As the regional bank crisis of March failed to spread through the broader financial system, markets regained momentum to finish the quarter at a new 2023 high. Despite continued recession fears, persistent inflation and a “hawkish” Federal Reserve, the S&P 500 has now recovered 72% of the loss that occurred between January and October of last year. As we said last quarter, however, these gains have continued to be “narrow,” with much of this year’s gain for the S&P 500 attributable to the largest five names in that index, each with a market capitalization above $1 trillion. As evidence of this, the market cap weighted index was up over 16% for the first half of the year, while the equal weighted index was up less than 7%. While there are no clear conclusions to draw from this, it seems likely that, for this rally to continue, gains will need to broaden out to more companies and market sectors.

Market gains appear to be the result of two primary factors. First, the market is “pricing in” the end of Federal Reserve rate hikes. With the old saying “don’t fight the Fed” playing out in a textbook manner last year, with markets dropping during aggressive rate hikes, the opposite is now occurring as the Fed has paused their rate hikes and, while still talking tough about inflation, hinted that the end of hikes is near. Second, and related to Fed actions, the economy has defied expectations and, so far, avoided falling into recession despite the impact of much higher borrowing costs. Two industries most impacted by higher rates, residential housing and autos, have been surprisingly resilient. Of course, as we look forward, in order for the Fed to claim “mission accomplished” in their fight against inflation, housing and auto prices do not need to drop, they simply need to stop rising.

We have said many times that over a long period of time markets follow earnings. With that in mind, while the broader economy has not entered a recession, we have now experienced an earnings recession. By definition, this means that we have now experienced two quarters of declining earnings for the S&P 500. Results for the recently completed quarter are uncertain, as earnings are forecast to be roughly in line with those of the same quarter last year. While an earnings slowdown is not surprising following the post-COVID earnings boom, the components of this slowdown are somewhat surprising. In reviewing first quarter earnings, two industries that are typically most resilient to economic downturns, Healthcare and Information Technology, have experienced the greatest earnings declines, while two that are typically more economically cyclical, Industrials and Energy, have experienced the highest earnings growth! These upside-down results help explain the difficulty of economic forecasting in this post-COVID recovery. In the case of the earnings losers, IT is slowing after very strong COVID-era results while Healthcare is being impacted by declining vaccine sales. For the earnings winners, Energy is recovering after a deep COVID downturn while Industrials are positively impacted by a strong aerospace and airline recovery.

These mixed messages from the economy have many asking “where is the recession?” The key metric to sum up the surprising resiliency of the economy is employment. Unemployment remains near generational lows, and almost every

recent employment report has been better than consensus. Anecdotes remain common about labor shortages in various industries and labor hoarding by companies that are wary to cut competent employees. As long as unemployment remains low, our consumer-focused economy should continue to remain on solid footing.

The Federal Reserve, and the Biden administration, are hopeful that the U.S. economy can pull off the rare “soft landing,” in which inflation cools while recession is avoided. While this is possible, and we would be happy with the result, we remain concerned that the cumulative impact of these aggressive rate hikes has not yet been fully felt by the economy. We know from history that monetary policy has long and variable lags before being felt by the economy, as was eloquently noted by legendary economist Milton Friedman over 60 years ago. As we said before, both housing and autos are significantly impacted by higher borrowing costs and this is being felt at a time when consumer cash balances have been declining and consumer borrowing is rising. Most debt on both consumer and corporate balance sheets was taken on when rates were still very low. The longer that interest rates stay elevated, the more maturing and resetting debt will need to be refinanced at higher rates. The inversion in the yield curve is nearing its 1 year anniversary, which means it is nearing the point in which historically a recession has become more likely. Given leading indicators and tight monetary policy, it seems inevitable to many investors that a recession is around the corner, yet this cycle continues to flummox even the savviest on Wall Street.

History suggests that the equity rally may slow from here. Since 1957, the S&P 500 has gained 15% or more in the first half of the year on 9 different occasions. In those 9 years, the market was positive in 5 years, with an average gain of 1.6%. After the rally over the past 9 months, equity markets may need to consolidate gains, even if we continue to elude a recession. This may be especially true for the mega-cap stocks that we noted have driven many of the year-to-date gains. Our recent investment activity has skewed towards fixed income purchases as we look to lock in attractive yields at longer durations within portfolios, providing higher income and a potential ballast should the soft landing thesis prove faulty and the Fed changes course towards interest rate cuts instead of interest rate hikes.