Market Perspectives

July 2023

KEY HIGHLIGHTS

- Performance – The weather and markets were hot in July
- The rally broadens
- Earnings are beating estimates so far
- The Fed raised by 0.25%
- Delayed recession and a soft landing?

PERFORMANCE

Stocks continued their steady climb higher in July. The NASDAQ rose 4.08%, the Dow Jones Industrial Average had a historic 13-day winning streak (longest since 1987) and posted a gain of 3.44% for the month. The S&P 500 tacked on 3.21%. The NASDAQ has a sizzling gain of 37.71% for the year, the S&P 500 is up 20.65% and the Dow 8.55%. There have been 18 instances where both the S&P 500 and the NASDAQ were up double digits from January through July. There was only one occurrence (1987) where the S&P 500 did not go on to additional gains for the remaining 5 months of the year. The top performer for July was Emerging Markets at 6.29% and the Russell 2000 Small Cap Index followed closely with a 6.12% gain. This marks two consecutive strong months for small caps.

While the Magnificent Seven retained luster in July, the shine certainly spread to other areas of the market.

THE RALLY BROADENS

Early this year we wrote about market concentration and how market performance was mainly driven by the Magnificent Seven (AAPL, MSFT, AMZN, GOOGL, NVDA, META and TSLA). Last month we saw the beginnings of some broadening out of the rally to other areas of the market. While the Magnificent Seven retained luster in July, the shine certainly spread to other areas of the market evidenced by former laggers beginning to lead (small caps, emerging markets). Also, not unnoticed, was that each of the 11 sectors of the S&P 500 posted gains for the second straight month. That is an indication of breadth which has now meaningfully broadened. This is a positive sign for equities. Bonds were slightly negative for the month due to a rise in yields. Many fixed income assets appear attractive from a yield, price, and relative valuation standpoint. Specifically, municipal bonds now have the highest yields in over a decade and state and municipality financial health appear to be stellar. This combination leads to attractive opportunities for yield enhancement along with potential price appreciation should rates decline in the coming years.

Index	MTD	QTD	YTD	1 Year	2022
S&P 500	3.21	3.21	20.65	13.02	-18.11
Dow Jones Industrial Average	3.44	3.44	8.55	10.62	-6.86
Russell 2000	6.12	6.12	14.70	7.91	-20.44
NASDAQ Composite	4.08	4.08	37.71	16.82	-32.61
Europe, Australia, & Far East (EAFE)	3.25	3.25	15.77	17.42	-14.05
MSCI Emerging Markets	6.29	6.29	11.71	8.83	-19.78
Bloomberg Barclays U.S. Aggregate Bond	-0.07	-0.07	2.02	-3.37	-13.04

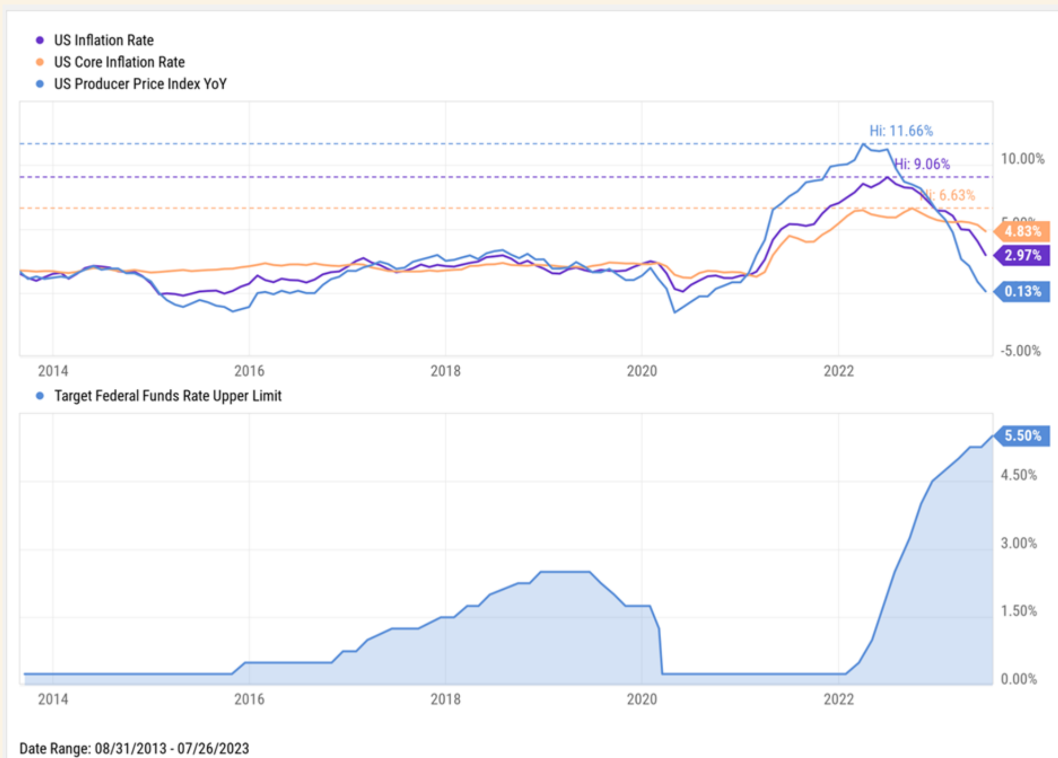
As of 7.31.23; Returns in percent

EARNINGS

Just over 50% of the S&P 500 companies have reported Q2 2023 earnings through July 31st. Of these companies, 80% have reported EPS above estimates which is above the 5-year average of 77%. However, the amount by which companies are beating EPS numbers is lower than the 5 and 10-year averages. So, more companies are beating but by lower amounts than in the past. Even with these positive surprises, earnings are expected to decline by -7.3% for the second quarter. However, analysts believe earnings will grow in the second half of the year. Per FactSet, Q3 2023 and Q4 2023 are projected to show earnings growth of 0.2% and 7.5% respectively. If earnings can indeed grow, current valuations as measured by the forward 12-month PE ratio would look more attractive than the current figure of 19.4, which is above the 5-year average of 18.6.

INFLATION

Inflation took a cue from the Tom Petty classic "Free Falling". After peaking at 9.1% last June, the widely followed Consumer Price Index (CPI) has been on a steady free fall since. The July 12th CPI release (June figure) came in at 3%, down from May's 4% reading and just one percentage point away from the Fed's 2% target. However, for inflation to arrive at the Fed's target, the two primary drivers of inflation, housing and auto prices will need to flatten out. Core CPI (excludes food and energy) fell below 5% for the first time since November of 2021, landing at 4.8% for June. It wasn't too long ago when every CPI report was higher than expected. The tide has seemingly turned, and we are now seeing inflation numbers coming in lower than expected. While the job is not complete, much headway has been made on the inflation fight. We expect inflation to continue moderating but at a slower pace going forward due to year-ago comparisons becoming more difficult thereby delaying the arrival of the 2% Fed target.



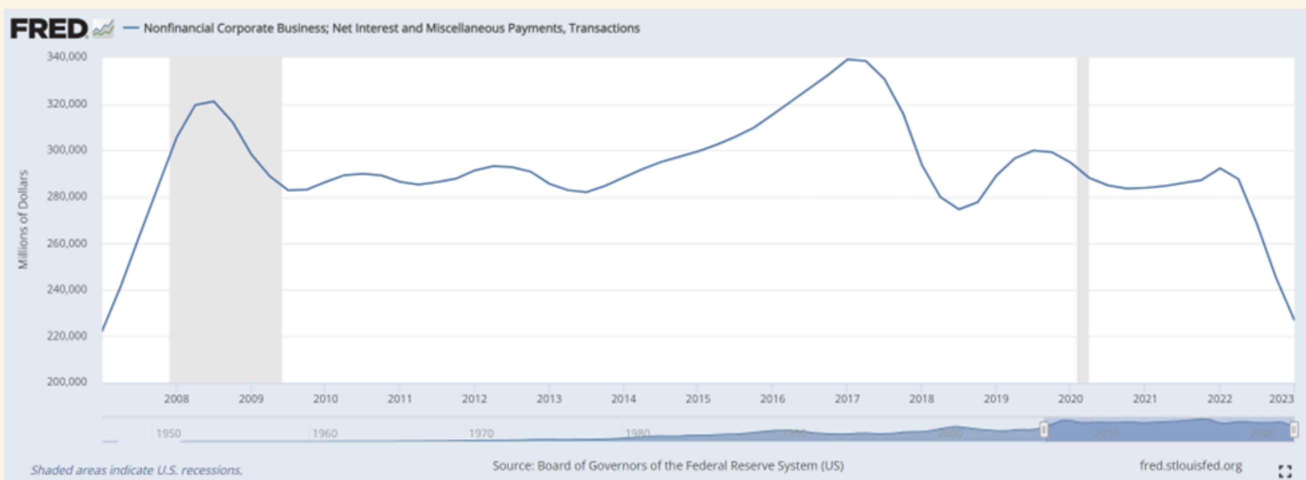
THE FED RAISED

After pausing in June, the Fed hiked rates by 0.25% on July 26th to 5.25-5.50% which is a 22 year high. This outcome was widely expected and felt perfunctory. Chairman Powell's post meeting commentary was somewhat dovish in nature with mentions of data dependency for guiding future policy decisions. The next rate decision comes on September 20th so the Fed will have the benefit of two more CPI reports, two more employment reports along with a host of other economic activity data between now and then. Currently the probability of another Fed pause stands at 82.5% and a 0.25% hike at 17.5% per the CME FedWatch Tool. After the July hike, it is likely that the Fed has concluded this cycle's hiking regime as monetary policy is now sufficiently restrictive.

DELAYED RECESSION

Perhaps the most talked about and anticipated recession ever has yet to appear. There have been numerous reasons why most economists have been predicting a recession. Some include the inverted yield curve, bank failures, inflation, and sharply higher interest rates, yet a recession has not materialized at least by the National Bureau of Economic Research (NBER) definition.

Although it is worth noting, the NBER's declaration of a recession is retrospective in nature and wouldn't be declared until a recession had already occurred. So why hasn't the recession arrived? Consumers which account for approximately 68% of GDP have been quite resilient partially due to a strong labor market and stockpiled savings from prior stimulus. Corporate earnings have held up better than expected as well. But why? One reason may be that corporations made timely and smart moves to refinance liabilities to low-rate fixed rate debt when rates were incredibly low during and coming out of the pandemic. Normally, when rates rise as dramatically as they have, corporate net interest payments rise correspondingly. This has not happened, and corporate net interest payments have in fact declined. These lower net interest payments combined with continued pricing power have helped prop up corporate profits for now and could lead to a soft landing rather than a recession over the coming year.



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Sources: YCHARTS, Barron's, NDR, Bespoke, CME Group, FRED