

Equities in Review

The domestic equity markets continued to gain ground in the second quarter, showing signs of economic resilience and a generally downward trend of inflation pressures. Increased expectations that the Federal Reserve may stop hiking rates soon was the primary impetus behind the moves higher. With thoughts switching to interest rates being stable, or even dropping by year-end or in early 2024, growth stocks continued to be investors' sector of choice, while value stocks lagged again. In the growth vs. value arena, the first half of 2023 was almost a 180-degree reversal of 2022, when value out-performed growth.

One cause for concern is that the US market performance described above and outlined below is concentrated in very few names. Seven stocks – Alphabet (the parent of Google), Amazon, Apple, Meta Platforms (formerly Facebook), Microsoft, Nvidia, and Tesla – which were recently nicknamed the “Magnificent 7”- were essentially responsible for the gain in the S&P 500, while the broader large cap stock market represented by the other 493 companies in the index was slightly in the black.

Foreign stocks also performed well as Eurozone inflation declined, which increased expectations that the European Central Bank would end its monetary tightening. China's economy seems to be the outlier, faltering in its recovery as concerns mount that higher interest rates there will cause a slowdown.

Higher yields in the debt market continue to provide investors with strong alternatives to equities in the form of higher yielding bonds.

Following are the quarterly, year-to-date, and 5-year average returns for the three equity indexes that we track:

INDEX	DESCRIPTION	Quarter	Year-to-Date	5-Year Avg.
S&P 500	Large cap stocks	+8.7%	+16.9%	+12.3%
Russell 2000	Small cap stocks	+5.1%	+8.0%	+ 3.9%
MSCI World (excluding US)	Foreign stocks	+2.4%	+9.5%	+ 3.5%
Weighted Index Benchmark*	Diversified Equities	+6.7%	+13.6%	+ 8.9%

*The Index weighting is 60% S&P 500 Index, and 20% each Russell 2000 Index and MSCI World (excluding US) Index.

Other Important Data

For the twelve months ending June 30, 2023, the consumer price index (CPI) inflation measure increased 3.0% compared to the prior 12 months. This increase was the smallest 12-month increase since March 2021. For comparison purposes, the CPI increased 6.5% for the twelve months ending December 31 and 8.5% for the twelve months ending September 30, 2022. This data suggests the Federal Reserve's aggressive rate-hiking strategy is having the desired effect of slowing inflation.

The spread on the yield curve (the difference in yield between the 1-Year and 30-Year Treasury bond) has often been a reliable leading indicator of the likelihood of recession. During the second quarter, the spread fell further to -1.55%. This “negative spread” represents an inversion of the yield curve, which occurs when shorter-term bonds offer higher yields than longer-term bonds. This phenomenon has frequently preceded a recession, which has led many pundits to predict a recession is coming.

The spread on the yield curve at the end of the past six quarters (as shown in the list below) continues to trend in a negative direction (six straight quarters of steepening inversion). This is the result of investors locking in longer-term bonds at lower yields than shorter-term bonds, while the Fed continues raising rates on the short end. We will continue watching both the Fed and longer-term yields, which are determined by market forces.

- June 30, 2023 (1.55%)
- March 31, 2023 (0.97%)
- December 31, 2022 (0.76%)
- September 30, 2022 (0.26%)
- June 30, 2022 0.34%
- March 31, 2022 0.81%

Equities Looking Forward

We are bullish on all categories of stocks for the long-term. Following last year’s bear market, we believe stocks in general – small, mid, and large companies, value and growth companies, and domestic and foreign companies – will be the best performing asset class for those with a three-year or greater time horizon.

In the short-term, we are generally optimistic about the majority of the stock market, but we are cautious that the “Magnificent 7” and a few other of the largest companies may be getting a bit ahead of themselves. For the second straight quarter, stock prices increased more than corporate earnings, which drove P/E ratios higher. In the same way that the “Magnificent 7” accounted for almost all of the S&P 500’s year-to-date gains, they have also been responsible for most of the index’s P/E ratio increase. In the large cap space, this leaves us with two different markets in the short-term: one being a small group of seemingly over-valued companies, mixed with a large group of fairly valued and undervalued companies. Because the indexes are market-cap weighted and because the small group contains the largest companies, the S&P 500 has been, and may continue to be, driven by just five to ten different entities.

Hybrid and Hedging Assets

We believe that the Tax Managed Balanced Composite Hybrid Index offers the best benchmarks for hybrid and hedging assets. Returns are as follows:

INDEX	DESCRIPTION	Qtr.	Year-to-Date	5-Year Avg.
Tax Managed Balanced Composite	Hybrid (bonds and stocks)	+4.0%	+9.2%	+7.4%

Since the hybrid assets we own in our portfolios invest in a combination of securities including, but not limited to, bonds and stocks, the hybrid assets typically produce returns close to the average of the bond and stock index returns. This is the case for the quarter and for the annualized returns of the past five years.

Hedging assets like commodities or alternative strategies generally move with little, zero or negative correlation to the bond and stock markets. We believe hedging assets should play a role in diversified portfolios because, over the long-term, their limited or inverse correlation to bonds and stocks should reduce the volatility of overall portfolio returns.

Bonds in Review

During the quarter, inflation continuing to moderate resulted in optimism about future Fed action and resulted in bond prices decreasing (and by extension, yields increasing). Longer-term yields, which are controlled by market forces (and not the Fed), increased as the yield on the 10-year U.S. Treasury went from 3.48% on March 31 to 3.81% on June 30. Interestingly, while the yield on the 10-year Treasury increased, this increase was notably less than the jump in the 1-year yield, which popped from 4.64% to 5.47%. The fact that the spread between the short-term yield and longer-term yields continues to widen does seem to indicate that investors are still trading cautiously despite seemingly stronger fundamental data.

The quarterly and historical results for the bond indexes that we track are as follows:

INDEX	DESCRIPTION	Quarter	Year-to-Date	5-Year Avg.
Bloomberg US Universal	US Gov't and Corporate Issues	-0.6%	+2.3%	+1.0%
Bloomberg Municipal Bond	US Municipal Issues	-0.1%	+2.7%	+1.6%
Bloomberg TIPS (0-5 Years)	Inflation Protected Gov't Issues	-1.4%	+1.9%	+2.5%
Weighted Index Benchmark*	Diversified Fixed Income	-0.9%	+2.3%	+1.4%

*The Index weighting is 60% US Universal and 20% each Bloomberg Municipal Bond and Bloomberg TIPS (0-5).

Bonds Looking Forward

The 3.81% yield on June 30 was lower than the yields of both shorter and longer-term bonds. The 1-year treasury was yielding 5.40% while the 20-year treasury's yield was 4.06%. Because this unique situation in treasury yields remains in the markets, we continue to believe shorter term bonds generally provide the best value in the bond market but investors may also be well served to use a barbell strategy and also have some longer-term bond (+/- 20 years) exposure to serve as a hedge against rates dropping in the near future.

Our Asset Allocation Philosophy

It is our philosophy that investors with long-term time horizons are best served by using a disciplined, diversified asset allocation approach (investing in bonds, hybrid and other hedging assets and stocks) rather than trying to time the markets. It is important to periodically review your asset allocation and your target allocation and to rebalance your assets among the classes to keep the allocation close to the target. We will address the issues specific to you when we review your situation in the coming months. In the interim, if you would like to discuss these issues, please contact us at howard@kadescheifetz.com or steve@kadescheifetz.com.

Reminders

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