QUARTERLY MARKET INSIGHTS

2ND QUARTER 2023

THE "MAGNIFICENT SEVEN" AND NARROW MARKET LEADERSHIP

– The Magnificent Seven stocks have benefited from both the perceived safety of their business models and a wave of AI enthusiasm.

– This group has added a combined $4.1 trillion of market capitalization in the last six months, roughly the size of Germany's economy.

– The best opportunities for valuation expansion in coming quarters are likely to be in the 493 non-Magnificent Seven S&P 500 stocks.

The U.S. stock market's surprisingly strong first half was driven by a small group of innovative, mega cap, premium-growth stocks affectionately dubbed "The Magnificent Seven." In descending order of market capitalization as of June 30, they are Apple (AAPL), Microsoft (MSFT), Alphabet (GOOGL), Amazon.com (AMZN), NVIDIA (NVDA), Tesla (TSLA), and Meta Platforms (META). These seven stalwarts were responsible for more than 70% of the S&P 500's 16.88% total return in the first months of 2023. (This calculation is based on multiplying each stock's total return by its weighting in the index on December 31). Combined, this group accounts for 24% of the S&P 500's market capitalization and between 15% and 20% of the index's profits. Their aggregate market capitalization of $11 trillion as of June 30 was larger than the combined 2022 gross domestic products of Japan and Germany (the third and fourth-largest economies in the world).

We ascribe several key drivers of this concentrated leadership thus far in 2023. First, the Magnificent Seven benefited from overextended bearish positioning in the fourth quarter after suffering severe downward valuation re-ratings amid the inflation and Fed tightening fears of 2022. They were primed to get a boost from short covering and sector rotation flows away from the industry winners of 2022 (energy, defense, pharmaceuticals, packaged food, and insurers among others).

Second, these highfliers have been supported by the perceived safety of their long-term earnings profiles. This was especially pronounced during a period of acute economic uncertainty bookended by the failures of California lenders Silicon Valley Bank on March 9 and First Republic Bank on May 1. Over this period, investors rotated away from economically sensitive industries including banks, industrial machinery, upstream energy, and base metal miners following the sudden eruption of stress in the U.S. banking system. Investors are probably correct to assume these companies' cultures of innovation and current dominance of their respective industries make their future revenue and earnings streams less sensitive to the economic cycle than most other businesses. This type of income statement durability through an economic cycle is one of several hallmark characteristics of companies assigned the "quality" moniker. More skeptical observers have argued many of the industries these companies dominate (premium smartphones, digital advertising, e-commerce, cloud computing, high-end graphics processing chips, and electric vehicles) are far from immune to the ebbs and flows of the global economic cycle.

Last (and perhaps most important), this group enjoyed a gale-force tailwind of investor enthusiasm surrounding accelerated spending on AI-enabled chips and software. This optimism was kicked into overdrive on May 24 when NVDA issued astonishing revenue guidance for its quarter ending July 31 of roughly $11 billion compared to the consensus analyst estimate of $7.1 billion. The massive upside guidance surprise was driven by a surge in orders from its major public cloud computing customers (Amazon AWS, Microsoft Azure and Google Cloud) for advanced GPUs enabled to support AI-related workloads.

Elevated concentration in S&P 500 returns and composition tends to occur near the end of business and market cycles. This was certainly the case in 2000 with then-internet darlings Microsoft, NetApp, Cisco Systems, Qualcomm, Sun Microsystems, and NEXTEL Communications. Of course, this is merely an observation and does not assure a recession or future weak performance for the Magnificent Seven stocks.

> "THIS GROUP ENJOYED A GALE-FORCE TAILWIND OF INVESTOR ENTHUSIASM SURROUNDING ACCELERATED SPENDING ON AI-ENABLED CHIPS AND SOFTWARE."

Moving forward, investors may want to consider the distortive effect that the lofty valuations of the Magnificent Seven have on the broader market's valuation. As of the second week of July, the S&P 500 traded at nearly 21-times expected earnings per share of $220 over the next four quarters. This looks expensive compared to a 20-year median price-multiple between 16 and 17. Yet, if we exclude the Magnificent Seven (which, in aggregate trade at about 30-times), the rest of the index is priced at about 16 times expected earnings – right in line with its long-term median valuation. If the U.S. either avoids a recession or stumbles through a mild recession, many of the best opportunities for a combination of earnings growth and upward valuation re-ratings are likely to be found in the 493 S&P 500 stocks outside of the vaunted Magnificent Seven.

DID GOLDILOCKS STEAL THE BEARS' THUNDER?

EXECUTIVE SUMMARY

- A recession has likely been postponed, but not cancelled.
- Less liquidity in 2H23 could be a market headwind.
- The disinflation of the last 12 months might be ending.
- Equity bull markets need better breadth and profit growth.

The second quarter began with front-and-center worries about regional bank failures, a U.S. federal debt default, and slowing global growth. Just twelve weeks later, it ended with a growing sense of optimism across equity markets that the U.S. economy could avoid a recession altogether and corporate earnings would return to growth mode by the fall. This hopefulness was reflected in very strong (yet tremendously top-heavy) first half returns of 16.88% in the S&P 500 and 32.32% in the technology-heavy Nasdaq. As seen in Chart 1, the Treasury market did not share such enthusiasm as evidenced by a sharply inverted yield curve structure in which short-term rates are substantially higher than long-term rates. Yield curve inversions are generally viewed as one way the bond market signals an impending economic slowdown and subsequent Fed rate cuts. Undaunted by the bond market's skepticism, equity investors perceived mounting evidence during the quarter of a potential "goldilocks" U.S. economic environment characterized by slowing inflation and better-than-expected growth. The inflation component of this mix was particularly important as a streak of progressively lower annual consumer price index (CPI) prints raised hopes the Federal Reserve would soon end a 15-month tightening campaign. Added to the bullish mix was a first quarter earnings season that exceeded low expectations and an explosion of investor enthusiasm for a select group of mega cap stocks deemed best positioned for a rapid acceleration in spending on generative artificial intelligence (AI). Finally, an agreement in Washington to suspend the U.S. debt ceiling for 18 months, an apparent stabilization in the regional bank funding crisis, and the Fed's decision to pause its rate hikes on June 14 supercharged the stock market's risk-on tone in the final four weeks of the quarter.

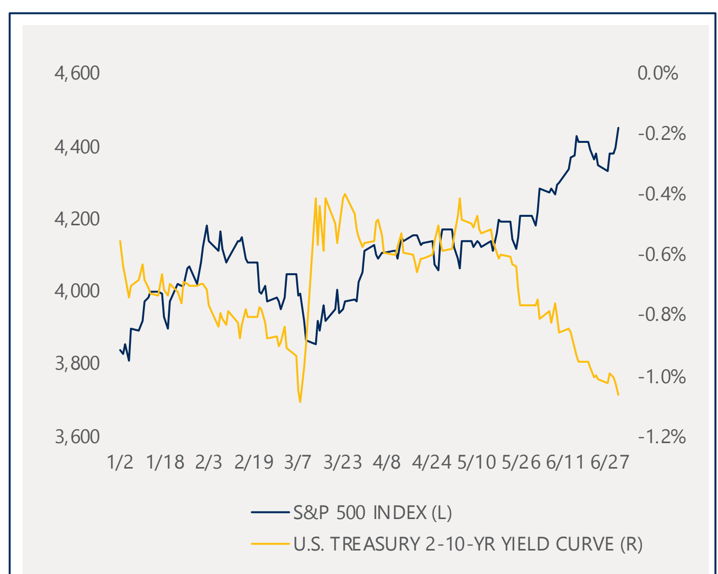
WAS THE RECESSION CANCELLED?

Heading into this year, we argued calls for an imminent U.S. recession and collapse in corporate earnings seemed premature given our expectations for moderating inflation, resilient consumer spending, and elevated demand for workers. Far from painting a gloomy picture, the trend of official economic data generally improved as the second quarter progressed. This outcome contrasted sharply from the stagflation or outright deflation predicted by many bearish observers for most of 2022.

A net 732,000 workers were added to U.S. nonfarm payrolls (NFP) in the second quarter. This was a deceleration from gains of 853,000 and 937,000 in the prior two quarters, but still 34% above the average gain of 548,000 in the forty quarters from 2010 through 2019. Underscoring the surprising strength in labor market data during the Fed's rate hike cycle, NFP gains surpassed the median estimate in contemporaneous Bloomberg surveys of forecasters for 14 straight months beginning in March 2022. The streak ended in the first week of July with net payroll gains in June of 209,000 missing the median estimate of 230,000. Investors should probably avoid leaning too heavily on NFP data to gauge the likelihood of an economic slowdown. This is because in many previous cycles, monthly payrolls data and the unemployment rate have been lagging indicators, often peaking (payrolls) or bottoming (unemployment rate) several

CHART 1

S&P 500 AND U.S. TREASURY YIELD CURVE INVERSION



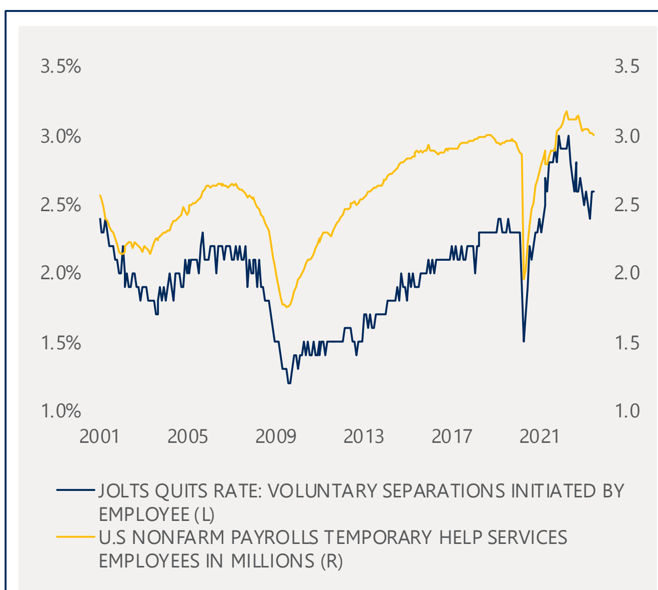
Source: Bloomberg. Data as of 6/30/23. Past performance does not guarantee future results.

months before the onset of a recession. Continuing weekly jobless claims (which tend to be a solid coincident indicator of the economic cycle) declined to 1.72 million in the third week of June from an 18-month high of 1.861 million in early March. Continuing claims are useful in determining real-time labor market friction because they signal the difficulty faced by laid off workers in finding a new job.

As seen in Chart 2, the Labor Department's Job Openings and Labor Turnover Survey (JOLTS) Quits rate (the percentage of U.S. workers who voluntarily resigned each month) has declined from a 20-year high of 3.1% in November 2021 to between 2.4% and 2.6% in recent months. This suggests the jobs market has cooled from overtight conditions but is not signaling a sharp decline in demand for labor. All other things equal, workers are more likely to quit when prospects for finding another (often high paying) job are strong. We would likely need to see the Quits rate fall below 2% (like it did in 2002, 2008, and the spring of 2020) to signal a recession might be approaching. Several potential early signs of softening in the labor market have emerged in recent months including lowered hiring

CHART 2

QUITS RATE AND TEMPORARY PAYROLLS



Source: Bloomberg. Data as of 6/30/23. Past performance does not guarantee future results.

expectations of small businesses and moderate declines in both the average work week and temporary employee payrolls (also seen in Chart 2). There have also been signals of slowing consumption, including an uptick in the U.S. savings rate to 4.6% in May from a trough of 2.7% in June 2022. Additionally, there have been plenty of examples in recent months of U.S. retailer quarterly conference calls in which management teams point to customers “trading down” to lower-priced brands and items. These trends warrant monitoring but they are not yet in warning territory. Although economic activity held up nicely in the first half of 2023, we expect the lagged impact of Fed tightening and a slowdown in bank lending to eventually restrict growth. As such, we think a mild or moderate recession in the U.S. is more likely to be pushed back to 2024 than completely avoided.

THE LIQUIDITY FACTOR

In addition to an improving inflation situation and solid trends in labor and consumer spending data, some commentators pointed to a shift in the global liquidity picture as an overlooked feature of the first half stock market rally. Neuberger Berman estimates global central banks and governments injected $1.3 billion of liquidity into the global financial system in the first six months of 2023. This may come as a surprise to some investors given the year-plus campaign of policy tightening by most major central banks outside of China and Japan to combat excessive inflation. This unexpected dose of liquidity over the last eight months was driven by a combination of unique events. In mid-March, the Federal Reserve launched an emergency lending facility for U.S. banks in response to a trio of failures. Meanwhile, the People's Bank of China took a series of modest policy-easing measures in the winter and spring designed to strengthen a weaker-than-expected post-COVID recovery.

The debt ceiling-driven drawdown of the U.S. Treasury's General Account (TGA) from October through May provided another significant liquidity boost to the financial system. We can think of the TGA as the federal government's operating account. Tax receipts and the proceeds of Treasury debt sales flow in, while all types of federal government payments flow out. From October through May, the Treasury continued to pay its obligations including social security payments and federal employee salaries out of the TGA but did not issue new debt in anticipation of the $31.4 trillion federal debt ceiling threshold being reached in January. This drawdown of the TGA resulted in a substantial net provision of liquidity. In normal times, most of the liquidity the Treasury injects into the financial system via government payments (cash put into system) is offset by debt issuance (cash taken out of the system when individuals, corporations, pension funds, etc. purchase Treasury debt). If the Treasury does not issue new debt (like occurred from November

through May), there is no natural mechanism to offset the injection of cash into the system from government payments. As seen in Chart 3, the TGA balance drew down from $692 billion to $45 billion by the first week of June. This offset about seven months' worth of the Federal Reserve's $95 billion monthly pace of balance sheet reduction measures.

Why does liquidity matter? Since the Global Financial Crisis of 2007-2009, the direction of equity markets has mostly coincided with trends in central bank liquidity. Plentiful liquidity (lower policy rates and increased asset purchases) has generally supported the stock market for the last 14 years. This is because excess liquidity is often more likely to find its way to more speculative corners of the economy and markets than to less risky (though probably more productive) areas. Who can forget the manias surrounding meme stocks, SPACs, NFTs, and cryptocurrencies in 2020 and 2021? The S&P 500 experienced only three calendar years with a negative price return since 2008. All three instances, 2015 (-0.7%), 2018 (-6.2%), and 2022 (-18.2%), occurred against a backdrop of either the beginning of a Fed rate hike cycle (2015, 2022) or, like in 2018, widespread concerns that the rate hike cycle had gone too far too fast. Looking forward, as the Treasury Department refills the TGA and the Fed continues to wind down its balance sheet, the resulting withdrawal of liquidity could suppress an important pillar of the powerful stock market rally over the last eight months.

JUNE SKIP AND HIGH HOLD

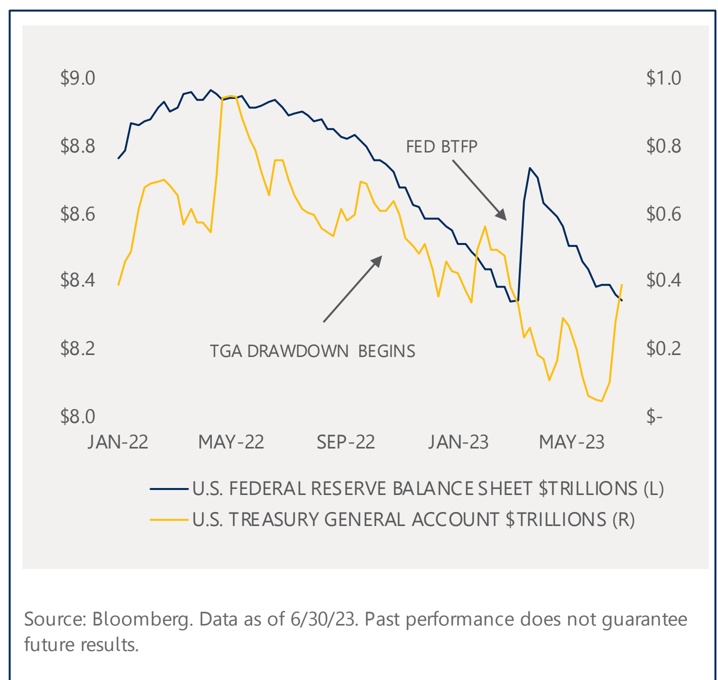
Of course, the liquidity environment could once again become accommodative if the Federal Reserve and other major global banks communicated plans to shift toward policy easing (i.e., rate cuts and a resumption of largescale asset purchases). This seems unlikely given recent messaging from Fed policymakers indicates a bias toward keeping the federal funds rate near 5.5% through the end of 2023. This type of "high hold" would allow Fed Chairman Powell and his colleagues to evaluate whether the lagged impact of more than 500 bps of policy tightening has properly quelled inflation without damaging economic growth. Notably, markets are finally on board with the "high hold" game plan after many months of projecting rate cuts that never arrived. As an indicator of how focused Fed officials are on vanquishing excessive inflation, we remind readers that the Federal Open Market Committee (FOMC) unanimously voted to raise the fed funds rate by 25 bps on March 22 (two weeks after Silicon Valley Bank failed) and again on May 3 (two days after First Republic Bank failed). Over the last eight weeks, Fed rate cuts in the second half of the year have been completely priced out of market expectations. On May 15, fed funds futures pricing implied a policy rate of 4.4% by the end of this year, embedding one or two 25 bps rate cuts over the following seven months. By mid-July, odds were for up to two additional quarter-percentage point hikes in the second half and a December policy rate of roughly 5.4%.

DIVINE DISINFLATION?

Inflation data in the second quarter generally showed a clear trend of cooling. This disinflation (price levels rising at a decelerating pace) was music to the stock market's ears. The March through June period brought four consecutive months of cooler-than-expected year-over-year increases in the headline consumer price index (CPI). The Fed's preferred inflation gauge, the core personal consumption expenditures (PCE), has been stickier, however, with readings of 4.6% or 4.7% for seven straight months spanning November to May. Several other measures of core services inflation excluding housing have stayed between 4% and 5% amid a combination of wage pressures and strong consumer demand in sectors like leisure and hospitality. In our view, last summer almost certainly marked the peak in U.S. inflation during this economic cycle, with annual CPI touching 9.1% in the twelve-month period ending June 2022 (see Chart 4). But this summer might mark the bottom in annual headline inflation for this cycle as favorable base effects from last July and

CHART 3

FED BALANCE SHEET AND TREASURY GENERAL ACCOUNT



Source: Bloomberg. Data as of 6/30/23. Past performance does not guarantee future results.

August fall out of the year-over-year calculations and services inflation looks increasingly unlikely to fall much below 4% on an annual basis.

NARROW STOCK MARKET LEADERSHIP

In 2022, excess inflation and the resulting Fed policy tightening were gale-force headwinds for areas of the stock market with elevated valuations and embedded expectations of strong long-term earnings growth. The reverse (disinflation and a downshift in Fed rate hikes) has been an equally powerful tailwind for premium growth stocks thus far in 2023. A short list of mega cap names spread across the technology, communication services, and consumer discretionary sectors dubbed the "Magnificent Seven" or the "Super Seven" have been the primary beneficiaries of several major narratives over the last six months. The most prominent of these storylines were 1) the perceived safety of their business models during a period of elevated economic uncertainty in March and April amplified by the trio of regional bank failures and 2) the outburst of investor enthusiasm around the prospects for exponential growth in spending on AI-enabled semiconductors and software. In descending order of market capitalization as of June 30, this group of seven are Apple (AAPL), Microsoft (MSFT), Alphabet (GOOGL), Amazon.com (AMZN), NVIDIA (NVDA), Tesla (TSLA), and Meta Platforms (META). Combined these seven companies account for approximately 24% of the S&P 500 market capitalization and 17% of its profits.

THE AI BOOST

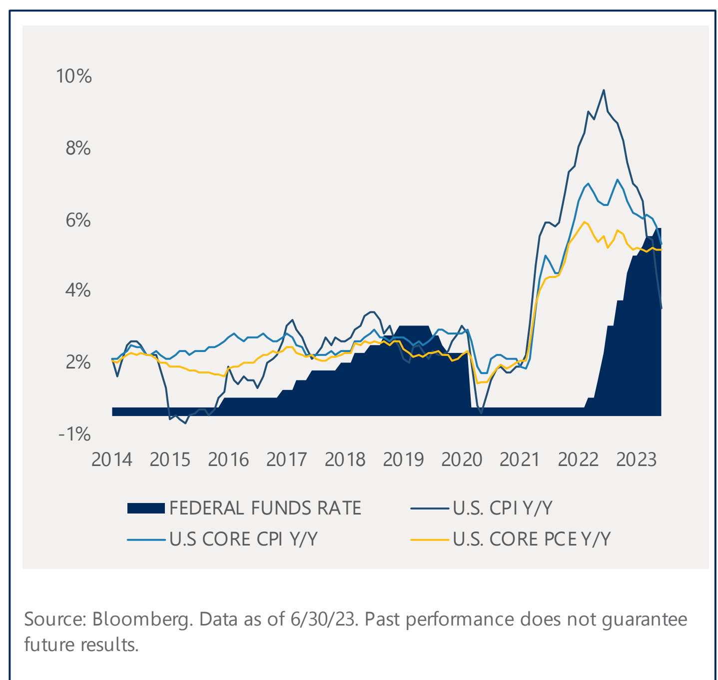
Anticipation of graphics processing unit (GPU) designer NVIDIA's (NVDA) fiscal 1Q24 results and 2Q24 guidance on May 24 was the primary catalyst of the AI-driven technology sector market gains in the first half of the quarter. This occurred against a surge in user adoption during the winter and spring of Microsoft (MSFT) partner OpenAI's generative AI-driven chatbot, ChatGPT. On the afternoon of May 24, NVDA's stronger-than-expected results and astounding sales guidance for its fiscal quarter ending July 31 of roughly $11 billion compared to the consensus analyst estimate of $7.1 billion kicked the AI rally into overdrive to close the quarter. NVDA CEO Jensen Huang's comments on the conference call suggested an explosion in orders for high-end GPUs capable of supporting generative AI workloads were the principal driver of the 53% upside surprise in quarterly sales guidance. Huang implied the bulk of these orders came from its U.S. hyperscale public cloud customers (Amazon's AWS, Microsoft's Azure, and Google Cloud) and large Chinese consumer technology firms like TikTok owner ByteDance. As seen in Chart 5, the strongest first half stretches for a market capitalization-weighted index of the "Magnificent Seven" were a short-covering period in the first five weeks of the year and a roughly nine-week period straddling NVDA's May 24 results and guidance.

A NEW BULL MARKET?

The S&P 500 convincingly broke out above the key resistance range of 4,180 to 4,200 in the first week of June. The following week, it eclipsed its bear market rally closing high of 4,305 from August 16, 2022. Upon its close of 4,294 on June 8, the benchmark entered a new bull market based on the criteria of a 20% gain from its mid-October closing low of 3,577. Using this definition, the bear market that began on January 4, 2022, lasted 248 trading days, longer than the Global Financial Crisis-era downdraft from October 12, 2007, through March 23, 2009. Individual investor sentiment abruptly turned net-bullish in the week ended June 15. As seen in Chart 6, the percentage of AAII U.S. Investor Sentiment survey respondents in the week ended June 15 that expressed a bullish outlook on the domestic stock market over the next six months climbed to 45%. The reading marked a 17-month high and is nearly double the 22.9% level in the week ended May 18, several weeks before a deal was reached to raise the U.S. debt ceiling. The percentage of survey respondents who expressed a bearish outlook on U.S. stocks

CHART 4

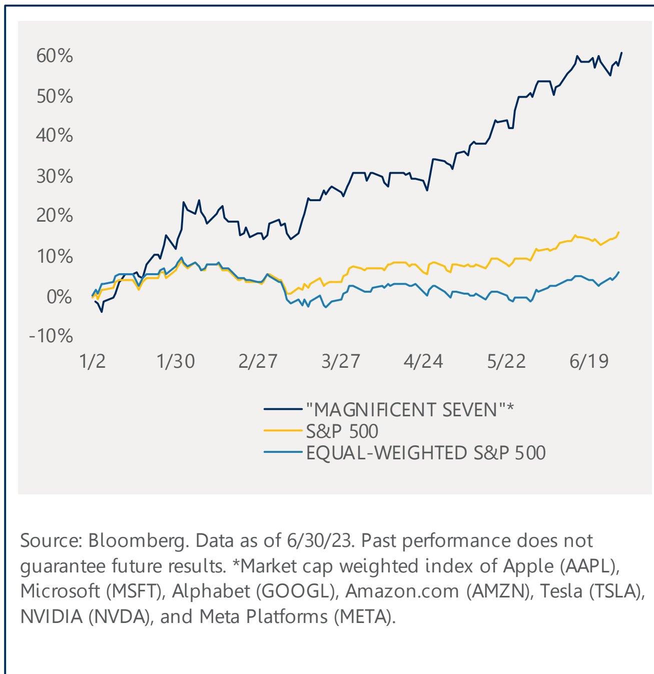
U.S. INFLATION MEASURES AND FED FUNDS RATE



Source: Bloomberg. Data as of 6/30/23. Past performance does not guarantee future results.

CHART 5

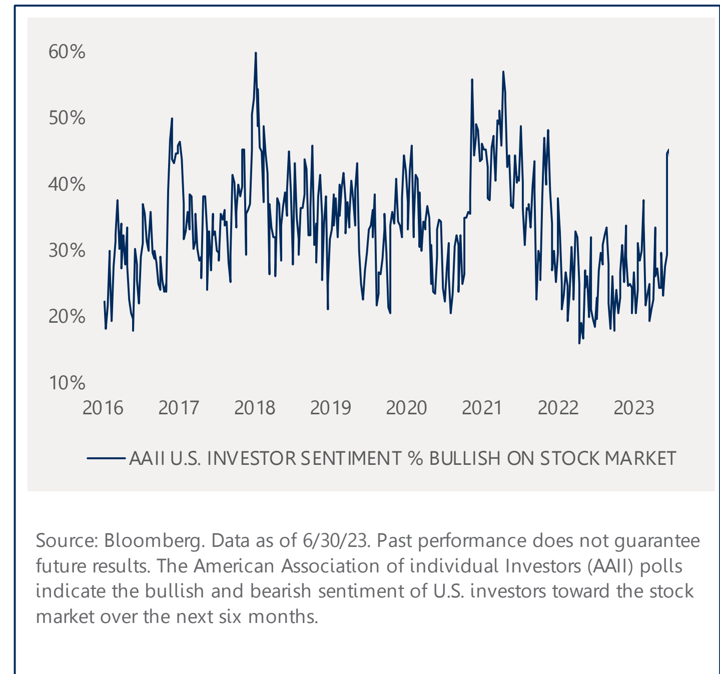
THE "MAGNIFICENT SEVEN" MARKET LEADERS



Source: Bloomberg. Data as of 6/30/23. Past performance does not guarantee future results. *Market cap weighted index of Apple (AAPL), Microsoft (MSFT), Alphabet (GOOGL), Amazon.com (AMZN), Tesla (TSLA), NVIDIA (NVDA), and Meta Platforms (META).

CHART 6

U.S. INDIVIDUAL INVESTOR SENTIMENT



Source: Bloomberg. Data as of 6/30/23. Past performance does not guarantee future results. The American Association of individual Investors (AAII) polls indicate the bullish and bearish sentiment of U.S. investors toward the stock market over the next six months.

over the next six months fell to a 23-month low of 22.7% in the week ended June 15.

WE NEED MORE BREADTH AND EARNINGS GROWTH

Encouragingly, June witnessed a broadening of the equity market rally, including an 8.1% gain for the Russell 2000 after a flat first five months of the year. All eleven S&P 500 sectors finished June in positive territory, with the cyclical industrials (+11.3%) and materials (11.1%) sectors handily outpacing the broad benchmark's 6.6% monthly return. Notably, the previously out of favor financials (+6.7%) and energy (+6.6%) sectors kept up with the broad market in June after trailing the S&P 500 by 16% and 21%, respectively, in the first five months of the year.

S&P 500 index-level earnings per share (EPS) contracted 3.1% in 1Q23 from a year ago, which was a better-than-feared outcome compared to expectations from the last week of March for an 8.0% decline. In 2Q23 (reporting period May 16 through August 15), S&P 500 EPS are projected to contract at a year-over-year rate of 8.9% and then decline by a more modest 1.1% in 3Q23. If these expectations materialize, it will mean a shallow earnings recession occurred in which index-level EPS fell for four straight quarters between 1% and 9%. In dollar terms, S&P 500 EPS expectations for 2023 have fallen 12% from a peak of $249 in late April 2023 to $219 in recent days. Looking forward to 2024, index-level EPS is projected to grow about 10% from $219 to $241. The trend in analysts' bottom-up expectations for U.S. corporate profit growth in 2024 should be key for equity returns over the next six to twelve months given valuations have already expanded significantly. As of mid-July, the S&P 500 traded at a multiple of approximately 20.5 times forward 12-month EPS expectations of roughly $222. This is about 12% above the 10-year weekly average of 18.2 and roughly 17% above the 30-year average of 17.5.

THE TREASURY MARKET IS NOT IMPRESSED

Signals from the rates markets continue to suggest the confidence of equity investors may be excessive. The Treasury yield curve inversion intensified in June to nearly 110 basis points (bps). The policy-sensitive 2-year yield climbed 50 bps during the month to 4.90%, while the 10-year yield rose by a more modest 20 bps to 3.84%. Yield curve inversions have generally been harbingers of economic slowdowns whereby the Fed is compelled to cut rates to boost growth in a downturn. Credit markets appear less concerned, however, as U.S. corporate high yield credit spreads narrowed by about 100 bps from the peak of the banking sector turmoil in mid-March (+555 bps) to the relative calm of mid-July (+455 bps). High yield credit spreads are the excess yield relative to a similar maturity Treasury demanded by investors on a bond issued by a company with a below-investment grade credit rating.

Notably, several developed nation central banks outside the U.S. restarted their rate hike cycles in June in response to not enough progress in cooling inflation. In the second week of June, the Reserve Bank of Australia, and the Bank of Canada both hiked their benchmark lending rates by 25 bps after both pausing earlier in the year. A week later, the Bank of England continued its policy tightening by increasing its policy rate a larger-than-expected 50 bps. These hikes put upward pressure on the government bond yields of these countries and U.S. Treasury yields. We would expect any additional surprise policy tightening from major central banks outside the U.S. to push Treasury yields higher over short-term periods.

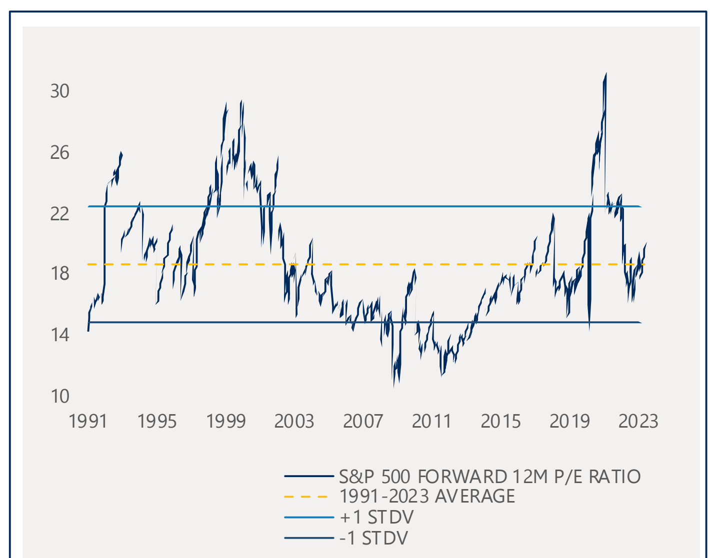
OUTLOOK AND POSITIONING

Heading into 2023, we recommended client portfolios remained moderately overweight equity and underweight fixed income based on our sense that the domestic labor market was too strong and U.S. consumers' balance sheets were too healthy to permit a durable growth slowdown. In our view, if a recession was going to occur, it would probably not materialize until 2024 due to the lagged effects of 500 bps of Fed rate hikes that only began in earnest in the summer of 2022. Although that call was correct in the first half, we now wonder if the strong equity market returns of the last eight months have overshot a realistic path for economic and corporate earnings growth in 2024. We find it difficult to believe this is not a late-cycle environment considering the cycle that began in May 2020 has never given a clear signal that it ended like a substantial increase in the unemployment rate, a durable contraction in consumer spending, or Fed rate cuts. With the S&P 500 trading at more than 20-times expected earnings per share over the next four quarters (see Chart 7), we think the "better-than-feared" economic and corporate profits landscape that we expected in 2023 is probably close to fully priced. This does not mean that there cannot be another (perhaps final) sentiment-driven leg in the U.S. stock market rally in the second half 2023. Price momentum and performance chasing have certainly been powerful short-term factors in prior late cycle environments. The current technical and sentiment backdrops seem strong enough to support another 5% to 10% gain in the S&P 500 to re-test or eclipse its all-time closing high of 4,796 from early January 2022. If that occurs, and 2024 profit estimates do not increase at a similar clip, the index will likely trade at a valuation bordering on excessive relative to the economic and policy reality.

Putting it all together, we continue to recommend client portfolios remain near, or slightly above, neutral risk exposure (equity and credit) and look for opportunities to reduce risk if markets overshoot excessively to the upside in the second half of 2023. Portfolios should be biased toward quality in equity and fixed income. In equity allocations, the out of favor healthcare sector provides an attractive balance of near-term cash flow visibility, reasonable valuations, and relatively healthy balance sheets. Certain industries and companies in the cyclical energy, materials, and industrials sectors are worth considering for portfolios given the exposure they provide to important secular themes including automation, supply chain reshoring, precision agriculture, energy grid expansion, and the renewable energy transition. Finally, we think investors should be preparing a shopping list of premium growth stocks across sectors with lofty valuations but strong secular opportunities in the likely event many come back down to earth over the next 6 to 12 months. Portfolios should probably be more open to extending duration in fixed income allocations if longer term Treasury yields again approach 4% given our view that the end of the economic cycle and subsequent Fed rate cuts are probably in the works for 2024. We think Fed officials will likely keep their policy rate near 5.5% for the remainder of 2023 without causing pain in the labor market. But this balancing act will probably get wobbly in 2024 as the economic and credit cycles take their natural course.

CHART 7

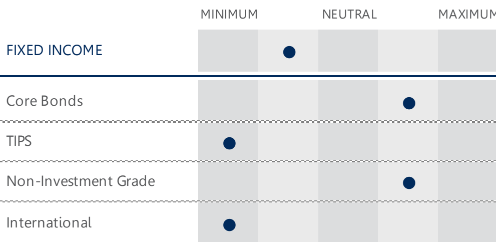
S&P 500 VALUATION: 1991 THROUGH 2023



Source: Bloomberg. Data as of 6/30/23. Past performance does not guarantee future results.

ECONOMIC OUTLOOK AND INVESTMENT POLICY

ECONOMIC FACTORS	CURRENT OUTLOOK
U.S. GDP Growth	The U.S. economy is expected to stall in the second half of 2023 based on the median real GDP estimates for 3Q23 (0.0%) and 4Q23 (-0.5%) in a recent Bloomberg survey.
Federal Funds Rate	As of July 14, fed funds futures implied 92% odds Fed officials will hike the policy rate by 0.25% on July 26 but only a 17% probability of another 0.25% hike on September 20.
Inflation	Treasury Inflation Protected Securities (TIPS) pricing suggests investors expect inflation to average 2.15% over the next five years, down sharply from 2.78% in early March.
Employment	Although nonfarm payroll growth has slowed and initial jobless claims have risen in recent months, neither data series suggest imminent trouble for the labor market.
Consumer Confidence	Measures of U.S. consumer sentiment have risen from suppressed levels last summer amid cooling inflation, a resilient jobs market and strong stock market rally.
Oil	China's feeble economic recovery and lingering U.S. recession fears could keep WTI crude oil below $80 barrel in coming months despite recent Saudi production cuts.
Housing	An unexpected 1H23 acceleration in domestic new home construction, sales, and building permits suggest the U.S. economy is likely not on the precipice of a recession.
International Economies	According to forecasts aggregated by Bloomberg, India (7.0%), China (5.5%), and Indonesia (5.0%) are the G-20 nations with the highest 2023 real GDP growth estimates.

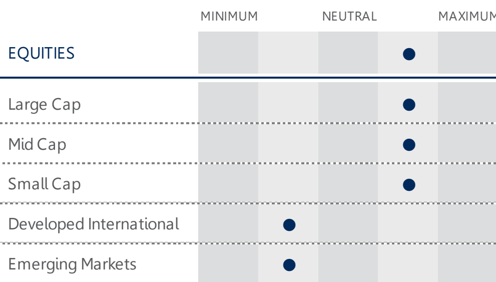


CURRENT OUTLOOK

The back-up in yields across the fixed income universe over the last 15 months has made high-quality bonds a more attractive component for diversified portfolios due to the combination of stability and income they can provide in most market environments. This contrasts with most of the period from 2009 to 2021, in which easy Fed policy and ultra-low yields suppressed the income component of bonds.

In mid-January, we recommended allocations to short-term Treasuries be further increased in our three most conservative portfolios. If signs of a substantial deterioration in the U.S. labor market or corporate profits emerge in coming months, we would likely consider further increasing our recommended allocation to high-quality segments of the fixed income universe and reducing our recommended exposure to non-investment grade bonds.

We believe most fixed income portfolios should target a neutral or moderately lower-than-benchmark duration given expectations for a "higher-for-longer" rate environment at least through the end of 2023. We would favor adding duration to portfolios, however, should longer-term Treasury yields retest their highs from the fall of 2022. U.S. Investment grade and high yield corporate bond spreads tightened considerably in June, supported by resilient economic data. As the tightening cycles of the Fed and other global central banks mature, however, we would expect the path of least resistance to be one of wider credit spreads outside of the highest-quality issuers.

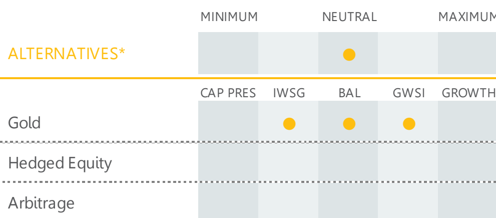


CURRENT OUTLOOK

Heading into 2023, we recommended client portfolios remained moderately overweight equity based on our sense that the domestic labor market was too strong and U.S. consumers' balance sheets were too healthy to permit a durable growth slowdown. Although that call was correct in the first half, we now wonder if the strong equity market returns of the last eight months have overshot a realistic path for economic and corporate earnings growth over the next 6 to 18 months.

With the S&P 500 trading at more than 20-times expected earnings per share over the next four quarters, we think the "better-than-feared" economic and corporate profits landscape that we expected in 2023 is probably close to fully priced. This does not mean there cannot be another (perhaps final) sentiment-driven leg in the U.S. stock market rally in the second half 2023. Price momentum and performance chasing have been powerful short-term factors in prior late cycle environments. Earnings expectations will be key in determining the path of stocks in coming months as further multiple expansion at the index level seems unlikely.

In our view, it makes sense to stay overweight the U.S. market given its favorable mix of momentum and quality relative to international equity indexes. In the U.S., the out of favor healthcare sector provides an attractive balance of near-term cash flow visibility, reasonable valuations, and relatively healthy balance sheets. Certain industries and companies in the industrial, energy, and materials sectors are worth considering for portfolios given their exposure to important secular themes including, supply chain reshoring, advanced manufacturing, energy grid expansion, and the renewable energy transition. Finally, we think investors should be preparing a shopping list of premium growth stocks across sectors with lofty valuations but strong secular opportunities in the likely event many come back down to earth over the next 6 to 18 months.



CURRENT OUTLOOK

Over the last year, we recommended hedged equity and merger-arbitrage strategies be sold in client portfolios and reallocated to a combination of short-term Treasuries and cash. The ultra-low interest rate world of the last 12 years appears to be shifting to one in which market interest rates establish trading ranges meaningfully higher than existed for most of 2009 through 2021. In this environment, we expect the risk-adjusted return benefits of most alternative strategies to subside especially compared to assets traditionally viewed as risk-free including cash and U.S. Treasuries.

We believe gold deserves a moderate allocation in most client portfolios in the current late cycle environment. The economic and policy backdrops headed into the second half of 2023 appear well suited for the precious metal. This view is based on our observations that the Fed's rate hike cycle is likely nearing an end, core inflation could easily remain stickier than consensus expectations, and many central banks in Asia and the middle east have substantially accelerated gold purchases over the last 18 months. Our alternatives allocations, as seen in the table to the left, are designed to decrease the overall risk profile of our five investment objective-based portfolios (CAP PRES, IWSG, BAL, GWSI, and GROWTH.

The above minimum/neutral/maximum recommendations represent MainStreet Advisors' current positions relative to our Strategic Asset Allocation ranges. Views expressed have a 6-12 month horizon and are those of the MSA Investment Committee.

*Cap Pres: Capital Preservation, IWSG: Income with some growth, Bal: Balanced, GWSI: Growth with some income

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