A View from the Bevy – 2Q23

Market Review

Stocks continued to rally in the second quarter, led by technology and Artificial Intelligence-related (AI) stocks. The S&P 500 and NASDAQ both rose more than 6% in June. The S&P 500 has now risen for three straight quarters and had its best first half of a year since 2019. It also re-entered bull territory on June 8th, following a 20% increase from its low on October 12, 2022. The NASDAQ has had positive performance in both quarters of 2023 and had its best first half of a year since 1983.

The quarter started relatively flat but gained momentum as three overhanging concerns dissipated: corporate earnings season turned out to be better than expected, the uncertainty surrounding the debt ceiling was successfully resolved, and the regional banking crisis did not snowball out of control.

Investor sentiment was also aided by the growing belief, which turned into reality on June 14th, that the U.S. Federal Reserve (Fed) would pause its interest rate increase cycle at its June meeting. This was the first Fed meeting since January 2022 that the central bank did not raise interest rates.

Stock Market Indices	2nd Quarter 2023	Year-to-Date
S&P 500	8.74%	16.89%
S&P 500 (Equal-Weight)	3.99%	7.03%
Dow Jones Industrial Average (DJIA)	3.97%	4.94%
NASDAQ Composite	12.81%	31.73%
Bloomberg US Aggregate Bond	-0.84%	2.09%
Russell 2000	5.21%	8.09%
MSCI World	6.83%	15.09%
MSCI World ex U.S.	3.03%	11.29%
MSCI Emerging Markets	0.90%	4.89%

Source: AJO. Data supplied by FactSet Research Systems.

As shown in the table, the U.S. once again led the world, although markets around the globe generally advanced during the 2nd quarter, with China and the emerging markets lagging somewhat. And after a terrible 2022, the bond market began to recover during the first half of 2023, with U.S. and Global broad bond indices up 2.1% and 1.4%, respectively. The outlook for the second half of the year looks better as well, and we expect this rebound in bonds to continue.

The quarter also ended on a strong note with a better-than-expected inflation report on June 30. The report showed that the May core personal consumer expenditure price index (PCE) rose by 4.6% from a year ago (3.8% when excluding the volatile food and energy components of the index.)

Market Outlook

While we enter the third quarter with momentum, it is important to note, as we do each year, that the summer months tend to be a volatile time for stocks. With many market participants on vacation, trading volume is generally light (which can exaggerate market swings). We expect this year will be no exception. Markets will likely be choppy as investors shift their focus from inflation to the health of the macro economy, while still weighing the ever-changing path of Fed rate hikes.

While the Fed did not increase short-term interest rates in June (as expected), Fed Chairman Powell was more bearish in his comments than usual, and a resumption of interest rate increases seems likely given the persistence of core inflation. In fact, most members of the Federal Open Market Committee (FOMC) expect that there will be two more interest rate increases during 2023. The Bank of Canada and Bank of England both pursued similar strategies, pausing rate increases for a single meeting only to subsequently resume raising them.

On the positive side, even if the Fed follows through on their projection and raises short-term interest rates a few more times, bullish sentiment is supported longer-term. Markets have a lot more certainty around the Fed's path of rate increases than in 2022. Interestingly, according to Forbes, the S&P 500 gained 18.9% on average in the 12-month period following the first (but not last) pause in the four tightening cycles since 1990.

While market sentiment has improved, there are still questions around corporate earnings and the breadth of this market rally. While 1st quarter earnings were better than expected overall, it was still the second straight quarter with negative earnings growth. The negative trend is expected to continue into the 2nd quarter. Because earnings growth has been negative, the positive returns this year are due to valuation expansion as markets look forward to a better operating environment in 2024 and beyond.

On a sector level, Consumer Discretionary, Information Technology, and Communication Services have driven almost all the performance in the first half of the year. Information Technology alone contributed about 60% of the S&P 500's total return. In fact, just seven companies – Nvidia, Meta, Tesla, Apple, Amazon, Alphabet and Microsoft – accounted for nearly 90% of the rise in the index. For a bull market to have a strong foundation, returns should be spread across a larger group of companies and a larger number of sectors.

We did see some broadening of the rally as the quarter ended, which is a positive sign. Towards the end of June market participants seemed to get more optimistic about the economy, with fewer seeing a recession on the horizon. All eyes will be on the Fed to see how they navigate monetary policy while trying to engineer a "soft landing" for our economy.

As always, regardless of the macro environment, we focus on finding companies with healthy balance sheets and the ability to benefit from long-term trends. We will be monitoring developments closely, and adjusting client portfolios as circumstances dictate.

Enjoy the summer, and don't hesitate to reach out with any questions.

Of Interest: Two Steps Forward, One Step Back

Consider everything investors have been through in recent years: a global pandemic, rapid inflation, war in Europe, and volatile stock and bond markets. It's reasonable to feel uneasy in the face of so much uncertainty.

Now imagine it's the end of 2019 and you know what you know now. You're asked to predict market returns over the next three years. Will stocks be: Up 25%? Flat? Down 25%?

You might be surprised to find out that the market, as measured by the S&P 500, was up almost 25% from 2020 through 2022. That includes last year's 19% decline. Too often, people look only at year-by-year returns, and don't look at the total history of returns, which can be very informative.

We now have 97 years of quality data on stock returns. The bar chart below shows the distribution of annual returns over that time period, ranging from a year when the market lost almost 50% to two years when it gained more than 50%. The bulk of the returns are between –10% and +40%. The chart gives us a sense of the distribution of returns, rather than a forecast of what any year's return will be. The best prediction of what will happen this year or next year is a random draw from one of these 97 years.

The returns from 2020 and 2021 were positive, while 2022 was negative. These three years seem representative of the history of stock returns: two steps forward and one step back. Two positive years and one negative. That's about the way the world seems to work.

Two Up, One Down
Distribution of calendar-year S&P 500 returns
1926-2022

Source: Dimensional Fund Advisors

But how do we explain this performance given the stress of the pandemic? Perhaps ingenuity and flexibility have bailed us out. When companies or individuals get hit with bad news, they try to figure out how to get back on track. The pandemic hit in 2020 and markets dropped 20%, but human ingenuity kicked in by the end of the year. We had a vaccine and started distributing it at an incredible speed. That innovation continued as businesses continued to adjust.

Now let's look at how the past three years compare to the previous 94 by considering returns on the S&P 500 index and U.S. Treasury bills over the entire 97-year period. For the first 94 years, the S&P 500 index compounded at 10.2% per year. Treasury bills, which we think of as being a riskless asset, compounded at 3.3%, according to data provided by Morningstar.

The difference of almost 7% per year is the reward, or risk premium, for taking on the risk of the stock market. Interestingly, the results for the last three years are almost exactly what investors experienced the previous 94, about a 7% spread per year between the S&P 500 and Treasury bills.

How can we explain normal returns when it seemed to some people that the world was falling apart? Think of public financial markets as a giant information-processing machine. When bad news comes in, prices drop. When good news comes in, prices rise. Every day, the stock market is trying to set prices to induce investors to come in to invest. If the stock market had a negative expected outcome, nobody would invest.

One of the most important principles of investing is being a long-term investor with an investment plan you can stick with. What will happen over the next three years? Who knows? The good news is, if you've planned for a range of outcomes, you won't have to worry about relying on a prediction.