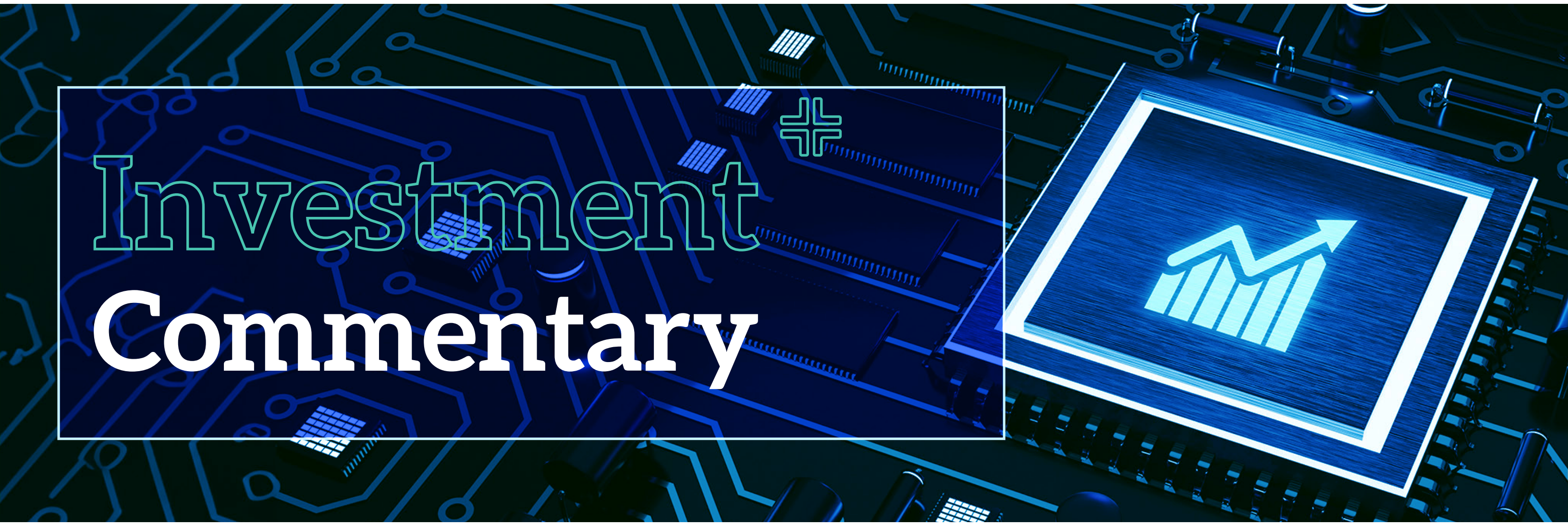
withum WEALTH MANAGEMENT

Summer, 2023



Summer Investment Outlook

The first half of 2023 has concluded, and it is one for the record books. Despite seemingly countless reasons to be wary of the markets – regional banks collapsing, core inflation (excluding food and energy) stubbornly remaining above or near 5% and a debt-ceiling resolution being pushed to the 11th hour– the S&P 500 climbed over 16% on a total return basis to start the first half of the year.

US stock performance was bolstered again by sectors that declined the most in the 2022 bear market. Big cap technology stocks led the way on a wave of optimism that artificial intelligence could boost global GDP and company profits up to $7 trillion over the next ten years.

Unemployment has remained steady at historically low levels while new jobs created have continued to exceed expectations. With the labor market acting well, it's hard to see why consumer spending would dry up. At the same time, inflation continued to decline to 3% as of the June report last week. This goldilocks setup could be why stocks have rallied – earnings estimates dropped too much yet corporate profit margins remain strong, and it hasn't been hard for companies to jump a low hurdle after the seemingly inevitable recession that was looming last fall.

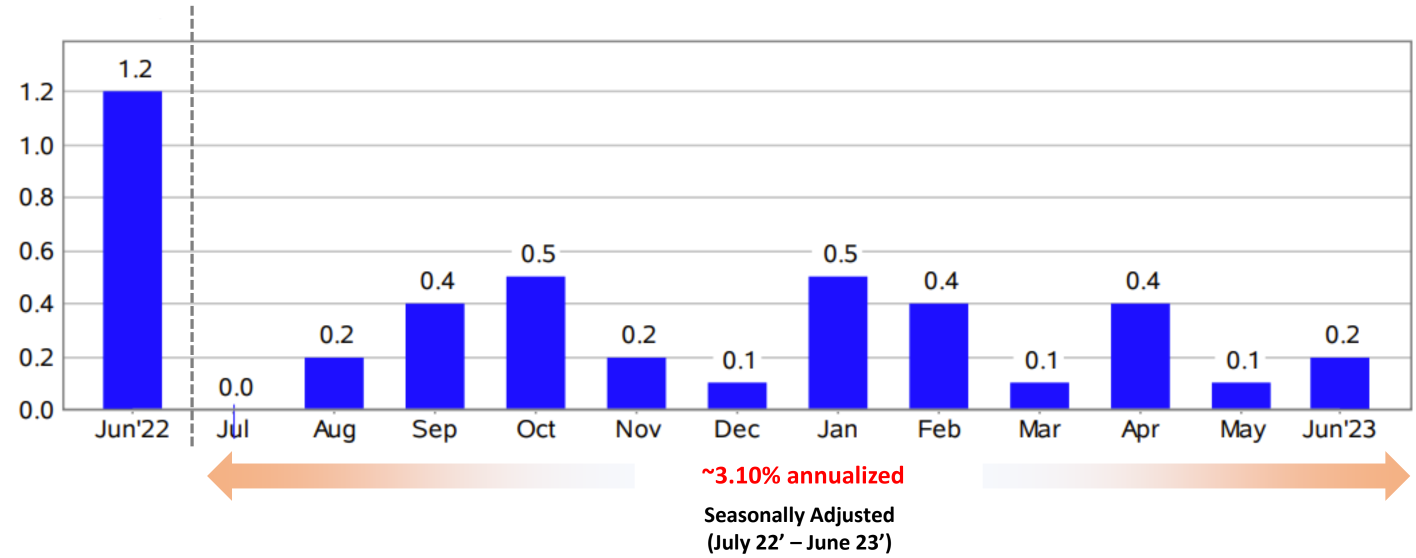
The Federal Reserve and Inflation

Last month, the Federal Reserve (Fed) announced that they were pausing their barrage of interest rate hikes. Rates are now at a level that are sufficiently "restrictive" to economic growth. Despite their actions, the language used by Chairman Jerome Powell signaled anything but the fact that they have completed their mission to quell inflation. While the board members were split, the indications are that Fed members expect one to two more interest rate hikes before the end of the year and no cuts are forecast for a considerable time. Currently, US Treasuries maturing between 1-18 months are yielding north of 5% - an excellent substitute for excess cash savings, money market funds and CDs.

See important disclosures on last page

One-month percent change in CPI for All Urban Consumers (CPI-U)

Seasonally adjusted, June. 2022 – June. 2023 Percent change

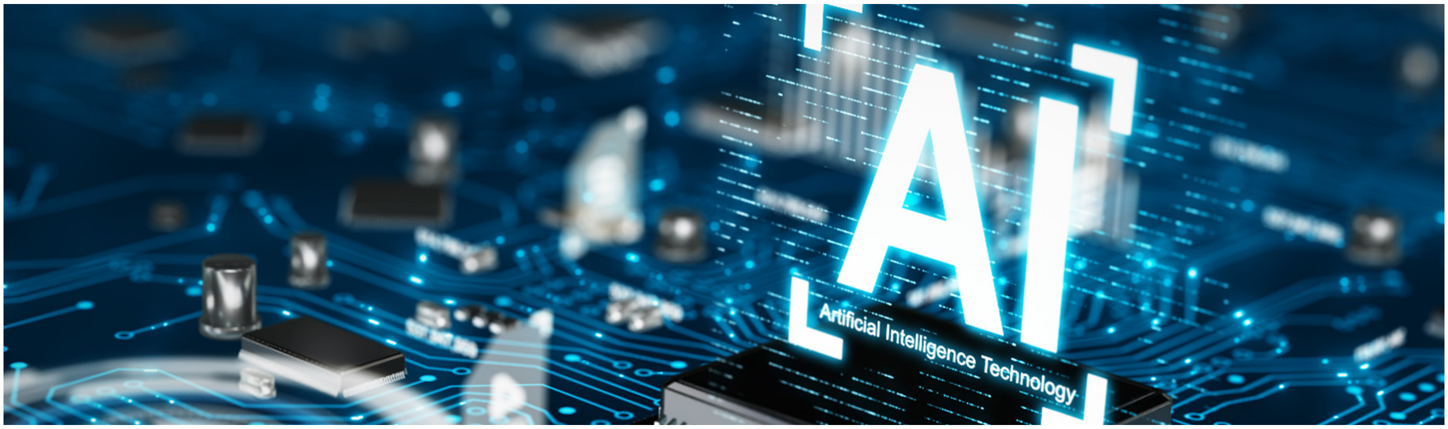


Source: Bureau of Labor Statistics

Historically, when the benchmark rate set by the Fed rises above the 2-year yield, there are no more interest rate hikes in that cycle. It is curious why they would not just continue hiking rates if they thought they were not in a restrictive enough position. June's headline inflation report came in at 3% which is much more normal, however when looking at the monthly data, it is hard to see a trend of continued declines coming unless there are some months of price declines. As we discussed this winter, year-over-year calculations would allow inflation to get below 4% simply because high inflation months of early 2022 would no longer be part of the current trailing 12-month figure. Moving lower from here however is going to be challenging.

One aspect of inflation that could continue to be a thorn in consumers' side is rent/housing. This is one of the largest components of the CPI Index. Economists often cite the lagging effect that rents have when compared to housing prices. It is true that housing prices briefly topped out and began retreating, however with the rise in equity markets, housing prices too have rebounded. Buyers are hungry for opportunities with bidding wars nearly impossible to avoid. The problem is that sellers do not want to move – over 60% of homeowners are locked into mortgages below 4%. Demand for homes due to 7%+ mortgages is weaker, however supply has declined faster, keeping prices elevated. From a comparative perspective, the cost of owning a home relative to renting is still near 2006 levels, which means rents may not alleviate the way that many predict unless housing prices truly do decline meaningfully.

The Fed has made incredible progress thus far, however the last mile – getting core inflation back down below 3% - might just be the hardest. It's hard to imagine a world where inflation normalizes and higher rates for longer do not cause some sort of problem, be it bank lending drying up, unemployment rising or a rise in consumer credit defaults.



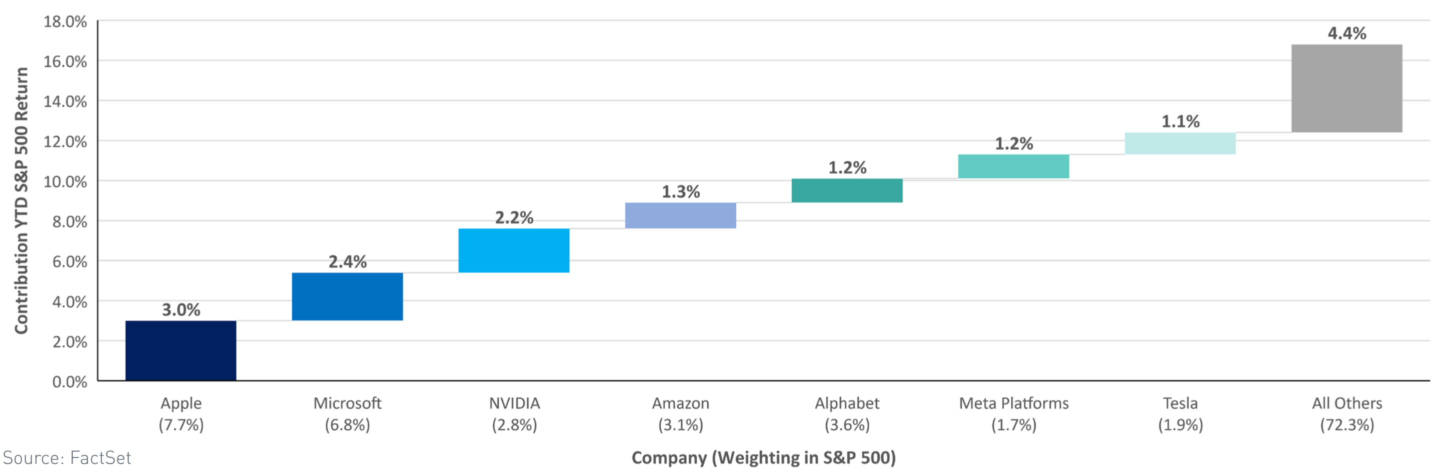
Artificial Intelligence & Technology Stocks

Artificial Intelligence (AI) has taken the world by storm. ChatGPT popularized the amazing strides being made in generative AI which is the practice of creating something new based on a simple prompt. The ability for AI to help make workers more efficient is likely being underestimated today as humans have always had a hard time evaluating technological potential. The fear of jobs being lost is a popular one but likely years away. It is also worth noting that 85% of jobs today were not around prior to 1940 and are from technological improvements – surely the same trend will hold true with AI as it did with the prominence of combustion engines, TVs and the internet.

While the potential to change our lives is substantial, so too are the profits for companies that are heavily involved in this space. Some of the largest companies in the world have been involved in this space for some time and experienced amazing returns through the first half of the year. Below are just a few riding the AI wave.

- Microsoft (MSFT) – Originator of OpenAI (ChatGPT).
- Alphabet (GOOGL) – Bard AI embedded in Google search.
- Nvidia (NVDA) – Prominent chip maker necessary for computing power.
- Adobe (ADBE) – Products which automate workflows and image forensics.
- Amazon (AMZN) – AI to help users find the right products faster.
- Tesla (TSLA) – Autonomous driving could unlock hours of potential for commuters globally.

Seven stocks have driven market returns in 2023

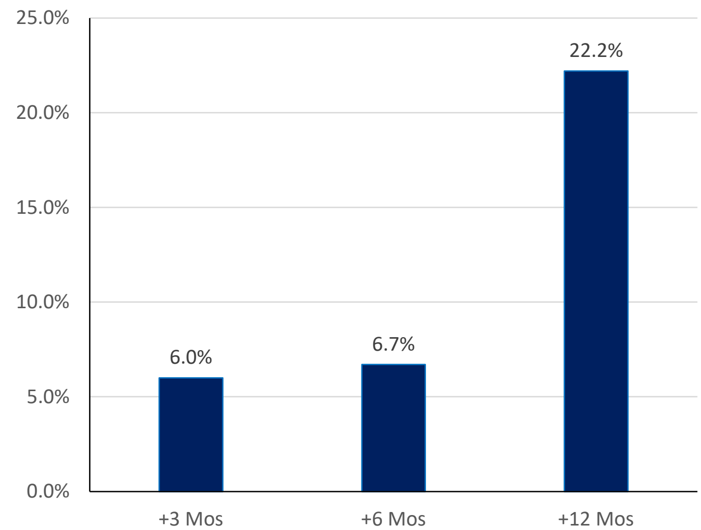


Source: FactSet

It is no wonder why technology stocks have had their best first half since the early 1980s. As we mentioned, the S&P 500 started the year up over 16%, however the Nasdaq Composite surged nearly 32% during the same time period. Recall that the Nasdaq was down over 33% last year, but the performance of the top holdings in the index have rebounded significantly:

A lack of market breadth, the term for how broad or concentrated the returns are, is often cited as a concern. Looking deeper at similar periods in history of outperformance by mega cap companies (see graph) we see that the overall index continues to perform well. When the top five companies in the S&P 500 (currently technology companies) outperform, the next three, six and twelve months exhibit above average returns. Most assume that when a small percentage of companies are responsible for most of an index's performance, the greater number of companies are more likely "telling the truth" about the underlying economy. Contrary to that assumption, the adjacent chart shows after periods of concentrated performance in the top five companies in the index, like this last six months, the broader market has above average periods of return. This suggests that the rest of the stocks and economy are likely to catch up to what the leaders have done. The month of June showed signs of this type of improvement.

S&P 500 Average Price Performance Following Mega Cap Outperformance Streaks



Source: BMO, FactSet

Looking ahead to the back half of 2023 and 2024

Be it the slower pace of rate hikes, the realization that inflation is normalizing, or the potential of AI, the stock market is not focused on any sort of profit decline or recession ahead. There are several underlying datapoints suggesting that a recession may be ahead, but that seems to be playing second fiddle to the reasons why profits might be higher than expected.

As with many other times of panic and market selloffs, people tend to extrapolate worst case scenarios without assigning the probabilities of those bad scenarios taking hold. Looking ahead to the remaining months of 2023 and 2024, a recession seems likely, and most pundits acknowledge that. The only thing that could upset markets in the months and years ahead is if the expectations for a short, mild recession are met with something worse. It almost seems like the longer it takes to have a recession, the further the Fed can push rates higher or retain a tight monetary posture to restrain economic growth and lending. Eventually something may break, but the market is signaling that whatever may break (or may have broken in the case of regional banks) is not enough to override the AI tidal wave of potential efficiency and greater profits for corporations.

We hope you are enjoying a wonderful summer and as always, we are available to discuss any questions, thoughts or concerns that you may have.

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Need More Information? Please do not hesitate to contact a member of the Withum Wealth Management team with any questions or concerns:

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