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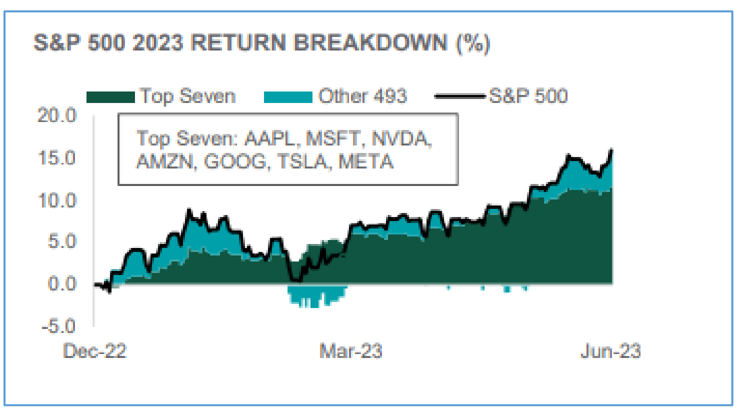
First Half Review and Investment Outlook
July 2023

Following an extremely difficult 2022 for both stocks and bonds, the first half of 2023 saw positive returns across most asset classes, as shown in the table below. Global economic activity has proved more resilient than anticipated, and a much-feared recession has yet to materialize. As inflation has receded from peak levels in most countries, the pace of monetary tightening by central banks has slowed. Despite a backdrop of considerable volatility, especially surrounding the regional banking sector, as well as geopolitical risks that in some ways are unprecedented since the second World War, U.S. consumption has continued apace, and unemployment has remained low. In summary, the lingering effects of pent-up pandemic demand and a resilient employment market have thus far staved off an expected recession.

As we noted in our January 2023 commentary, in the absence of a recession the equity market's return prospects were positively skewed. Given the strong stock market performance over the first part of the year, we have become more cautious on the prospects for stock returns in the second half of 2023. Macroeconomic risks continue to mount, price-to-earnings ratios have expanded, and investors are for the first time in many years seeing attractive yields in lower-risk alternatives to stocks, such as U.S. Treasury Notes.

Major Asset Class Indices[1]	Total Return First Half 2023	Total Return Last 12 Months
S&P 500 (U.S. Large Cap Stocks)	+16.9%	+19.6%
MSCI EAFE (Foreign Developed Large Cap Stocks)	+12.2%	+19.5%
Bloomberg Aggregate Bond Index (U.S. Investment Grade Bonds)	+2.1%	-0.9%
US Short-Term Treasury Bills (Money Market Fund)	+2.4%	+4.1%

In sharp contrast to a year ago when defensive sectors such as consumer staples performed the best, market leadership shifted back to technology, communications, and growth stocks in the first half of 2023. This has been especially true for U.S. equities, where a small number of companies dominate the index. Only seven technology-related stocks – which are being called the Magnificent Seven[2] and consist of Microsoft, Apple, Alphabet, Amazon, Meta, Nvidia, and Tesla – now account for over 25% of the S&P 500's total weight and have delivered almost the entire gain thus far in 2023.



[1] The S&P 500 Index is a broad measure of U.S. large capitalization stocks; the MSCI EAFE Index (Net) is a broad measure of mid-large capitalization stocks in developed international markets; the Bloomberg U.S. Aggregate Bond Index is a broad index of U.S. investment grade bonds; the 90-Day U.S. Treasury Bill represents short-term government money market funds. Returns are provided by sources deemed to be reliable but are subject to change or revision.

[2] In accounts where it is appropriate to purchase individual stocks, the vast majority of client portfolios hold five of the so-called Magnificent Seven, with Nvidia and Tesla not widely held. Although some or all of the remaining five may be among an account's largest holdings, for reasons of diversification and risk control their combined value rarely rises to the same concentration these stocks currently command in the S&P 500.

For further comparison, the Dow Industrial Average returned less than 5% through the end of June, while the tech-laden Nasdaq returned over 30%. Other characteristics associated with the best-performing stocks for the first half of 2023 include price-to-earnings ratios well above historical market averages and dividend yields of less than 1%. According to Ned Davis Research, within the S&P 500, stocks that do not pay a dividend collectively returned almost 20% in the first half of 2023, while stocks that do pay a dividend[3] returned less than 5%.

The market consensus is that the U.S. economy will either avoid a recession or experience a "rolling recession" where weakness in specific sectors is offset by strength in others, and overall growth remains positive. We, however, are moderately more cautious. There are pockets of weakness visible across several leading economic indicators, such as weak manufacturing results and tightening lending standards, and the Federal Reserve's attempts to force inflation back to 2% are still working their way through the economy. Regardless of whether the U.S. enters a recession, we note that most of the return equity investors have seen so far this year has come from rising P/E ratios, while earnings growth has been weak. Long-term investors in particular should remain focused on the fact that the P/E at which a stock is purchased – referred to as its valuation – is a good predictor of multi-year returns (i.e., the higher the starting P/E, the lower the likely long-term return). As Northern Trust has pointed out, in order for stocks to continue their strong recent returns underlying corporate earnings will need to grow.

The worldwide economy is still adjusting to the effects of the worst pandemic in living memory, and we continue to believe that the process is highly unlikely to be smooth and predictable. The uncertainty inherent in this process of adjustment, along with rising interest rates and year-to-date performance of the leading U.S. stock indices, leads us to conclude that investors should consider reducing their strategic allocation to risk assets. Additional diversification may be warranted, including inflation hedges (e.g., TIPS and commodity stocks) and high yield bonds. Finally, safe-haven assets such as government-backed bonds generate significantly more income than has been available for some time. For example, the 10-Year U.S. Treasury Note is yielding almost 4%, making it much more attractive on a risk-adjusted basis.

Above all, we remain focused on our long-term goal of participating in market rallies while limiting exposure to significant declines. This strategy we implement by regularly rebalancing diversified portfolios of high-quality stocks and bonds, which we believe should compensate investors for the uncertainty ever-present in the economy and capital markets.



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[3] In accounts where it is appropriate to purchase individual stocks, we tend to prefer high-quality stocks in established, growing, well-managed corporations, most of which pay a dividend. This results in a "defensive growth" investment approach coupled with our fiduciary based desire to pay reasonable prices, which we believe has served our clients well, particularly in many difficult environments.