of July, headline prices will have declined to as low as 3.0%. While goods price inflation may have indeed been "transitory" as greater supply has caught up to somewhat dampened demand, the shift of consumer spending to services prices has caused core inflation to be a bit stickier on the downside.
- After hiking the federal funds rate after every Federal Open Market Committee (FOMC) meeting since March 2022, the Fed left rates steady in the 5.00%–5.25% range at its June meeting. The lack of action was described as a "pause" to give Fed officials time to better assess the effects of their aggressive tightening on the economy. Some of the more skeptical market participants prefer to describe it as a "skip" with tightening to resume as early as the July meeting. While markets were rather heartened by a clearer sense the Fed is

near the end of its tightening cycle, Fed Chair Jerome Powell was adamant in his reminder that the battle against inflation is far from over and the collective membership still believes there will likely be more rate increases by year-end. They continue to monitor most closely core services inflation excluding housing, which theoretically will give them a better idea of the progress in bringing down dreaded wage inflation, which, if left unchecked, could result in more stubborn and entrenched overall inflation rates.

- The lack of recession and surprisingly strong economic growth in the first half of the year put upward pressure on rates, with the 10-year U.S. Treasury rising roughly 40 basis points during the quarter. The entire yield curve shifted higher as the curve became even more inverted in what many view as an ominous sign of impending recession. A continued offset to this recessionary indicator within the fixed-income markets is the lack of any notable spread widening in high-yield bonds, with end-of-quarter spreads to Treasurys remaining firmly in the 400–500 basis point range. For context, in past recessionary environments, spreads widened to roughly 1,000 basis points, as higher default rates caused investors to demand substantially higher yields.
- Comfortably positive GDP growth, ebbing inflation indicators and stable interest rates culminating in a Fed pause proved to be a powerful combination leading to another strong quarter in the U.S. equity markets. As earnings were down year over year for the first half of 2023, stocks appear to be anticipating a second half earnings recovery. The biggest criticism of this market advance, which has been fodder for the bears and probably a bit disappointing to the bulls, is the very narrow breadth of the advance. Year to date, the five largest positions in the S&P 500 equity index accounted for 25% of the weighting and roughly 70% of the performance. While a strong argument can be made that these top companies have achieved lofty valuation levels because they all own a competitive advantage in their industries, generate tremendous cash flows and are true innovators, it would be more comforting if the rest of the market, including those stocks in the small- and mid-cap sectors, would join the advance. This began to occur somewhat at the end of the second quarter as sectors such as industrials and materials outperformed the overall market with small- and mid-cap companies also closing the gap slightly against the S&P 500.
- International equities also advanced in the quarter, but they notably trailed the performance seen in the U.S. large cap asset class. Higher and apparently more stubborn inflation in Europe will likely keep the central banks firmly in tightening mode, which was somewhat of a relative headwind to foreign equities in the quarter. The differences in market structure, with not as many companies in these markets leveraged to the artificial intelligence and technology themes, was another factor driving the relative underperformance.
- Japanese equities were a standout performer in their local markets as the Bank of Japan purposely bucked the trend of most other global central banks in remaining very easy and loose in its monetary policy. This allowed multiples to expand, as global inflation is expected to boost the revenues and earnings of Japanese corporations. The resulting depreciation of the Japanese yen did take some return away for U.S. dollar-based investors, but even after the currency effect, the Japanese equity market outperformed the United States over the first half of the year.
- Chinese equities were down on the quarter both on the mainland and in Hong Kong, as the recovery from the relaxation of severe pandemic-related restrictions has been rather underwhelming. There was also some disappointment that the government has not been more aggressive in providing monetary and fiscal stimulus. Lingering trepidation around continued trade friction with the United States and the recent government crackdown on private industry champions may have been additional contributors to the underperformance.
- Latin American equities have been a strong but under-the-radar relative performer in the emerging markets equities category. Proximity to the growing U.S. economy is helpful and many of these countries, particularly Mexico, are ancillary beneficiaries of the reshoring movement occurring in a post-COVID, less globalized world economy.
- Despite the pledges of OPEC+ Russia to curtail supply, crude oil prices fell further in the quarter, as the lower supply has yet to become visible and global demand has remained somewhat muted. Industrial metals were also weak as the slower-than-anticipated recovery in China, particularly in its voracious industrial sector, has restrained demand. Some agricultural commodities such as wheat rose from fears of an escalation in the Russia-Ukraine war. Gold gave up some of the

outsize first quarter gains as turmoil in the banking industry subsided and the Fed gave strong hints that even if it is nearly finished raising rates, it will likely not need to decrease them until 2024 at the earliest.

OUTLOOK FOR THE SECOND HALF OF 2023

- The strength and resiliency of the U.S. economy in the first half of the year has meaningfully pushed back concerns for a recession into 2024. Consumer spending will be driven by continued jobs growth through the summer and ample accumulated savings. There is likely to still be a skew toward spending on services and "experiences," but lower inflation rates and more discounting should increase consumer interest in certain goods sectors. Capital spending by businesses will slow in the manufacturing sector, particularly energy extraction as prices remain low. Businesses are likely to focus spending on technology outlays to maintain competitiveness in a tight labor market. Housing is arguably the most interesting sector moving into the second half of the year as an anticipated extended bottom has likely turned into an earlier-than-expected rebound. Mortgage rates have stopped increasing, which helps affordability, and inventory of new and existing homes for sale remains too low to satisfy the demographic demand.
- Inflation in the United States is down to roughly 4.0% year over year through May, and when the June number is announced, it could be as low as 3.0% as the large June 2022 inflation will roll off the year-over-year calculation. Services inflation, which is much more driven by wage increases on the cost side, will be slower to decline and keep core inflation (excluding food and energy) higher than headline inflation but that rate should continue to decline as shelter inflation, a large component of core prices, appears set to decline.
- Although the banking turmoil subsided and nothing has yet "broken" in the economy due to the sharp increase in the federal funds rate over the past year, the Fed was still compelled to pause the rate increase cycle during the June FOMC meeting. Odds of a resumption of hikes in the July meeting are high going into the third quarter and Fed speakers, including Chair Powell, will stress the need for continued vigilance in bringing down inflation. However, notable recent improvement, which is expected to continue, will likely mean that July will be the last rate increase.
- As the largest current risk to the economy and markets is excessive central bank tightening into an already slowing economy, it may be more instructive to look to Europe where inflation appears to be much stickier. The power of labor and labor unions that have already bargained for aggressive cost-of-living adjustments could make inflation much more entrenched and cause the central banks in the United Kingdom and on the continent to remain in tightening mode. With continental Europe now only barely growing its GDP in this high inflation environment, the European Central Bank may see recession as the only means to resolve its inflationary dilemma.
- While disappointing to some market participants, the Chinese economy is still growing between 4%–5%, with the government recently targeting 5% as its goal for 2023. Achieving this growth would likely require government support from both monetary and fiscal policy, although the government is wary of decreasing rates too much and causing a sharp decline in the value of its currency.
- The outlook for continued economic growth with no recession through year-end should continue to exert upward pressure on interest rates throughout the yield curve. The expected progress on inflation may begin to limit rate increases at the short end of the curve as the Fed ends its tightening cycle. The inverted yield curve should begin its move back to normalcy with intermediate and longer maturity rates beginning to catch up to the levels already seen at the shorter end of the curve. There may be no meaningful pickup in credit downgrades or default rates in this rather benign economic environment, but high-yield debt appears rather expensive at current spread levels.
- Equity markets in the United States have had quite a run in the first half of the year although the advance has not been very broad-based. As earnings have declined in the first two quarters, valuations have been stretched. The second quarter earnings season is expected to produce a 6.5% decline in earnings per share with the primary weakness

coming out of the energy, materials and health care sectors. However, as with the first quarter, companies should largely beat analyst estimates, so the end of season results should be a meaningfully lower decline. More interesting is likely to be the corporate commentary accompanying the earnings releases as earnings are expected to begin growing again in the second half of the year. The sharp year-to-date appreciation may already be discounting this improvement so expect some consolidation and a potential catch-up of the more cyclical and defensive sectors to the phenomenal performance of the information technology and communication services sectors.

» With the Fed closer to the end of its tightening cycle than many other global central banks that have not had as much success battling inflation, there may be some downward pressure on the U.S. dollar, which should help the performance of international equities, both developed and emerging. Ultimately, the driver in any catch-up of these markets to the United States would be a function of relative economic and earnings growth, which may prove difficult to match at least over the rest of this year.

» Less supply coming out of both OPEC and non-OPEC producers combined with stable demand in a global economy that is still growing should help stabilize oil and other energy prices and perhaps allow some price appreciation over the coming months. Industrial metals prices should also begin to stabilize after the sharp year-to-date decline in many key commodities. The success of the Chinese government in driving economic growth will determine any near-term rebound in prices. Gold will likely struggle to advance much from current levels as global central banks should maintain rates at high-enough levels to present rather intense competition with this zero-yielding asset.

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