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Market Overview

All major stock indices experienced second quarter gains as the regional banking crisis settled down. The annual percent change in the Consumer Price Index (CPI) continued to decline, contributing to bullish sentiment for growth stocks as investors anticipated a pause in the rate hiking cycle. The Nasdaq[1] led second quarter stock returns finishing up 13.05%, with the S&P 500 Index[2] and the Dow Jones Industrial Average[3] ahead by 8.74%, and 3.97%, respectively.

In the second quarter of 2023, Technology was the top performing sector rising 15.37% followed by Consumer Discretionary at 13.78%, and Communication Services by 12.45%. These sectors are currently the best performing sectors for 2023. In terms of performance, U.S. large cap stocks led the way, finishing the 1st half of 2023 ahead by15.5%. However, despite the rally, returns have been mostly driven by the market's largest stocks, with the top 10 companies in the S&P 500 accounting for over 95% of the index's year-to-date performance. Elsewhere, U.S. small caps lagged behind their large cap peers in the first half of 2023 due to the lower quality of earnings and their greater exposure to cyclical sectors, which have underperformed this year.

The Federal Reserve ("the Fed") continued to hike interest rates in the second quarter with a 25 basis point increase in May and a pause in June. These moves brought the Federal funds rate range to 5.00% to 5.25%. The Fed has now changed the trajectory of their rate hiking cycle. Fed Chair Powell is expected to increase rates two more times before the end of the year and the market doesn't see rate cuts until 2024. While there has been a notable softening in manufacturing and declines in real consumer spending, labor market conditions have remained resilient. Workers continue to have jobs, and there are plenty of job openings. However, credit conditions have tightened further and student loan payments are due to resume in October. Though some think this will lead to a consumer recession, current economic data still do not point that way.

Ten-year Treasury bond yields rose 32 basis points (.32%) during the second quarter as the bond market expected the Fed to continue hiking rates but at a slower pace. Even as bond yields rose, equities pushed higher. This was partly due to earnings surprises to the upside as well as a declining volatility seen in the VIX index.

International and emerging markets were positive for the second quarter of the year as the falling US dollar and stronger foreign economic data bolstered returns.

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U.S. Equity Returns Table
Source: Tamarac

Index	Q2 2023 Returns	2023 Returns
Dow Jones	3.97%	4.93%
S&P 500	8.74%	16.89%
NASDAQ	13.05%	32.32%
Russell 2000	5.20%	8.09%
MSCI World	6.35%	14.26%

U.S. Treasury Yield Table
Source: Treasury

	06/2023	06/2022	06/2021
3 month	5.17%	1.66%	0.05%
2 year	4.87%	2.92%	0.25%
5 year	4.13%	3.01%	0.87%
10 year	3.81%	2.98%	1.45%
30 year	3.85%	3.14%	2.06%

Other Indices Table
Source: Morningstar

	Q2 2023 Returns	2023 Returns
Gold (GLD)	-2.70%	5.09%
Brent Oil (BNO)	-4.18%	-9.94%
U.S. Dollar Index (UUP)	1.79%	2.05%
Int'l Equity Markets (EFA)	3.25%	12.49%
Emerging Equity Markets (EEM)	1.04%	5.20%

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The Two Faces of First Half Stock Returns

The first half of this year was outstanding for most of the major market averages, but not so much for the average stock. While the S&P 500 advanced by 16.8% and the Nasdaq Composite index rose 32.2%, the average stock represented by the equal-weighted S&P 500 Index gained only 6.9%. And dividend oriented stocks represented by the iShares Select Dividend ETF *declined* 4.5%.[4]

But in 2022, things went the other way. There was a significant return difference between the cap weighted stock indexes and those that have equal-weighted stocks. Technology stocks are 28% of the S&P 500. And these were the stocks that declined 50% on average last year, resulting in an 18% decline in the overall S&P 500 and a 39% decline in the Nasdaq Composite index versus a 11.6% decrease in the S&P equal-weighted version.[5]

The combination of a long called-for recession and rising interest rates are especially harmful to technology-linked returns, and supportive of more defensive stocks such as consumer staples and healthcare to which the equal weighted index has higher exposure. As the Wall Street recession consensus took hold, investors sought out those defensive sectors in 2022. The result was market beating returns in those stocks, and sharp declines in technology stock prices, whose movements are closely tied to low interest rates and positive economic growth.

But as 2023 progressed, it became apparent that the economy refused to buckle under rapid increases in Federal Reserve-induced interest rates. Unemployment remained near historic lows, inflation was declining, and corporate earnings shortfalls were much milder than expected. As a result, investor expectations began to shift. The mild recession/soft landing scenario started to take hold. And Federal Reserve comments about "pausing" their increases in interest rates in the Spring of this year added to the growing chorus.

So, in the first half of this year, the tables turned, and technology was buyable again. While this result has plenty of historical parallels, the spread of Artificial Intelligence (AI) has amplified the "mean reversion". The potential for that software to become imbedded chiefly in the largest technology companies and be made available to economy-wide applications amplified investors' movement into large cap technology. Meta's 66% decline last year is set against its 138% return this year through June 30, and Nvidia's 50% decline in 2022 has been followed by an 189% return so far this year.[6]

But investors' mad rush into what many believe as "game-changing" technology has inflated their valuation metrics to all-time highs, which should give pause to investors chasing the other face of first half returns.

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Disclosures

Sources:

1. The Nasdaq Composite is a stock market index that includes almost all stocks listed on the Nasdaq stock market and is heavily weighted towards companies in the information technology sector.
2. The S&P 500 Index is designed to be a leading indicator of U.S. equities and is commonly used as a proxy for the U.S. stock market.
3. The Dow Jones Industrial Average (DJIA), or simply the Dow, is a stock market index of 30 prominent companies listed on stocks exchanges in the U.S.
4. https://www.ishares.com/us/products/239500/ishares-select-dividend-etf
5. https://investor.morningstar.com/quotes/0P000003RE
6. https://investor.morningstar.com/quotes/0P00002D7X

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