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Market Newsletter
June 30, 2023

EXECUTIVE SUMMARY

- Global stocks produced a positive performance in the second quarter. Credit sensitive bonds rose but interest rate sensitive bonds fell.

- The hype surrounding Artificial Intelligence helped about 10 stocks to contribute almost all the performance of the S&P 500 index.

- Rising interest rates have curtailed inflation but have adversely impacted the manufacturing sector. The services sector is continuing to grow. A strong job market has supported consumer confidence and retail sales.

- Chasing the performance of the largest stocks has not been a good decision historically. The performance of these stocks after becoming the largest is significantly worse than before. An investor's best bet to profitably capture the performance of these stocks is to invest in a diversified portfolio.

Table 1: Market indices

(Returns include dividends reinvested)	**Quarter to date**	**Year to date**	**1 Year**	**3 Year Annualized**	**5 Year Annualized**
S&P 500	8.74%	16.89%	19.59%	14.60%	12.31%
S&P Mid Cap 400	4.85%	8.84%	17.61%	15.44%	7.79%
S&P Small Cap 600	3.38%	6.03%	9.75%	15.19%	5.22%
MSCI Emerging Markets	1.04%	5.10%	2.26%	2.72%	1.32%
MSCI EAFE	3.22%	12.13%	19.41%	9.48%	4.03%
Vanguard Total Bond Market Index (VBMFX)	-0.93%	2.17%	-1.02%	-4.12%	0.67%
Investment Grade Credit (C0A0)	0.42%	3.23%	1.41%	-3.25%	1.80%
Non-Investment Grade Credit (H0A0)	2.54%	5.4%	8.87%	3.21%	3.19%
Bloomberg Commodity Index Total Return	-2.57%	-7.79%	-9.61%	17.82%	4.73%
Dollar Index (DXY)	0.40%	-0.59%	-1.69%	1.86%	1.73%
10 Yr. Rate	3.82% 06/30/2023	3.88% 12/31/2022	2.97% 06/30/2022	0.64% 06/30/2020	2.85% 06/30/2018

Source: S&P Dow Jones, ml.com, MSCI.com, Morningstar, Bloomberg, Yahoo Finance

Table 2: Recent Major US Economic Releases (These indicators have a significant impact on the stock market)

As of 07/07/2023			
	Latest Release	Recent Trend	Notes
Non-Farm Employment	209,000	Negative	In June, the US economy added the least number of jobs in two and a half years. However a drop in the unemployment rate to 3.6% and an increase in hourly earnings by 4.4% over the last year, indicates that the job market is still strong.
Weekly Claims for Unemployment Insurance	253,250	Positive	Initial jobless claims rose moderately recently but is still at historically low number, reflecting a strong jobs market.
ISM Manufacturing Index (over 50 indicates growth)	46	Negative	Manufacturing activity has slumped and is currently contracting. The index is at the lowest level since the high set in April 2021.
ISM Non Manufacturing Index (Over 50 indicates growth)	53.9	Negative	The services sector is showing renewed vigor after a few months of sluggishness. The ISM index popped up as the services sector expanded the most in 4 months.
Consumer Prices (Month over month change)	0.1%	Positive	Year over year increase in consumer prices was 4%, the least in 2 years. Excluding food and energy, core prices rose 5.3%, the least since December 2021.

	Latest Release	Recent Trend	Notes
Producer Prices (Month over month change)	-0.3%	Positive	Like consumer prices, producer prices fell sharply in May. It has fallen for 11 consecutive months and is now at the lowest level since December 2020.
Retail Sales (Month over month change)	0.3%	Positive	Retail sales surprised to the upside despite higher interest rates and relatively high inflation. Falling gas prices allowed consumers to spend on other items. Retail sales excluding auto and gas rose a healthy 0.4%.
Consumer Confidence (Conference Board)	109.7	Positive	Despite fears of a recession, consumer confidence rose to the highest level in one and a half years.
Durable Goods Orders (Month over month change)	1.7%	Positive	Companies are continuing to spend on investment as evidenced by a healthy increase in durable goods orders. Core capital goods orders, which excludes aircraft and military and is seen as a proxy for capital spending rose 0.7%.
Industrial Production (Month over month change)	-0.2%	Negative	Factory output has been sluggish as higher interest rates are beginning to bite. Manufacturing output, which excludes mining and utility, rose 0.1% last month, but is still below where it was a year ago.
Capacity Utilization	79.6	Positive	Capacity utilization is continuing to inch up to its long term average.
Housing Starts	1.631MM	Positive	New construction of homes surged 21.7% in May helped by single family home construction.
Home Prices (Case-Shiller Home Price Index- Year over Year)	-1.7%	Positive	Home prices rose for three consecutive months through April but are still 1.7% below where they were a year ago.
GDP (Real, Annualized)	2%	Positive	US GDP growth for the first quarter of 2023 was revised up to 2% from 1.3%.

Source: Bloomberg, www.federalreserve.gov, www.bls.gov, www.ismword.org, www.nahb.org

Stocks of companies around the world rose in the second quarter with US stocks outperforming non-US stocks. Bonds fell, especially those that are interest rate sensitive such as US Treasury bonds, while credit sensitive bonds rose as credit spreads (The extra yield that these instruments provide as compared to comparable US Treasury) narrowed. Commodities, which were last year's strong outperformer, continued to fall in the quarter.

Industries that underperformed last year, such as technology, continued to outperform this year while defensive sectors such as healthcare, which held their ground last year, have underperformed this year. The performance of US stocks was primarily propelled by a small number of stocks of companies in the technology and consumer discretionary sector such as Apple, Amazon, Nvidia, Meta, Microsoft, and Google. These stocks were helped considerably by the hype surrounding Artificial Intelligence. The lopsided performance of individual stocks in the market is best illustrated by the difference in the S&P 500 index, which is market capitalization weighted and the S&P 500 equal weighted index, in which all 500 stocks are given an equal weight. The former was up over 16% in the first half of the year while the latter was up only 6% as seen in Fig 1.

Fig 1: S&P 500 (IVV) vs S&P equal weighted performance year to date.

Source: Morningstar

There were plenty of events in the first half for investors to assimilate- from banking turmoil to an inverted yield curve to the debt ceiling debate to the state of the economy. As seen in the table above, the US economy is a mixed bag of developments. While manufacturing is showing clear signs of stress and contraction, the services sector is relatively strong and growing. Helped by a robust jobs market, the consumer remains confident (Fig 2) and is continuing to spend, helping retail sales. Inflation, which was a big concern last year, is continuing to moderate as the Federal Reserve's (Fed) interest rate hike is beginning to take effect. It has now retreated from last year's four-decade high, with the 12-month rise in US consumer prices falling to 4% in May. (Fig 3).

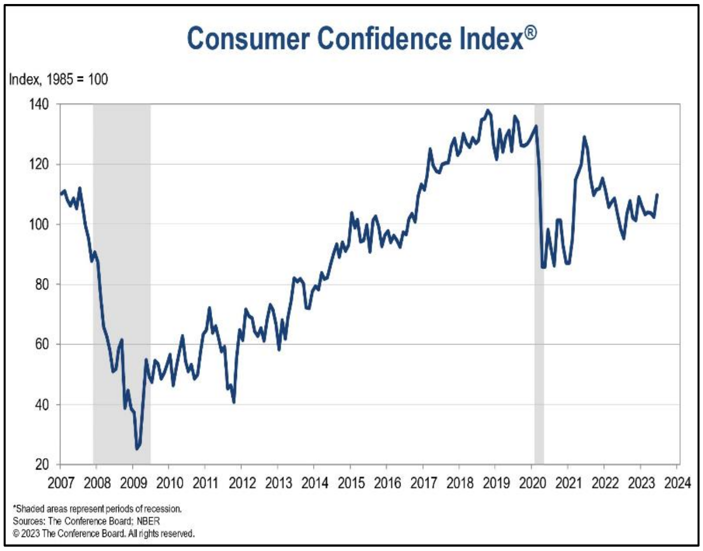
Fed officials paused raising the benchmark federal funds rate in June after more than a year of increases, but signaled they were likely to resume rate increases if inflation doesn't cool further. The rapid rise in interest rates since 2021 left some regional banks, such as Silicon Valley Bank, in precarious financial positions, causing three of the four largest bank failures on record. Silicon Valley Bank ended up being sold to First Citizens Bank, and a few other banks were also sold. The stress in the banking sector has since subsided as interest rates have stabilized.

In Washington, politicians debated the US debt ceiling. After much back-and-forth, the President and Congress agreed on a deal to raise the debt limit in June, avoiding the impending possibility of a US default. Amid the discussions, stock and bond markets seemed to take the news in stride. While debt ceiling negotiations make for catchy headlines, the implications for investors have historically been uncertain. This was the 78th time since 1960 that the debt ceiling was raised. The current deal imposes restraints on government spending for two years.

In economies around the word rising interest rates are similarly curtailing inflation (Fig 4) and hurting manufacturing, while the services sector is relatively strong. (Fig 5)

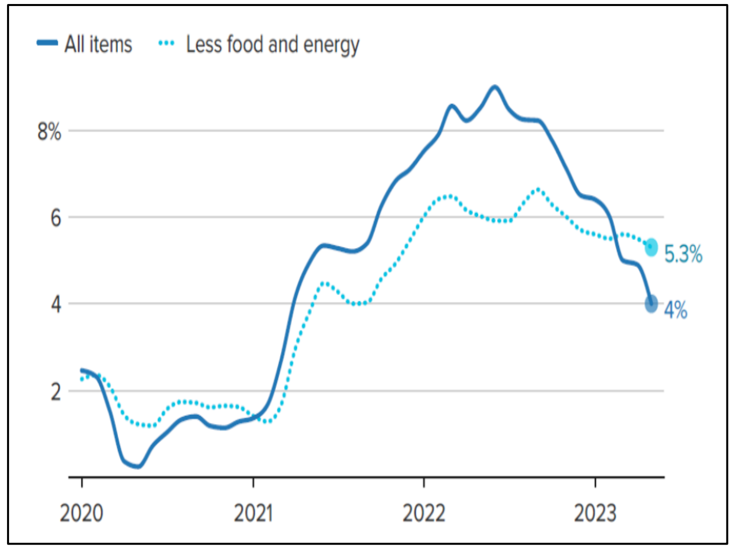
According to Factset, earnings of companies in the S&P 500 dropped 7.2% in the second quarter. They expect earnings to rise 0.3% in the third quarter and 8% in the fourth quarter. The index is currently trading at 19 times 12-month forward earnings, which is well above the 25 year average. However, historically the index has produced a positive 5 year performance when it traded at this level.

Fig 2: Consumer confidence remains high.



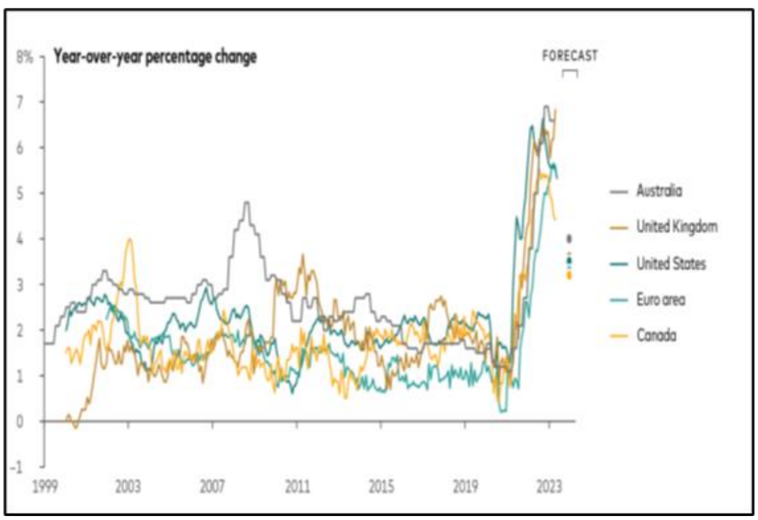
Source: Conference Board

Fig 3 Inflation has retreated from a four-decade high.



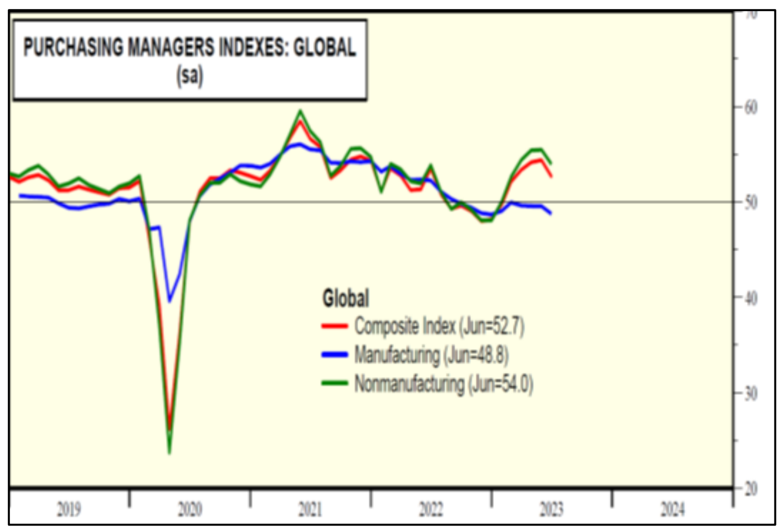
Source: CNBC.COM

Fig 4: Inflation is falling around the world



Source: Vanguard

Fig 5: Globally services stronger than manufacturing.



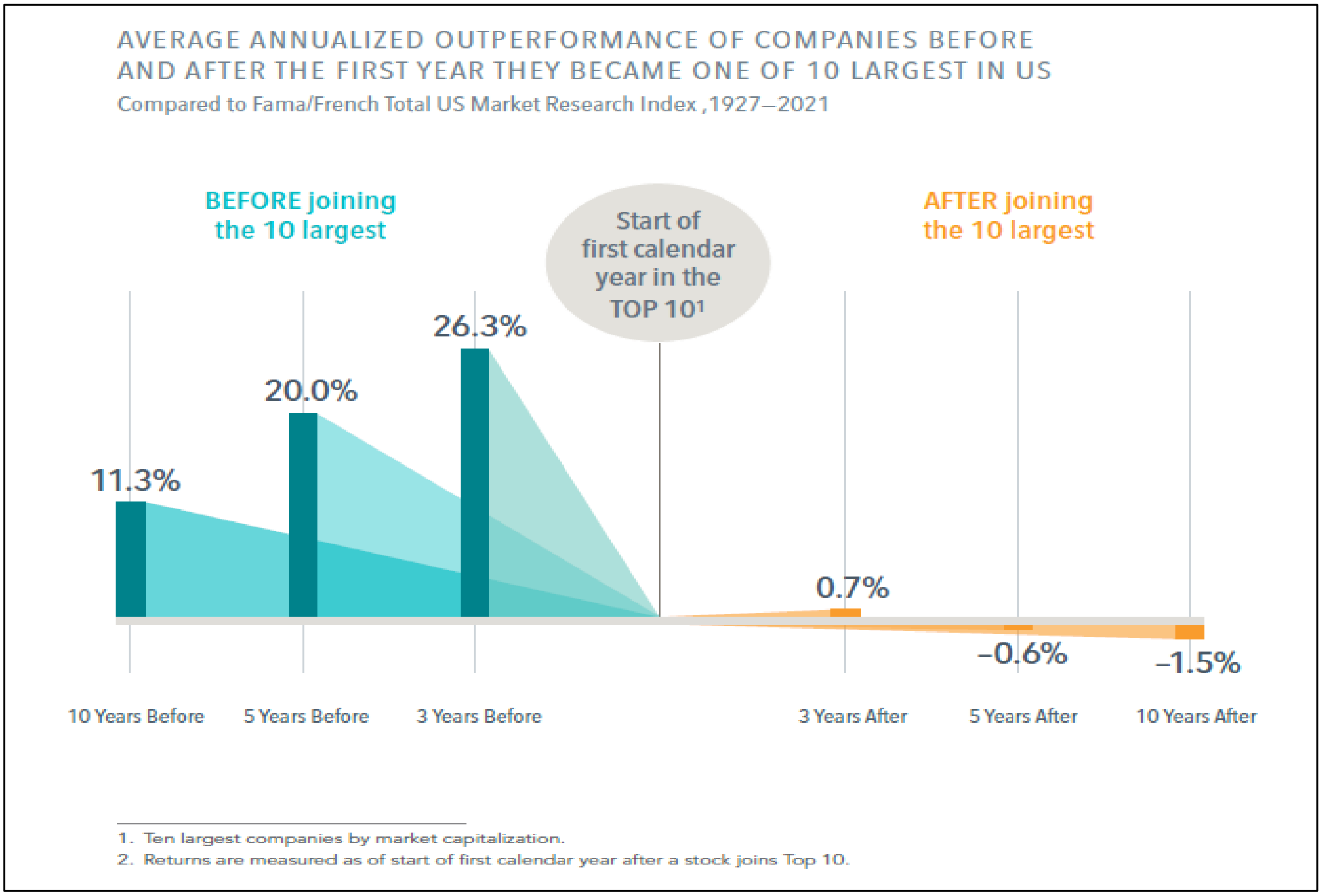
Source: Yardeni Research

<u>The risk of chasing the performance of large companies.</u>

The recent performance of stocks of large companies, especially in the technology sector, has convinced some investors that these stocks are 'failsafe' investments. History, however, is not on their side. Currently, the top 10 stocks in the S&P 500 index account for over 31% of the index's value. The last time the index was this top heavy was in 1980, when the top 10 stocks accounted for 25% of the index. The top companies then were IBM, AT&T, Exxon, Standard Oil, Schlumberger, Shell Oil, Mobil, Standard Oil, Atlantic Richfield and General Electric- companies whose stock performance deteriorated over time. Similarly, in the early 1970's investors were enamored by the 'Nifty Fifty' a group of stable, profitable, growth companies such as Polaroid, Xerox, McDonald's, Coca-Cola, IBM and JC Penney, that were expensive (i.e they were trading at a high price relative to their earnings) but were considered to be a 'buy it and forget it' kind of stocks. However, these stocks got ahead of themselves but subsequently crashed much harder than the market**.

These are not isolated incidents. According to research by Dimensional Funds, since 1926, the performance of stocks before and after they became the largest 10 are vastly different as seen in Fig 6.

Figure 6: Historical performance of the 10 largest stocks



Source: Dimensional Fund Advisors

Companies that rapidly grow to become some of the largest cannot and do not grow at the same rate forever. Many companies that grow rapidly initially crash even before becoming the largest. According to research by JP Morgan only 10% of the stocks in the Russell 3000 index can be classified as 'mega winners' i.e. they produced returns more than 500% over the index returns, 44% of the companies experienced a 'catastrophic stock price loss' i.e. a loss of over 70%, and 42% of the stocks experienced absolute negative returns during that time. 66% of the stocks in the index performed worse than the overall index. (See our **[March 2021 newsletter]()** for more details.)

The lesson is that it is difficult to identify which stocks will become the largest before the fact and it is not profitable to invest in those stocks after the fact. Your best bet of capturing the returns of the winners and managing the losses of the losers is to create a diversified portfolio.

*** In that crash, Polaroid was down 90%, Avon was down 85%, many others were down over 60%. Many of these stocks took years to recover. It is difficult to hold on to stocks that are down so much especially if they form a significant part of your portfolio. It is also not a reliable way to make financial plans.*