While the performance of capital markets in the first quarter of 2023 was certainly unexpected, the further run-up in Q2 has defied almost all forecasts. The S&P 500 returned an eye-popping 8.74% for the quarter, bringing its YTD return to 16.89% and though the aggregate bond market posted a -0.84% return for the quarter, the index is still positive for the year at +2.09%.

Investors have been confronted with the unique challenge of reconciling a bullish equity market with the prospect and anticipation of weaker economic data points on the horizon. Currently buoying the markets are an exceptionally strong and resilient labor market, moderating inflation, and an AI-driven rally in tech shares. Indeed, the market has shown a remarkably narrow breadth, as the equal-weighted S&P 500 index returned just shy of 7% through the quarter-end. Or, put another way, if the top 10 stocks were removed from the index, the other 490 would have returned just over 4%; Alphabet, Amazon, AMD, Apple, Meta, Microsoft, Netflix, NVIDIA, Snowflake and Tesla, which make up the so-called FANG+ index, have returned over 75% YTD.

At 18.9 times 12-month forward earnings, the P/E ratio of the S&P is far from cheap, though technicals and history indicate a favorable backdrop. Currently, industry analysts in aggregate predict a year-end S&P price target of 4,823 based on bottom-up company-level earnings estimates, a 7% increase from today's levels. While expectations for earnings have eroded slightly since the beginning of the year, so far in Q2 the number of companies issuing positive earnings guidance is well above previous quarters. Lastly, while history is not necessarily an indicator of the future, in the past 33 years, the S&P has had a positive first half return 16 times, 12 of which resulted in a further positive second half.

Just as the market has surprised to the upside, the economy has remained extremely resilient, defying forecasts for a 2023 recession and forcing economists to temper their calls for a slowdown or push them out further into the future. The recent ADP payrolls report stunned market participants, doubling the consensus estimate for private payrolls adds and the unemployment rate decreased 0.1% to a near-record low of 3.6%. Similarly, the June CPI print showed a year-over-year increase of just 3%, the smallest such advance in more than two years, while producer prices (PPI) were unchanged. All these data points indicate a higher probability of the so-called "soft landing" scenario, or at the very least, an extremely mild recessionary environment that now does not appear to take shape before year-end.

Of course, the spoiler of the proverbial party could turn out to be the Federal Reserve. In their most recent meeting, the decision to pause, but telegraph another two rate hikes by year-end marked a distinct departure from the beginning of the year, when the market was pricing in rate cuts by December. The Fed has adopted a more hawkish tone as of late, intent on taming inflation at all costs. Nonetheless, they have signaled their willingness to be data-dependent and should weigh recent data points as they assess the future trajectory of monetary policy. Regardless of the number and magnitude of rate hikes to come, it seems almost a certainty that the path of "higher for longer" is inevitable and knowing that policy often operates with long and variable lags, the effects of such a regime may yet remain to be seen.

In positioning the portfolio going forward, we continue to see value across the spectrum in fixed income, as short-term Treasury yields remain close to 5% and opportunities exist in other areas such as corporate credit and Agency mortgage-backed securities, to further enhance yield while moderating risk. Our focus on high-quality, domestic equities has proved positive so far, as our overweight to tech has been a significant tailwind to the portfolio. Those sectors that have underperformed YTD, e.g., healthcare, energy, and financials, represent value and despite their run-up, certain consumer-focused discretionary names remain attractive as well. We are continually monitoring our current holdings and the broader market for opportunities and will look to rebalance or deploy cash, where appropriate.

We hope you are enjoying the summer, staying cool and dry (if that is possible!) and we look forward to speaking with you soon. As always, please do not hesitate to contact us if you have any questions or concerns, or to schedule a portfolio review.