Third Quarter 2023 Investment Outlook

Walkin' The Tightrope

"We've been walkin' the tight rope, trying to make it right, walkin' the tight rope, every day and every night."

– Stevie Ray Vaughn and Double Trouble - Tightrope

"In the 22 instances when the S&P 500 finished the first half of the year more than 10 percent higher since 1950, the median return for the second half is 8 percent with a 82 percent win ratio."

– Thomas Lee – Fundstrat Global Advisors

"1,2,3,4,5,6,7,8. Every one of the eight times this happened, we caught a recession. Leading indicators divided by lagging indicators is falling like a knife. Number nine, here we go."

– Jeff Weniger – Head of Equities – Wisdom Tree

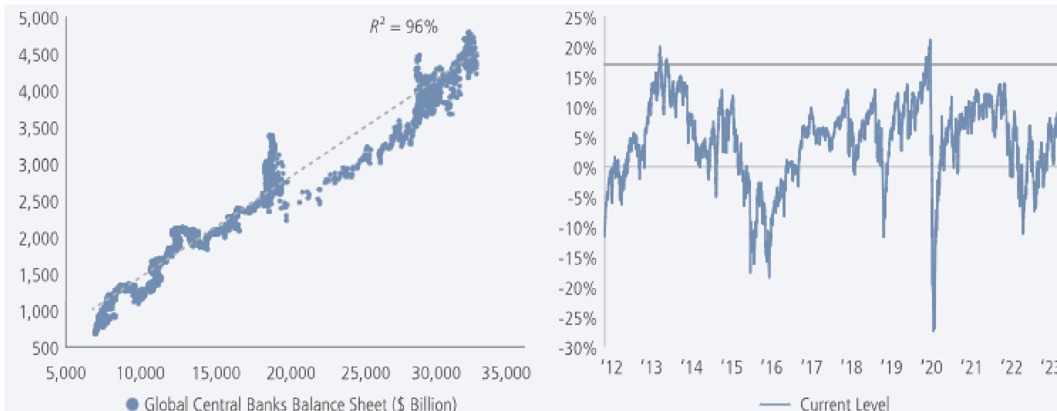
2023 marks the 40th anniversary of Stevie Ray Vaughn and Double Trouble's first performance on the popular PBS show Austin City Limits. Stevie Ray Vaughn and Double Trouble were a blues/rock trio out of Texas that were popular during the 1980's. Stevie was acclaimed as one of the pre-eminent blues guitarists of his generation. Born in Dallas, TX, Stevie eventually settled in Austin, TX, where he made a name for himself in the local music scene and eventually formed the three member band called Stevie Ray Vaughn and Double Trouble. Stevie's reputation was growing in the music community and David Bowie asked him to play lead guitar on what would eventually be Bowie's multi-platinum album, Let's Dance, which turned Bowie into a global superstar. With more commercial recognition, the band was signed to Epic Records and their 1983 album, Texas Flood, reached 38 on the Billboard album chart, a rare event for the blues/rock genre. In the same year and at age 29, Stevie and his two bandmates played on Austin City Limits, which raised their popularity to another level. Their second album, Couldn't Stand The Weather, was released in 1985 and reached 31 on the Billboard album chart and went gold.

Like many musicians, Stevie went through a period of drug and alcohol abuse and difficult personal times. He collapsed while on a European tour in 1986 and checked himself into rehab and eventually got himself back on track. After some time off, in 1989, the band recorded their fourth studio album, In Step. Stevie and Double Trouble performed again on Austin City Limits in 1989. The song Tight Rope was about his personal struggles. He had gotten his life back together and was as popular as ever until he died tragically in August 1990 in a helicopter crash after performing at a blues festival in Wisconsin. Stevie was only 36 years old. In his honor, Austin erected a bronze statue of Stevie at Lady Bird Lake in 1994.

Walking the tightrope is a saying associated with having to do something with extreme care or precision. The U.S. Federal Reserve ("Fed") is surely walking the tightrope nowadays. Since March 2022, the Fed has been aggressively raising interest rates to tame the high inflation (that it had a big role in creating) but without tanking the U.S. economy at the same time. The banking crisis that hit in mid-March added another level of complication to the Fed's job. As the Fed raises the Fed Funds rate, U.S. banks have more pressure to raise their deposit rates when they already have had significant amounts of deposits leave to capture higher yields elsewhere. Additional interest rate hikes puts even more pressure on bank profitability, which

negatively impacts their willingness to make loans. The Fed's mandate doesn't include managing bank stress even though its interest rate policy decisions flow through and greatly impact bank profits. The Fed's only mandates from Congress are to control inflation and maintain full employment. If inflation doesn't cooperate and decline at a faster pace towards its 2.00% inflation target, the Fed has more pressure to raise interest rates even though it has already raised interest rates by 5.00% since March 2022. Higher interest rates have a negative impact on economic activity, which historically has translated into higher unemployment. On one hand, the Fed has pressure to reign in inflation while at the same time not doing signficant damage to the economy and employment to achieve a lower inflation level. Walking a tightrope, every day and every night, is where the Fed finds itself today.

The biggest surprise of the first half of 2023 was the strong performance of global stocks when just about everyone was cautious coming into the year given the backdrop of rising interest rates globally. Why did this happen? The big surprise was that central bank liquidity was supportive during the first half of 2023 when it was expected to be restrictive. The banking crisis required the Fed to open up some special programs to give banks a relief valve from the negative impact of their bond holdings declining in value due to rising interest rates. One high correlation relationship in investing is when central banks are providing excess liquidity, risk assets have strong performance. The next chart on the left is from research done by Citigroup on this relationship, showing a 96% correlation between the performance of equity markets and central bank liquidity. The chart on the right shows that central bank liquidity support was suprisingly strong in the first half of 2023 and a major reason why risk assets like stocks had strong performance during the first half of 2023.



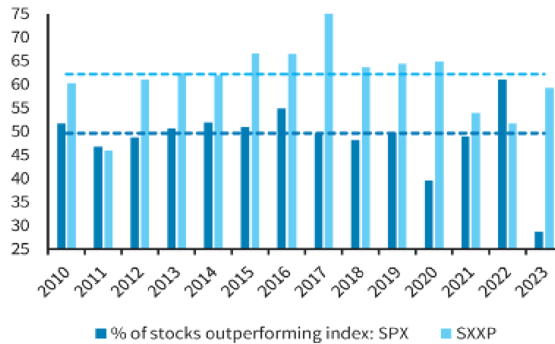
Source: Citi APAC. Data as of June 21, 2023.Source: Citi APAC. Data from Jan 1, 2009 to June 21, 2023.

This positive central bank liquidity setup should reverse in the second half of 2023. The next chart shows that global stock prices as represented by the MSCI ACWI were tightly correlated to central bank liquidity trends from early 2021. In 2022, when global stocks declined by 18%, the Big 5 central banks were withdrawing sizable amounts of liquidity from the global financial system. This trend bottomed in October 2022, about the time the U.S. stock market bottomed. Since October 2022, global stocks have rallied through June 2023 as central bank liquidity increased. However, as shown on the right side of the chart, the Big 5 central banks are expected to withdraw liquidity again in the second half of 2023, which will remove a leg of support that propelled global stocks to have strong performance despite weakening global economic growth.

Source: Neuberger Berman, FactSet

There was a very unique profile to U.S. stock returns during the first half of 2023 that calls into question the quality of the rally. The next chart below shows the number of stocks in both the U.S. (dark bar) and European stock markets (light bar) that are outperforming the broad stock market benchmark in each region. In the case of the U.S., the number of stocks outperforming has never been at such an extremely low level going back to 2010, meaning stock market returns so far in 2023 were heavily concentrated in the fewest number of stocks compared to prior years.

Figure 23. US market has always had a narrow leadership, but it is more extreme this year

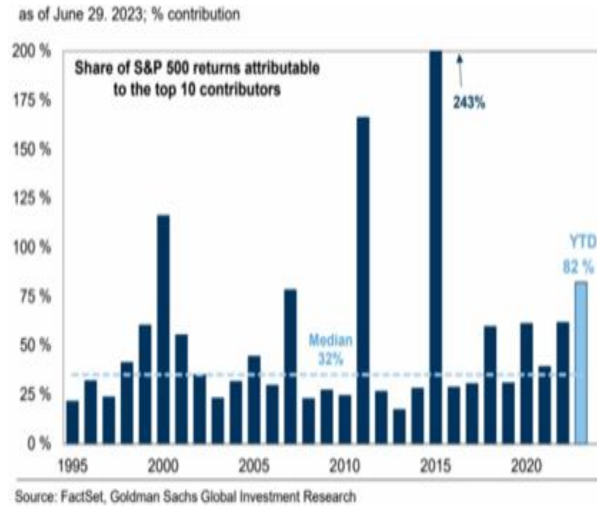


Source: Bloomberg, Barclays Research

It's not an over simplification to state that the first six months of 2023 were about whether you had enough exposure to just 10 stocks. Those 10 stocks, predominately U.S. megacap tech stocks, dominated global stock returns. In addition, because these stocks are the biggest weighted stocks in passive stock market indices like the S&P 500 Index or Russell 1000 Index, investment products designed to duplicate the returns of those indices significantly outperformed the rest of the broad U.S. stock market and most other global stocks market benchmarks as well. The narrowness of market returns is reflected in each of the following charts.

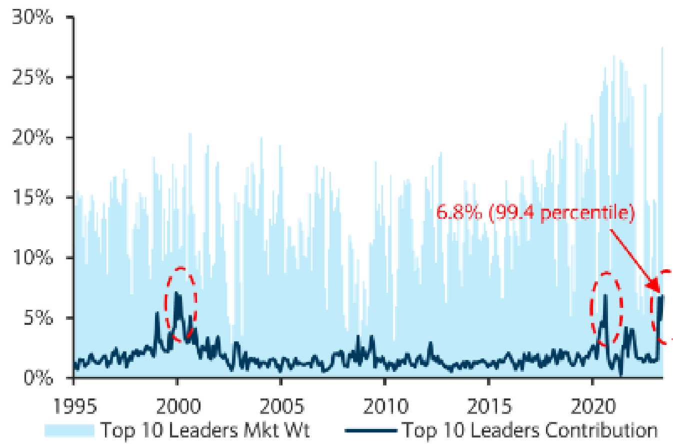
The next chart shows how much of the year to date returns for the S&P 500 Index came from the Top 10 largest stocks. Since 1995, the median contribution to return coming from the Top 10 stocks is 32% whereas in the first half of 2023 it was 82%. There were only three years going back to 1995 where the contribution

of the Top 10 stocks was bigger. How concentrated were U.S. stock returns during the first half of 2023? The five largest stocks (Apple, Amazon, Microsoft, Google, Nvidia) were responsible for 75% of the year to date return of the S&P 500 Index through 6/30/23. With such extreme returns already reflected in the U.S. stock market, some degree of a reversion to the mean move almost certainly comes next, just as it did during the Tech bubble period.

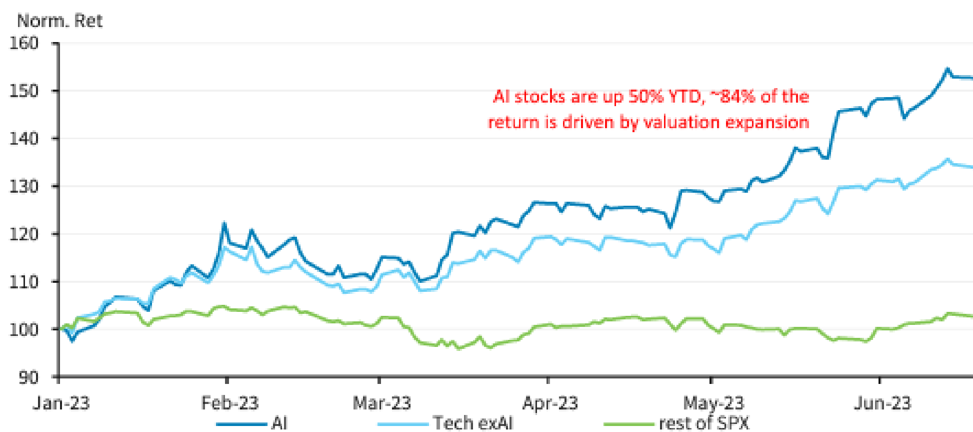


The next chart shows that the cumulative weight of the Top 10 stocks in the U.S. stock market is now in nearly the 100th percentile over the past 30 years. Only three times since 1995 have the Top 10 stocks been such a large portion of the total U.S. stock market. The dark blue line shows that only during the 1999/2000 Tech bubble and when the Covid-19 pandemic hit in early 2020 did the Top 10 stocks represent as high of a percentage weight of the U.S. stock market as they do today. This degree of dominance by one country and a limited number of stocks is evident by the following crazy stat. The market capitalization of Apple at $3.0 trillion is greater than the total market capitalization of all stocks trading in emerging markets. Let that sink in for a bit.

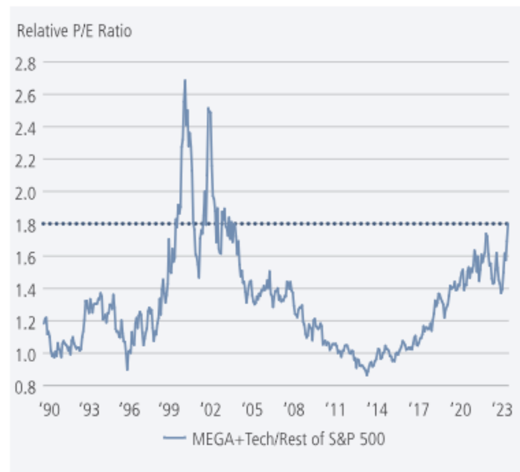
Also note that in the prior two cases when the market hit this level of extremism, the setup reversed course and the rest of the stock market ex the Top 10 started to outperform the Top 10 stocks. In the case of the Tech bubble, it was a severe price collapse of those Top 10 stocks and in the case of the pandemic it was the rest of the stock market outperforming the Top 10 as the economy recovered and the flight to safety effect reversed. The March banking crisis combined with the emergence of artificial intelligence (AI) related hype were big factors on the rare market setup this year. Looking ahead, as the banking crisis and initial AI hype recedes, the concentration of U.S. stock returns should broaden out to some extent and would help the relative performance of international, non-tech large caps, mid-caps, and small cap stocks versus the U.S. Top 10.



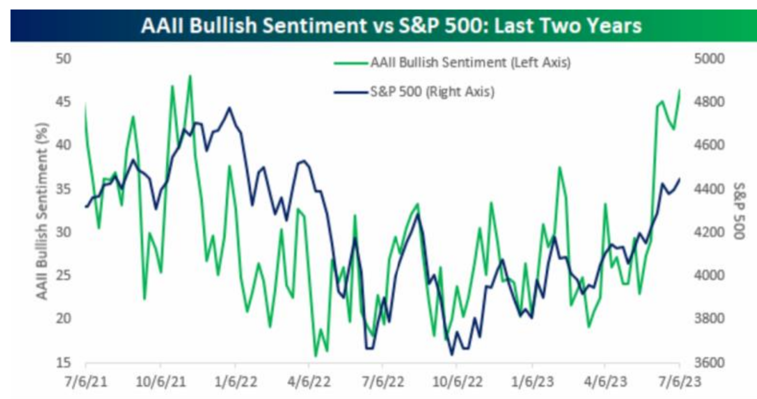
One of the key factors driving up the prices of the mega cap techs stocks has been the euphoria over AI. The next chart shows market return information for 2023 through late June. The top dark line represents stocks associated with this AI theme, which were up 50%. Other tech stocks not fully associated with AI benefited from a pull-through effect of AI hype and were up just over 30% year to date. Too bad, too sad for the rest of the stock market that couldn't claim any association with AI, as those stocks barely registered positive returns over the first six months of 2023. AI undoubtedly will be the next major technology advancement that is in its early stages of growth. However, as with most new technology, there is the initial investor euphoria that typically gets way overdone in the short term (remember Bitcoin at 65,000, but now 30,000?) but then there is the actual reality of how long it actually takes for an emerging technology to meaningfully impact a company's revenues and earnings.



All of this outsized performance coming from a narrow subset of the market has pushed the valuations of those stocks to record levels. The next chart shows the relative price/earnings (PE) multiple of this small group of mega cap tech stocks versus the rest of the S&P 500 constituents. You can see from the Tech bubble in 1999/2000 how massively overvalued that group became compared to the rest of the market. The far right of the chart shows the current period and the recent huge gap higher in the relative PE of mega cap techs stocks is now getting quite extreme again at 1.8X the PE of the rest of the market.



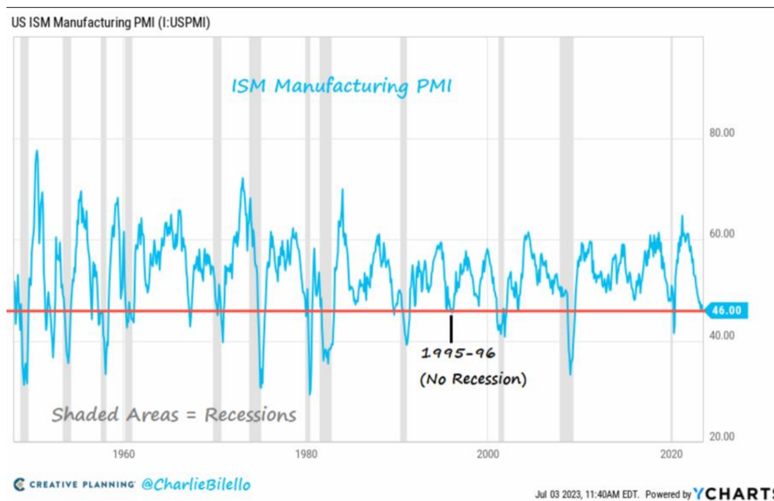
The market rally from the October 2022 low and the AI related technology sector rally has once again turned individual investors bullish on stocks. As shown in the next chart, at the October 2022 stock market low, the AAII bullish sentiment indicator hit its recent low. Now that the S&P 500 Index has been a strong run with returns of nearly 25% over the past nine months, AAII bullish sentiment has returned to frothy levels and most especially in the last three months when AI related stocks were putting up significant outperformance on what seemed like a daily basis.



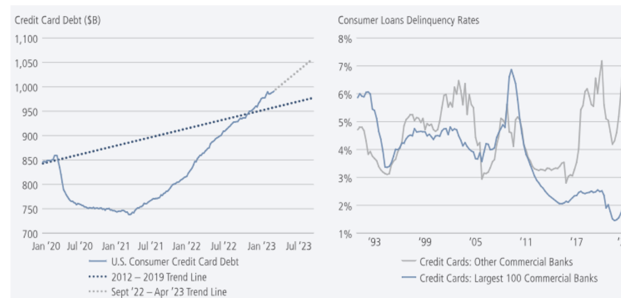
The stock market is a forward discounting mechanism, meaning it trades today based on what investors expect to happen over the next 6-12 months. However, some negative macro related data has been ignored by investors who are in love with the narrow group of stocks that dominated returns during the first half of 2023. The next chart shows that the economic outlook has worsened even as the stock market has rallied. This chart goes back to 1958 and shows the relationship of leading economic indicators to lagging economic indicators with grey areas representing recession periods. When the line is moving higher, it means leading

economic indicators, or those tied to forward-looking economic growth, are rising more than lagging economic indicators. Conversely, if the line is moving lower, leading economic indicators are softening more than lagging economic indicators. This data relationship has correctly predicted 8 out of the last 8 recessions or a 100% batting average as shown by the yellow circles numbered 1 to 8 in the chart. The leading/lagging line is once again heading lower and near levels of the past two recessions (7&8). The U.S. economy has not officially been declared to be in a recession yet but this data, based on its success rate over time, suggests one may be forthcoming in the not too distant future. Economists with a negative take on the U.S. economy think a recession may occur by year-end while those with a more sanguine view think the first half of 2024, if at all.

The strong performance of mega cap tech stocks this year to date has ignored macro blemishes that have been prevalent all year. One example is the weakness of the U.S. manufacturing sector. The next chart shows the ISM Purchasing Managers' Index (PMI) going back to the 1950s. A level of 50 for the PMI is the demarcation line between growth and contraction. The manufacturing PMI moved below 50 earlier this year and the latest reading for June was near 46. The grey areas of the charts are U.S. recessions and show that almost every time the U.S. manufacturing PMI went down to current level (except for 1995-1996), the U.S was in a recession. During more severe and deeper recessions like 2008, the manufacturing PMI can go below 40. If the U.S. ends up in a recession, it shouldn't be a severe one if the PMI bottoms around the current level.



The job market is one area of the U.S. economy that has remained suprisingly resilient. However, due to inflationary pressures, U.S. consumers have been under increasing pressure the past 18 months and the consumer credit data is starting to have a negative impact on the economic outlook. The chart on the left shows credit card debt levels are now well above the trend line and indicates U.S. consumers are relying more on their credit cards for basic purchases. The right chart shows that loan deliquencies are starting to rise for both banks and non-bank financial institutions. Rising credit card balances and deliquencies indicate that more consumers are under financial stress and income levels are not high enough to cover basic living expenses. Banks are getting more leery of lending, rejecting 22% of credit card applications in June. In addition, more auto loans were rejected than applications received, the first time since 2013.



Source: Neuberger Berman and FactSet. Data as of June 2, 2023.

The economic story outside the U.S. has not been as positive. A good example is China, whose economy is weak and underperforming expectations. After China eliminated its draconian C-19 lockdowns late last year, most global economists expected the reopening of the Chinese economy to be a major boost to its 2023 GDP. That was certainly the case in first quarter when China real GDP growth jumped by 4.85%. However, second quarter real GDP was surprisingly weak at just 0.8%. China's weaker than expected economy weighed on global investor sentiment and it was one one of the worst performing equity markets during the first half of 2023 with a -5% return.

Unlike most other parts of the world dealing with persistent inflation, China has deflationary pressures due to an outsized debt problem created from overbuilding in its property markets the past decade. After the initial pop from ending lockdowns, consumer spending has remained cautious. Youth unemployment in China was 21% in June (the two next worst countries are Italy and France). Also, the U.S. trade war and tensions over Taiwan are taking a toll on China's economy as some U.S. companies rethink their offshoring policies and move production elsewhere in the world including back to the U.S. The rising level of political tensions between China and the U.S. has unnerved corporate America and more U.S. based multi-national companies with China exposure are rethinking their global operational footprint. For example, Apple is moving some of its Iphone production to India to reduce its dependence on China.

China has the second largest economy in the world so when it struggles then world GDP growth struggles too. Europe in particular has a sizable amount of exports to China and so is more negatively impacted by declining China GDP growth than the U.S., which has a more diversified export base. The next chart shows the latest Economic Surprise Index for Europe, China, and the U.S. Both Europe and China are seeing a more notable slowdown in their respective economic indicators than the U.S. China had a huge move higher after its lockdowns were lifted, which resulted in the large pop through April. However, growth has decelerated again and its positive economic surprises are decelerating faster than both Europe and the U.S. by a wide margin. China stabilizing its economy will be an important factor for the second half of 2023.

Source: Bloomberg, Barclays Research

Summary

U.S. investors experienced a surprisingly strong second quarter and first half of 2023, mostly due to unexpectedly strong U.S. stock market performance. However, sources of return in the U.S. were very narrow and mostly due to a limited number of mega cap tech stocks. In addition, the U.S. stock market got an unexpected boost due investor euphoria over AI. The broad U.S. stock market valuation is now full and AI euphoria has most likely played out for now. This leaves U.S. stocks vulnerable to a loss of price momentum in mega cap techs stocks and additional gains will be more dependent upon the direction of the U.S. economy and corporate profits during the back half of 2023. The Fed is walking the tightrope, as it tries to slow down inflation while trying to avoid doing significant damage the U.S. economy to achieve its 2.0% inflation mandate. The Fed is expected to raise interest rates 0.25% at least one more time in late July. Interest rate decisions after that will depend heavily on whether inflation continues its recent declining trend and whether wage gains and the job market soften. Walking a tightrope is a difficult balancing act. The Fed's success in doing so will determine whether the solid gains for stocks during the first half of 2023 hold up for the rest of the year.

Mark J. Majka, CFA
Chief Investment Officer

July 18, 2023

IMPORTANT DISCLAIMER:

This report and all content on mjminvtadvisors.com is presented for educational and/or entertainment purposes only. Under no circumstances should it be mistaken for professional investment advice, nor is it intended to be taken as such. The commentary and other contents simply reflect the opinion of the author alone on the current and future status of the markets and various economies. It is subject to error and change without notice. The presence of a link to a website does not indicate approval or endorsement of that web site or any services, products, or opinions that may be offered by them. Neither the information nor any opinion expressed constitutes a solicitation to buy or sell any securities or investments. Do NOT ever purchase any security or investment without doing your own sufficient research. None of the parties adding to or affecting the content of mjminvtadvisors.com in any way shall have any liability for any loss sustained by anyone who has relied on the information contained herein. Neither mjminvtadvisors.com nor any of its principals or contributors are under any obligation to update or keep current the information contained herein. The principals and related parties of mjminvtadvisors.com may at times have positions in the securities or investments referred to and may make purchases or sales of these securities and investments. The analysis contained is based on both technical and fundamental research. Although the information contained is derived from sources that are believed to be reliable, it cannot be guaranteed.

FAIR USE NOTICE: mjminvtadvisors.com and reports downloaded from the site contain copyrighted material the use of which has not always been specifically authorized by the copyright owner. We are making such material available in our efforts to advance understanding of issues of economic and social significance. We believe this constitutes a 'fair use' of any such copyrighted material as provided for in section 107 of the U.S. Copyright Law. In accordance with Title 17 U.S.C. Section 107, the material on the site and in reports downloaded from the site is distributed without profit. If you wish to use copyrighted material from this site for purposes of your own that go beyond 'fair use', you must obtain permission from the copyright owner.