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Second Quarter 2023 Investment Commentary

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Market Recap

Global equities continued to rally in the second quarter, led by surging U.S. mega-cap technology and growth stocks, particularly anything related to Artificial Intelligence (AI).

The S&P 500 index gained 6.6% in June and 8.7% in the second quarter, driving its year-to-date return to 16.9% overall. The technology heavy Nasdaq Composite has driven the majority of returns in U.S. stocks, rising over 13% in the second quarter, and 32% year to date.

Outside the U.S., stocks in Europe and emerging-markets have also posted solid results. Developed international stocks (MSCI EAFE Index) rallied 4.6% in June, gaining 3% for the quarter and 11.7% YTD. Emerging markets stocks (MSCI EM Index) rose 3.8% in June, resulting in a 0.9% gain for the second quarter and a 4.9% return YTD.

Moving to the fixed-income markets, core bond returns (Bloomberg U.S. Aggregate Bond Index) were slightly negative for the quarter as interest rates slightly rose/prices fell. The benchmark 10-year Treasury yield ended the second quarter at 3.8%, up from 3.5% at the end of March. Riskier high-yield bonds (ICE BofA U.S. High Yield Index) gained 1.6% for the quarter and are up 5.4% YTD. Municipal bonds (Morningstar National Muni Bond Category) were generally flat on the quarter and up 2.3% YTD. Actively managed flexible/nontraditional bond funds (Morningstar Nontraditional Bond Category) gained around 2% and are up over 5% for the year.

Finally, multialternative strategies (Morningstar Multistrategy Category) and managed futures (SG Trend Index) underperformed stocks but outperformed core bonds for the quarter. Trend-following managed futures had a strong rebound after a tough first quarter, gaining around 8%.

The Narrowest Market in at Least 50 Years

The market-cap-weighted S&P 500 Index's rally this year has been one of the narrowest on record, with less than 28% of the index's constituents beating the overall index return. In an average year around 49% of the index's 500 companies beat the overall index. (The only other year comparable to this year was 1998, as the Tech/Internet stock bubble was inflating.).

More granularly, with the sudden frenzy in all things AI, the average YTD return for Amazon, Google, Meta, Microsoft, NVIDIA, and Tesla is 96%. The gains in these six mega cap tech stocks are responsible for almost the entire S&P 500 return for the year. Moreover, the combined market cap of these six stocks (plus Apple), now comprises over 27% of the total index, the largest concentration in history for the top seven stocks.

It remains to be seen whether this extremely narrow market rally resolves via the rest of the market catching up or the mega-cap tech stocks referenced above "catching down," but improved market breadth would be a plus. On a positive note, it appears the rally is potentially broadening; the small-cap Russell 2000 index shot up 8. 1% in June, while the large-cap Russell 1000 value index climbed by 6%.

Investment Outlook and Portfolio Positioning

Macroeconomic data remains mixed. On the one hand, the U.S. economy has been more resilient than most expected through the first half of the year, with the labor market remaining strong, supporting consumer spending; and headline inflation dropping meaningfully, thanks to a sharp decline in energy prices. On the other hand, key leading indicators of an impending recession are still flashing red, including a deeply inverted yield curve and tightening credit conditions, among others. Moreover, core inflation (excluding food and energy) remains stubbornly high, with the Fed signaling it will resume rate hikes later this year, further raising the likelihood of a recession.

We maintain our view that a recession is the most likely outcome over the next few quarters, however, a near-term recession is not a certainty. Each cycle is somewhat different and this one is considerably so due to the pandemic dislocations, and there have been three instances (out of 13) where the Fed tightening cycle ended without a recession.

Just as the U.S. economy has been more resilient than expected in the face of aggressive Fed tightening this year, the U.S. stock market (S&P 500) has been as well -- and then some -- gaining nearly 17%. The key drivers of this year's strength include the fact that the economy and corporate earnings have held up better than many expected, optimism that the Fed will soon end it's tightening cycle, and most importantly, investor euphoria around Artificial Intelligence.

Specific to the last point, while it is likely Ai will have a huge impact on society and the global economy, that doesn't necessarily mean these companies' underlying earnings fundamentals are justified. It may be in some cases, but we remember the tech/internet stock bubble in 1998-2000. The internet obviously has had huge economic impact over the past 25 years, but very few tech stocks were priced appropriately in early 2000 and even successful tech giants like Cisco are still below their tech-bubble highs of more than two decades ago.

Closing Thoughts

While we believe a recessionary bear market is the most likely outcome over the next 12-months, as we extend our time horizon over the next five to 10 years, we see reason for optimism. Within the U.S. stock market there are companies and sectors that are reasonably priced and offer attractive return potential. The fixed-income landscape is also attractive, thanks to higher yields and inefficiencies that can be exploited by skilled active managers.

We also see strong total return potential from international and emerging market stock markets, which have been out of favor and underperforming for more than a decade. These markets are not "priced for perfection" as the U.S. market seems to be. Instead they seem more susceptible to "upside surprise" – better-than-expected earnings growth and valuation expansion. While foreign markets will get hurt in a near-term recession, we don't want to try to time getting out and getting back in given their attractive five-year return outlook.

Successful investing requires a balance between offense and defense. Earning superior long-term returns does require one to take calculated risks when opportunities present themselves, but to also exercise caution during periods of market exuberance. By maintaining a disciplined and balanced investment approach, we are well-positioned to weather the inevitable market storms and capitalize on the opportunities that are also sure to arise.

As always, we thank you for your trust and welcome questions you may have.

Best regards,

iM Global Partner Research Team

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