Q2 2023
MARKET ROUNDUP

Market Recap

One of Wall Street's adages – the market does what it needs to do to prove the majority wrong – came true in the first half of 2023. Coming into the year and dating back to the October 2022 lows, investor and consumer sentiment had hit rock bottom, close to levels not seen since 2008-2009. In spite of, or perhaps because of, the pessimism, the market staged one of its best first halves on record. The S&P 500 jumped 15.9%, the best since 2019 and 2nd best this century. Meanwhile, the tech-heavy Nasdaq Composite rose 31.7%, its strongest start since 1983 and third best since data began in 1972. The stock market's quick recovery from the regional banking crisis brought many skeptics off the sidelines.

In the fixed income markets, some recent economic datapoints have been "less bad" and surprised to the upside. We saw rates across the yield curve tick up, resulting in negative returns for the quarter, except for high yield bonds.

	MTD	QTD	YTD	1 Year	3 Years	5 Years
Equities						
US Large Cap	6.61%	8.74%	16.89%	19.59%	14.60%	12.29%
US Mid Cap	9.16%	4.85%	8.84%	17.61%	15.44%	7.78%
US Small Cap	8.23%	3.38%	6.03%	9.75%	15.19%	5.22%
International Developed	4.55%	2.95%	11.67%	18.77%	8.93%	4.38%
International Emerging	3.80%	0.90%	4.89%	1.75%	2.32%	0.93%
Bonds						
US Aggregate	-0.36%	-0.84%	2.09%	-0.94%	-3.96%	0.77%
Short Term Bond	-0.62%	-0.62%	1.19%	0.19%	-1.57%	1.15%
Treasuries	-0.75%	-1.38%	1.59%	-2.13%	-4.80%	0.44%
High Yield	1.67%	1.75%	5.38%	9.06%	3.13%	3.35%
Specialty						
Real Estate (REITs)	5.31%	1.17%	3.00%	-4.28%	6.14%	4.83%
Gold	-2.65%	-3.41%	5.43%	5.24%	2.65%	8.86%
Bitcoin	12.46%	7.00%	83.14%	60.77%	49.28%	38.80%

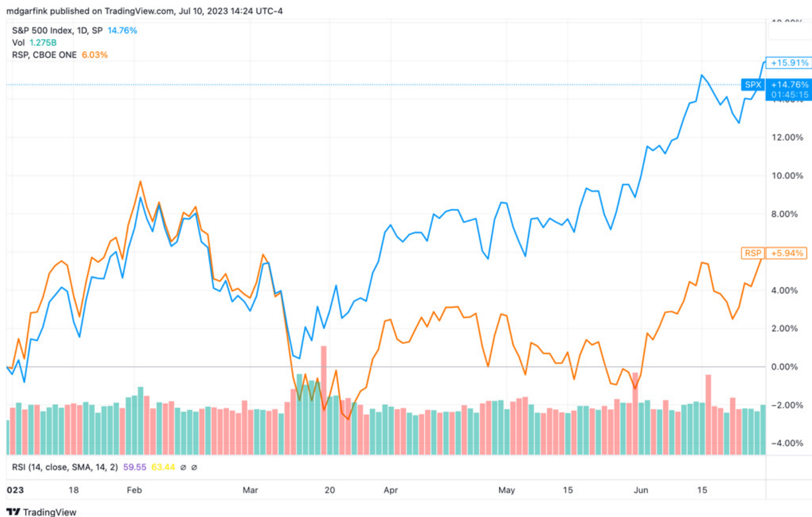
The following is a summary of our key observations over the quarter and the impact on our outlook:

- Mega-Cap stocks have contributed the lion's share of performance to the S&P 500 in the first half of the year, significantly outperforming the broader market of stocks.
- After a pause in rate hikes, Fed policy may once again be taking center stage, as recent economic data has been more positive, potentially prompting future rate hikes.

- The 10 vs 2 year Treasury yield curve inverts to new lows.
- "Fear of missing out" (FOMO) has lured the average investor from the sidelines, as we have seen record inflows into index funds massive purchases of short-dated call options. Investor sentiment has swung from extremely bearish to wildly bullish in just half a year.

Mega-Cap Stocks Outperform the Broader Market

In early June, we previously highlighted the powerful impact that Mega-Cap stocks have had on both the S&P 500 and Nasdaq 100, pointing out that Meta, Amazon, Apple, Microsoft, Google, Tesla, and Nvidia had comprised a bulk of the benchmark's returns, while the remaining 493 companies had flatlined with 0% total return in the same timeframe. While we did see some broadening of the market in June with solid returns in small and mid-cap stocks, the story remains the same as the S&P 500 Index significantly outpaced the S&P 500 "equal-weighted" version: 16.8% vs 6.9% in the first half of the year. The leadership from mega-caps is not a problem if other stocks are rallying. Issues arise typically when mega-caps are the only stocks going up and driving all the returns.



When we refer to the S&P 500 as a "cap-weighted" index, it signifies that each company's impact on the index's performance aligns with its size or market capitalization (or "cap"). The seven companies mentioned above constitute 27.65% of the S&P 500, boasting a combined market cap of slightly above $10 trillion. This matches the combined GDP of Japan, Germany, and South Korea - nations with a total population of around 260 million. The concern here is that any mean reversion in the mega-cap tech stocks, even small, would have a meaningful impact on the levitation act we have seen for these cap-weighted indices.

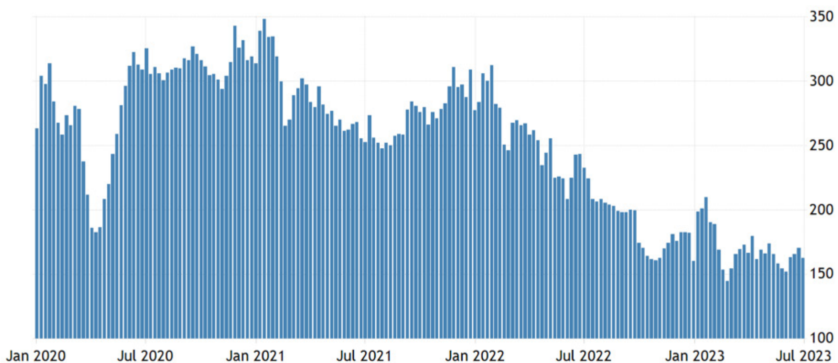
The Economy, Fed Policy, and Inflation

Starting in May, some of the economic datapoints have shown some marginal improvement and surprised to the upside. Just in the last week or two we have seen the following reports:

- Jobless Claims: Weekly Jobless Claims came in much lower than expected, the largest month over month decrease in 20 months.
- Housing Starts: The most recent report saw US Housing Starts spike 20% month over month, to the highest level in 12 months.
- GDP Revision: Q1 GDP (albeit a lagging indicator) was revised higher.
- Durable Goods: Durable Goods orders accelerated across the board in May versus the prior month.

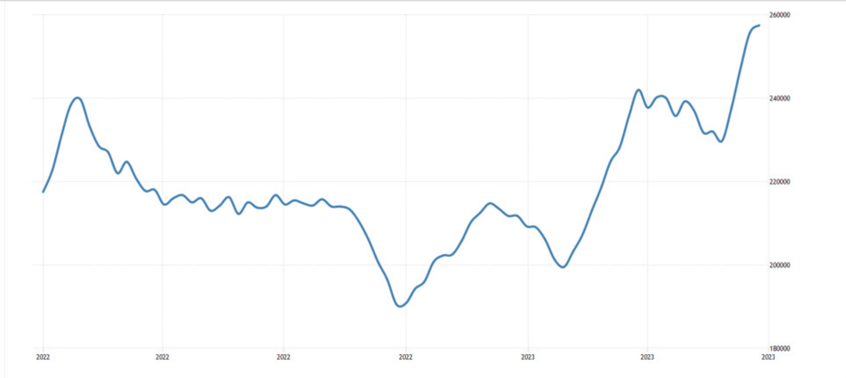
At face value, these latest economic releases indicate the economy has not yet given into the inevitability of a recession, which is positive in one respect; however, the risk of this improving data is that it further emboldens the Federal Reserve and Chairman Powell to tighten monetary policy. We have already had the hawkish pause in place with the likelihood of two additional rate hikes this year. So, what happens if the economy remains resilient, the job market continues to be robust, and inflation reaccelerates? Such an occurrence would not be out of the realm of possibility and would force the Fed into a conundrum between taming inflation and the potential of causing real damage not just to the economy, but also to the Federal deficit with rising interest costs.

Before we get too far ahead of ourselves, we can temper some of that concern with economic data that is not quite as robust. Despite the strong housing starts number, existing home inventory remains at record low levels due to higher rates that have owners locked in, so to speak, to their current homes. Since you cannot buy what is not for sale, we have the chicken & egg phenomenon, whereby, no one is going to move if there is no supply and how do you get more supply if no one is willing to move? This will continue to cultivate inventory tightness and home price firmness for the time being, until something gives. Mortgage purchase application data remains at extremely low levels, reflecting that overall housing turnover and activity is not quite as robust as the housing starts data might suggest.



Similarly, while the latest jobless claims data surprised to the upside, when we view this data on a smoothed basis, the typical 4 week moving average, initial unemployment claims are still trending upward from the cycle lows of early 2022.

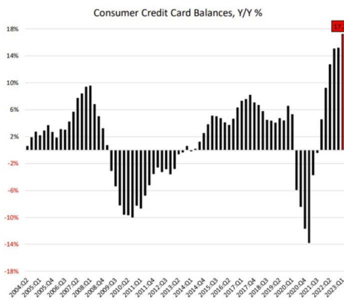
United States - 4-Week Moving Average of Initial Claims

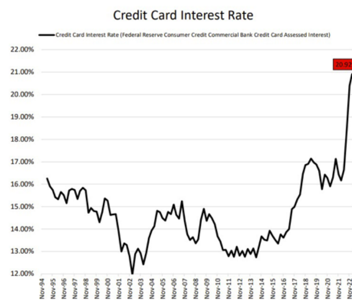


Lastly, with respect to the economy, the consumer has continued pushing the envelope with respect to spending, but the trend of rising consumer credit card balances and higher interest costs on that debt will remain a headwind. Coupled with the resumption of student loan debt repayments to begin in just a few months, at some point, we should begin to see dampening effect on consumer spending.

Consumer Squeeze, #Reiterated → Update = Re-Reiterated! HEDGEYE

The updated 1Q data shows Credit Card Balances grew at the fastest pace in at least 20 years while the Cost of that Revolving Credit continues to summit higher, multi-decade highs.



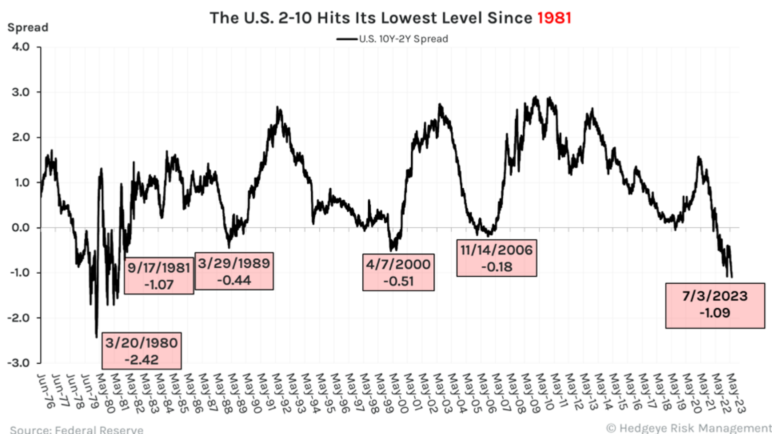


Data Source: NY FED, Federal Reserve © Hedgeye Risk Management LLC. 37

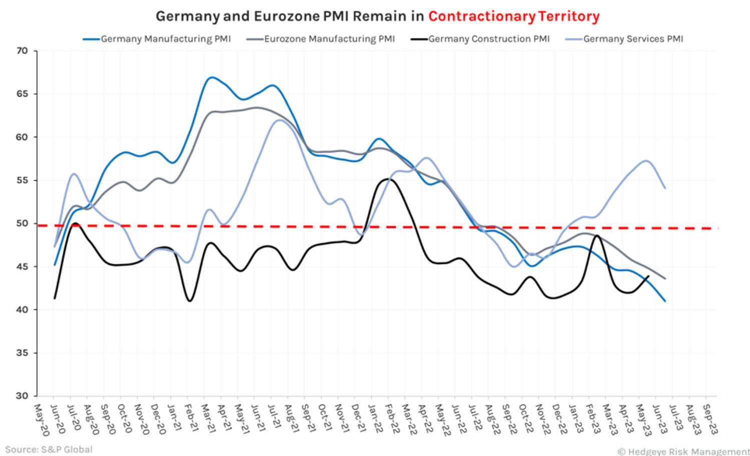
On the inflation front, the Fed has been hoping to pare the core inflation rate to 4% by the end of 2023, but there is more work to be done on that front with the latest reading on Core PCE coming in around 4.6%.

The Inverted Treasury Yield Curve and Bond Market Volatility

Two-year Treasury yields tend to move in tandem with Fed Funds rate expectations. Even though the Fed Funds rate has been just above 5%, the two-year yield had been trading around 4% as late as mid-May until it became apparent that the Fed would be raising rates again following the latest pause in rate hikes. Since that time, the 2-year yield has risen to 4.9%, while 10-year yields have also risen sharply over that same time span from 3.52% to 4.08%. This has resulted in the largest inversion of the yield curve since the early 1980's. The significance is that yield curve inversions have been a solid predictor of slowing economic growth or even a recession, as the increase in short-term rates chokes off credit availability and economic growth.



The economic weakness foretold by the 10-year vs 2-year curve is reflected across the globe. Global Flash PMI (Purchasing Managers Index) Reports reflect decelerating and contractionary industrial activity across the Eurozone. Meanwhile, back at home, the ISM Manufacturing index printed a new cycle low of 46 for June vs 46.9 in May. Remember that any reading below 50 is contractionary. Note that with the most recent ISM survey in the US, all of the components of manufacturing are now in contractionary territory. It was after this report that the 10 vs 2 inverted to -109 basis points, reflected above.

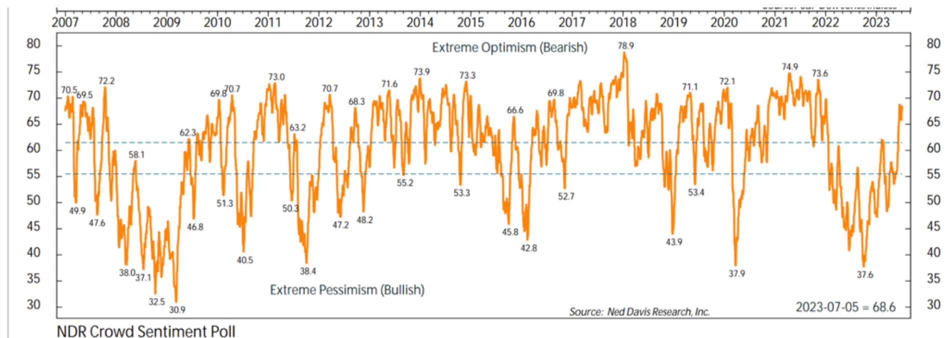


Bond market volatility was a key driver of stock market volatility in 2022 as interest rates rose precipitously through the year. Bond market volatility is measured by the MOVE Index. The MOVE is a benchmark for US treasury market volatility, and the index is based on 1-month treasury options weighted for 2, 5, 10, and 30-year contracts. The index captures the implied volatility of the bond market, which is important because the bond market can tend to signal things to come ahead of the equity market, since the underlying plumbing of finance happens in the bond market.

Below is a chart of the MOVE index. This metric had been trending lower over the last couple of months, until the start of July. Why is this relevant? It is always important to pay attention to volatility because downward trending volatility is generally bullish for the underlying asset class. In this case, the asset class that we are discussing is US Treasury Bonds. Slowing growth is positive for bonds and if bond volatility continues to fall lower, that would create another layer of positive conditions for US Treasury Bonds. The recent jump in the MOVE index is something that we will be monitoring with interest, not just with respect to fixed-income performance, but also in relation to equity volatility.

Investor Sentiment Shifts to Bullish

In just a few short months, investor sentiment has swung from extremely bearish at the end of 2022 to wildly bullish today. This can be interpreted as both good and bad. Fear has dissipated from the market reflected by the steady decline in stock market volatility, represented by the VIX index. One measure of investor sentiment that we follow is the Crowd Sentiment Poll from Ned Davis Research. In the chart below, one can see the level of peak bearishness that was reached in the fall of 2022, and then the rebound to bullishness that we see today.



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Ned Davis likes to say beware of the crowd at extremes. Certainly, the bearish levels that we saw last fall represented a good time to break from the crowd. Looking at the level today, however, the pendulum has swung the other direction, which is indicative of the average investor re-entering the market en masse. Chasing the S&P 500 and the Nasdaq 100 higher, investors have flocked back into the market reflecting only the fear of missing out on further market upside. At the very least, we are now seeing a higher level of investor complacency and lack of investor fear of risk or volatility, signaling that the market may be due for a rest or pullback in the short to intermediate term.

Indicative of the mad rush back into equities, we can see the nearly unprecedented June inflows from investors into index funds, along with massive call option purchases, which has helped to suppress market volatility.

The Bottom Line

We have discussed at great length the impact of the largest stocks on the cap-weighted market benchmarks, but one other interesting factoid reflecting just how large these companies have become is that Apple's market capitalization is now larger than the entire Russell 2000 small cap index. This can lead to some wide divergences of performance between Apple and the S&P500 compared to small cap stocks in general, just as we have witnessed in the first half of 2023.

Thus far, there has been a dichotomy between the relationship of stocks and Fed policy in 2022 and that same relationship in 2023. Aggressive Fed policy drove rising bond market volatility, which led to rising stock market volatility, pushing stocks down. Thus far, in 2023, similar Fed policy with continuously rising interest rates has not yet led to the same stock market volatility we saw last year. Growth stock valuations are certainly beneficiaries of lower, not higher, interest rates, which begs the question, what has been the driver of growth stock valuations in the face of rising interest rates in 2023? Perhaps it is merely the collapse in volatility that we have witnessed across most asset classes, including stocks (the VIX from 22 to 14), bonds, or high yield credit spreads which have fallen from 455 to 400 basis points. All of this is happening in the face of rising business bankruptcies, a continued deterioration in the corporate profits cycle, and tightened credit conditions and lending standards. Either market participants are becoming overly complacent and not pricing in the aforementioned risks or the Fed is going to be able to engineer the perfect soft landing along a very rocky runway.

While 2023 is off to a much better start than 2022, the broader market has not experienced the exuberance of the S&P 500 or the Nasdaq. There have been a few more positive indicators that the economy is holding up; however, there are other signs that the economy will not be accelerating anytime soon. As we manage our portfolios, it is important that we keep that broader perspective that includes an historical context and to see the entire forest that exists beyond the trees. No one can say with 100% certainty how the current situation will play itself out, but we maintain a more cautious approach with equities at the lower end of our allocation. Furthermore, we maintain exposures to alternative asset classes, such as private credit, that tend to be less correlated with the stock market, and in some cases, perform well in times of market stress.

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Index definitions: "U.S. Large Cap" represented by the S&P 500 Index. "U.S. Small Cap" represented by the S&P 600 Index. "International" represented by the MSCI Europe, Australasia, Far East (EAFE) Net Return Index. "Emerging" represented by the MSCI Emerging Markets Net Return Index. "U.S. Aggregate" represented by the Bloomberg U.S. Aggregate Bond Index. "Treasuries" represented by the Bloomberg U.S. Treasury Bond Index. "Short Term Bond" represented by the Bloomberg 1-5 year gov/credit Index. "U.S. High Yield" represented by the Bloomberg U.S. Corporate High Yield Index. "Real Estate" represented by the Dow Jones REIT Index. "Gold" represented by the LBMA Gold Price Index. "Bitcoin" represented by the Bitcoin Galaxy Index