Market analysis

June 26, 2023

At a glance

Investors remain focused on the Federal Reserve and inflation as we near the end of the second quarter amid broader equity market performance.

Number of the week

28.9%

The year-to-date return of the NASDAQ Composite through June 23.

Term of the week

Investment-grade bond – A bond with a rating that signifies a relatively low risk of default. While bond rating firms like Standard & Poor's and Moody's use slightly different designations to identify a bond's credit quality rating, "AAA" and "AA" (high credit quality) and "A" and "BBB" (medium credit quality) are considered investment grade.

"Year- and month-to-date performance suggest differing outlooks. Year-to-date performance breadth is narrow, a reflection of macroeconomic uncertainty, a headwind to rising equity prices. Conversely, June performance is superb, and breadth is broad-based, often indicative of a market poised to trend higher. The S&P 500, NASDAQ Composite and Russell 2000 are up between 4.0% and 4.3%, with 10 of 11 S&P 500 sectors in positive territory."

- **Terry Sandven,** Portfolio Manager, Chief Equity Strategist, U.S. Bank

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[1] Important disclosures provided on page 4.

Global economy

Quick take: Global manufacturing activity remains weak, while service business activity points to slower growth. U.S. housing market activity is stabilizing as builders and buyers adjust to higher mortgage rates.
Our view: Our U.S. Health Check is hovering above levels consistent with historical recessions as the Federal Reserve (Fed) continues tightening monetary policy to combat elevated inflation. Outside the U.S., our foreign scores are below median, reflecting choppy progress in China's reopening. Japan is the exception, displaying economic expansion.

- **The U.S. economy continued to expand in June, according to "flash" (preliminary) S&P Global Purchasing Manager's Index data**, with strength in services offsetting manufacturing contraction. The index fell slightly from May, indicating the pace of activity is slowing. The manufacturing index fell to 46.9 from 51.0 in May on falling new orders, though hiring remains a positive. The service index also slowed from May, but new orders and hiring remain positive.
- **U.S. housing market activity appears to be stabilizing** as buyers and builders adjust to the higher interest rate environment, with mortgage rates above 6%. Home builder sentiment improved into positive territory for the first time in 11 months on low inventories and solid demand. Annualized housing starts in May rebounded to 1.63 million, near the 2022 peak of 1.8 million and consistent with average building activity before the global financial crisis of 2008-2009.
- **Flash purchasing manager surveys for June show slowing activity in Europe, Japan and the United Kingdom (UK).** Manufacturing output continues to lead the slowdown, with services businesses still modestly expanding. Price pressures are easing in Europe and Japan, while inflation remains a challenge in the UK. The Bank of England raised interest rates 0.5% last week to tame inflation; consumer prices, excluding food and energy, accelerated to a 7.1% year-over-year gain in May from 6.8% in April.

Equity markets

Quick take: U.S. equities are in pause mode. The tug-of-war between bull and bear market investors is balanced, which implies uncertainty and increased volatility for the foreseeable future.
Our view: Persistent inflation, elevated interest rates and uncertainty over the pace of earnings growth in 2023 remain headwinds to advancing equity prices, but the pace of inflation is waning, the Fed is becoming less hawkish and earnings projections have stabilized.

- **Year- and month-to-date performance suggest differing outlooks.** Year-to-date performance breadth is narrow, a reflection of macroeconomic uncertainty, a headwind to rising equity prices. For the year as of Friday's close, the S&P 500 and NASDAQ Composite are up 13.3% and 28.9%, respectively, versus the 3.4% gain of the small cap-oriented Russell 2000. In addition, sector performance leadership is narrow. Communication Services, Consumer Discretionary and Information Technology sectors are outpacing the remaining eight sectors by a large margin. Conversely, June performance is superb and breadth is broad-based, often indicative of a market poised to trend higher. The S&P 500, NASDAQ Composite and Russell 2000 are up between 4.0% and 4.3%, with 10 of 11 S&P 500 sectors in positive territory this month.
- **Consensus earnings projections for 2023 and 2024 remain at $220 and $244 per share, respectively**. Second quarter reporting is slated to ramp in mid-July. Expectations are for flat sales and earnings declining roughly 6.8% over year-ago levels, according FactSet. We are monitoring consumer and business spending trends, guidance and insights into company cost structures and profit margins.
- **Factors supporting a durable U.S. equity rally include indicators suggesting that inflation's pace is waning**, increased likelihood the Fed will soon stop interest rate hikes, mounting prospects for only modest economic slowing toward year-end, better earnings growth, technology-induced growth drivers and resilient consumer spending.
- **Factors supporting a less aggressive bias are also persuasive.** Increased competition from bonds given higher interest rates, narrow year-to-date performance leadership, persistent inflation, potential "higher-for-longer" Fed rate hikes, possible economic and corporate earnings pressures later in the year and stretched valuations warrant a cautious bias.

Bond markets

Quick take: Short-term Treasury yields rose based on expectations that the Fed will increase interest rates another 0.25% this year. Long-term Treasury yields fell, aided by inflation expectations anchored near the Fed's 2% target. Higher-quality bonds benefited from the decline in long-term Treasury yields.
Our view: Persistent labor market strength that supports consumer spending offsets some of the risks presented by restrictive monetary policy and contracting liquidity, presenting balanced risks to portfolios for now. Normal fixed income allocations can help buffer against two-sided risks to stocks, and high-quality bonds offer favorable income opportunities with yields near 15-year highs.

- **Fed Chairman Jerome Powell addressed the need for high rates to cool inflation in testimony to Congress.** In his semiannual monetary policy report, Powell said the Fed is close to delivering enough rate hikes slow inflation, but a little more tightening may be needed. The Fed has raised rates by 5% since early 2021 and held rates steady on June 14 to observe the lagged impact of policy rate tightening on the economy. Still, recent Fed officials' comments and market expectations indicate additional tightening may be necessary. Market interest rates reflect a roughly 70% chance of a 0.25% rate hike in July. The Fed also emphasized its flexibility to respond to evolving economic conditions. This heightens the importance of upcoming data releases for the labor market and inflation.
- **High yield corporate bond prices fell last week, ending a three-week winning streak.** Riskier bonds benefited from improving investor sentiment that corresponded with higher equity prices over the past month. However, the recent gains drove valuations on high yield corporate bonds, measured as their extra yield over Treasuries, slightly above long-term averages. Valuations on both investment-grade corporate and municipal bonds are cheaper relative to their riskier high yield counterparts. The extra yields on riskier bonds can aid in their outperformance if economic growth and investor sentiment prove resilient, but we prefer normal bond exposures comprised primarily of high-quality bonds to help balance equity risk in portfolios.

Real assets

Quick take: Real assets lagged the S&P 500 last week, with global central banks indicating that monetary tightening would continue. Dividend-paying sectors, such as Infrastructure and Real Estate, continue to struggle with growth sectors in favor. Commodity prices fell last week on signs of weakening global demand.
Our view: We see some value in real assets' defensive sectors. Decelerating economic growth and corporate earnings should support tangible assets with stable cash flows. Commodities remain vulnerable as expectations for falling inflation and decelerating growth come to fruition.

- **Real Estate trailed the S&P 500 by 3.4% last week,** with growth-oriented and defensive stocks outperforming interest rate-sensitive sectors. Data centers were the top-performing properties, outperforming the broader market by 0.4%. Offices lagged considerably for the second consecutive week, trailing the S&P 500 by 5.6%. Real Estate continues to offer compelling value at current levels, but we acknowledge that near-term risk is elevated, and sentiment can change abruptly.
- **Infrastructure trailed the S&P 500 by 1.2% last week**. Toll roads led performance but lagged the broader market by 0.1%. Midstream energy was the worst-performing sector, trailing the broader market by 1.5%.
- **Crude oil prices fell 4.1% last week** despite declines in the domestic supply. Signs of weakening global demand and continued monetary policy tightening by central banks were catalysts for the move lower. The crude oil market remains undersupplied over a longer time horizon, which provides support for oil prices. However, we acknowledge downside risks to oil prices exist as the global economy slows.

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