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Week in Review

Equity Markets:

The S&P 500 stretched its weekly winning streak to five despite the small pullback on Friday. The index now sits 8.5% below the all-time high of 4,818 from January of 2022 following the 26% run from the lows from last October. Market breadth has improved over the recent weeks but the leadership remains concentrated year-to-date. Large-Cap Growth, the Tech Sector, in particular, is driving much of the gain. The Technology sector is up 41.6% compared to the S&P 500's return of 15.8%[1].

Second quarter earnings season is around the corner. Following the stronger-than-expected reports from the first quarter, in which analysts were expecting a 6.7% decline but came in essentially flat. The declines have been pushed out to the current quarter. According to data collected by I/B/E/S data from Refinitiv, Q2 2023, earnings are expected to decline 5.4%[2].

Fixed Income Markets:

The Federal Reserve decided to hold rates at the current range of 5-5.25%. Long-term rates briefly dropped following the decision but finished the week flat. The 10-yr yield closed the week at 3.76%. Chairman Jerome Powell emphasized that members of the FOMC saw that a pause was prudent at this point because of the historic pace of rate hikes last year and that inflation has moderated. Despite the pause, he indicated that the terminal rate estimate increased to 5.6%, 50 basis points higher than the previous estimate. This would mean that the Fed anticipates more rate hikes through the end of the year.

The Fed Funds Futures market slightly revised its rate outlook through the end of the year. The market reduced the probability of cuts this year and pushed them out until 2024[3].

Economic:

The Fed decision was not the only important economic news for the week. Headline CPI came in at expectations with a 4% year-over-year increase. This marks the lowest annual increase since 2021. Core CPI, which excludes food and energy, remains stubbornly high and increased by 5.3% in May. The Producer Price Index surprised to the downside in May. The annual increase came in at 1.1% which could be a sign of relief ahead as the PPI reading has historically been a leading indicator for the direction of inflation felt by consumers. The consumer remains resilient despite the inflationary environment. May saw a 0.3% increase in retail spending.

Looking Ahead

Equity Markets:

Our focus for the equity markets remains on the fundamentals and earnings. As we move into this quarter's earnings reports we believe special attention should be put on corporate margins and balance sheets. Impacts of the steep rate hiking from last year have started to emerge for some corporations, but we believe there will be more to come given the lag effects of monetary policy actions. The average earnings decline during the last 10 recessions is 29.5%, excluding the collapses in 2001 and 2008, the average is 18.7%[4]. Given the strong position of the consumer, labor market, and corporations following the pandemic, we believe an earnings decline is likely to be less severe than the historical averages if one does in fact occur.

The strong rally since the October low has been fueled by multiple expansions and has little to do with market fundamentals as witnessed by continued earnings weakness. We believe that the current level of rates has the potential to put a ceiling on multiples so, in order for a sustained move higher, we will need to see earnings numbers improve.

These events have the ability to impact investor psychology, just as market downturns do. As long-term investors we believe keeping an objective view of the market, no matter the environment, should reward investors over the long term. Implementation of a thoughtful, diligent investment plan is key for investors blocking out the short-run temptations, either to increase risk or abandon the markets. In the near to intermediate term, we expect a return of volatility, and target allocations are appropriate.

Fixed Income Markets:

The commentary following the FOMC rate decision indicated the Federal Reserve believes that inflation remains the key focus. Inflation has come down, but is still well above their target of 2%; which supports their narrative of a higher terminal rate of 5.6%. Future inflation is greatly impacted by consumer expectations, and it is clear that the Fed is not ready to take its foot off the gas just yet.

The increase in the expected terminal rate does not impact our rate call for the long end of the yield curve. We still believe that the high from October will be the cyclical high. We could experience some volatility on the long end and see the 10-yr move closer to 4% but that will likely be short-lived.

Economic:

Following a busy week, the economic calendar is relatively light. We will see housing starts reported Tuesday and existing home sales on Thursday. The conference Board's Leading Economic Index will be released on Thursday, as will the weekly unemployment report from the Department of Labor.

**** *See Important Disclosures on following page*

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Sources:

1)JP Morgan
https://am.jpmorgan.com/content/dam/jpm-am-aem/americas/us/en/insights/market-insights/wmr/weekly_market_recap.pdf

2)I/B/E/S Refinitiv
https://lipperalpha.refinitiv.com/wp-content/uploads/2023/05/TRPR_82201_20230526.pdf

3)CME Group
https://www.cmegroup.com/markets/interest-rates/cme-fedwatch-tool.html

4)D.A. Davidson
https://dadavidson.com/News/Perspectives/ArticleID/3582/What-a-Recession-Means-for-Markets#:~:text=Recessions%20Are%20Usually%20Not%20Good%20for%20Earnings&text=The%20average%20earnings%20decline%20across%20all%20ten%20recessions%20was%20%2D29.5%25.

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