Second Quarter 2023 Market Review

So far in 2023 equity markets have recovered a fair bit of their 2022 losses. Over the last 18 months the S&P500 is down 4.4%, Small Cap stocks are down 15% and international stocks are down 3%. These figures include the recovery the first six months of this year of 16.8% for the S&P500, 6.3% for small cap stocks and 12.5% for international stocks. Gold is up 4.5% over the last 18 months and down 0.6%% YTD through June 30. Bonds are up 2.5% this year after losing 13% last year.

In the past when the central banks (the Federal Reserve in the U.S.) would raise interest rates this much, it would put pressure on the economy which would impact employment and typically end in recession. During recessions, earnings fall and uncertainties increase and the equity markets struggle to maintain valuations. One direct link between higher rates and pressure on business is the link to cash flow. Companies that have had bank loans come due this year are seeing their interest expense double from what it was. This means less cash for investment or payroll. The longer rates stay high, the more loans and companies will be affected. Adding support for recession expectations is the Leading Economic Indicators falling for 14 consecutive months.

But where is the recession? The S&P500's YTD performance certainly does not reflect the belief of a recession occurring. Or maybe the current valuation of the S&P500 is not sustainable in the near term.

One explanation of the recessions' delay is the giant piggy bank of extra savings that the Government created during the COVID pandemic with their multiple fiscal responses. While real incomes have been declining all year and prices for goods and services have remained high, people have been using these extra savings to continue funding their living expenses. These excess savings have now declined by 75%. If real incomes do not rise soon, the point at which people will have to cut back is quickly approaching.

Is the current S&P500 valuation sustainable? At the end of 2021, the domestic equity markets were expensive by historical measures. 2022 corrected that. The high December 2021 valuations could not withstand the fear of higher interest rates in 2022. But this year after beginning at historically normal valuation levels the S&P500 has raced ahead 16% and its valuation has risen to historically high levels again.

Looking inside the index tells give another perspective. The gains in the S&P500 index are far from evenly distributed. Most of the gains have occurred in the largest holdings. The S&P500 is a capitalization weighted index meaning that the largest holdings represent a larger portion of the overall index. For example, in an equal weighted index of 500 companies, each company would make up 0.2% of the index. In this equal weighted case, the top 7 names would make up 1.4% of the index. In the capitalization

weighted index the top 7 names make up 28% of the index. Apple, Microsoft, Google, Amazon, Nvidia, Tesla, and Meta(Facebook) are these 7 names.

The YTD performance of these seven names is 49%, 41%, 35%, 55%, 190%, 137%, and 127%. At around 28% of the index, these seven stocks drove most of the performance of the overall index. The Price Earnings Multiples of these seven companies are 32, 35, 23, 82, 54, 80 and 25. The average PE ratio of the market is in the teens over the last 25 years.

There is an equal weighed index S&P 500 index. The gap in performance between the S&P500 and the equal weighted index was the fourth largest in the last 33 years. Two years that had larger gaps were 1998 and 1999. Some might remember these years as the ones leading up to the internet bubble and crash.

The breadth of this recovery in stocks is therefore very narrow. There have been nine other bear markets since 1982. The recovery of the equal weighted index this time is the worst of the group. Its recovery of 14% since market lows last year is about 40% lower than the average of all 10 recoveries. If this is a real economic recovery, the rest of the stocks will have to make up territory.

Value strategies and their cousin Dividend Growth strategies have certainly lagged this year. The Vanguard Dividend Growth fund is up 2.6% and the iShares Dividend Growth ETF is up 4.2%. But this is where the value is found in the markets today. These gains are more sustainable in a recession as cash being produced today is valued more than promises tomorrow.

Previous letters spoke of a two-phase market correction: Adjusting from high valuations back to normal, and then getting through a recession. The giant piggy bank created by the Government, along with the stimulative actions after the banking crises in March and the Treasury spending its general fund during the debt limit crises has created conditions resulting in a euphoric intermission in some sectors of the market. The lights are flashing for the second act.

Sincerely,

Peter B. Harre, CFA