Beacon Trust
INNOVATING WEALTH STRATEGY

Market Outlook 2Q 2023 Review July 6, 2023

Second Quarter Summary

The S&P 500 continued its strong rally over the second quarter, rising 8.7%. Combined with its robust performance in the first quarter, the S&P increased 16.8% for the first half of the year, its best performance since 2019. By some measures, the S&P 500 has started a new bull market since it has increased more than 20% since its September 2022 lows. However, we are not quite ready to put on our rally hats until there is greater clarity on the chance that the U.S. economy slides into a recession in the upcoming months. The rally has been fueled in part by investor enthusiasm for stocks tied to artificial intelligence (AI). FANG stocks led the prior bull market rally, while those leading the current market resurgence have been dubbed the “Magnificent 7” by some analysts. Specifically, the Magnificent 7 stocks refer to Alphabet, Amazon, Apple, Meta, Microsoft, NVIDIA and Tesla. Apple became the first company ever to reach $3 trillion in market capitalization, a figure larger than the entire stock market of some countries. The disparity (~16%) between dividend and non-dividend paying stocks over first half of the year is the largest since 2019. Small caps (+8.1%) have significantly lagged large cap stocks year-to-date but showed signs of life, with the Russell 2000 Index increasing 5.2% in Q2.

The Federal Reserve continued its year plus rate hike campaign despite (temporarily) pausing after its June meeting. Short-term interest rates now stand at 5.25% and are very likely to increase to 5.5% after the Fed’s late July meeting. The Fed remains quite concerned over “sticky” levels of inflation, despite the Consumer Price Index (CPI) trending down to its current level of 4.0%. Rising interest rates across the maturity spectrum have resulted in subdued returns for broader bond market indexes. For example, the benchmark Bloomberg Barclays Aggregate Index fell 0.9% in Q2 and is up a meager 2.2% for the first half of 2023. The regional banking crisis that erupted near the end of Q1 has now largely been relegated to the sidelines, although there remains some concern about the commercial real estate loans on the books of many banks.

Geopolitically, tensions between China and the U.S. continue to percolate. The U.S. has placed curbs on the exports of high-powered computer chips to China that are used in artificial intelligence and many other cutting-edge applications. China, in turn, has placed restrictions on the export of certain rare earth materials that are used in many electronic devices. In an effort to diffuse tensions between the two economic superpowers, Secretary of State Blinken and Treasury Secretary Yellen have made recent visits to China. Russian President Vladimir Putin faced an apparent coup d'état from the leader of its Wagner mercenary force, while he continues to wage war against Ukraine.

Market Outlook

Just as trees don’t grow to the sky, financial markets rarely move straight up. Hence, we think it is unlikely that the S&P 500 will duplicate its stellar first half performance during the second half of the year. Nevertheless, we do not believe in market timing and the U.S. economy has remained remarkably resilient. Rather, as we alluded to in our opening paragraph, we have a more tempered outlook for asset class returns in the short-term period going forward until the Fed is done hiking rates and the path of economic growth is a bit clearer. Historically, a “soft landing,” where the economy slows but avoids recession, occurs roughly a quarter of the time.

Although economic growth over the first half of the year has generally been sluggish (< 2% GDP growth), the services component of the economy remains strong. Pent up demand from the pandemic remains for travel, restaurants, concerts, sporting events, and other social activities. At some point the Fed’s rate hike campaign will take its toll on consumer spending, especially in concert with its quantitative tightening actions, and subdued lending activity by regional banks that grappled with their own problems. The restarting of student loan payments, which have been paused since the early stages of the pandemic, may act as a further drag on GDP.

The Fed's "higher for longer" mantra is largely coming into focus. Futures markets are pricing in another 25-basis point rate increase in July, with the odds skewed towards a final rate hike in the fall. Rate cuts, generally a salve to stock and bond returns, are unlikely to occur until 2024. Despite some volatility, we continue to believe that both short and intermediate terms bonds will act as effective diversifiers to a long-term portfolio. The relatively high yields on bonds today are in marked contrast to the slim yields during market downturns since the Great Recession, providing many investors with peace of mind.

Besides the aforementioned risk of Fed policy pushing the economy into a recession, the other primary risks are geopolitical in nature. President Putin was embarrassed by the Wagner uprising, so the risk of escalation of Russia's war with Ukraine remains nontrivial, as Putin aims to change the media narrative. In parallel to its trade tensions with the U.S., the Chinese economy has weakly rebounded from COVID. The Chinese economy is still grappling with the fallout from drops in sizeable swaths of its real estate market. Furthermore, global manufacturers are diversifying their supply chains away from China both at home and abroad, with India being one of the prime beneficiaries. Lastly, moving on to domestic politics, the U.S. federal debt ceiling was extended yet again. Politicians can only "kick the can down the road" so many times, before eventually facing an unstable fiscal situation. Any sustainable solution is likely to result in higher taxes and/or less federal spending, tactics which may crimp future economic growth.

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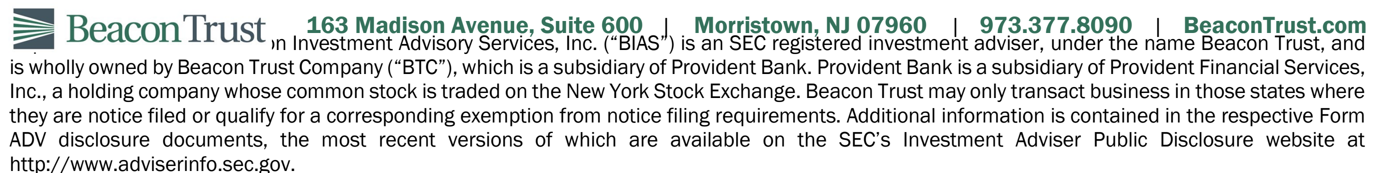

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