HIGHTOWER
Westchester

Market Commentary Q2 2023

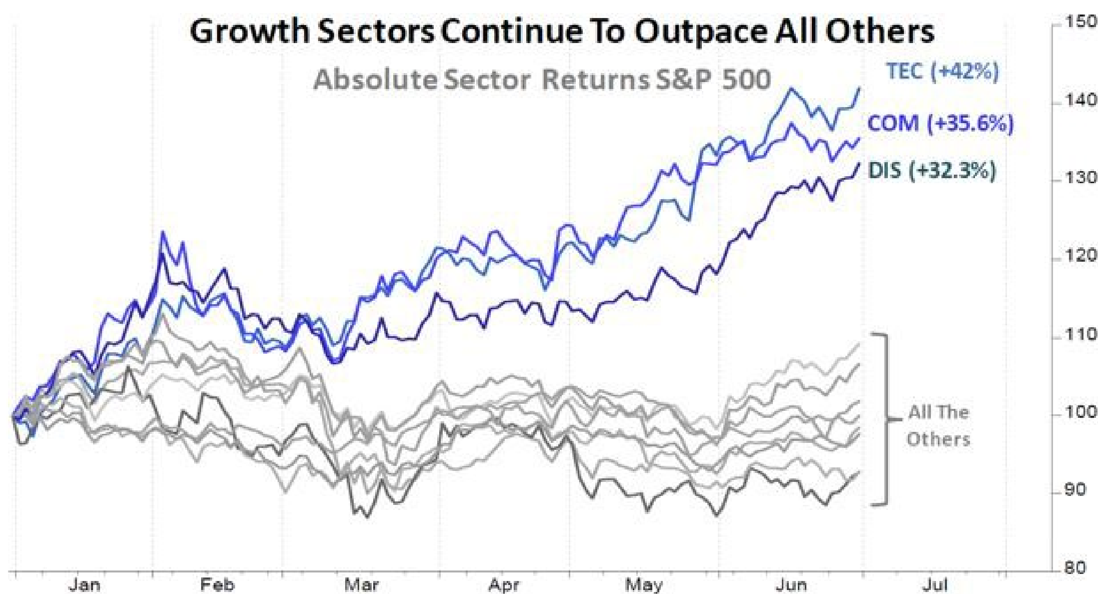
Investors went into the second quarter on high alert for a recession, thinking the Federal Reserve ("Fed") could soon be cutting rates. Instead, the first half of 2023 has proven to be the best half year for markets since 2018, which of course, predates the economic, social, and political disruptions brought about by the pandemic. Here we are at quarter end, with still no economic downturn, sticky inflation, and the Fed expected to tighten further and to keep rates higher for longer. The S&P 500 was up 8.3% in the second quarter and now is up 15.9% year-to-date.[1] Artificial Intelligence ("AI") euphoria helped to fuel the strongest first half of the year for the Nasdaq in its history, up over 30% YTD.[1]

Leading US Indices (Total Return)	4Q'21	1Q'22	2Q'22	3Q'22	4Q'22	1Q'23	2Q'23 (sorted)	TTM
Nasdaq	8.4%	-8.9%	-22.3%	-3.9%	-0.8%	17.0%	13.1%	26.1%
S&P 100 Mega-Cap	11.3%	-4.6%	-16.9%	-5.4%	5.6%	10.1%	11.1%	22.2%
S&P/Citigroup Growth	13.4%	-8.6%	-20.8%	-3.9%	1.4%	9.6%	10.6%	18.3%
S&P 500 Total Return	**11.0%**	**-4.6%**	**-16.1%**	**-4.9%**	**7.6%**	**7.5%**	**8.7%**	**19.6%**
S&P/Citigroup Value	8.3%	-0.2%	-11.3%	-5.8%	13.6%	5.2%	6.6%	20.0%
Russell 2000	2.1%	-7.5%	-17.2%	-2.2%	6.2%	2.7%	5.2%	12.3%
S&P 400 Mid-Cap	8.0%	-4.9%	-15.4%	-2.5%	10.8%	3.8%	4.9%	17.6%
S&P 600 Small-Cap	5.6%	-5.6%	-14.1%	-5.2%	9.2%	2.6%	3.4%	9.8%
Dow Jones Wilshire 5000	8.1%	-5.9%	-17.6%	-4.6%	6.2%	6.9%	3.3%	12.0%

Source – Strategas Securities, LLC – 07/06/2023

There were significant divergences in performance under the hood of the markets. Within stocks, the "Magnificent Seven", as many are calling them, were responsible for the bulk of the rally, while the rest of the market was relatively flat on balance. In the bond market, changing expectations for Fed policy sent rate-sensitive bonds slightly lower.

As the market pundits continue to debate the soft vs. hard vs. no landing scenarios, we've witnessed a large dispersion in leadership and are at one of the most polarized points so far in the cycle. Size, style and sector leadership in the second quarter looks very similar to what we saw in the first quarter with technology, communication services and discretionary now significantly outpacing the rest of the market.



Source – FactSet – 07/05/2023

The Fed raised interest rates by 0.25% in May. However, it did not hike rates in June, adopting what many have called a "hawkish pause". The "dot plot" of rate predictions is currently indicating two further rate hikes in the back half of the year, as do we.

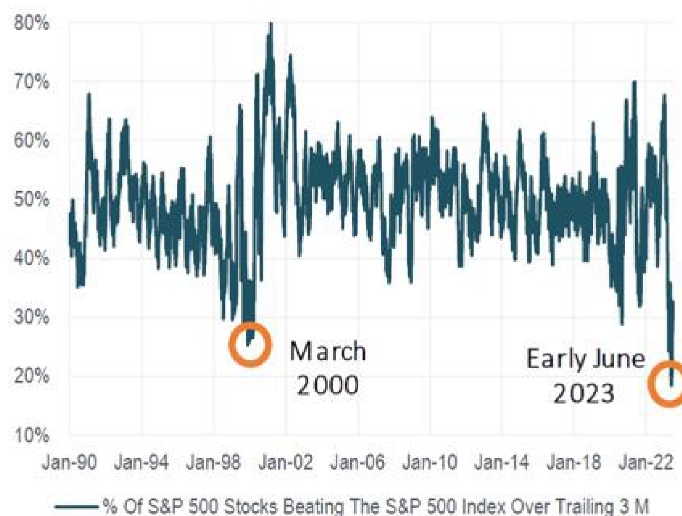
Inflation has come down meaningfully from mid-2022 when it peaked around 9% and currently hovers around 4%. The big question going forward is, when and how do we get to the Feds 2% inflation target. The unemployment rate remains extremely low and might, along with other factors, force the Feds hand in keeping rates higher for longer. We can't say with any degree of certainty whether that trend will continue, and economists are sharply divided on the subject. But if inflation doesn't keep falling closer to the target, we could see a more aggressive removal of policy accommodation, along with it the potential for higher interest rates and lower asset prices.

Sector leadership in the quarter mirrored what we saw in the first quarter of the year. The cyclical and defensive sectors all underperformed the market with a few of the sectors declining in the quarter.

S&P 500 Sectors (Total Return)	4Q'21	1Q'22	2Q'22	3Q'22	4Q'22	1Q'23	2Q'23 (sorted)	TTM
Technology	16.7%	-8.4%	-20.2%	-6.2%	4.7%	21.8%	17.2%	40.3%
Discretionary	12.8%	-9.0%	-26.2%	4.4%	-10.2%	16.1%	14.6%	24.7%
Communication Services	0.0%	-11.9%	-20.7%	-12.7%	-1.4%	20.5%	13.1%	17.3%
S&P 500 Total Return	**11.0%**	**-4.6%**	**-16.1%**	**-4.9%**	**7.6%**	**7.5%**	**8.7%**	**19.6%**
Industrials	8.6%	-2.4%	-14.8%	-4.7%	19.2%	3.5%	6.5%	25.2%
Financials	4.6%	-1.5%	-17.5%	-3.1%	13.6%	-5.6%	5.3%	9.5%
Materials	15.2%	-2.4%	-15.9%	-7.1%	15.0%	4.3%	3.3%	15.1%
Health Care	11.2%	-2.6%	-5.9%	-5.2%	12.8%	-4.3%	3.0%	5.4%
Real Estate	17.5%	-6.2%	-14.7%	-11.0%	3.8%	1.9%	1.8%	-4.1%
Staples	13.3%	-1.0%	-4.6%	-6.6%	12.7%	0.8%	0.5%	6.6%
Energy	8.0%	39.0%	-5.2%	2.3%	22.8%	-4.7%	-0.9%	18.8%
Utilities	12.9%	4.8%	-5.1%	-6.0%	8.6%	-3.2%	-2.5%	-3.7%

Source – Strategas Securities, LLC – 07/06/2023

In the second quarter, breadth collapsed and only 32% of the S&P 500 beat the index over the last three months.[1] Breadth is generally a good indication of the health of the overall market. A healthy, strong market usually has breadth north of 60% of stocks advancing!



Source – FactSet – 07/05/2023

The concentration we are seeing in a few large cap stocks is reminiscent of the Tech Bubble of the late 1990s and the Nifty-Fifty Bubble of the early 1970s. History shows that any time a few stocks become so dominant in the S&P 500, it has not been kind, eventually leading to an often long down period for those stocks. With that being said, such markets can persist for a long time. However, when they finally peak and roll over, the popular stocks have historically underperformed for an extended period, and because of their heavy weighting in the S&P 500, the once highflyers could drag down the whole index.

It was a mixed quarter for bond investors as they came to terms with the idea that rates aren't coming down any time soon (as many anticipated in Q1). The BBgBarc U.S. Aggregate Bond index was down slightly for the quarter and remains up about 2% on the year. The economy and hope of a near-term end to rate hikes led investors to embrace riskier assets.

Looking deeper into the fixed income markets, shorter-duration bonds outperformed those with longer durations in the second quarter, while optimism regarding economic growth caused investors to rotate out of the safety of longer-dated fixed income. The yield curve remains heavily inverted, which is the reason for such performance but also a big reason why many remain skeptical of this rally.

In the corporate bond market, lower-quality, but higher-yielding "junk" bonds grew modestly in the second quarter while higher-rated, investment-grade debt gained only slightly. But higher yields resulting from the Fed's rate hikes also mean fixed-income investments are potentially more attractive than they've been in

years, even if the Fed's not yet done with its inflation fight.

US Yields	1Q'22	2Q'22	3Q'22	4Q'22	1Q'23	2Q'23	Q/Q Chg (bps)	Y/Y Chg (bps)
Fed Funds Target Rate	0.5	1.8	3.3	4.5	5.0	5.3	25	350
3-Month T-Bill	0.5	1.7	3.3	4.4	4.9	5.4	58	378
2-Year Note	2.3	2.9	4.2	4.4	4.1	4.9	82	196
5-Year Note	2.5	3.0	4.1	4.0	3.6	4.1	53	114
10-Year Note	2.4	3.0	3.9	3.9	3.5	3.8	28	84
30-Year Bond	2.4	3.1	3.8	3.9	3.7	3.9	17	73

Source – Strategas Securities, LLC – 07/06/2023

Municipal bonds posted mixed results in the second quarter. The general theme across bond land of lower quality bonds outperforming their higher-quality peers extended into the sector. The Bloomberg Municipal Bond index was flat for the quarter.

On the commodity front, oil prices continued to fall in the quarter with WTI down almost 7% and closing the quarter at about $70/barrel.[1] National average gasoline prices, however, were little changed in the quarter. The S&P GSCI Index recorded a negative performance in the second quarter. Industrial metals and energy were the worst-performing sectors, while livestock prices rose in the quarter. Within industrial metals, zinc, nickel, and aluminum prices were all sharply lower in the quarter. Within energy, crude oil, Brent crude, heating oil, and gas oil all declined, while prices for natural gas and unleaded gasoline were modestly higher. In precious metals, both gold and silver ended the month in negative territory.

The energy sector is trading at a significant discount to the broader market while petroleum prices and product inventories remain low. The Strategic Petroleum Reserve is at historically low levels, and supplies of petroleum and petroleum products are expected to fall lower with potential further OPEC cuts. The energy sector has a free cash flow yield at multi-decade highs, strong balance sheets and a strong 15% earnings growth last earnings season. The market continues to question the appetite for petroleum and petroleum product demand as a possible recession still looms.

Looking abroad, Eurozone shares posted gains in the quarter with the advance led by the financials and IT sectors. Underperforming sectors included energy and communication services. Much like in the U.S., the IT sector was boosted by semiconductor stocks.

The European Central Bank raised interest rates twice in the quarter, taking the main refinancing rate to 4.0%. Headline inflation declined during the period, with annual inflation estimated at 5.5% in June, down from 6.1% in May.[1] However, the core inflation rate (which excludes energy, food, alcohol and tobacco prices) crept up to 5.4% in June from 5.3% in May.[1] Sound familiar?!

Growth data showed that the eurozone experienced a mild recession over the winter, with GDP declines of -0.1% in both Q4 2022 and Q1 2023.[1] Forward-looking data pointed to slowing momentum in the Eurozone economy. The flash eurozone composite purchasing managers' index fell to 50.3 in June from 52.8 in

May. That represents a five-month low and suggests the economy may be close to stagnation (50 is the mark that separates expansion from contraction in the PMI surveys).

Emerging market ("EM") stocks trailed in developed market peers by delivering a small gain over the quarter. Tension between the U.S. and China remains a contributing factor behind EM underperformance, as were concerns about China's less than stellar economic recovery.

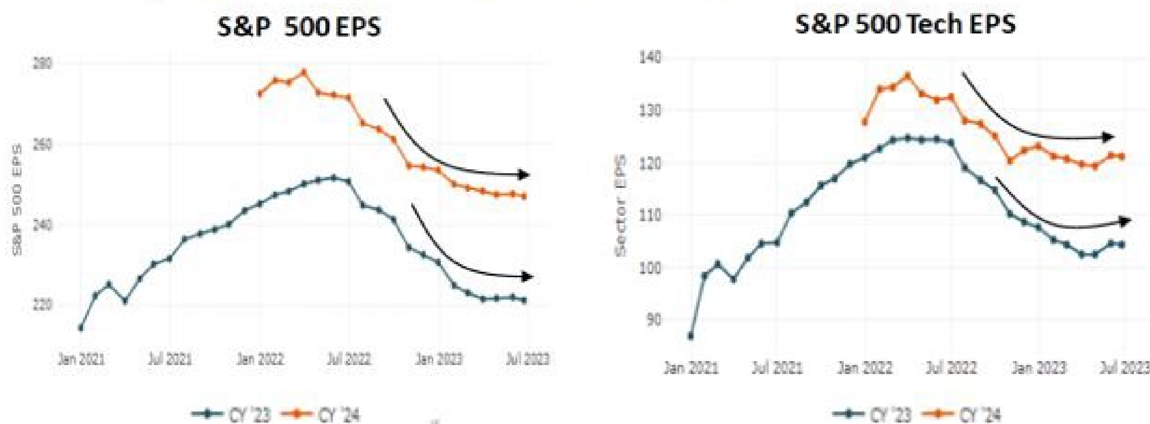
Brazil was a top performer amid easing fiscal policy concerns, optimism about potentially imminent rate cuts, and a better-than-expected Q1 GDP print. Improved macroeconomic data and signs that accommodative monetary policy will be ongoing were also supportive in India, which gained strongly in the quarter as well.

International Indices (Price Chg)	4Q'21	1Q'22	2Q'22	3Q'22	4Q'22	1Q'23	2Q'23 (sorted)	TTM
Nikkei 225 (Japan)	-2.2%	-3.4%	-5.1%	-1.7%	0.6%	7.5%	18.4%	25.7%
Bovespa (Brazil)	-5.5%	14.5%	-17.9%	11.7%	-0.3%	-7.2%	15.9%	19.8%
Sensex (India)	-1.5%	0.5%	-9.5%	8.3%	5.9%	-3.0%	9.7%	22.1%
MSCI AC World	**6.7%**	**-5.1%**	**-14.1%**	**-5.3%**	**7.0%**	**6.5%**	**6.0%**	**14.4%**
IBEX 35 (Spain)	-0.9%	-3.1%	-4.1%	-9.0%	11.7%	12.2%	3.9%	18.5%
OMX Stockholm 30 (Sweden)	7.1%	-13.4%	-10.6%	-2.3%	11.7%	8.8%	3.9%	23.3%
Kospi (South Korea)	-3.0%	-7.4%	-15.4%	-7.6%	3.8%	10.8%	3.5%	9.9%
MSCI EAFE	**3.6%**	**-4.4%**	**-8.8%**	**-4.3%**	**8.4%**	**6.7%**	**3.2%**	**14.2%**
Swiss Market Index	10.6%	-5.5%	-11.7%	-4.4%	4.5%	3.5%	1.6%	5.0%
CAC 40 (France)	9.7%	-6.9%	-11.1%	-2.7%	12.3%	13.1%	1.1%	24.9%
All Ordinaries (Australia)	2.0%	0.1%	-13.4%	-1.0%	8.1%	2.1%	0.4%	9.7%
DAX (Germany)	4.1%	-9.5%	-13.8%	-5.3%	14.9%	11.9%	0.3%	22.2%
S&P/TSX (Canada)	5.7%	3.1%	-13.8%	-2.2%	5.1%	3.7%	0.3%	6.9%
Bolsa (Mexico)	3.7%	6.1%	-15.9%	-6.1%	8.6%	11.2%	-0.7%	12.6%
FTSE 100 (UK)	4.2%	1.8%	-4.6%	-3.8%	8.1%	2.4%	-1.3%	5.1%

Source – Strategas Securities, LLC – 07/06/2023

No, we didn't predict this stock market strength six months in, and neither did many others. Even the raging bulls would only whisper 10%, and that was for the entire year! So, what did we miss? And why haven't we had a recession yet? It's likely because the Fed hasn't raised rates enough.

Throughout last year, many brilliant strategists explained that higher interest rates were bad for technology companies, yet a handful of these shares have been responsible for most of this year's gains despite these higher rates! The seven largest companies in the S&P 500, all widely considered to be technology companies, are up almost 90% on average year-to-date![1] Meanwhile, the other 493 companies in the S&P 500, in aggregate, have barely budged year-to-date. Solid, blue chip, defensive stocks have mostly languished. Why ignore these perfectly good companies, and why the technology pile-on? It wasn't that money had nowhere else to go. It had over 5% treasury-bills and suddenly appealing money market yields.



Source – Strategas Securities, LLC – 07/06/2023

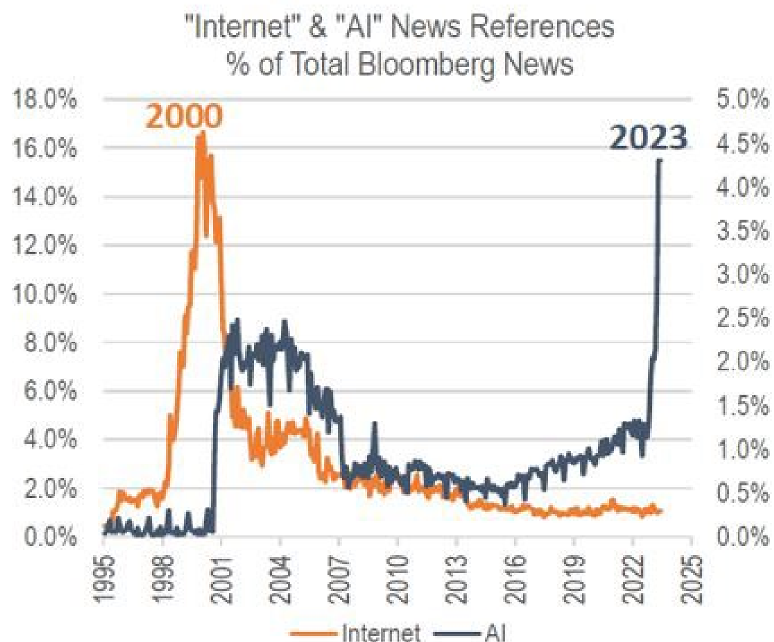
If you have a long-term time horizon, you must wait and see. Over many years, stock market returns have lots of periods of inexplicable volatility that fade into reversions to the mean. We suspect this period will be seen in hindsight as having been aberrational. Moreover, we believe that those shares that have not participated in this stunning rally will have their day in the sun. As Warren Buffet likes to remind us, in the short run the market is a voting machine while in the long run, it is a weighing machine.

Clients expect us to avoid unnecessary risks and keep them safe. More than ever, we believe in owning investments that are well-managed, have strong balance sheets, and are growing their bottom lines. Good investors don't change disciplines to match market fads. Good investors adhere to time-tested disciplines through the fads so they may enjoy the benefit of hard-won lessons and solid long-term returns.

The economic forces at work in the U.S. and around the world have produced an inflationary environment unlike any we have seen in many decades. This environment has also prompted the Fed and other central banks around the world to raise rates more quickly than any other time in history. Under normal circumstances this would have plunged the U.S. and other world economies into a deep recession, but this has not happened. There may well be a technical recession later this year or early next, but will it be "unfelt" in the sense that most households still have excess savings leftover from the stimulus packages? In addition, the labor market remains strong, despite a growing pessimism by small and medium-sized businesses. Some of this pessimism persists since it's still difficult to find qualified workers to fill even basic job openings. There are currently 9.8 million unfilled positions in the American economy.[3] This hardly seems like a recession so far.

What might be happening in the economy is a reordering of sorts. Out with the old economy (pre-pandemic) and in with the new economy (post-pandemic). For example, look at the 1920s, when emergent technologies like electricity, aviation, automobiles, the telephone, and medical innovations catapulted the economy and society forward. None of those technologies were invented at the time but became mainstream in the economy as time moved forward after World War I and the recovery from

the global pandemic of the Spanish Flu of 1917. There is an eerie parallel between now and then. As we have seen in recent years, technologies like video conferencing, AI, machine learning, and the adoption of electric vehicles have captured the attention of society in general, the economy, and certainly the markets. Like the "Roaring Twenties" of the 20th Century, we are seeing our current decade of the 21st century off to a quick start with the adoption of new technologies hitting the mainstream.



Source – FactSet – 07/05/2023

In addition to the technological influences, we are also seeing a sociological transformation in how we work. This has happened several times in history, with generally good results after a period change proved painful for some. For example, when industrialization swept through the world and the U.S. in the 19th century, there was a mass domestic migration from the rural agrarian economy to an urban industrial economy. There was pain involved in the process, but the standard of living for almost everyone rose quickly over that of previous generations. In the 1920s in particular, automobiles and air travel displaced the horse and buggy, and the telephone revolutionized communication. Many jobs were destroyed, but many more new ones were created, resulting in overall economic progress for the masses. Today's work-from-home or hybrid environment is likely here to stay. Prompted by the COVID-19 pandemic, work-from-home was previously ambient but is now firmly established in today's workplace environment. Try as they might, one large company after another has tried to force their employees back to the traditional in-office model, with little to no success.

I think the sociological changes that are largely permanent at this point have rewarded many technology companies with multiple trillion-

dollar valuations. To give you a sense of just how much money that is, here is a real-life example. If one second equals one dollar, it would take 32,709 years to reach the trillion-dollar mark! The demand for decentralized (work-from-home) technologies have also challenged some professions that at one time appeared invulnerable to automation, but now too may be vulnerable to AI and the like. Companies are quickly adjusting to this new environment, either by growing or failing. Suffice it to say, the reordering is well underway.

What is the expectation for the second half of 2023? With leftover savings from the $5 trillion infusion of cash from fiscal and monetary stimulus over the past few years, consumers could keep on spending and potentially fuel economic expansion. Not only is federal spending on an unsustainable path, but deficit spending continues to support economic activity at a time when the Fed is trying to slow the economy and associated inflation. Perhaps most obvious, economists believe that about $500 billion to $1 trillion of excess savings remain from the estimated $5 trillion the federal government spent to support consumers and businesses during COVID. These excess savings are one of the major reasons that the economy has managed to keep growing at respectable rates and that the labor market remains tight despite sharply higher interest rates.

The strength of the labor market is such that wages could remain strong even with persistent inflation. Consequently, the market could continue to melt-up if nothing unexpected happens. The market does expect the Fed to continue to raise interest rates at a moderate pace, but the sense is that they are nearing the end of the tightening cycle.

With a degree of optimism, several areas of concern seemed to be less concerning in the last month or two. Inflation, while still persistent, has probably peaked and continues to head lower. The potential of more bank failures seems less today than a few months ago, although surprises could easily come when they are least expected. Geopolitical tensions seem less now than when brinksmanship characterized the U.S./China relationship and the Russian aggression in Ukraine will likely not go nuclear. Lastly, the market does not take political sides when it comes to domestic politics. In fact, the market does better when there is a divided government, meaning one political party does not control both the presidency and Congress at the same time.

As good as things might appear at the present time, the wise investor should always expect the unexpected. Since no one can consistently predict the future, evaluating your risk is always important in good times as well as bad. The longer the time horizon a person has the better, because over time the market always adjusts and prospers. Today’s reordering is a perfect example of the market adjusting to the unexpected, but time is a critical factor, which is an important factor in your long-term success.

To discuss this commentary further, please contact us at 914-825-8630.

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[1] FactSet – 07/05/2023

[2] Strategas Securities, LLC – 07/06/2023

[3] https://www.uschamber.com/workforce/understanding-americas-labor-shortage - 07/12/2023

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