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WEALTH MANAGEMENT, LLC

Quarterly Market Review and Outlook

Q2 2023 Market Re-Cap

The U.S. stock market continued a rebound during the 2nd Quarter. The S&P 500 was up 10% during the 2nd Quarter.ⁱ More on this later, but the market increase has been very shallow and can almost completely be attributed to several technology stocks. Large International stocks in developed countries were also upⁱⁱ, while Emerging Markets posted a positive return of 4% over the previous 3 months.ⁱⁱⁱ

The U.S. bond market was flat over the 2nd Quarter, but remains up nicely for the year.^{iv} Cash is continuing to pay rates at or near a 5% annualized rate.

On the surface it appears that all is well, and a market recovery is underway...

Q3 2023 Outlook & Beyond

Economic Situation

The economic environment in the U.S. is one of confusion. There is plenty of data to suggest that the U.S. is headed towards a recession while at the same time other data points show that the U.S. is on solid footing. We would continue to argue that a significant reason for the conflict is the unprecedented influx of liquidity during the aftermath of COVID—as we have said previously, M2 money supply increased over 40% in the first two years of the crisis.

First, the good news...

The most frequently referenced measure of U.S. economic growth is GDP. 1st Quarter GDP increased at an annual rate of 2.0%^v The Atlanta Fed's GDPNow model estimates 2nd Quarter GDP growth is 1.8% annualized.^{vi} There is growth, but the growth is low, slowing, and concentrated. This leaves little margin for error before causing economic activity to contract.

Another statistic that is often quoted as a measurement of economic health is unemployment. Currently, unemployment rates continue to hover around historic lows.^{vii} This would suggest that consumers have jobs and, therefore, income to support economic activity.

However, if we dig a bit deeper, we find some alarming trends...

First, the 1st Quarter GDP growth was highly concentrated in services (+2.6%) and government spending (+2.7%).^{viii} While good-producing industries declined by 0.7%.^{ix} Our interpretation of this trend is that consumers are aggressively spending money on services that they could not during COVID (i.e., travel, restaurants, etc.). And government spending, for the time being, continues to grow (big surprise, right?). Other than those two categories, growth looks sparse at best.

Further, we would suggest that eventually consumers will likely feel that they have caught up with activities missed during COVID and that consumer spending will slow. There is also growing levels of consumer debt^x and falling M2 money supply^{xi}. That leads us to believe that eventually demand spending will slow.

Finally, as part of the Debt Ceiling agreement, non-defense discretionary spending will be capped in 2024.^{xii} Certainly, government expenditures will remain enormous. However, decelerated increases could cause some short-term economic drag.

Unfortunately, our base case still calls for a recession in the U.S. economy. The combination of high interest rates and declining M2 supply should grind inflation, and GDP growth, to a halt. The question is when?

Interest Rates & the Federal Reserve

For those that have read our newsletters for a while, you know that we discuss interest rates and the Federal Reserve frequently. The reason behind this is that the Federal Reserve Board, and by extension their control of interest rates, has perhaps the largest impact on the economy than any other factor. It is important to remember that their impact is not always immediately felt. Think of it like trying to turn an aircraft carrier 180 degrees!

One of the topics of interest rates that we frequently discuss is the relationship between short-term rates and long-term rates. An “inverted yield curve” is where short term rates are higher than long term rates—specifically, 3-month and 10-year Treasury rates. In the nine recessions since 1955, eight have been preceded by a persistently inverted yield curve. Currently, 3-month Treasury rates are at 5.2%—the 10-year rate is 3.85%! This spread is higher than any point since 1981 and the curve has been inverted since last November.^{xiii}

The Federal Reserve finds itself in a difficult position. Yes, inflation is coming down, but inflation remains more than double that of the Federal Reserve’s stated inflation target.^{xiv} Additionally, the Federal Reserve is sending very mixed signals. They did not raise rates at their June meeting.^{xv} However, they continue to signal that they could raise rates two more times in 2023.^{xvi}

Our take is that if inflation stays well above their 2% target and unemployment does not dramatically increase, then the Federal Reserve will keep rates higher for longer.

Stock Market Depth

As we mentioned in the beginning, the S&P500 index seems to have done well this year. However, just like with economic data, once we dig deep, the case that “the stock market is doing well” falls apart very quickly. Almost all the year-to-date gains in the S&P500 are attributable to just seven stocks—all but one are technology names. Specifically, we are in the middle of an “artificial intelligence” craze. If we exclude AI-linked stocks, then the S&P 500 is essentially flat for the year.^{xvii}

Further, the Dow Jones Industrial Average, which is not a weighted index and more value oriented, is only up 3% for the year.^{xviii}

Market breadth, or lack thereof, is a sign of market health and sustainability. Based on the recent stock market action, we view the “rally” in a negative light.

To feel comfortable taking on the risk of stocks, we need to feel confident that the return potential far exceeds the return potential of low-risk assets—cash currently returns 5%. Our partners at First Trust run calculations using a similar methodology, “using a 10-year Treasury yield of 3.8% to discount profits suggests the S&P 500 index is fairly valued at about 3,500...”^{xix} Currently, the S&P 500 sits around 4,400. By this methodology it is 25% overvalued.

Lack of breadth, relatively expensive valuations, higher interest rates, a slowing economy headed to recession, and “risk-free or low risk” high yield alternatives doesn’t make us want to chase the “AI” based stock market rally. We remain under allocated to stocks and, to the extent we hold them, are focused on quality companies and dividend payers.

Summary

Nobody has a perfect crystal ball. We think we are headed for recession, but it's possible we won't have one. It may come sooner than we expect, but it may come later. When you put as much money into circulation as we did during COVID, the outcome has a lot of variables. We think all this points to an environment where it's prudent to be under allocated to the stock market. If we are wrong, we will miss a little return. If we are right, we will have an opportunity to buy stocks at cheaper prices than they are today.

We view it as our job to help protect our client's life savings as best we can. We do this without emotion. Rather, we focus on facts and data. We encourage clients to plan and organize their finances and focus on their goals and objectives. It's times like these where this seems more important than ever. Our life's work has been, and will remain, to offer guidance and wisdom in these endeavors.

As always, we thank you for your continued trust and confidence. The relationship we have with you is of vital importance to us.

We hope that you and your family have a wonderful and relaxing summer!

ⁱ <https://www.morningstar.com/etfs/arcx/spy/performance>

ⁱⁱ <https://www.morningstar.com/etfs/xnas/acwx/performance>

ⁱⁱⁱ <https://www.morningstar.com/etfs/arcx/eem/performance>

^{iv} <https://www.morningstar.com/etfs/arcx/agg/performance>

^v <https://www.bea.gov/news/2023/gross-domestic-product-third-estimate-corporate-profits-revised-estimate-and-gdp-industry>

^{vi} <https://www.atlantafed.org/cqer/research/gdpnow.aspx>

^{vii} <https://www.bls.gov/charts/employment-situation/civilian-unemployment-rate.htm>

^{viii} <https://www.bea.gov/news/2023/gross-domestic-product-third-estimate-corporate-profits-revised-estimate-and-gdp-industry>

^{ix} Ibid.

^x <https://www.federalreserve.gov/Releases/g19/current/>

^{xi} <https://fred.stlouisfed.org/series/M2SL>

^{xii} <https://www.reuters.com/markets/us/whats-debt-ceiling-deal-biden-mccarthy-are-negotiating-2023-05-26/>

^{xiii} chrome-extension://efaidnbmnnnibpcajpcglclefindmkaj/https://www.newyorkfed.org/medialibrary/media/research/capital_markets/Prob_Rec.pdf

^{xiv} <https://www.federalreserve.gov/newsevents/pressreleases/monetary20230614a.htm>

^{xv} Ibid.

^{xvi} <chrome-extension://efaidnbmnnnibpcajpcglclefindmkaj/https://www.federalreserve.gov/monetarypolicy/files/fomcproptabl20230614.pdf>

^{xvii} <https://twitter.com/rowancheung/status/1660539113844473858/photo/1>

^{xviii} <https://www.morningstar.com/etfs/arcx/dia/performance>

^{xix} Wesbury, Brian S. & Stein, Robert. "Monday Morning Outlook: Discount the Happy Talk". First Trust. May 30, 2023.