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Second Quarter 2023 Commentary

An Oxford Harriman & Company Market Commentary

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Financial Markets Rebound in the First Half of 2023

A year can make a big difference. One year ago, the market was trying to catch its breath after a volatile start to 2022. The Federal Reserve had raised interest rates by 1.5% in a single quarter. Inflation peaked at 9% as Russia's invasion of Ukraine upended commodity markets and competition for employees resulted in wage inflation. The S&P 500's first half 2022 return was its worst start to a calendar year since 1970. In contrast to the first half of 2022, the first half of this year is markedly different. Oil prices are 33% lower, inflation is running at a 4.1% pace, and the S&P 500 is up nearly 15%. This commentary will review the second quarter, recap the strong start to 2023, and discuss the outlook for the second half of the year.

Data Highlights U.S. Economy's Momentum

While the backdrop has significantly changed, second quarter economic data highlighted the U.S. economy's continued resilience. In the housing market, new home sales rose more than 10% year-over-year in both April and May as tight inventories pushed homebuyers to the new construction market. Personal income, which measures an individual's total income from wages, investments, and other sources, continued to grow. While unemployment rose slightly to 3.7%, companies added approximately 300,000 jobs in both April and May. Revised data showed the economy expanded at a faster pace in the first quarter than previously estimated. First quarter U.S. GDP growth was revised up to a 2% annualized pace from the initial 1.3% estimate, reflecting upward revisions to exports and consumer spending.

The data underscore the economy's momentum, but it's backward-looking rather than forward-looking. An index of leading economic datapoints suggests the U.S. economy may be near a turning point. Comparing the year-over-year change in the Leading Economic Index (LEI) against the Coincident Economic Index (CEI) provides some interesting insights. For context, the LEI is an index of ten economic datapoints, such as unemployment claims, building permits, and manufacturing hours worked, whose changes tend to precede changes in the overall economy. The CEI is an index of four datapoints, such as industrial production and personal income, that tend to move with the economy and provide an indication of its current state.

Data shows the LEI declined 8% during the past 12 months, an indication the economy may be approaching a turning point as the Fed's interest rate hikes take effect. Conversely, the CEI rose 2% over the same period, an indication the economy currently remains strong. Positive

CEI doesn't necessarily mean the economy has avoided a recession, but the CEI's rise does provide additional evidence showing the U.S. economy's resilience despite higher interest rates. Similarly, it's not uncommon for the LEI to decline even as the CEI remains positive. However, past data indicate the U.S. economy has been near the start of a recession each time the LEI fell by more than 5% in preceding 12 months.

S&P 500 Companies Beat Q1 Earnings Estimates

While collective S&P 500's earnings declined 2% year-over-year in the first quarter, an increasing number of companies reported results that exceeded analysts' estimates.

Corporate earnings tell a similar story to economic data. While collective S&P 500's earnings declined 2% year-over-year in the first quarter, an increasing number of companies reported results that exceeded analysts' estimates. Approximately 75% of companies in the S&P 500 beat their sales estimate in the first quarter, up from 65% the prior quarter and above the 5-year average of 69%.

From an earnings perspective, 78% of companies beat their estimate, up from 69% the prior quarter and slightly above the 5-year average of 76%. Like the economy, investors appear to be underestimating corporate earnings strength.

A look ahead to second quarter earnings season reveals a dynamic that is similar to the LEI/CEI divergence mentioned earlier. The S&P 500's earnings are forecasted to decline 7.1% year-over-year in the second quarter of 2023. It's not uncommon for analysts to revise earnings estimates during earnings season as they get more up-to-date information from companies. The downward revision indicates analysts remain skeptical about companies' ability to grow earnings in an environment with higher interest rates and the economy returning to trend after a period of strong growth over the past several years. Like economic data, the question is whether the downbeat earnings forecast, or first quarter's better-than-expected actual results, are more indicative of the path forward

An Update on the U.S. Banking System

Bank deposits plunged in March after steadily declining for almost a year, but data from the Federal Reserve shows deposits stabilized in Q2.

It's been four months since the first signs of bank stresses in early March, and data indicates the stress is easing. Bank deposits plunged in March after steadily declining for almost a year, but data from the Federal Reserve shows deposits stabilized in Q2. On a related note, there were concerns deposit outflows would cause banks to slow, and potentially shrink, their lending activity. However, another Federal Reserve dataset shows loans and leases on bank balance sheets held relatively steady during the second quarter. While banks are not increasing their lending activity, the data indicates they are not pulling back either.

Although banks appear to be on more stable footing today, there are still questions about the banking system. Recent stability doesn't necessarily rule out the risk of deposits resuming the trend lower, especially with interest rates remaining elevated. In addition, profitability is a concern. Banks make money by charging a higher interest rate on loans than

An increase in interest expense without an offsetting increase in interest income means banks' profit margins may decline.

the interest rate they pay on deposits. Now that depositors can earn a higher yield on money markets & bonds, banks must pay a higher interest rate on deposits to remain competitive. However, banks' interest income is still tied to loans made during the past few years when interest rates were lower. An increase in interest expense without an offsetting increase in interest income means banks' profit margins may decline. In addition, there is concern banks may lose money through higher defaults on consumer, business, and real estate loans if the economy weakens. The pressure on deposits eased as we finished the second quarter, but we will continue to monitor this sector during the second half of the year..

Equity Market Recap – Gains Continue

The stock market held first quarter gains and traded relatively flat until a steady climb began in mid-May leading to a second quarter gain of 8.3% for the S&P 500 Index. The biggest Technology stocks performed even better, with the Nasdaq 100 returning 15.3% in Q2 after its 20.7% Q1 return. The Nasdaq 100's 39.1% return is the strongest first half year return since 1989, ranking ahead of both 1998 and 1999 during the dot-com bubble. Small cap stocks also participated in the rally, returning 8.1% through the end of June.

While the S&P 500's headline return is impressive, a look underneath the surface tells a different story. We compared the first half return of the S&P 500 Index to an equal weight version of the same companies. The S&P 500 Index is weighted by market cap, which means the biggest stocks can significantly impact the index's performance. An equal weight index neutralizes the impact of the bigger companies and allows investors to track how the average stock is performing. Early in 2023, both versions of this index traded similarly, an indication market cap didn't significantly impact performance.

While the S&P 500 ended the first half of 2023 with a strong return, the average stock's return was noticeably smaller and indicates the first half rally was top-heavy. Investors will be watching to see if the first half S&P 500 rally broadens in the second half of the year.

However, the market cap and equal weight versions of the S&P 500 diverged in March when the first signs of regional bank turmoil appeared. The S&P 500 traded higher in April and May, while the equal weight index traded sideways. The split indicates the biggest stocks drove a large portion of the S&P 500's gain in the second quarter. While the S&P 500 ended the first half of 2023 with a strong return, the average stock's return was noticeably smaller and indicates the first half rally was top-heavy. Investors will be watching to see if the first half S&P 500 rally broadens in the second half of the year.

After outperforming in the first quarter, international stocks underperformed U.S. stocks in the second quarter. The MSCI EAFE Index of developed market stocks gained 3.2%, outperforming the MSCI Emerging Market Index's 1.0% return. Looking across international markets, Latin America was the top performing region as both Brazil and Mexico traded higher. Latin America is benefitting from geopolitical tensions between the U.S. and China, which is pushing investment toward the region. Within developed markets, Asia outperformed Europe as Japanese stocks traded to a 30-year high. However, Japanese stocks are only now getting back to their level from the late-1980s when the bursting of a real estate bubble contributed to a significant stock market decline.

The 2-year Treasury yield, which is viewed as a proxy for Federal Reserve policy rate, rose from 4.06% to 4.87%.

Bond Market Recap – Yields Continue to Move Higher

Treasury yields continued to rise sharply in the second quarter after ending the first quarter lower due to regional bank stress. The 2-year Treasury yield, which is viewed as a proxy for Federal Reserve policy rate, rose from 4.06% to 4.87%. Over the same period, the 10-year Treasury yield rose from 3.49% to 3.81%. The increases are being attributed to better-than-expected economic data, which could in turn force the Fed to raise interest rates higher than previously thought. Rising interest rates weighed on bonds in Q2 with the Bloomberg U.S. Bond Aggregate Index declining .9%.

An interesting piece of information we found during the second quarter is the increase in bankruptcy filings. The number of bankruptcy filings stayed below average in 2021 and 2022. During the pandemic companies benefitted from low interest rates, fiscal stimulus, and loose bank lending standards. This made financing easier and allowed even highly leveraged companies to refinance their existing debt as well as incur new debt. Separately, rising inflation increased companies' pricing power and drove strong sales growth, which in turn led to higher profit margins.

The number of bankruptcy filings in March 2023 crossed above the 20-year median for the first time since December 2020, coming back in line with the pre-pandemic trend. The increase may be due in part to higher interest rates, tighter bank lending standards, and easing inflation.

However, it appears this trend may be reversing. The number of bankruptcy filings in March 2023 crossed above the 20-year median for the first time since December 2020, coming back in line with the pre-pandemic trend. The increase may be due in part to higher interest rates, tighter bank lending standards, and easing inflation. Higher interest rates and tighter bank lending standards are increasing companies' financing costs at the same time inflation is easing and companies are starting to lose pricing power.

Third Quarter Outlook – Will the Strength Continue?

The first half of 2023 was marked by continued economic resilience and a rebound in the equity market. The U.S. economy outperformed expectations despite the Fed's aggressive 2022 rate hikes, with new home sales rising, personal income growing, and continued job creation. Corporate earnings exceeded expectations, and the S&P 500 gained more than 15%.

The risk remains that the Fed is too aggressive in tightening monetary policy in the face of a weak economy thereby causing any economic slowdown to become much worse.

As we enter the second half of 2023, investors are left asking whether the good times can continue. The LEI indicates the U.S. economy may be nearing a turning point, and the economic data may start to show the cumulative effect of the Fed's interest rate hikes. Interest rate futures indicate an expectation of at least two more rate hikes in 2023. The risk remains that the Fed is too aggressive in tightening monetary policy in the face of a weak economy thereby causing any economic slowdown to become much worse. While the first-half S&P 500 rally was impressive with subdued volatility, it was also top-heavy, with larger stocks driving a significant portion of the gains. Corporate earnings are forecasted to decline, and bankruptcy filings could rise further if borrowers struggle to refinance and/or profit margins decline.

We have presented some of the known risks that the economy and market face as we move into the second half of the year. However, we also expect currently unknown events to impact the markets as we move forward as well. Our team will continue monitoring conditions as they evolve and will be prepared to adapt portfolios if needed as the second half plays out.

Thank you for your continued support,

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Sources:

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The S&P 500 Index consists of 500 stocks chosen for market size, liquidity, and industry group representation. It is a market value weighted index with each stock's weight in the Index proportionate to its market value.

The NASDAQ 100 Index is an unmanaged group of the 100 biggest companies listed on the NASDAQ Composite Index. The list is updated quarterly and companies on this Index are typically representative of technology-related industries, such as computer hardware and software products, telecommunications, biotechnology and retail/wholesale trade.

The MSCI EAFE Index is designed to represent the performance of large and mid-cap securities across 21 developed markets, including countries in Europe, Australasia and the Far East, excluding the U.S. and Canada.

The MSCI EM Latin America Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of emerging markets in Latin America. The Index consists of the following six emerging market country indices: Argentina, Brazil, Chile, Colombia, Mexico, and Peru. Source: MSCI. MSCI makes no express or implied warranties or representations and shall have no liability whatsoever with respect to any MSCI data contained herein. The MSCI data may not be further redistributed or used as a basis for other indices or any securities or financial products. This report is not approved, reviewed or produced by MSCI.

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