After hitting the midpoint of 2023, we take a more pointed look at the horizon to see what is forming up ahead. Despite recent strength, we see several headwinds pressuring consumer and business spending which could be pointing to a decline in economic activity.

Recap: 2nd Quarter 2023

The global economy continued to face a number of uncertainties including high inflation, elevated interest rates, and the ongoing war in Ukraine. These factors were headwinds to economic activity, while strong labor markets and robust corporate profits were positive. Inflation readings, which have recently reached levels not seen in 40 years, remain elevated but are down substantially from their highs. The Federal Reserve is ready to raise interest rates as needed in an effort to bring inflation back toward the long run target of 2%.

In the U.S., the unemployment rate is currently at a 50-year low with corresponding wages rising at a healthy pace. Consumer spending, accounting for approximately 70% of economic activity, remained relatively strong. With an ongoing healthy demand for goods and services, and the leveling off of commodity prices, corporate profits have been supported by strong economic growth and robust spending by consumers.

Macroeconomic

GDP

Real GDP growth slowed during the first quarter but was still positive, having expanded at an annualized 2.0%. Consumer spending was quite strong, registering its best quarter in nearly two years and contributing 2.8% to growth. However, private spending was down by double-digits. The Atlanta Federal Reserve's (Fed) GDPNow forecast for the second quarter of 2023 currently stands at 2.2%.

On a global basis, the International Monetary Fund (IMF) downgraded its forecast for global economic growth for the year, citing the war in Ukraine as a major factor. The IMF now expects growth to slow to 2.8%, down from 3.4% in 2022.

Inflation

Despite inflation continuing to weigh heavily on the global economy, there were signs of price pressures beginning to moderate. When compared to a year earlier, the Consumer Price Index came in at 5.0% for April, 4.1% in May, and 3.0% in June. When stripping out food and energy, the Core CPI came in at 5.5% for April, 5.3% in May, and 4.8% in June. This is still well above the Fed's 2% target for inflation but moving in the right direction.

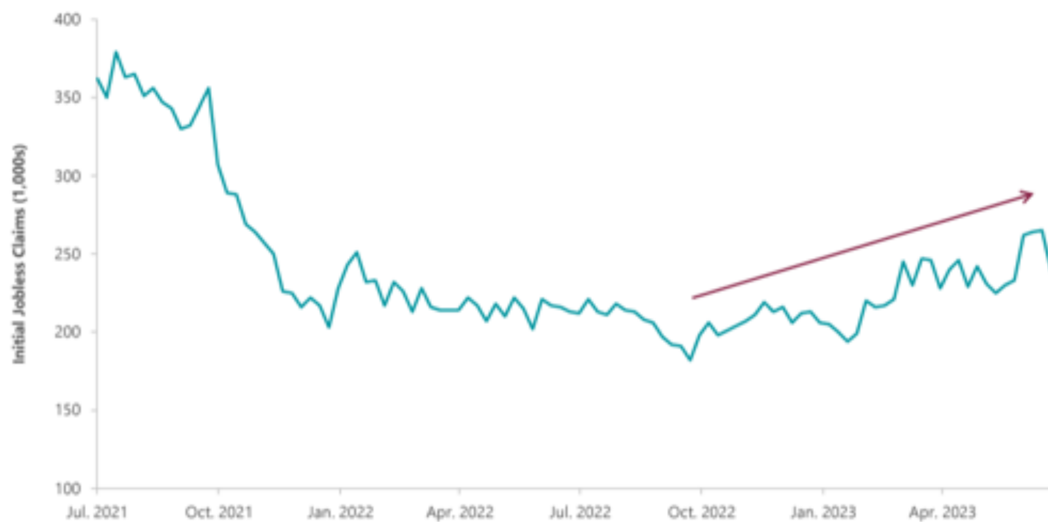
A Path to Slower Consumption?

- **The normalization in credit card use has helped fuel consumption (and in turn inflation) even as accumulated savings wane and wage gains moderate.**
- **Spiking credit card rates and the return to pre-pandemic trends in borrowing suggests that debt-fueled consumption will be less of a boost going forward.**

Labor
Hiring slowed in June while wages rose and unemployment fell. U.S. employers added 209,000 workers in June, a solid monthly gain and down from May's revised 306,000. In the first half of this year payrolls grew by an average of 278,000 a month down from nearly 400,000 a month last year.

The unemployment rate, meanwhile, slipped to 3.6% from May's 3.7%, putting it a bit higher than the multi-decade low of 3.4% back in January and April. Employers ramped up wages as they competed for a limited pool of workers. Average hourly earnings grew 4.4% in June from the previous year, matching gains in the preceding two months and remaining well above the pre-pandemic pace.

Canary in the Coal Mine



- **Jobless claims have been mostly steady since hitting 53-year lows in 2022, but appear to be climbing higher more recently.**
- **Initial jobless claims have been one of the best high-frequency indicators on the ClearBridge Recession Risk dashboard, making them particularly insightful into the health of this expansion.**

Equities (Stocks)

The second quarter was a standout from a performance perspective. Technology stocks continued to move higher on narrow market breadth as shown by the spread between technology heavy indices and the broader market indices.

At the end of the quarter, for the year-to-date period (thru 6.30.23), the NASDAQ 100 Index was up +39.4%, while the S&P 500 Index and the Dow Jones Industrial Average were up +16.9% and +4.9%. Such narrowness of leadership has not been seen since the late 1990s immediately preceding the implosion of

the Dotcom bubble.

Returns (%) as of 6.30.23

	June	QTD	YTD	Trailing (Annualized) 1-Yr	3-Yrs	5-Yrs
Blended Benchmarks[2]						
100% Stocks	4.9	5.0	11.0	13.9	10.4	6.9
90% Stocks / 10% Bonds	4.4	4.4	9.9	12.2	9.0	6.3
60% Stocks / 40% Bonds	**3.2**	**3.0**	**7.3**	**7.9**	**5.0**	**4.9**
100% Bonds	0.0	-0.5	2.5	0.3	-3.3	0.5
U.S. Large Cap Equity						
S&P 500 Index	**6.6**	**8.7**	**16.9**	**19.6**	**14.6**	**12.3**
DJ Industrial Average Index	**4.7**	**4.0**	**4.9**	**14.2**	**12.3**	**9.6**
NASDAQ 100 Index	**6.5**	**15.4**	**39.4**	**33.1**	**15.2**	**17.7**
Russell 1000 Index	**6.8**	**8.6**	**16.7**	**19.4**	**14.1**	**11.9**
Russell 1000 Growth Index	6.8	12.8	29.0	27.1	13.7	15.1
Russell 1000 Value Index	6.6	4.1	5.1	11.5	14.3	8.1

For the quarter, all market capitalizations delivered strong performance with large cap outperforming both mid cap and small cap as shown by the Russell 1000 Index +8.6% topping both the Russell Mid Cap Index +4.8% and the Russell 2000 Index +5.2%. From a style perspective, growth outperformed value across capitalizations as shown by the spread between the Russell 1000 Growth Index +12.8% and Russell 1000 Value Index +4.1% which was the largest spread across capitalizations.

U.S. stocks outperformed their non-U.S. counterparts in both developed and emerging markets as shown by the S&P 500 Index +8.7%, MSCI EAFE Index +3.0%, and MSCI Emerging Markets Index +0.9%.

	June	QTD	YTD	Trailing (Annualized) 1-Yr	3-Yrs	5-Yrs
U.S. Mid Cap Equity						
Russell Mid Cap Index	***8.3***	***4.8***	***9.0***	***14.9***	***12.5***	***8.5***
Russell Mid Cap Growth Index	*7.7*	*6.2*	*15.9*	*23.1*	*7.6*	*9.7*
Russell Mid Cap Value Index	*8.7*	*3.9*	*5.2*	*10.5*	*15.0*	*6.8*
U.S. Small Cap Equity						
Russell 2000 Index	***8.1***	***5.2***	***8.1***	***12.3***	***10.8***	***4.2***
Russell 2000 Growth Index	*8.3*	*7.1*	*13.6*	*18.5*	*6.1*	*4.2*
Russell 2000 Value Index	*7.9*	*3.2*	*2.5*	*6.0*	*15.4*	*3.5*
International & Emerging Market Equity						
MSCI EAFE Index	***4.6***	***3.0***	***11.7***	***18.8***	***8.9***	***4.4***
MSCI EAFE Growth Index	*3.5*	*2.8*	*14.2*	*20.2*	*6.3*	*5.4*
MSCI EAFE Value Index	*5.6*	*3.2*	*9.3*	*17.4*	*11.3*	*2.9*
MSCI Emerging Markets Index	***3.8***	***0.9***	***4.9***	***1.7***	***2.3***	***0.9***
MSCI ACWI ex. U.S. Small Cap	*3.4*	*2.0*	*6.8*	*10.9*	*8.1*	*2.6*

[1] Source: Morningstar (all ex. blended)
[2] Source: BridgeFT

Fixed Income (Bonds)

Returns were negative across most of the fixed income landscape during the second quarter. The Bloomberg U.S. Aggregate Bond Index posted a negative absolute return (-0.8%) but outperformed the Bloomberg Aggregate Bond Treasury Index (-1.4%) as interest rate volatility remained elevated during the quarter. *Volatility simply means prices changing quickly and unpredictably and generally leading to a wider than average range of returns over the referenced period.*

Early in the quarter, the market was still digesting the impact of regional bank failures and weighing the potential for additional rate hikes from the Federal Reserve (Fed). The Fed's response was measured with a quarter-point rate hike at its May meeting and a pause in June. The pause ended the streak of 10 straight meetings with a decision to raise rates.

Treasury yields moved higher across the entire yield curve, while remaining inverted, to finish the quarter at its most extreme inversion since 1981. An inversion is measured as the difference in yield between the 10-year Treasury and the 2-year Treasury. When this difference is positive the yield curve is considered upward sloping and when negative is considered downward sloping, i.e., inverted.

This inversion was notable as a healthy and normally functioning market and economy will be reflected in a positively sloping curve with longer maturity bonds yielding more than shorter maturity bonds. *Since 1978, the yield curve has inverted six times (excluding the current period), and has preceded a recession each time, with the average time to the start of the recession ranging*

between six to 36 months after the first inversion.

Corporate bond spreads were mixed over the quarter (wider spreads are a negative while tighter spreads are a positive for performance). June was marked by a relatively strong first quarter earnings season and continued economic resilience. This led to spreads finishing the quarter generally tighter across both investment grade and below-investment grade corporates. In both, the most pronounced move (tighter) came from Financials versus other sectors.

Market Outlook: Where's the Value?

When looking at the current investment opportunity set, it is hard to find value in stocks especially when looking over the next 18- 24 months and taking the forward outlook for economic activity into account. Instead, we look to areas that can provide stock like returns with much less risk over that same period.

The graphs above show the prices of the S&P 500 Index (top graph) and Bloomberg Aggregate Bond Index (bottom graph) over the last five years. The S&P 500 is close to hitting all time highs while the Agg is near all time lows. Which of the two look cheap relative to their long-term averages? Answer: the bond index.

As of late, it is hard to find any research or commentary not comparing the current market runup to other periods preceding major market downturns or significant slowdowns in economic activity. It looks eerily similar to past periods.

Financial Conditions Deteriorating

In looking at economic data there are several indicators pointing to credit contraction, rising corporate defaults, tighter lending standards, and deteriorating liquidity. These all point to potential perilous times ahead. It is hard to see a way out of the fastest and most severe interest rate hiking cycle in history without some sort of pain in the financial markets.

Clearbridge Investments publishes a real-time recession dashboard (first chart below) in which it tracks several indicators across consumer spending, business activity, and financial conditions. They recently did a webinar laying out their research (43 pages of charts) and we pulled a couple of those charts to help illustrate the current situation. You can access the full presentation here.

Economic indicators have been declining each month for the past fourteen months. History has shown a recession forthcoming when economic indicators have declined, on average, for four months. The second chart below shows this trend back to 1960.

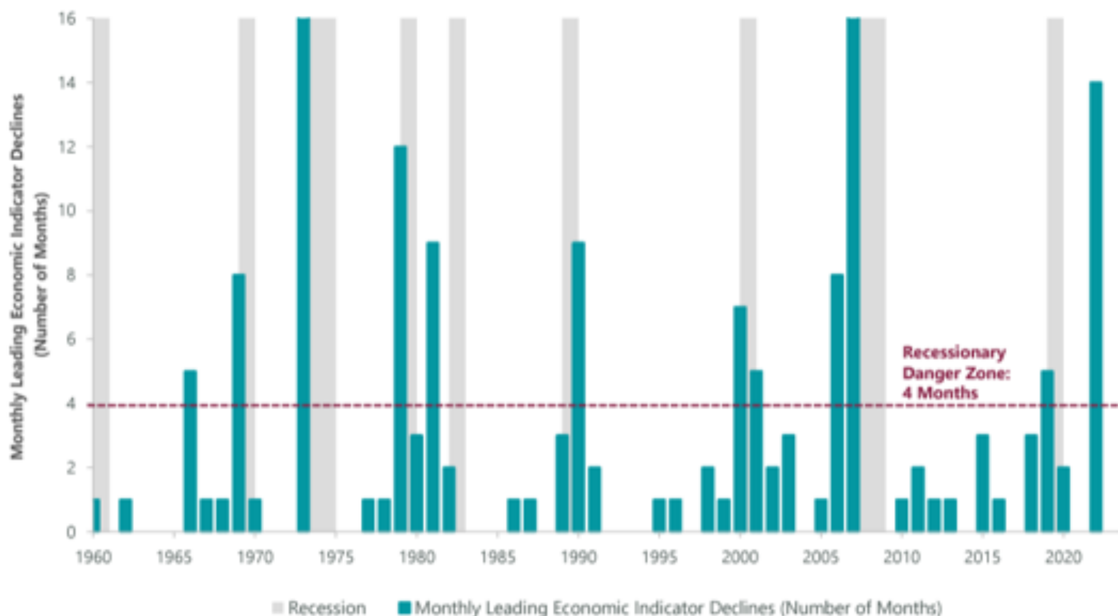
U.S. Recession Risk Indicators

- 12 variables have historically foreshadowed a looming recession
- The overall dashboard is currently signaling recession

		Current	2020	2007-2009	2001	1990-1991	1981-1982	1980	1973-1975	1969-1970
Consumer	Housing Permits	✖	⬆	✖	●	✖	✖	✖	✖	✖
	Job Sentiment	✖	●	✖	✖	✖	✖	●	●	●
	Jobless Claims	●	⬆	●	✖	✖	✖	✖	⬆	✖
	Retail Sales	✖	⬆	✖	✖	✖	✖	✖	●	✖
	Wage Growth	✖	✖	✖	✖	✖	✖	✖	✖	✖
Business Activity	Commodities	✖	⬆	✖	✖	✖	✖	●	●	●
	ISM New Orders	✖	●	✖	✖	✖	✖	✖	✖	✖
	Profit Margins	✖	✖	✖	✖	✖	✖	✖	●	✖
	Truck Shipments	●	⬆	●	✖	✖	✖	✖	n/a	n/a
Financial	Credit Spreads	✖	⬆	✖	✖	✖	✖	✖	⬆	●
	Money Supply	✖	⬆	✖	✖	✖	✖	✖	✖	✖
	Yield Curve	✖	✖	✖	✖	✖	✖	✖	✖	✖
	Overall Signal	✖	●	✖	✖	✖	✖	✖	●	✖

⬆ Expansion ● Caution ✖ Recession

Leading Indicators Point to Recession

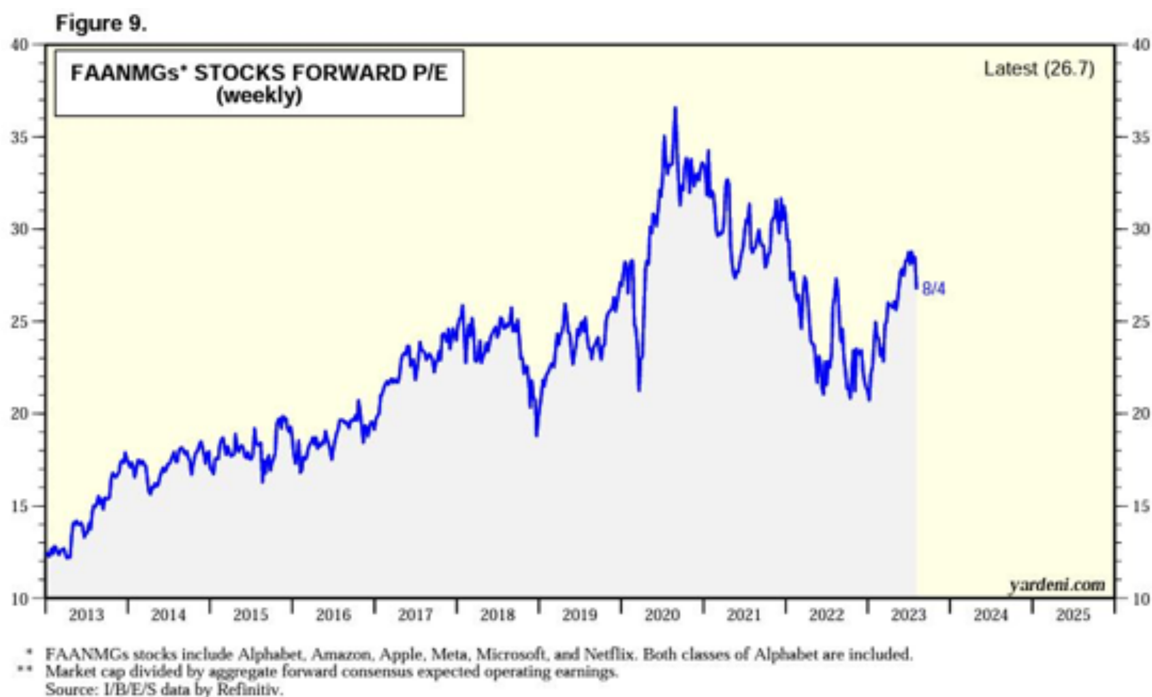


- **Historical declines in the Leading Economic Indicators lasting more than several months have foreshadowed economic downturns.**
- **The Leading Economic Indicators have been declining for the last 14 months.**

From a valuation standpoint, the outliers are definitely in technology with the remainder of the market also looking expensive given the economic outlook for 2024. As of this publication, the stocks mostly known as FAANG (Facebook,

Apple, Amazon, Netflix, and Google) are trading at an average forward price-to-earnings ratio (“fwd. P/E”) 30.0x earnings relative to the fwd. P/E of the S&P 500 Index of 20.8x and the Dow Jones Industrial Average of 19.4x. This is a significant premium to historical averages (~16.0x forward earnings for the S&P 500 Index) and causes concern as it relates to our forward outlook.

It is certainly hard to watch from the sidelines as these technology stocks touch exorbitantly high valuations and the rally attempts to broaden to other sectors. But, we remain patient looking for a better entry point back into stocks later this year or in early 2024 as we still see value in the asset class over the long-term (next ten years).



Looking Ahead & Positioning

To reiterate our previous outlook, we maintain our expectations for elevated volatility across markets over the remainder of the year. However, we do see the potential for both stock and bond markets to end the year higher as inflation declines further and the Federal Reserve slows or ends its hiking cycle.

We continue to believe bonds are better positioned to outperform if recession fears persist and inflation slows at a faster pace. As of now, given the economic uncertainty, we see more risk for stocks to the downside than the potential for outperformance. We have reduced or even eliminated most of our stock exposure in favor of a better entry point in the back half of 2023 or early 2024.

In summary, we are maintaining an overweight to bonds and an underweight to stocks. We believe bonds are attractive as they exhibit healthy yields and the prospect of short-term outperformance. We the potential for bonds to deliver equity like returns with much less risk, as stock market volatility spikes and investors look for safe havens such as bonds. At current yields, we are getting paid handsomely for patience.

We appreciate your continued support and partnership. In the meantime, stay disciplined- stay invested.

If you have any questions or want to discuss further, please reach out at info@eamoncap.com

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