THE PRIVATE CLIENT GROUP
BALANCING LIFE & WEALTH

ECONOMIC & MARKET INSIGHTS

An Executive Summary for Second Quarter 2023

During the second quarter, U.S. economic growth continued near a 2% pace, the Fed raised rates once and promised to deliver another two hikes prior to year-end, U.S. equities were strong performers led by mega cap Nasdaq names, fixed income returns were negative as long rates rose, real assets were mixed with gold and real estate rising while energy fell. U.S. growth estimates, as forecast by Blue Chip Financial Forecasts rose above 1% from an initial estimate near 0%. Real time nowcasts, as measured by GDPNow, suggest the economy may be growing at a rate above 2%. Key indicators such as non-farm payrolls, retail sales, ISM manufacturing, housing starts, and consumer confidence all showed growth or improvement during the quarter.

Globally, growth is mixed to negative. Europe is experiencing stagnant growth with the Eurozone reporting -0.1% in Q2 2023, largely driven by the recession in Germany. Its normally resilient, export-driven economy has suffered due to rising energy costs, which hurt margins and reduced output. Demand from China has also accelerated at a slower pace than in past downturns. The UK reported +0.1% growth, China 2.2% and Japan registered 0.7% - versus the U.S. which reported 2% for 2023 Q2.

Equity markets continued their upward trajectory over the second quarter of 2023. While nearly all major global equity markets posted gains, U.S. stocks retook the lead from developed international stocks over the quarter. Despite the positive gain for the S&P 500 Index so far this year, an extremely narrow handful of mega-cap technology and consumer names drove nearly all of that performance.

There has been a wide level of dispersion between S&P 500 sectors so far this year, with a nearly 50% gap between the top (IT) and bottom (utilities) performing sectors. The IT, communication services, and consumer discretionary sectors were standouts for the quarter and year-to-date. Positive performance paired with stalling earnings growth has raised valuations across most global equity markets. Compared to the start of the year, current valuations have risen to be either expensive (U.S.) or closer to long-term averages (international).

Fed raised rates once during the quarter and made clear that it will maintain a restrictive stance until there is additional progress on inflation or signs of meaningful weakness in the labor market. Chair Powell's most recent comments indicate that "a strong majority of Committee participants expect to raise interest rates two or more times by the end of the year."

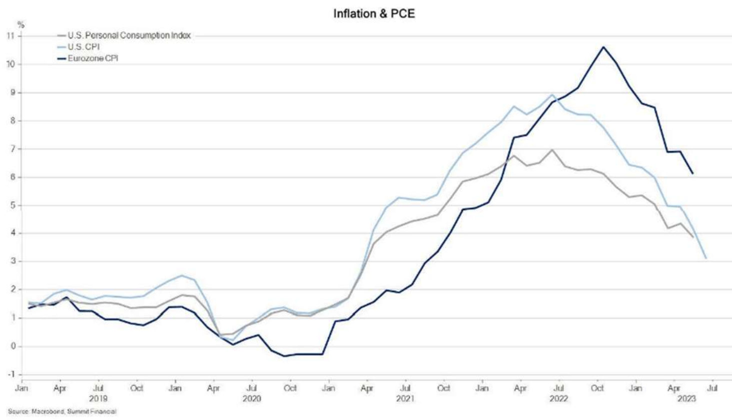
Most fixed income sectors underperformed as intermediate and long-term rates rose during the quarter. Credit spreads across corporate bonds are priced for continuing economic growth, not recession.

During the quarter, Real Assets continued the pattern of mixed performance seen in Q1. Energy drifted moderately lower with West Texas Intermediate (WTI) falling from $72 towards $70, largely trading in a tight range between $66 and $70 while Brent crude fell from $80 towards $75. Gold rose towards a 13-month high, closing near $2,060, but could not hold that level and ended the quarter approximately 3% lower. Public Real Estate markets continued to display very choppy performance in Q2.

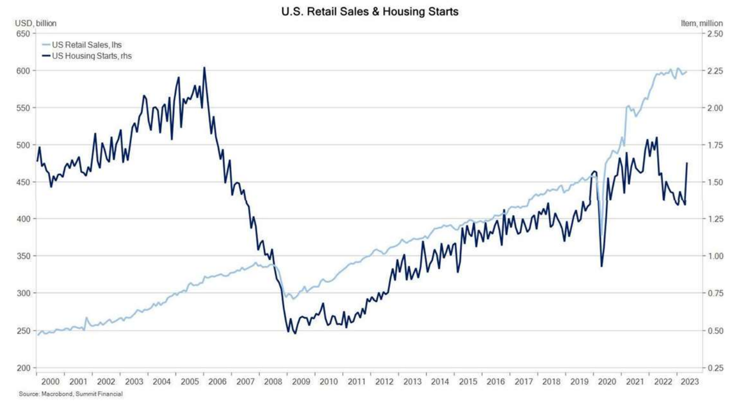
Economic Insights

During the second quarter, U.S. growth estimates, as forecast by Blue Chip Financial Forecasts rose above 1% from an initial estimate near 0%. Real time nowcasts, as measured by GDPNow, suggest the economy may be growing at a rate above 2%. Key indicators such as non-farm payrolls, retail sales, ISM manufacturing, housing starts, and consumer confidence all showed growth or improvement during the quarter. Looking forward, concerns over 'sticky' inflation continue to linger. Core CPI remains above 4.5%, though down from 5.6% at the start of the quarter. Core PCE, the Fed's preferred measure, is currently running at 4.6%. Both are well above the Fed's target level of 2%.

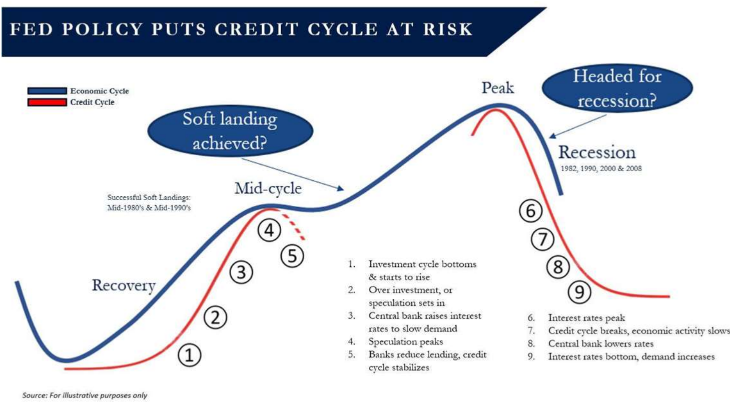
While 'the most anticipated recession' continues to lurk in the background, the lagged effects from monetary tightening may last longer this cycle. Economic growth has been more resistant to Fed rate hikes due, in part, to cash from fiscal stimulus remaining in consumer bank accounts. Additionally, a higher percentage of homeowners have fixed rate mortgages versus 2008 and corporations extended balance sheet duration during 2020/21, eliminating the need to refinance at higher rates. Investment grade corporate borrowing alone exceeded $3 trillion during 2020 and 2021 - all at longer durations.

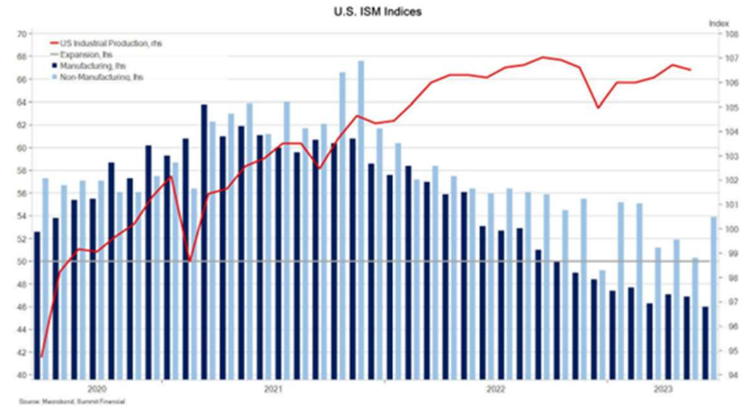


Inflation remains above target levels. With wage gains running near 4%, the Fed may be concerned that consumer expectations around future wage gains may rerate higher to levels above their inflation target, potentially creating an adverse feedback loop. However, a lower CPI reading for June offers evidence that inflation has receded further.



U.S. Retail sales resumed growth during May and June after declining moderately during March and April. Motor vehicle, building materials and food and beverage sales were the main contributors to growth. Housing starts and new home sales moved notably higher in the quarter, though median sale prices declined. Existing home sales moderated slightly but prices increased.





Equity Markets

Equity markets continued their upward trajectory over the second quarter of 2023. While nearly all major global equity markets posted gains, U.S. stocks retook the lead from developed international stocks over the quarter. The recovery in U.S. large-cap stocks has also pushed valuations higher from lower levels at the end of 2022. Positive equity market performance, in conjunction with rising U.S. rates, has compressed the equity risk premium (equity market earnings yield less 10-year treasury yield) to its lowest level since 2000 – a notable headwind going forward. On the contrary, outside of the narrow subset of the U.S. market that has supported recent gains, other portions of the U.S. market and many international markets are trading at reasonable levels. Resiliency from these portions of the market that have largely been left out of the rally could offer additional support in the future if the breadth of the rally were to widen.

Positive performance in stocks so far in 2023 reflects a less dire economic reality than was anticipated. In response to expectations for slow or declining growth, many companies prepared for the worst by reducing cost structures and/or delaying expenditures. Earnings and profits were again the focus of investors where revenue growth, above all, has captivated many over the past several years. Greater cost discipline from management teams and the ability to continue to raise prices has largely protected margin and profit levels.

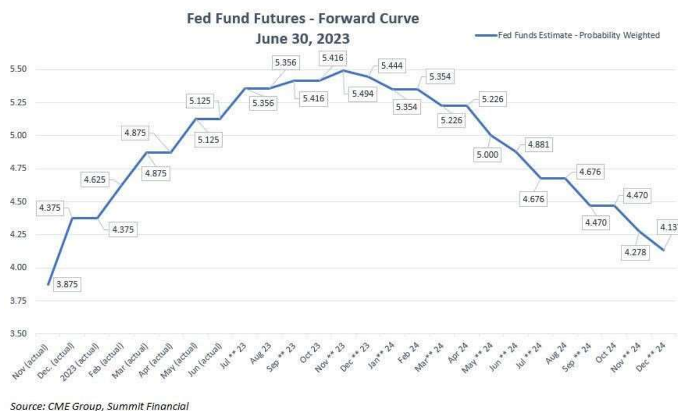
Looking forward, the market's ability to sustain the rally or even hold at current levels come into question. Higher rates, rising interest payments and a resumption of student loans payments- which have been suspended for almost three years - will reduce overall consumer purchasing power. If this translates into firms having a diminished ability to push through inflationary price increases to consumers, margins and earnings could suffer.

Risk premiums have narrowed. Positive performance paired with stalling earnings growth has raised valuations across most global equity markets. Compared to the start of the year, current valuations have risen to be either expensive (U.S.) or closer to long- term averages (international).

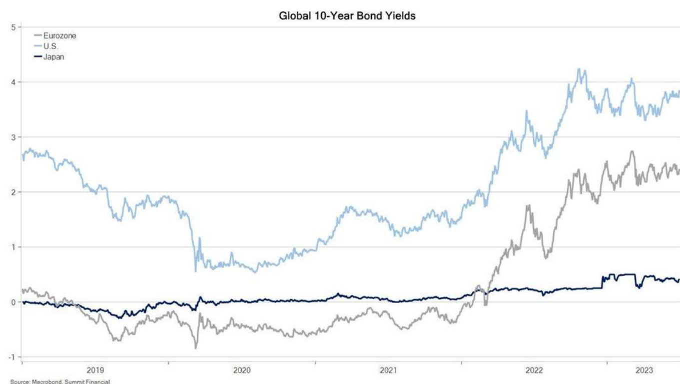
Fixed Income Markets and Alternatives

During the second quarter, the Fed raised rates once and made it clear that it will maintain a restrictive stance until there is additional progress on inflation or signs of meaningful weakness in the labor market. Looking forward, Fed futures are predicting 25 basis point hikes in July and September. Despite concern over the banking failures in the first quarter, Federal Reserve board member Chris Waller was blunt stating that he does not support altering policy "over worries of ineffectual management at a few banks."

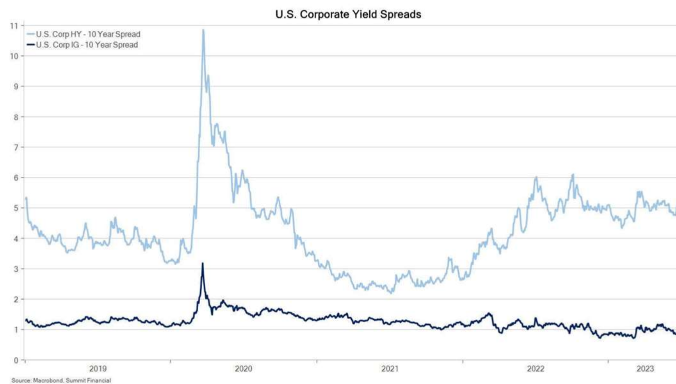
Long rates, as measured by the yield on the U.S. Treasury 10-Year Bond, rose from 3.5% towards 4%. The yield remains negative versus inflation as it is below both headline CPI and core PCE. Nonetheless, the relentless increase in rates is starting to have an impact. The uptick in credit costs has caused defaults to rise across bond and leverage loan portfolios, as well as consumer credit card obligations. It is also driving an increase in corporate (smaller firms) bankruptcy filings. Recent research from Apollo suggests that "the lagged effects of Fed hikes will continue to drag down growth" over the next year, with the steepest impact likely during Q2 and Q3 of 2024.



Futures markets see a greater than 90% probability that rates are above 5% in December 2023, and a greater than 50% probability that rates remain above 4.5% through summer 2024. Regardless, the Fed will have to see material progress towards lower inflation before it can shift towards a less restrictive stance.



While U.S. long bond yields ticked higher by almost 30 basis points ending the quarter at 3.8%, there was little change in the Euro benchmark 10-year yield as rates oscillated between 2.4% and 2.5%. Japan's remained pinned at less than 50 basis points.

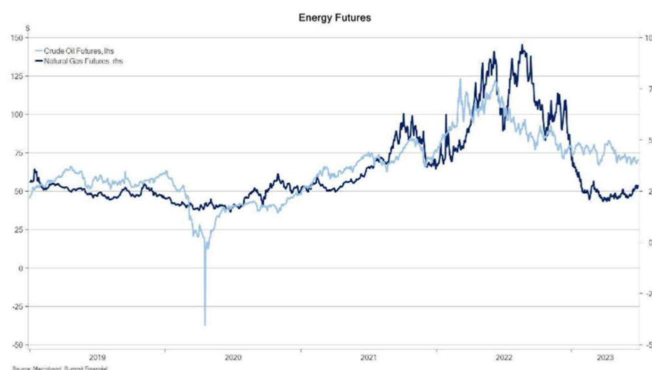


Credit spreads across corporate bonds are priced for continuing economic growth rather than a recession. Investment grade spreads are near cycle lows and interest coverage ratios, as measured by EBITDA/Interest expense, at 8x are near all-time highs dating back to 2000. High yield spreads are toward the higher end of the cycle range and interest coverage ratios are close to 4x, comparable to the 2010 period. Bond volatility has moderated compared to last cycle's peaks but remains high versus historic levels.

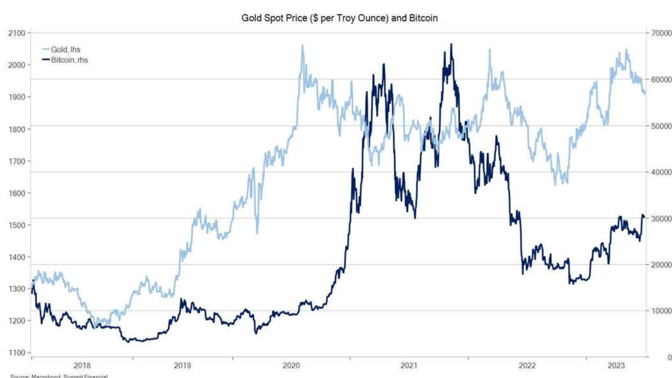
Real Assets continued the pattern of mixed performance seen in Q1. Energy futures drifted moderately lower. A late quarter pledge by Saudi Arabia to unilaterally cut output by 1 million barrels a day, approximately 10% of its production, may begin to impact markets as we enter the back half of the year. Analysts estimate that Saudi Arabia requires prices near $80 a barrel to balance its budget and fund upcoming building projects. An expected strong rebound in Chinese oil demand has been slow to materialize. Looking forward, the EIA - Energy Information Administration – raised its price forecast for Brent crude by $1 to $79 for the second half of the year and by $9 to $84 for 2024.

Gold rose towards a 13-month high, closing near $2,060, but could not hold that level and ended the quarter approximately 3% lower. Since early 2021 when inflation levels began to rise dramatically, gold - which is normally a good hedge for inflation - has not outperformed U.S. equities. Though it has significantly outperformed bonds. If inflation continues to decline and the Fed remains restrictive, gold prices may face further downward pressure. Alternatively, geopolitical tensions and a falling USD may provide ongoing support for the precious metal. Investors are also regaining interest in crypto currencies, likely at the expense of gold. Bitcoin, after a very strong Q1, continued to rise during Q2.

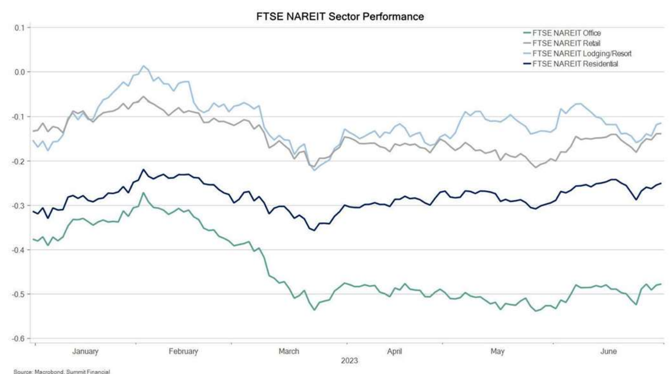
Public Real Estate markets continued to display choppy performance in Q2 with a large dispersion between sectors year to date. Data centers led, followed by Industrial, and Self-Storage. Office and Shopping Centers/Malls have remained notable laggards.



Natural gas rose 27% towards $2.50 during the quarter but continues to trade towards the low end of its historic price range which averaged $3.35 over the past 20 years and $4.60 over the last 10 years. Looking forward to Q3, energy prices will likely return to the fore as markets consider stockpiling and potential supply issues related to increasing winter demand.



Gold may gain a steady bid from countries and central banks looking to diversify away from the USD. Bitcoin remains far off from its 2021 high but has clearly regained a strong bid gaining over 80% YTD, although it has retained extreme levels of volatility.



Public REITs have experienced significant dispersion in returns through Q2. Year to date, Industrials and Data Centers lead performance while Office, Regional Malls, Shopping Centers and Manufactured Housing lag.

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