Commonwealth

2023 Midyear Market and Economic Outlook

Executive Summary: Cutting Through the Noise

The story of the first half of 2023 was simple: the results were better than anticipated. Hiring remained strong, consumers and businesses stayed confident, and the economy grew. All market indices were up, and corporate earnings beat expectations. Although growth slowed, financial conditions remained steady, with inflation and longer-term interest rates pulling back.

As we enter the second half of the year, the story appears more complicated. Inflation may be heating up again, and recession fears persist. The U.S. relationship with China remains rocky, and the war in Ukraine continues. In short, we have as many risks now as we did in January. And with slower growth, there's less cushion for the economy and markets.

Still, inflation is down from its highs, and the Federal Reserve (Fed) has suggested it may pause rate hikes. The debt ceiling has been resolved without a crisis. The international situation, while still worrying, isn't much different than it has been for the past year. Add strong job growth and consumer confidence, and the economy looks much like it did at the start of the year. That economy proceeded to outperform, and it could very well do so again given the low expectations.

As we forecast what's ahead, we need to acknowledge the risks, including the real possibility of a recession. But when we cut through the noise, we see positive data. Economic growth looks poised to continue. Market tailwinds—namely, earnings growth and potentially lower inflation and rates—are blowing. Yes, growth will almost surely be slower. But that slower growth could mean lower rates, which would help support markets.

This is the big picture for the rest of 2023. Now let's dive into the details.

By the Numbers: 2023 Year-End Expectations

Inflation	GDP growth	Fed funds rate	U.S. Treasury 10-year yield	S&P 500
3%–4%	1%–2%	5%	3.75%	4,350

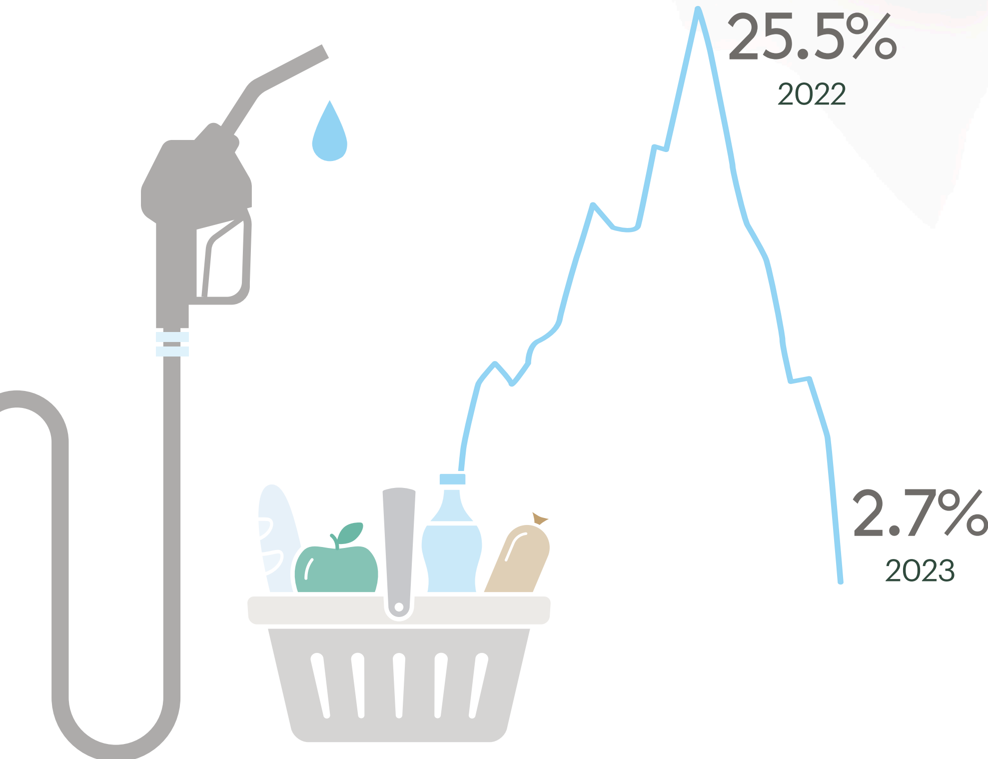
U.S. Economy:
Uncovering Reasons for Optimism

The looming economic question remains whether the Fed can execute its soft landing—in other words, cool inflation without sending the economy into a recession. Although inflationary pressures have moderated significantly, investor skepticism remains high, and markets have been volatile. Even with this uncertainty, there are reasons for optimism as we enter the second half of 2023—especially when we look beyond the headlines to the data.

Moderating Inflation

Elevated food and energy prices have been a headwind to growth. But inflationary pressures in this area have dissipated—a trend that is certainly favorable from an economic perspective.

Food and Energy Prices Trending in the Right Direction



Source: Bureau of Labor Statistics, Haver Analytics, as of May 31, 2023

Food and energy inflation approaching the Fed's long-term target of

2%

Gasoline prices are

30%

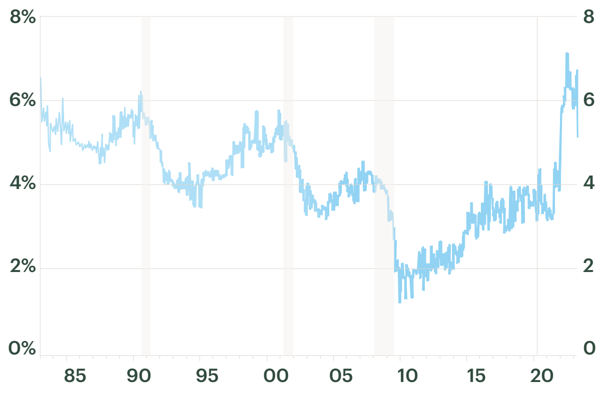
lower than they were a year ago

Improving Wage Growth

As price growth has slowed, wage growth has moved in the opposite direction. In fact, individuals are experiencing some of the largest wage gains in decades, amounting to an average 5.2 percent increase year-over-year.

The Path to Recovery: Wage Growth on the Upswing

Wage Growth: Y/Y %Chg



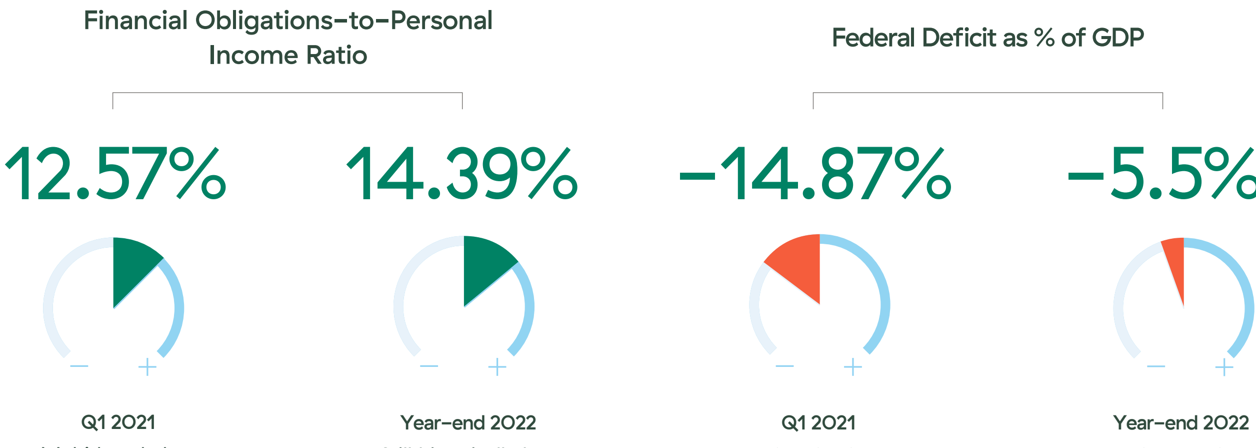
Source: Federal Reserve Bank of Atlanta, Haver Analytics, as of May 31, 2023

> With consumption being two-thirds of the U.S. economy, increased consumer purchasing power on a backdrop of stable prices could be a boon for markets and the economy.

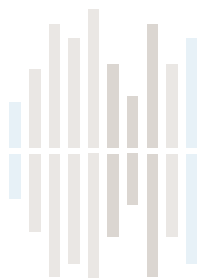
Increasing Fiscal Responsibility

Consumers. Another factor contributing to our positive outlook is the American household, which has shown a high level of fiscal responsibility in recent years. Specifically, many consumers have avoided high-interest credit card debt and refinanced mortgage debt at every opportunity. As a result, the ratio of financial obligations to disposable personal income for the average American household is at a multidecade low.

Government. We're also seeing positive developments at the government level. A significant amount of fiscal stimulus was deployed to keep the economy afloat during the pandemic. As tax revenues fell and spending increased, the deficit as a percentage of GDP increased to historical extremes. Fortunately, the economy recovered in short order. Tax revenues have increased as a result, and the deficit has moved back toward more sustainable levels.



Source: Federal Reserve Board, U.S. Treasury, Bureau of Economic Analysis, Haver Analytics



Equity Markets:
Seeing Through the Risks

In the first half of 2023, equity markets faced elevated inflationary data and Fed rate increases, the simmering debt ceiling debate, and shocking bank failures. Despite this backdrop, some markets managed to see gains.

Large-cap growth was the best-performing area in the U.S. market, while small-cap value fared the worst. With financials accounting for 22 percent of the Russell 2000 Value Index, the failures of Silicon Valley Bank, Signature Bank, and First Republic weighed heavily on its performance. Overseas, international markets dealt with their own banking issues (e.g., Credit Suisse) but rallied in Europe fueled by China's reopening.

Year-to-Date Returns by Investment Style

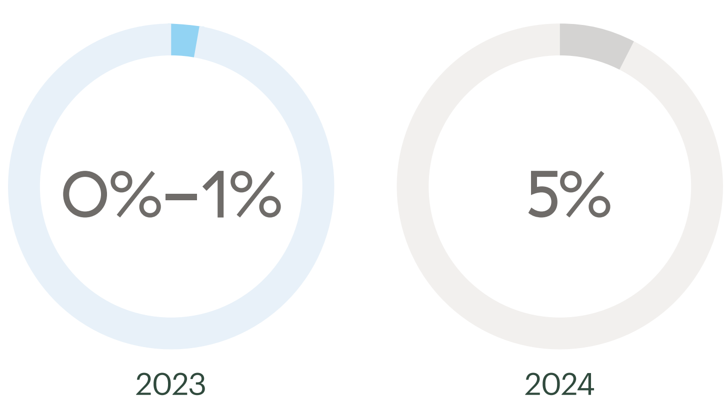
	Value	Blend	Growth
Large	2.3%	12.8%	23.6%
Mid	1.7%	4.9%	11.0%
Small	1.9%	6.6%	11.3%

Source: FactSet, Refinitiv Datastream, Russell Investment Group, Standard & Poor's, J.P. Morgan Asset Management, as of June 9, 2023. All calculations are cumulative total return, including dividends reinvested for the stated period. Total return is based on Russell style indices except for the large-blend category, which is based on the S&P 500 Index.

What Drove the U.S. Market Rally?

There are two factors behind the market rally: the Fed and earnings. First, Fed futures are starting to price in the potential for rate cuts in the second half of the year. Second, first-quarter earnings fared largely better than expected, with corporations delivering solid results despite setting relatively low expectations.

Earnings Expectations Breakdown



Source: Bloomberg Intelligence

S&P 500 has rallied nearly **13%** this year (through June 9)

Large-cap growth is up more than **23%**

International markets are up by just under **9%**

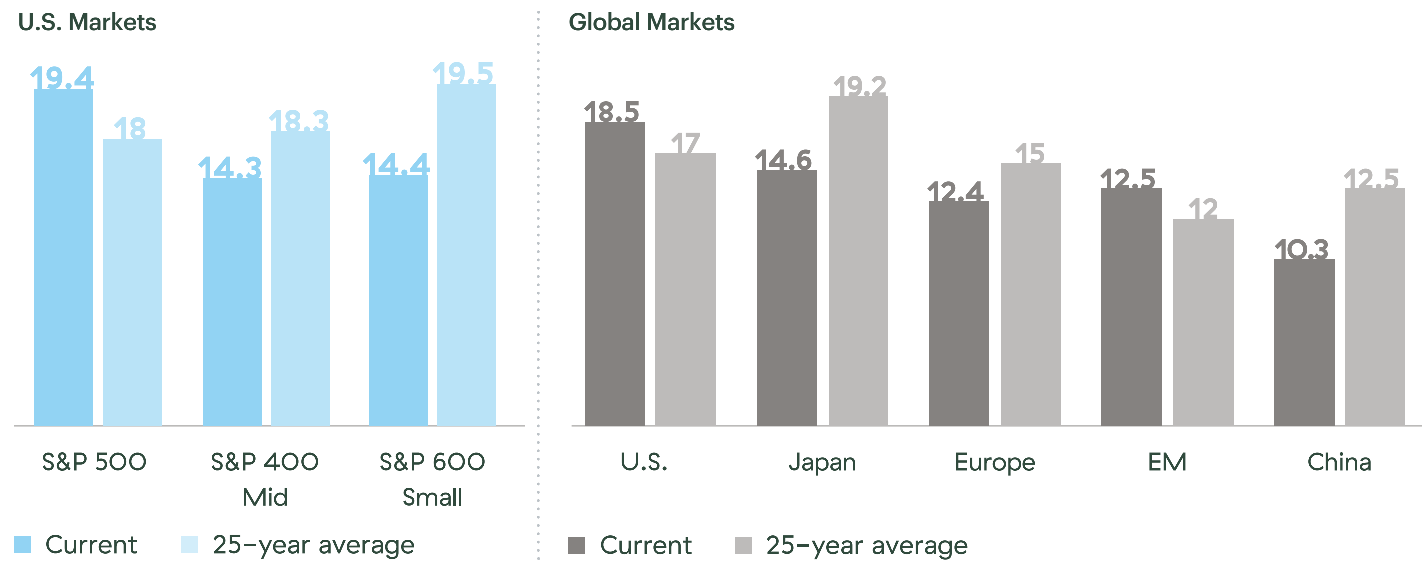
Where Do We Go from Here?

Entering 2023, stocks were relatively attractive—especially after a difficult year in the equity markets. The S&P 500 was trading just below its 25-year average forward P/E ratio of 16.8x. (The forward price-to-earnings [P/E] ratio divides the current share price of the index by its estimated future earnings.) Equity valuations have since risen on the heels of the market rally and a muted earnings growth outlook.

But looking at the S&P 500 from a broad market-cap-weighted basis doesn't tell the full story. Mid- and small-cap areas of the market, for example, are trending below their historical averages, showing there may be opportunities for growth in the longer term.

International remains cheap compared to the U.S.

Current Valuations Vs. Long-Term Average



Source: FactSet, MSCI, Standard & Poor's, Thomson Reuters, J.P. Morgan Asset Management, as of June 9, 2023. Forward P/E ratios are based on pro-forma earnings and are in U.S. dollars. MSCI Europe includes the eurozone as well as countries not in the currency bloc, such as Norway, Sweden, Switzerland, and the U.K., which collectively make up 44 percent of the overall index.

What About the Fundamentals?

Valuations alone don't necessarily determine the relative attractiveness of an investment. Fundamentals also play a role in determining the future direction of asset classes. In fact, the best investments tend to have a combination of relatively attractive valuations and improving fundamentals.

Besides inflation and monetary policy, markets will be watching to see whether banking issues continue and the impact that would have on lending and economic growth. While geopolitical risks are not quite as front-and-center today as they were at the start of the year, the environment remains fraught with uncertainty, and any bad news could weigh on stocks.

What's on our mind?

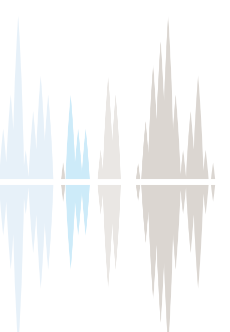
What if banks continue to fail?

Will companies continue to cut their earnings forecasts?

What are the unknown unknowns?

Look Beyond the Headlines

As a result, the path forward for equity markets calls for caution. Given the diversion in potential outcomes, a portfolio balanced across the risk spectrum remains the best path forward for most investors. It's important to remain focused on the underlying data, not the headlines—and to react accordingly to take advantage of potential opportunities.



Fixed Income Markets:
Mining for Value Opportunities

2022 was a volatile year for fixed income markets. But as 2023 began, the rising yield environment set the stage for a smoother start. Most major fixed income sectors saw positive performance, supported by improved starting valuations and falling long-term yields. As we look ahead, value opportunities across various fixed income sectors may be on the horizon.

U.S. Treasuries

If we hit 2 percent inflation in the next few years, long-term Treasuries at current yields would be an attractive option.

Short-term Treasury bills and intermediate-term Treasury notes are options for those looking to capitalize on the inverted Treasury yield curve (which is when short-term rates are higher than longer-term ones).

Corporate Bonds

The Bloomberg U.S. Corporate Investment Grade Bond Index had an average yield-to-worst (the lowest yield an investor can receive) of 5.49 percent (as of June 9, 2023), a meaningful increase over similar-duration Treasuries.

Investment-grade corporates may work for those who want to generate additional yield and are willing to take on moderate credit risk.

High-Yield Bonds

High-yield credit spreads remain relatively tight, at roughly 4.29 percent as of June 9, 2023. This is a sign that investors aren't being adequately compensated for the high credit risk.

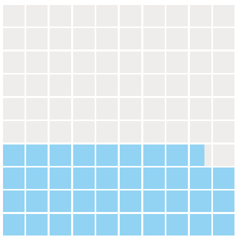
These bonds tend to underperform investment-grade bonds in times of economic slowdown.

Municipal Bonds

The decision to choose municipals is heavily dependent on the investor's tax situation.

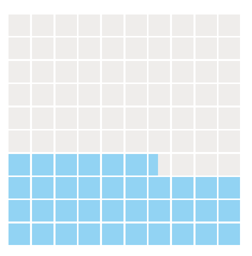
When compared to taxable bonds, municipal bonds generally make sense for those in the top federal tax bracket.

10-Year Treasury Yield



3.87%

Year-end 2022



3.75%

June 9, 2023

The drop in yields helped support bond prices.

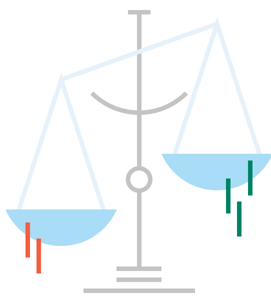
Asset Allocation:

Finding Balance in an Underwhelming Economic Environment

Equity market gains, combined with declining long-term interest rates, created a generally favorable environment for portfolio performance in the first half of the year. But with increasing risks and slowing growth, where should investors look for opportunities?

These viewpoints are based on our subjective assessment of asset classes. The approach is largely qualitative and based on current relative fundamentals, valuations, and sentiment.

A balanced and diversified fixed income portfolio allocation continues to make sense.



	Less Attractive		Neutral	More Attractive	
Equity					
U.S. Large-Cap				●	
U.S. Mid-Cap			●		
U.S. Small-Cap			●		
U.S. Growth				●	
U.S. Value		●			
International Developed Large-Cap			●		
International Developed SMID		●			
Emerging Markets			●		
Fixed Income					
Short-Term			●		
Intermediate-Term				●	
U.S. Treasuries			●		
Mortgages				●	
Investment-Grade Corporates			●		
High-Yield			●		
Bank Loans		●			
International Developed		●			
Emerging Markets				●	

Spotlight: The Headline Risks

Inflation: Stubbornly Hanging On

Inflation is down significantly from its highs, and we expected that drop to continue. Markets had priced in a pause in rate increases from the Fed and even a cut or two later in the year. But the recent data suggests they may have gotten ahead of themselves. Inflation may not be dead yet.

While some prices have come down, service inflation—especially around wages—remains quite high and may be increasing again. Job growth, which has remained very strong, has kept demand hot, even as capacity has been constrained, which is causing prices to increase. This puts the Fed in a bind and will likely force it to keep raising rates to cool down the economy.

Rising rates weigh on both economic growth—the Fed wants and needs to see slower growth in demand—and financial markets. So, this potential headwind will be something to watch closely for the rest of the year.

Bank Failures: Not Over Yet

The first half of the year saw the first wave of major bank failures in some time. Silicon Valley Bank, Signature Bank, and others collapsed suddenly, seemingly out of nowhere. The headlines screamed about fears of a new financial crisis.

Indeed, the risks seemed real. Rising rates eroded banks' capital bases, leaving them less solvent even as deposits fled from the riskiest banks. Although only a couple of banks went down, more seemed vulnerable. Another 2008 seemed possible.

But the government saw that possibility, too, and took immediate action. By offering to lend against banks' security holdings at par, the government gave the financial system time to work out its problems, and the collapses stopped. Crisis over? Not so fast.

More Failures Ahead?

While the government provided time for the banks to solve their problems, the problems remain. Those issues may not be solvable for all institutions. So, expect more failures during the second half of the year, along with more forced mergers and acquisitions as the regulators and banks sort out which banks will make it.

The system will survive and be stronger for the elimination of the weakest members. What caused the 2008 crisis was a sudden collapse in confidence, which threatened the system as a whole. In 2023, the government has laid the groundwork to resolve the problems with systemic risk. While we are likely to see more individual bank failures, we won't see a rerun of 2008.

The 7 Largest Bank Failures in History

Source: Bankrate

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