# Quarterly Market Commentary

Second Quarter 2023

## Solving Puzzles

DBR & CO
412.227.2800
dbroot.com

436 Seventh Ave.
Suite 2800
Pittsburgh, PA 15219

> "The Cube is, at the same time, a symbol of simplicity and complexity"
>
> - Erno Rubik

Twenty-one-year-old Max Park recently broke the Speed Cube record by solving the Rubik's Cube puzzle in 3.13 seconds. Just 3 seconds to complete what most of us have been unable to accomplish in our lifetimes is quite an incredible feat. Born in Budapest, Hungary during the height of World War II, Erno Rubik is a Hungarian inventor, architect, and professor, and child of an engineer father and poet mother. The 1979 Toy of the Year was a mix of beauty, simplicity, and difficulty that has captured the minds of enthusiasts since.

For the past eighteen months, markets and the economy have presented investors with their own multi-dimensional puzzle. Last year the economy remained strong, but stock markets experienced the worst performance since the Great Financial Crisis and fixed income markets experienced the worst performance in nearly 50 years. In the first half of 2023, on the other hand, economic data has weakened significantly while major equity indices have soared. Though markets and the economy rarely move in perfect tandem, the discrepancy between the economic data and the headline indexes has been stark. Attempting to solve these disconnects requires a deeper understanding of where we are in the economic cycle as well as a review of market structure.

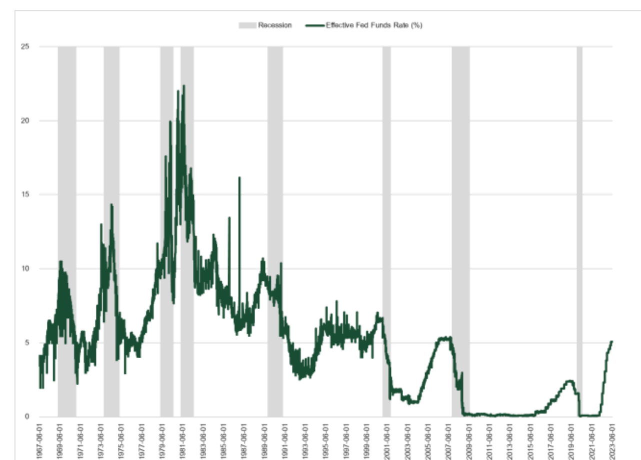
## Cautionary Data Points

As our Investment Committee reviews the incoming data, it is striking to analyze the long list of cautionary data points. In summary:

- Interest rates, liquidity, and credit conditions have tightened rapidly and simultaneously.
- Fragilities in the banking system continue to fester due to the historically inverted yield curve and deteriorating credit environment.
- Leading indicators of economic growth including retail sales, home sales, and industrial production remain on a decidedly downward trajectory.
- Business and consumer credit metrics continue to decline.
- High and sticky inflation remains well above the Fed's target.
- Federal Reserve Chair Jerome Powell in his June congressional testimony expressed the intention to raise interest rates further: "Inflation pressures continue to run high, and the process of getting inflation back down to 2% has a long way to go."[1]

Additional interest rate hikes will further pressure the already challenged data. As of the end of the second quarter, the Fed Funds rate is set at a range of 5.00-5.25%. Currently, futures market pricing is expecting another two hikes before year-end, which implies a level well above the terminal rate, intentionally restricting future growth. Should two additional hikes materialize, the Fed Funds rate would be above the prior high in August 2007, on the eve of the financial crisis.

Effective Fed Funds Rate (Green) & Recessions (Gray)[1]




[1] FactSet

The bond market, always the arbiter of risk, has been sniffing out the slowing growth environment since November 2021. The yield curve, historically a reliable indicator of stress in the economy, is now the most inverted it has been in over 42 years.

Inflation is proving sticky across the globe, not only in the US but especially in Europe and the U.K. A few months ago, monetary policymakers abroad were tentative while the banking sector wobbled. Now they are being forced to raise rates ever higher.

At the corporate level, the S&P 500 is officially in an earnings recession. Earnings per share declined in 4Q22 and 1Q23, and forecasts for the 2nd quarter predict an earnings decline of -5%. Meanwhile earnings estimates for the back half of 2023 continue to step lower. Expected growth for the year has declined from 5% in December to just 1.5% currently.

Adding it all up, aggregate indicators from the New York Federal Reserve estimate the probability of a future recession in the US at around 70-80%. Nonetheless, risk assets have steadily marched higher.

| Year To Date as of June 30, 2023[2] | |
|---|---|
| S&P 500 Total Return Index | 16.9% |
| Dow Jones Industrial Average | 4.9% |
| Nasdaq Composite Index | 31.7% |
| Russell 2000 Index | 8.1% |
| MSCI EAFE Index | 12.1% |
| MSCI Emerging Markets Index | 4.8% |
| Bloomberg Aggregate Bond Index | 2.1% |

## Better Than Expected

One way to reconcile the dichotomy is to remember the starting point. Coming out of the pandemic, the economy's underpinnings were as conducive to recovery as we've seen in recent history. Consumer and business balance sheets were very healthy, employment neared all-time lows, asset prices were rising, demand was robust, and liquidity was ample.

While central and commercial banks have sharply reversed the flow of credit and liquidity, excess liquidity was available for far too long. As mentioned in previous writings, 25% of all the money ever created in the history of the world was printed between 2020 and 2021.

The consumer, while facing rising costs of goods and services, has remained employed, and further, has enjoyed increasing wages. Though inflation has eroded the purchasing power of those wage gains, increasing cash on a nominal basis has lined the pockets of main street, and amongst the more affluent, in bank accounts earning higher levels of interest.

Another thing to remember is that, while some things seem bad, they could have been much worse. Several key dynamics prophesized to happen simply have yet to materialize.

- The spike in borrowing costs has not contributed to widespread defaults, as many companies and consumers refinanced at historically low rates available from 2020-2021.
- Inflation, while sticky, has steadily declined amid falling energy and commodity prices.
- Decelerating economic growth has not led to recession or widespread layoffs.

As financial markets are forward-looking, this dynamic of 'better-than-expected' has been a driving force behind rising markets and investors have been forced to rethink their prior pessimistic views.

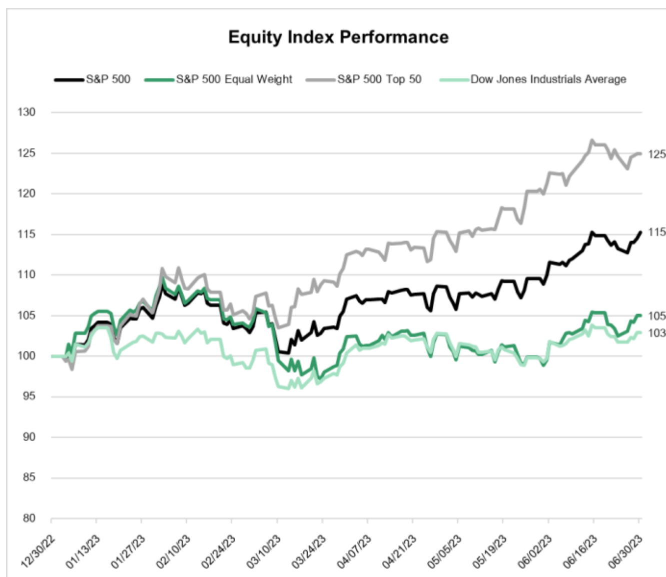
## Fitting the Pieces Together

It may appear that investors are strangely calm in the face of recessionary data and swirling tail risks. But, in our opinion, the market has largely gotten it right. A handful of tech stocks have made the S&P 500 performance and valuation look much higher than the

[2] Black Diamond

underlying reality. Seven companies (Apple, Amazon, Microsoft, NVDIA, Alphabet, Meta and Tesla) have accounted for 95% of the market return through the first half of 2023. What all of these companies have in common is that they are perceived to be beneficiaries of what investors are hoping will be the "new internet" – Artificial Intelligence.

Equity Index Performance & Market Breadth[3]




It may also be true that these stocks have traded as safe havens during a period in which traditional safe assets—particularly US Treasuries—are surrounded by the doubt of rising interest rates. When looking past the big seven to the other 493 companies in the index and to other assets classes such as commodities and real estate, which are more tethered to the broad economy, we see much more volatility. This signals there is more uncertainty about the path of the economy than the headline index return suggests.

## Solving the Puzzle

The foundation of our asset allocation process is to create strategic allocations that work over the long term while modifying exposure in response to the market realities. To solve the puzzle of these dynamics is to realize that the economy has neither been as bad as projected nor as strong as the S&P 500 index return suggests. The global economy could have been in a far worse state than it is, given the conditions it confronted one year ago. At the same time, broad positioning and sentiment within risk assets is more defensive than it appears.

With that said, preservation of capital is our primary objective. We remain wary of the lagged effects of restrictive monetary policy, including further pressure on credit markets and continued recessionary pressures on revenues and profit margins. In combination with higher prices and rosier investor expectations since the start of the year, more volatility for risk assets may be in store. Alternatively, fixed income assets with high and contractually obligated cash flows represent a highly attractive return profile with lower volatility. As the sides of the cube inevitably come together, the cycle will enable an opening for more constructive positioning in portfolios. As always, we appreciate your partnership and trust as we navigate the investment environment together.

Respectfully,

Michael J. Aroesty, CFP®
Investment Committee Chair
Chief Investment Officer
maroesty@dbroot.com

[3] FactSet

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The impact of the outbreak of COVID-19 on the economy is highly uncertain. Valuations and economic data may change more rapidly and significantly than under standard market conditions. COVID-19 has and will continue based on economic forecasts to have a material impact on the US and global economy for an unknown period.