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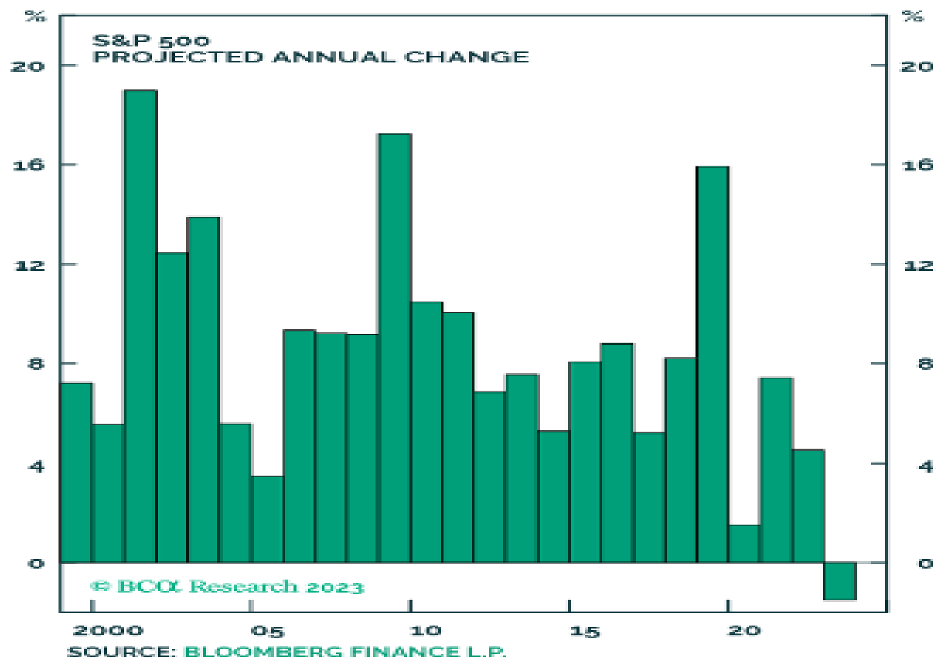
COMMENTARY | Q2 2023
July 2023

OUR VIEW

Falling inflation and resilient corporate earnings supported global equity returns during the first half of the year.

Mid-Year Review and Outlook

During the first half of the year, equity markets shrugged off persistent recession fears, the failure of several large regional banks, a debt ceiling battle, and the continuation of the most aggressive rate hike cycle in 40 years. The global equity rally likely surprised many investors, although this itself is not surprising given how gloomy the mood was to start the year. In fact, as shown below, 2023 marked the first time in history in which Wall Street strategists expected equities to decline on the year. Surveys of fund managers and individual investors were also historically downbeat. The combination of poor sentiment and more attractive valuations didn't require enormously positive news to underpin markets, just incrementally better news.



Some of this better news appeared on the inflation front. To the extent markets were buffeted by rising and persistent inflation for most of 2022, they have responded to falling inflation in a similar, albeit opposite, manner in 2023. In fact, one can pinpoint the market bottom last October to the peak of the year-over-year increase in the Core Consumer Price Index (CPI).

Forward-looking indicators for each of the three main baskets of inflation – goods, shelter, and services – suggest inflation may continue to decelerate over the coming months. Data from the June S&P U.S. Purchasing Managers Index showed input prices charged by suppliers fell at

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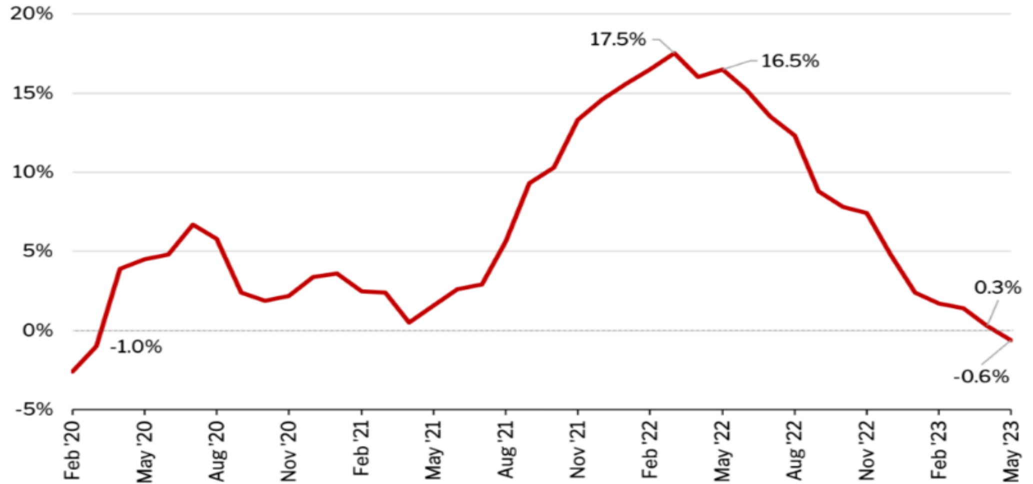
the fastest pace since 2009, while prices charged for goods leaving the factory barely budged. Continued easing of supply chain pressures should also contribute to declines in prices for goods. While price pressures for goods have been declining for close to a year, shelter inflation has been stickier. However, after growing slowly for several months, the median U.S. asking rent fell -0.6% year-over-year in May, the largest annual decline since May 2020.



June's inflation data suggests the disinflationary process is well underway.

Rents normally lead shelter inflation data by several months. Average hourly earnings growth, the primary driver of non-shelter services inflation, has decelerated from nearly 8% to under 5%. Forward-looking indicators such as job openings, the job quits rate, and wage surveys suggest the labor market, while still tight, should soften over the coming months. Used car prices, a key component of Core CPI, just registered their steepest monthly decline since the pandemic.

June's inflation data suggests the disinflationary process is well underway. Both headline and core CPI rose just 0.2% from May to June, bringing the year-over-year rates down to 3.0% and 4.8%. However, the June employment report showed that wages are still sticky. Average hourly earnings growth rose more than expected, keeping another interest rate hike firmly on the table later this month.

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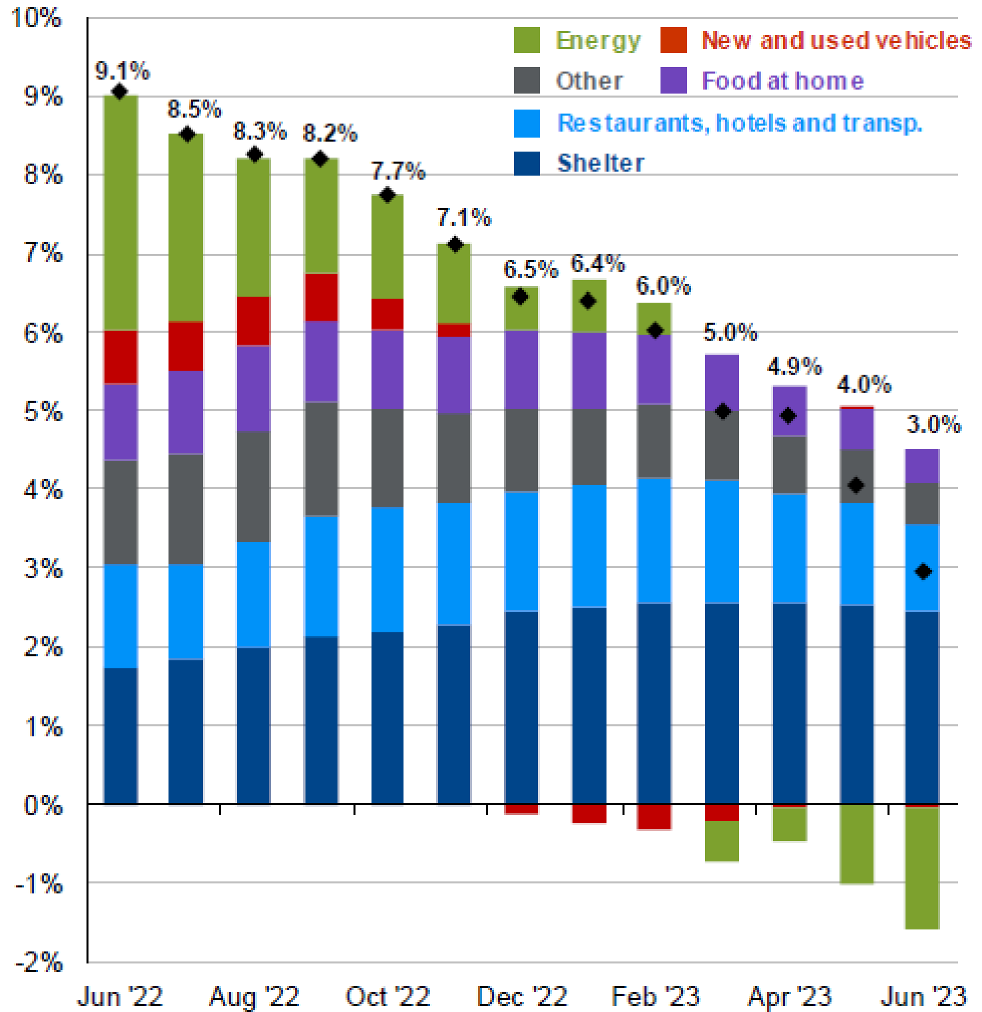
Wage growth has been stickier; the Fed will likely raise rates again this month.



Source: Bureau of Labor Statistics, Factset, JP Morgan Asset Management

Additionally, aggregate U.S. corporate earnings have exceeded expectations. During the first quarter reporting period, 77% of companies in the S&P 500 beat analysts' expectations. Furthermore, after declining year-over-year for three straight quarters, earnings growth may resume in the third quarter. Developed international markets such as the EMU and Japan should also report positive earnings growth that may exceed that of the U.S.

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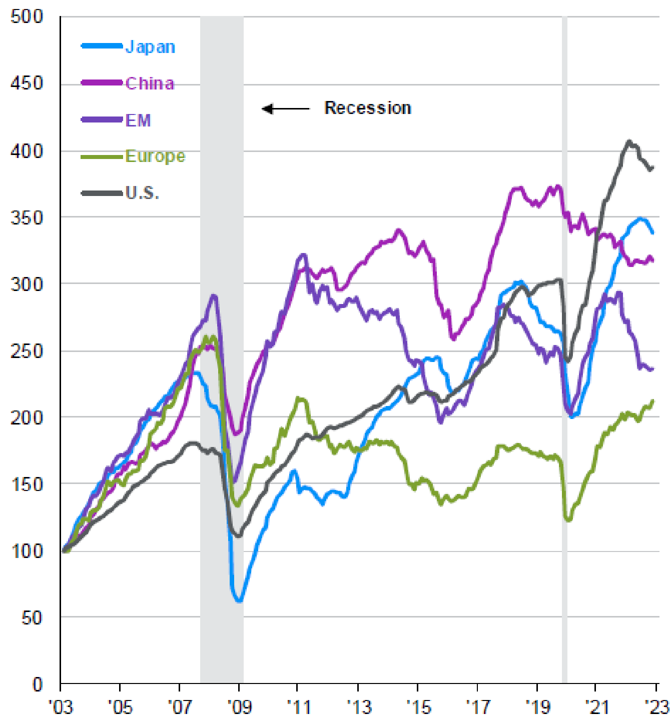
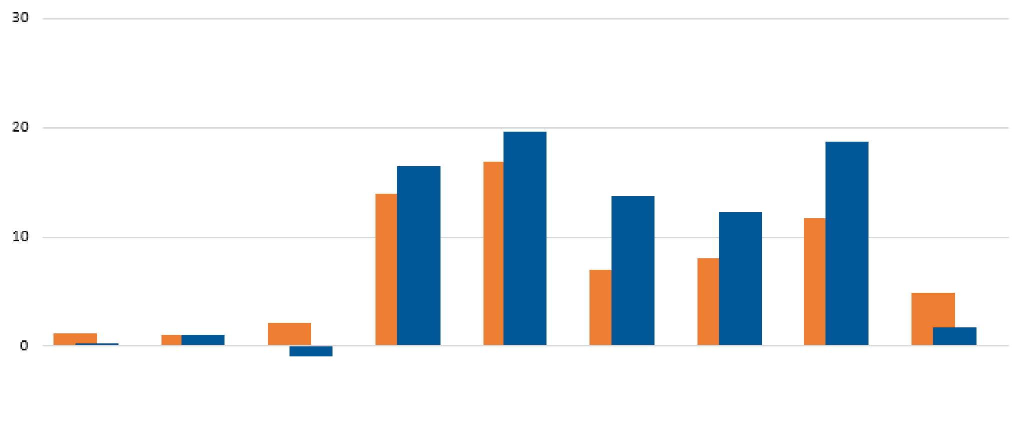
U.S. corporate earnings growth may resume in the third quarter.



Source: JP Morgan Asset Management

Asset Class Performance Review

Year To Date Returns 6/30/2023



	Short Term Bonds	Short Term Muni Bonds	Barclays Agg.	Global Equities	S&P 500	S&P 500 Equal Weight	U.S. Small	Intl. Large Core	Emerging Market Equity
YTD	1.2	1.0	2.1	13.9	16.9	7.0	8.1	11.7	4.9
12M	0.2	1.1	-0.9	16.5	19.6	13.8	12.3	18.8	1.7
Full Cycle*	-0.5	0.1	-2.3	6.9	10.5	9.5	4.9	4.1	-0.6

* Full Cycle is the annualized return from February 12th 2020 peak to present.

Within the U.S. market, returns varied substantially based on company size and style and in many ways reflected a mirror image of 2022. Simply put, the larger and "growthier" the

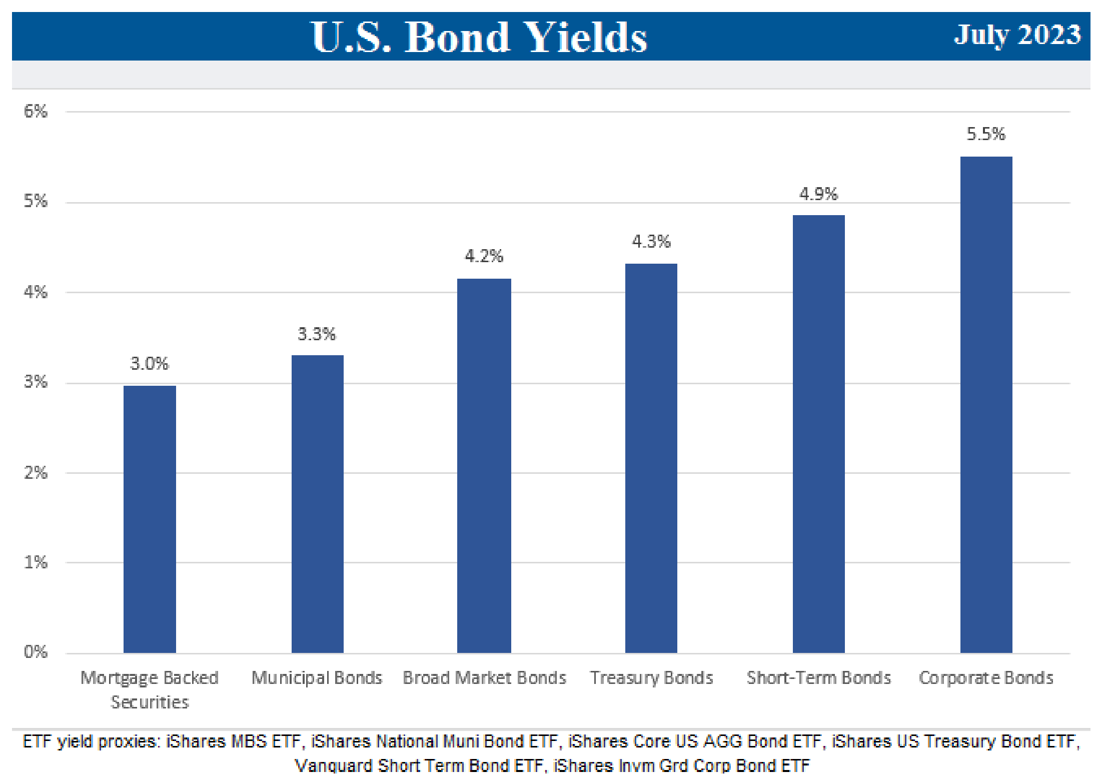
company, the better it likely performed. An index of large company growth stocks returned 29.5% through June 30th, while an index of small company value stocks rose 2.5% - a historic gap!

Not surprisingly, sector returns showed a similar dispersion with the technology and communications services returning nearly 43% and 36% respectively, while returns in financials, health care, energy, and utilities were actually negative. The primary catalysts for this outperformance were the regional bank crises in March and the onset of investor exuberance in AI stocks in May.

Recall the opposite occurred in 2022. Value stocks performed materially better than growth stocks (i.e., fell far less). This volatility reinforces the difficulty of predicting which market cap or style will shine in any given year. To provide perspective, since the March 2020 low, the total returns of large company growth and small company value stocks have not been that far apart (115.7% vs. 111.3%). Our long-term approach is to provide balance and diversification. We invest in large and small companies, growth and value stocks, and across industry sectors, with a strategic tilt towards quality and value.

Yields on high quality bonds are the highest they have been in many years.

During the first half of the year, the yield curve inverted further as yields on 2-year Treasury notes rose from 4.41% to 4.87%, while rates on 10 and 30-year Treasury bonds declined. Corporate bond returns were supported by positive economic growth and resilient corporate earnings. Our strategy of combining high quality shorter duration bonds with active managers who pursue flexible, dynamic strategies has continued to add value within your fixed income allocation. In today's steeply inverted yield curve, short-term bonds provide higher yields with less interest rate risk than longer-maturities. Experienced active managers have been able to uncover pockets of value throughout the fixed income spectrum.



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Our investments in real and diversifying assets should continue to provide valuable diversification benefits.

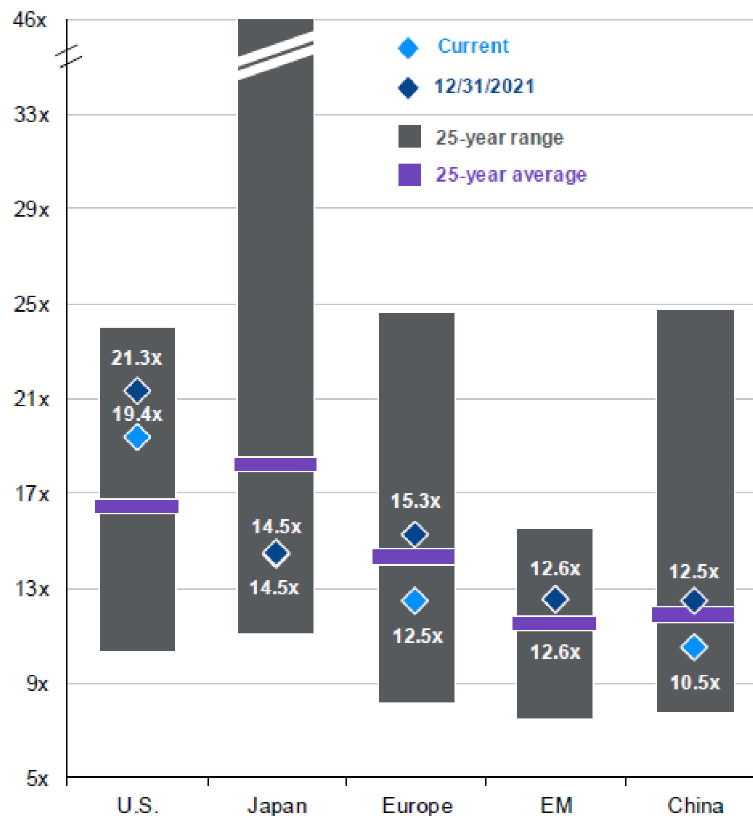
Additionally, we continue to believe that our investments in real and diversifying assets will provide valuable income and diversification benefits in what may be a more volatile second half of the year. Real assets continue to provide inflation protection, while reinsurance returns are benefiting from the most attractive pricing environment in nearly two decades.

Portfolio Positioning and Outlook

In the short term, data points to a mixed economy that may gradually weaken over the coming months. The lagged effects of higher rates and tighter lending standards will likely weigh on capital investment, consumer spending and ultimately employment growth. We believe any downturn will be mild given falling inflation, positive nominal GDP growth, and excess consumer savings which should keep balance sheets healthy as employment softens.

Market breadth should improve during the second half of the year. The U.S. stock market is historically top-heavy. The ten largest stocks in the S&P 500 account for just under a third of the index's market capitalization, a historic high. We would be surprised if this dynamic persisted and expect increased participation from small, mid-sized and value stocks.

We expect U.S. small, mid-cap, and value stocks to continue to catch-up during the second half of the year.



Source: JP Morgan Asset Management

Developed international equities are historically cheap and may benefit from continued weakness in the U.S. dollar.

We are optimistic on the long-term outlook for U.S. and international developed market equities. The latter trade at historically cheap valuations, offer attractive dividend yields, and should benefit if the dollar continues to weaken. However, we have become more cautious

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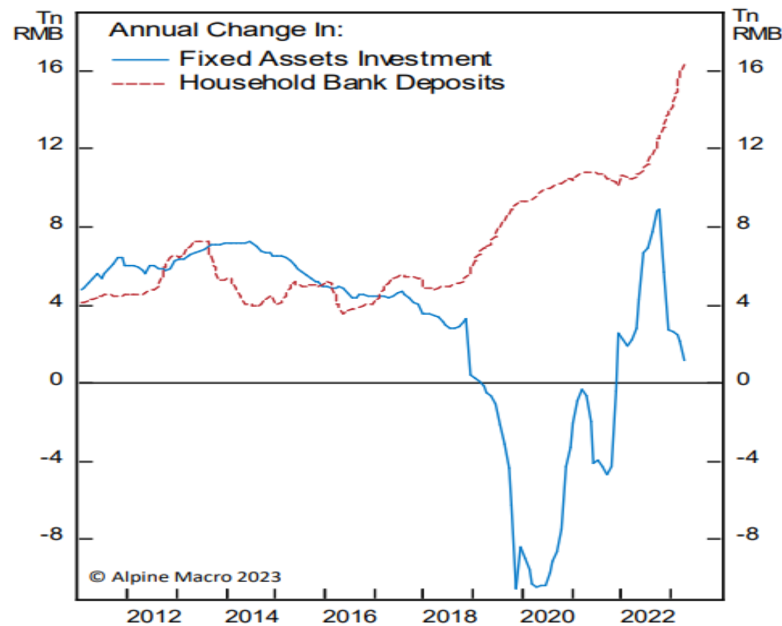
We are more cautious on emerging markets, especially China.

on emerging markets, particularly China. The recovery in China's economy after their reopening has been anemic and is evident of larger, more structural issues related to leverage, excess savings, high youth unemployment, and a lack of consumer trust and confidence. We believe these challenges will persist and aren't easily remedied with large-scale economic stimulus, a measure Chinese leaders have been increasingly reticent to adopt.

The chart below shows sharply higher savings in bank deposits and much lower investment in fixed assets, reflecting anxiety and a lack of confidence of Chinese citizens in the economy and government policy makers.



Thus, during the quarter we liquidated your position in a China-focused equity fund and reinvested the proceeds with an active manager who targets large-cap high quality U.S. companies. We are likely to further reduce your emerging markets allocation during the third quarter with the goal of increasing your exposure to domestic companies that exhibit high profitability, earnings consistency, and low debt levels.

Please contact your TFC Advisor or us directly if you have any questions or would like to discuss your portfolio further. Thank you.

Sincerely,

Renée Kwok, CFP®
President & CEO

Brian Presti, CFA®, Chartered SRI Counselor℠
Chief Investment Officer

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