PENOBSCOT
FINANCIAL ADVISORS

MARKET COMMENTARY

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MARKET REVIEW

Markets had plenty to fret about during the second quarter. Inflation remained high and the Fed Chair continued to deliver rhetoric that left no doubt it would have no problems in continuing its campaign to soften the economy with continued rate hikes. During the quarter, in fact, the FOMC raised its benchmark Fed Funds rate twice. Market volatility centered largely upon concerns about the debt ceiling, which was surpassed earlier in the year, with the risk of bringing the global economy knees mere days of a historically unprecedented US debt default.

Despite all of this, Wall Street proved resilient during the quarter. The economy remained relatively strong, despite predictions that it may be headed toward a recession. Gains in the markets weren't broad, with technology, communication services, and consumer discretionary sectors accounting for most of the market upside. Energy, utilities, health care, financials, and consumer staples slid lower. The market's positive performance during the second quarter was buoyed by strength in the bond market, waning inflation, and a better-than-expected first-quarter gross domestic product. With this as the backdrop, the Nasdaq enjoyed its third-best first half on record, a far cry from last year at this time, when the tech-heavy index was going through its second-worst six-month stretch. Bond yields rose in the second quarter and crude oil notched its fourth consecutive quarterly decline. China's emergence from the pandemic was slower than expected, in terms of demand and manufacturing.

April began the quarter with stocks posting modest gains from the previous month. While the large caps of the Dow and the S&P 500 rose slightly, the smaller companies that make up the Russell 2000 fell 1.9%. Communication services fared best among the major industry groups, while industrials underperformed. April also showed some signs of economic weakening, with job growth coming in well below the monthly average for the year. The number of workers receiving unemployment insurance reached its highest level since November 2021. Existing home sales dropped, while the median existing-homes sales price was 0.9% less than a year ago. Financials took a hit after another bank fell into Federal Deposit Insurance Corporation receivership. First-quarter corporate earnings were somewhat better than expected, and the Consumer Price Index inched up only 0.1%, bringing the year-over-year increase to 5.0%, the lowest annual pace since May 2021.

In May, with markets focusing on the debt ceiling negotiations between President Biden and Speaker McCarthy, stocks were mixed. The tech-heavy NASDAQ index climbed 6.0%, while the Dow lost 3.5%. The S&P 500 inched up 0.3%, but the small caps of the Russell 2000 fell 1.1%. Strong corporate earnings reports continued, and inflation remained elevated.

June brought on a more broad-based equity rally, with more companies participating in the gains. Inflationary pressures showed signs of cooling, with the Consumer Price Index rising 4.0% for the year, the smallest 12-month increase since the comparable period ended March 2021. The Federal Reserve elected not to increase interest rates in June, marking more of a 'skip' in rate increases than a 'pause'. Bank stress tests went well, and the labor market picked up steam, adding nearly 340,000 new jobs, in line with the average monthly gain over the past 12 months.

LOOKING FORWARD

We kick off the second half of 2023 with similar forces in focus. Inflation continues to dominate the attention of the Federal Open Market Committee. Fed Chair Powell and nearly all the remaining Fed governors continue to lay out expectations that the June pause in rate increases will be just that: A pause, and not the beginning of a reversal in monetary policy. The Fed has repeatedly acknowledged that this campaign of increasing rates will tighten the monetary supply and will cause pain in the economy. Does this 'pain' mean we're headed for a recession?

A major characteristic of the first half of 2023 was that the market gains were limited to a very small number of stocks. This has been a source of frustration for investors who see market-weighted indexes like the S&P 500 delivering performance that significantly exceeds the returns of the average stock. Will this result in a reversal of fortune for those few high-flying stocks, or will the rest of the market catch up?

Lastly, has the big run-up in tech stocks during the first part of the year created a bubble akin to the late 90's, just ahead of the dot-com crash, or is this something different? If stocks are expensive now, where can we find value?

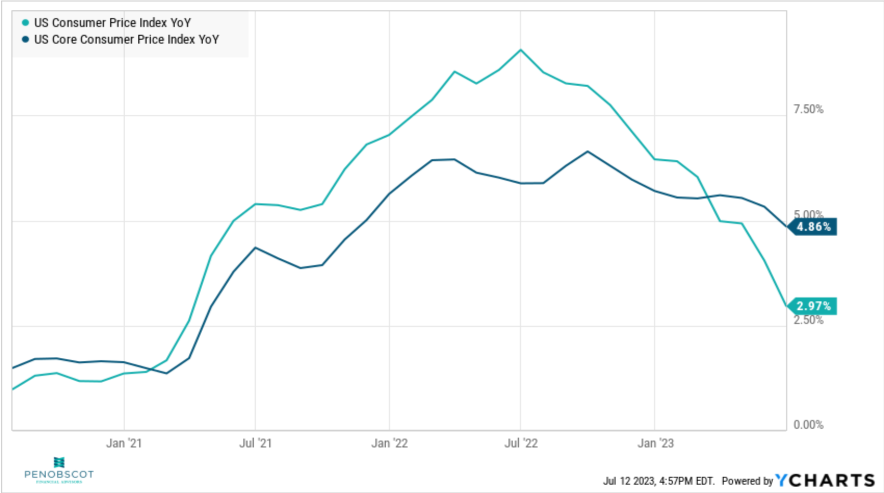
'TARGET INFLATION': When will we get there?

The Fed has maintained a 'target' rate of inflation for approximately 15 years. That target is 2%. Interestingly, that target, while having remained above the low level of inflation in the period since the 2008 Global Financial Crisis, is lower than the longer-term average of 3.28%.

While Consumer Price Index data are showing a significant retracement of the 2021-2022 increase in inflation, it's worthy of noting that when we remove some of the more volatile food and energy sectors and focus more on the remaining 'core' CPI, the return to lower rates isn't happening quite as quickly. That's not unexpected. Indeed, Core CPI went up more slowly and didn't peak at nearly as high a level as the 'Headline' CPI. It's reasonable to expect that the Fed will not declare 'mission accomplished' any time soon.

In fact, investors remain skeptical about the Fed's ability to even get to the 2% inflation target in the foreseeable future. While the shorter-term expectations have come in significantly since early 2022, median expectations for inflation rates three years in the future remain solidly above the Fed's target.

Looking at the remainder of 2023, investor focus could certainly turn to pricing risk assets for a future where inflation and interest rates may be higher than those of the past two decades.



'BAD BREADTH': Will the 'normal' stock join the party?

The S&P 500 index, more frequently looked at as a proxy for the US stock market, is 'market-cap-weighted'. That means that larger companies will have a bigger impact on the index when their prices move than will smaller components of the index.

Looking back on 2022 and the first half of 2023, this dynamic is stunning. Both the 2022 declines and, even more significantly, the 2023 run-up in the S&P 500 index were driven more than any time in recent memory by only the largest 10 stocks in the 500-stock index.

Amazingly, for a significant part of the first half of 2023, ALL the gains were attributable to just seven companies. 72% of return, year-to-date, in the S&P 500 has been contributed by these seven names.

This leaves investors looking out toward the second half of 2023 with a bit of a conundrum: Is there a trend that needs to be exploited? Is all the growth potential locked into just this handful of stocks while the rest of the investable stock universe provides little opportunity for providing returns? We obviously take a dubious view of such a position. Historically, significant runs on a small part of the market have remedied themselves, either by virtue of the bubble bursting on the high-fliers (as in 2000 – 2001) or as a result of the remaining market rising to join the high-fliers (as in 2004 – 2005).

One area we can look to for support for this thesis is overseas. Multi-trillion-dollar behemoths riding a wave of AI-induced frenzy seems to be a U.S. thing.

Elsewhere, value stocks – those that often pay more reliable dividends and hold firm positions in long-established industries – have been outperforming.

Value stocks have outperformed growth stocks by 4.1% since 1927, according to a study by Dimensional Fund Advisors. While macro trends can change over time, we see plenty of examples of where temporary runs in a small part of the market are supplanted by a reversion to the mean, and are sticking to our strategy of maintaining exposure to companies with reasonable valuations and convincing cases for sustainable earnings.

IMPROVING SENTIMENT: Can we really achieve a 'soft landing'?

A steady trend is beginning to emerge where analysts are pulling back from their assertions that a recession is inevitable and that the storied 'soft landing' where any damage to the economy as the result of Fed tightening would be minimal, was going to be difficult to achieve.

While the consensus remains that we should expect a slowdown in the upcoming year, the severity of such a slowdown is generally seen as lessening. More analysts at the beginning of this upcoming quarter than at the onset of the 2nd quarter are projecting an outcome where the US escapes a recession entirely. Earnings results have been beating expectations, although expectations have been set extremely low. The expectations are improving.

With all this considered, sentiment is increasing. That's not always a good indicator of near-term performance on markets, but it can explain to some degree the fact that we've seen increased valuations, both on an absolute level and relative to earnings.

BUBBLE OR BOLD NEW ERA?

Whether or not the US Market is over-valued is open to justifiable debate. We closed the 2nd quarter with earnings-relative prices slightly higher than average. In a low interest environment, this would be reasonable, but we aren't in such an environment any longer. Always a forward-looking instrument, the markets could very well be repricing for a 'soft landing' – or they could be anticipating lower interest rates in the foreseeable future, improving capital costs for companies and lessening the discount factor for future earnings. The problem: It's unlikely both of those will occur. In the case of a soft landing, the Fed will likely keep rates higher longer, given the cover of a job market with plenty of slack. In the case of interest rates dropping, that would likely be the result of a HARD landing, which many would argue isn't priced in to markets right now. What does seem clear is that there is a very significant gap between valuations in emerging markets relative to developed markets. Historically, this large of a dispersion between the two doesn't last. Either because developed markets lose some of their price advantage or because emerging markets catch up, there could be good opportunities in the latter to reap the knock-on benefits of the same forces driving US mega-caps higher.