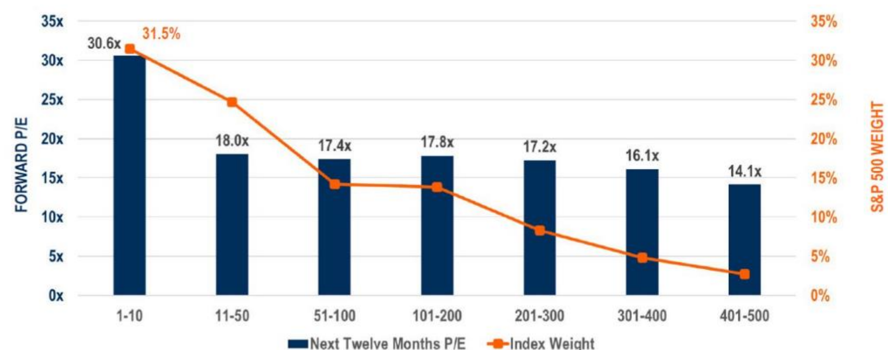
ICR® 2nd Quarter Newsletter – July 2023

Markets continued to rally in the second quarter with the S&P 500 notching an 8.3% gain. The gains in the market during the first half of the year haven't been widespread, however. A look at sector performance reveals technology easily leading the way this year with a 43% return while four sectors (energy, financials, health care, and utilities) are actually negative. So far, the difference between growth stocks (+28%) and value stocks (+4%) this year is a complete reversal from last year when value outperformed growth by about 20 percentage points.

It wasn't technology in general that pushed the market higher. According to Bank of America, almost three-quarters of the market's gain can be attributed to just seven large companies with extremely high valuations. As seen in the graphic to the left, the forward price/earnings ratio (a measure of valuation) for the top ten stocks in the S&P 500 is almost twice that of the rest of the constituents of the index. We saw a similar market environment in 2020 and 2021 before technology stocks faced sharp losses in 2022 with the tech-heavy Nasdaq losing 33%. Whether that same pattern holds again following this recent tech rally will depend on several factors, including whether the economy goes into recession and how long the artificial intelligence (AI) hype continues.

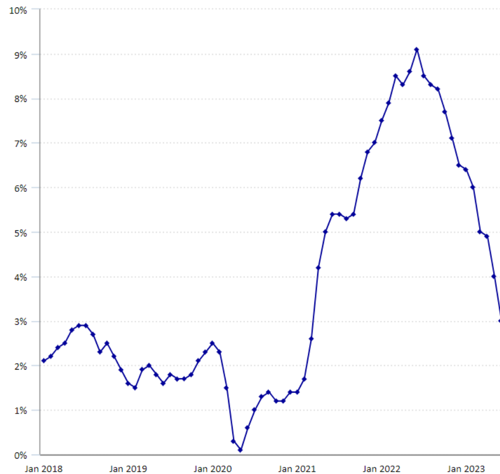


Source: Capital IQ. Data as of 6/30/23. Estimates are based on the next four quarters earnings per share.

As the enthusiasm over AI has grown, investors have poured money into companies with a footprint in that space to the detriment of almost anything not AI-related. Small cap value stocks (as measured by the Russell 2000 Value Index), for example, have only managed a 1.3% return so far this year. While AI technology is undoubtedly revolutionary and exciting, it's important to remember that it will be an extremely competitive space. There are lessons to be learned from the late-90s when investors bought anything internet-related and again over the last few years as cryptocurrency has been the rage. To be sure, there will be winners, just as there were with internet stocks and – though still early – some crypto-related companies.

With a low weighting to technology, foreign stocks (as measured by the MSCI EAFE Index for developed countries) also lagged in the second quarter, returning just 1.9%. Emerging markets stocks performed even worse, losing a fraction of a percent during the quarter.

Interest rates rose during the second quarter with the ten-year Treasury yield going from 3.47% to 3.84%, causing losses in interest rate sensitive fixed income securities. Short-term rates rose even more sharply and a three-month Treasury bill is now yielding 5.4% as of this writing. This inversion (where the three-month yield is higher than the ten-year yield) occurred in October of last year and the spread has only widened since. While this type of inversion has historically been a relatively reliable leading indicator of a recession, the timing is variable.



Source: U.S. Bureau of Labor Statistics

The direction of interest rates from here will likely hinge on what happens with inflation in the coming months. As seen in the chart on the left, the year-over-year inflation numbers have moved substantially lower from their peak a year ago, with the most recent reading at 3%. If that trend continues, the Federal Reserve may feel comfortable with ending their rate-raising campaign. However, the Fed has made it clear that their intention is to get inflation back down to their 2% target, so it should come as no surprise if they keep going until that mission is accomplished. The risk, of course, if that they raise rates too much and push the economy into recession. While the labor market is still not showing any signs of recession, bank lending standards have tightened recently and the ISM index (which measures manufacturing activity) has continued to decline.

This year's narrow market rally into a possible recession should give investors pause. While the odds of a severe recession seem to be fading, the market appears to be pricing in a no-recession scenario. That's certainly a possible outcome, but the risk of at least a modest economic slowdown still exists and, if that happens, it's likely to cause problems for stocks that are priced for perfection. The good news for investors is that high short-term interest rates have made it easier to wait for more attractive opportunities. When the Fed had interest rates at zero, it was painful to hold any cash, but with money markets currently earning over 4.5%, investors can actually be rewarded for their patience.

Throughout any type of changing market, it is important for investors to stay disciplined and remain committed to their investment plan. While it's tempting to try to follow the herd or time the market, we believe the best approach is to ignore the noise, focus on the plan, and take advantage of opportunities when they arise. As always, thank you for allowing us to help you achieve your financial goals and please reach out if you have any thoughts, questions, or concerns.

Sincerely,

James A. Heine

James L. Cobb

Market Report (as of 6/30/23)

Index	**2023 YTD (%)**	**3-Year Annualized (%)**	**5-Year Annualized (%)**
S&P 500	15.9	12.8	10.4
Dow Jones Industrial Average	3.8	10.1	7.2
U.S. Aggregate Bond Index	2.1	-4.0	0.8
MSCI EAFE (Foreign Index)	9.7	6.2	1.7

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