Investment and Economic Update
Second Quarter 2023

We know the continuous reminders of an imminent recession are getting kind of old as of this writing, especially since the markets delivered another quarter of solid returns. The market gains in the second three months of the year were stronger for larger stocks, but most sectors participated in the rally. The Wilshire 5000 Total Market Index—the broadest measure of U.S. stocks—picked up 6.67% gains in the second quarter and is now up 16.30% in the first six months of 2023.

Looking at large cap stocks, the widely quoted S&P 500 index of large company stocks jumped 8.30% in the second quarter and has now gained 15.91% during the year's first half. Meanwhile, the Russell Midcap Index is up 9.01% through the second quarter. The Russell 2000 Small-Cap Index posted a 7.24% return over the past six months. The technology-heavy Nasdaq Composite Index, the biggest loser in 2022, is on a tear this year, posting a 31.73% return in this year's first six months.

Foreign markets are delivering positive returns as well. The broad-based EAFE index of companies in developed foreign economies gained 9.66% in the first half of 2023. In aggregate, European stocks are up 8.95% this year, while EAFE's Far East Index delivered a positive 2.58% performance. Emerging market stocks of less developed countries, as represented by the EAFE EM index, gained 3.46% in dollar terms over the last six months.

Bond rates rose dramatically last year, but that trend seems to have moderated. 30-year U.S. government bond yields barely moved from where they were three months ago, with current yields at 3.86%. 10-year government bonds are yielding 3.84%, and from there we enter the inverted yield curve: 5-year government securities are yielding a higher 4.16%, 2-year Treasuries are yielding 4.90%, one-year government bonds are yielding 5.39% and 6-month securities are now yielding 5.41%. To say this is not normal is an understatement. Whenever shorter-term bonds are paying bond investors more than their longer-term counterparts, it means that bond investors (and, maybe, most professional investors) are feeling cautious about the future of the market.

Municipal bonds are a somewhat less dramatic story at the moment, but there is still inversion going on; 30-year munis, on average, are yielding 3.57%, and 10-year maturities are yielding 2.55%. But the inversion can be seen in 5-year (2.61%), 2-year (2.92%) and 1-year (3.01%) aggregate yields.

Of course, we're all wondering: will the second half of the year be as rewarding as the first half was? Our economic future has seldom been as cloudy as it is today, which is to say that the indicators are all over the place. In America's manufacturing sector, the ISM Purchasing Managers Index, a closely watched indicator of the health of manufacturing firms overall, suggests that manufacturing has been in a recession for the past seven months. Global indicators are saying essentially the same thing about manufacturing competitors overseas. New export orders for goods have been falling globally at the fastest pace since the end of 2022.

Adding to the downbeat news, the Conference Board's Leading Economic Index has been declining for 13 consecutive months, and the most often-cited recession indicator, the dramatic yield curve inversion in the bond market, is flashing its signals louder than ever. The corporate sector has not been unaffected by all this: financial and non-financial U.S. corporations have reported lower profits for the past two quarters.

But those indicators might actually make up less than half the story. The unemployment rate in the U.S. remains under 4% (bouncing between 3.4% and 3.7%) and the labor participation rate among workers aged 25 to 54 stands at a very strong 83.4%—the highest level since 2007. Consumer spending has remained brisk, with durable goods orders up 1.7% last month over the previous month. U.S. households are still flush with cash that was saved during the pandemic; the Federal Reserve Bank of San Francisco has estimated that households still have sufficient savings to support current spending levels at least through the fourth quarter of 2023. Indeed, the most recent consumer confidence index, measured by the Conference Board, rose to 109.7, the highest since early 2022.

And, not incidentally, the inflation rate keeps falling. Last year, alarm bells were sounding because June's annualized rate hit 9.1%. Today's rate is an annualized 4.0%.

There's no reason to imagine that any of us can predict the future with any accuracy, except to point out that markets have, historically, trended upward and rewarded patient investors. It's possible that a future recession will test our collective patience once again, but it's a test that may be easier to pass due to the gains that this year has provided us already.

While we remain cautiously optimistic, we are concerned we may not be out of the woods just yet. We don't want you to be taken by surprise if within the next six to nine months, potentially longer, we see another substantial pullback in the market as some economists are still saying that the measures the Fed has taken to combat inflation (raising rates/reducing the money supply) have not fully worked their way through the system.

Additionally, we are uncertain what the impact will be once the household savings that many built up from the government's various COVID-19 relief bills have been spent down if it hasn't already been. Many of these same households also enjoyed a little extra room in their budget for the past few years, thanks to the pause in federal student loan payments. But now, the student loan interest will resume starting on September 1, 2023, and payments will be due starting in October – this will have an effect on their discretionary spending, eating out, vacations and new vehicles for example. In turn, should consumers reduce their discretionary spending, it will have an effect on the economy and corporate profits.

Having a well-structured portfolio that contains a variety of investments, pursues individual objectives, and reflects personal risk tolerance is incredibly important. While we believe that we are well-positioned to weather this potential storm, we know that some of our clients are understandably concerned. If you are one of those individuals, we encourage you to reach out to us to chat about your specific situation and financial picture. We'd love the opportunity to speak with you. We always welcome your calls so never hesitate to reach out to us.

Below, we've summarized some of the widely quoted indexes for your reference. As a reminder the challenge is, the DJIA is not the same as the S&P 500, which is not the same as the NASDAQ – and none of these indexes perfectly match your own distinct mix of assets and their expected returns, especially if you own a globally diversified portfolio with exposure to stocks and bonds, large and small companies, value and growth companies, and U.S. and non-U.S. based companies. The following returns are quarter, year-to-date and the rolling 1-year; respectively:

S&P 500: 8.30%, 15.91%, 16.34%
Dow Jones: 3.41%, 3.80%, 10.65%
NASDAQ Composite: 12.81%, 31.73%, 23.90%
Russell 2000 (Small-Cap): 4.79%, 7.24%, 9.32%
MSCI EAFE (International): 1.87%, 9.66%, 15.46%
Barclay's Capital US Aggregate Bond: -0.84%, 2.09%, -1.53%