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Seat Backs Upright and Tray Tables Stowed

As we hit the halfway point in 2023, global financial markets continue to largely ignore recession fears as the economic data supports the "soft landing" scenario. The Fed's aggressive rate hikes have soothed inflation fears, while economic growth has moderated, and unemployment rates have held steady. Can this continue, or is it just a matter of time before the wheels come off?

Capital Markets Review

For the first six months of the year, US equities retook the lead over international stocks, returning 16.9% versus 11.7% thanks to a solid second quarter in which US stocks returned 8.7%, while international gained just 3%. US small cap stocks returned 5.2% for the quarter and 8.1% YTD, while emerging markets returned just 0.9% for the quarter and 4.9% for the first half.

As banking crisis concerns diminished, longer term bond yields settled back to pre-crisis levels, with the 10-year Treasury finishing the second quarter at a 3.8% yield (Source: FactSet), resulting in a total return of 2% for the aggregate bond index in the first half of the year. High yield and emerging markets bonds returned 5.4% and 4.1% respectively. Alternative investments, as measured by the HFRX Global Hedge Fund index, posted just a 0.6% return for the first half.

Asset Class Returns

	Asset Class	Index	June 2023	Q2 2023	YTD 2023
Equity	U.S. Large Cap	S&P 500	6.6	8.7	16.9
	U.S. Small Cap	Russell 2000	8.1	5.2	8.1
	International Developed	MSCI EAFE	4.6	3.0	11.7
	Emerging Markets	MSCI EM	3.8	0.9	4.9
Fixed Income	U.S. Investment Grade	Barclays U.S. Aggregate Bond	-0.4	-0.8	2.1
	U.S. Inflation-Indexed	Barclays U.S. TIPS	-0.3	-1.4	1.9
	U.S. High Yield	BBgBarc U.S. Corp High Yield	1.7	1.7	5.4
	EM U.S.$ Debt	JPM EMBI Global	2.2	2.2	4.1
Alternative	Absolute Return	HFRX Global Hedge Fund	0.8	0.6	0.6

Source: Morningstar

Sector Review

The technology, communication services and consumer discretionary sectors built on the solid gains of the first quarter to post returns of 42.8%, 36.2% and 33.1% respectively for the first half. With the S&P 500 returning 16.9% for the first half, the remaining 8 sectors all underperformed the market.

Sector Returns: Q1 and 2023

Sector	Index	June 2023	Q2 2023	2023
Technology	S&P 500 Sec/Information Technology	6.6	17.2	42.8
Communication Services	S&P 500 Sec/Commun Services	2.6	13.1	36.2
Consumer Discretionary	S&P 500 Sec/Cons Disc	12.1	14.6	33.1
Industrials	S&P 500 Sec/Industrials	11.3	6.5	10.2
Materials	S&P 500 Sec/Materials	11.1	3.3	7.7
Real Estate	S&P 500 Sec/Real Estate	5.6	1.8	3.8
Consumer Staples	S&P 500 Sec/Cons Staples	3.2	0.5	1.3
Financials	S&P 500 Sec/Financials	6.7	5.3	-0.5
Health Care	S&P 500 Sec/Health Care	4.4	3.0	-1.5
Energy	S&P 500 Sec/Energy	6.6	-0.9	-5.5
Utilities	S&P 500 Sec/Utilities	1.6	-2.5	-5.7

Source: Morningstar

Market Breadth – A Cause for Concern?

The performance for the S&P 500 in the first half of the year has arguably been stronger than any Wall Street analyst's predictions. Fears over recession, runaway inflation and rampant unemployment have thus far been unfounded, and the market's returns suggest that there are blue skies ahead.

Looking more closely at market returns for the first half of 2023 might lead to a different conclusion about the health of the market overall. The S&P 500 is a market capitalization weighted index, which means those companies with the largest *market capitalization* (shares of stock outstanding multiplied by price per share) have the greatest impact on the index's returns. Those companies with the largest market capitalization are found in the technology (+42.8%), communication services (+33.1%) and consumer discretionary (+36.2%) sectors, which were the top performing sectors in the first half of 2023. The remaining sectors posted returns below the S&P 500's 16.9% return, ranging from 10.2% percent (industrials) down to -5.7% (utilities). *Market breadth* gives us a sense for the number of companies that are driving the overall stock market's returns. As the chart below shows, the top 7 S&P 500 constituents (Apple, Microsoft, Amazon, Nvidia, Alphabet, Tesla and Meta) represent over 27% of the index and contributed 19.1% to the S&P 500's return in the first half of 2023.

Top 7 Stocks - S&P 500

Company	Sector	Market Cap	6/30 YTD performance	% of S&P 500	Contribution to S&P 500 Return*
Apple Inc.	Technology	$3.2 Trillion	49.7%	7.7%	3.8%
Microsoft Corporation	Technology	$2.54 Trillion	42.7%	6.8%	2.9%
Amazon.com, Inc.	Consumer Discretionary	$1.32 Trillion	55.2%	3.1%	1.7%
NVIDIA Corporation	Technology	$1.04 Trillion	189.5%	2.7%	5.0%
Alphabet Inc.	Technology	$1.53 Trillion	36.0%	3.6%	1.3%
Tesla	Consumer Discretionary	$866.5 Billion	112.5%	1.7%	1.9%
Meta Platforms	Communication Services	$748.3 Billion	138.5%	1.7%	2.3%
				27.3%	19.1%

Source: www.usatoday.com/money/blueprint/investing/s-and-p-companies-by-weight
*Position weighting multiplied by position performance 1/1/2023 to 6/30/2023

As portfolio managers attempting to provide competitive returns for our clients while maintaining prudent diversification, this lack of market breadth presents a challenge for us. As such, we are encouraged by June's data. While solid economic data supported a soft-landing scenario, improved participation from more cyclical sectors led the market with industrials, financials, materials and energy helping to broaden market breadth. The recent change in market behavior is encouraging and gives us confidence that the market can grind higher during the second half of 2023.

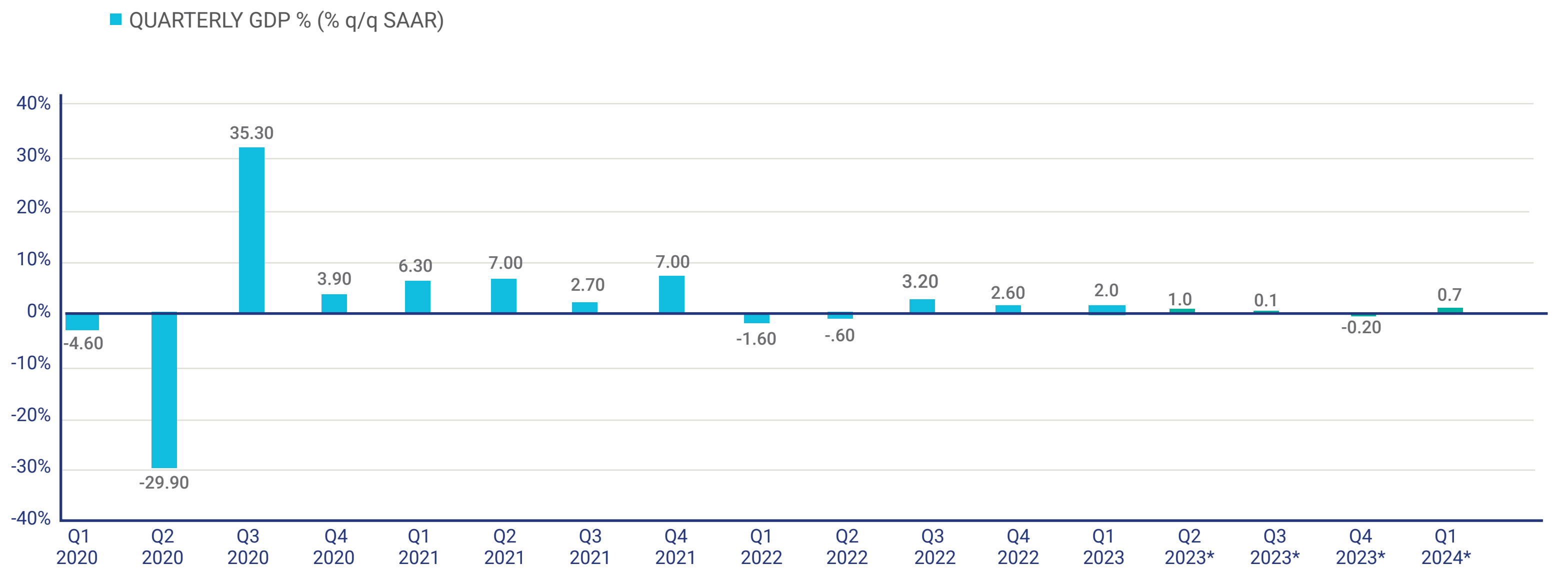
Looking Forward

As mentioned above, the "big picture" continues to support the soft-landing scenario. Inflation, as measured by both the headline Consumer Price Index (CPI) and Personal Consumption Expenditures Index (PCE), continues to fall, posting 4.1% and 3.8% respectively. UPDATE: On July 12, CPI report showed a decline of -1.1% to 3.0% for June. PCE will be reported later in July.

Inflation subsides as the economy expands

While inflation subsides, the US economy continues to expand (as US Real GDP continues to post quarterly numbers that support a low-growth economic picture), despite the Fed's efforts to remove the punchbowl from the party. Unemployment remains low at 3.6% (Source: FactSet, 07/07/2023). As the Fed continues to navigate interest rate policy, the CME Group's FedWatch Tool currently (as of 07/11/2023) shows a 95% probability for a 25 basis point hike at the July 26th FOMC meeting, followed by the highest likelihood being a pause before eventually lowering the Fed Funds rate at some point at the end of the year or early in 2024. It is important to remember that the lagged effect of the Fed's rate hikes may take 12 months or more to impact growth. As a result, recession expectations cannot be dismissed at this point in time.

Quarterly U.S. Real GDP Growth Including 2023 & 2024 Forward Estimates



Source: FactSet
*Estimates as of 7/12/2023

Playing the Artificial Intelligence Theme

An emerging theme that is currently bolstering equity markets is *AI* or Artificial Intelligence. Artificial Intelligence in one form or another has been around for decades. But in 2023, it seems to have captured the world's (and the investment markets') attention in an entirely different way. Both exuberance and concern about the potential for AI is everywhere: in politics, in schools, in your news feed. What does all this mean for investors?

NVIDIA, Microsoft and Meta Platforms have been the clear early beneficiaries of this "frenzy" in the first half of 2023. Through June 30, NVIDIA (who makes the chips that fuel many AI applications) saw their stock soar 189% in the first half of 2023. Meta (who is saying they will spend $33 billion on AI-related initiatives, per their CFO) saw their stock rise 138% for the same period. Microsoft, a co-developer of the much talked about CHATGPT, has also seen big gains in their stock price. These are among the most obvious ways to "play AI" right now, and it is no surprise that these stocks (and their overall sectors) have benefited greatly.

Companies in a frenzy to avoid getting left behind

Even more important for investors, however, is that the impact from AI will almost undoubtedly continue to broaden to nearly every sector and type of company. Companies in all industries are racing to determine how to best capitalize on AI to avoid being left behind. According to FactSet, 110 of the S&P 500 companies mentioned Artificial Intelligence on their first quarter earnings calls this earnings season (Source: Fact Set Earnings Insight), across all sectors and industries. Goldmans Sachs went as far as quantifying the potential impact of generative AI in a recent research piece: "As tools using advances in natural language processing work their way into businesses and society, they could drive a 7% (or almost $7 trillion) increase in global GDP and lift productivity growth by 1.5 percentage points over a 10-year period" (SOURCE: https://www.goldmansachs.com/intelligence/pages/generative-ai-could-raise-global-gdp-by-7-percent.html). To say we are in the "early days" is an understatement. The list of unanswered questions could fill many pages. How will companies profit from these exciting technologies? How many jobs will be lost? How many jobs will be changed for the better? Will there be some sort of regulation or guard rails? As always, companies with forward-thinking, practical management teams and strong balance sheets will have flexibility and the greatest chance for success. Think of the late 1990s with the internet; or the early 2010s with cloud computing. We acknowledge that something big is happening here, but it is far too early to know exactly how it will play out or which companies will benefit. Many of the companies that looked primed to benefit most from the "Internet Revolution" were not around 10 years later (and a little bookstore called Amazon.com ended up doing pretty well)!

As investors and fiduciaries, we will continue to research opportunities to incorporate these exciting new technologies into client portfolios. Although we hold NVIDIA, Meta and Microsoft in client portfolios, we always want to think beyond the "obvious." At the same time, we caution against getting too caught up in the hype: We do not advise making dramatic shifts in portfolios because of this and we stick to diversification and knowing our clients' goals and time horizon.

Portfolio Positioning

The first half of the year rewarded investors who had patience and stayed invested. The global economic outlook has improved considerably from the start of the year. As we enter the second half of 2023, we remain cautiously optimistic. Despite the strong performance delivered by a few US companies, we do not believe it is prudent to chase performance or over-concentrate in a particular sector, including AI. We prefer to hold a diverse mix of companies across sectors and geographies. We are at or near target weights for equities and balanced between growth and value equities. Attractive yields can be earned on short-term government bonds with very little risk, due to the continued inversion of the yield curve. This has created an opportunity to earn income while maintaining "dry powder" in portfolios. We have increased our allocation to short-term bonds to allow us to invest opportunistically in the coming quarters. Given we expect interest rates to increase and remain higher for longer, we are underweight intermediate and long-term bonds that will not perform well in a rising rate environment.

We expect market volatility to increase in the second half and maintain an overweight position to liquid alternative assets that tend to add diversification to traditional stock and bond portfolios. The equity markets are priced for a soft landing, and any contrary economic "bumps" will likely weigh on the prices of the top performing companies in 2023. The markets will continue to react to new economic data, and alternatives should help mitigate portfolio risk.

Conclusion

Finally, we present below an update to a recurring Market Insights chart, showing the S&P 500 return in the 12 months following a -20% decline. The market bottomed on October 14, 2022, posting a -20% decline after peaking on December 31, 2021. While it has not been a full 12 months since that bottom, we finished the second quarter up 25.7% from the October low, eight months ago. Despite the current recessionary concerns, we maintain a very bullish outlook over the longer term ahead.

Stock Market Corrections Since 1980
S&P 500 Index Total Returns

Start	End	# of Days Peak-to-Trough	Losses (%)	Returns 12 Months Later (%)	State of Economy	
2/13/80	3/27/80	43	-17.1	37.1	Recession	3/27/81
11/28/80	8/12/82	622	-27.1	58.3	Recession	8/12/83
10/10/83	7/24/84	288	-14.4	29.6	Expansion	7/24/85
8/25/87	12/4/87	101	-33.5	21.4	Expansion	12/4/88
1/2/90	1/30/90	28	-10.2	5.6	Expansion	1/30/91
7/16/90	10/11/90	87	-19.9	29.1	Recession	10/11/91
10/7/97	10/27/97	20	-10.8	21.5	Expansion	10/27/98
7/17/98	8/31/98	45	-19.3	37.9	Expansion	8/31/99
7/16/99	10/15/99	91	-12.1	10.2	Expansion	10/15/00
3/24/00	10/9/02	929	-49.1	33.7	Recession	10/9/03
11/27/02	3/11/03	104	-14.7	38.2	Expansion	3/11/04
10/9/07	3/9/09	517	-56.8	68.6	Recession	3/9/10
4/23/10	7/2/10	70	-16.0	31.0	Expansion	7/2/11
4/29/11	10/3/11	157	-19.4	32.0	Expansion	10/3/12
11/3/15	2/11/16	100	-13.3	26.6	Expansion	2/11/17
1/26/18	2/8/18	13	-10.2	4.9	Expansion	2/8/19
9/20/18	12/24/18	95	-19.8	37.1	Expansion	12/24/19
2/19/20	3/23/20	33	-33.9	74.8	Recession	3/23/21
1/1/22	10/14/22	286	-20.0	**24.2***	Recession	6/30/23
Average		**191**	**-22.0**	**33.2**		

Source: FactSet
*8½ Months

As always, please don't hesitate to reach out to your contacts at Webster Private Bank if you have any questions. It is a pleasure to serve you and we appreciate the trust you have placed in us.