Perspectives

A Quarterly Newsletter for Clients of Parsons Capital Management

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by John Mullen and Ruth Mullen

Liquidity, which was pumped back into the markets in response to the banking crisis in the first quarter, continued to pour in through April and May as the government worked to avoid breaching the debt ceiling. The result was a quarter of performance that looked similar to the first quarter and an official marking of a new bull market on June 8. Leadership in the just-completed quarter was decidedly tilted toward growth, with the Nasdaq posting its best first half since 1983 and the Nasdaq 100 (largest stocks), not to be outdone, with its best first half ever. Sector returns showed more of the same with Information Technology, Consumer Discretionary and Communication Services as the only three sectors to outperform the S&P 500. What is perhaps more notable than the outsized returns is the environment in which they occurred: Stocks were dealing with an inverted yield curve, shrinking money supply, declining profits and productivity, tightening lending standards and a Fed in restrictive mode. We often talk of stocks climbing a "wall of worry," but this backdrop more closely resembles Mount Everest.

Data as of June 30, 2023	June '23	Qtr. 2 '23	YTD '23
S&P 500	6.61%	8.74%	16.89%
MSCI AC World Index (incl. US)	5.85%	6.35%	14.26%
MSCI EAFE (Europe, Asia, Far East)	4.58%	3.22%	12.13%
MSCI EM (Emerging Markets)	3.89%	1.04%	5.10%
Russell 1000	6.75%	8.58%	16.69%
Russell 1000 Growth	6.84%	12.81%	29.02%
Russell 1000 Value	6.64%	4.08%	5.13%
Russell Midcap	8.34%	4.76%	9.02%
Russell 2000	8.13%	5.20%	8.09%
Bitcoin	11.92%	6.99%	84.29%

Data provided by Tamarac Inc.

Fixed Income Markets

After a very strong start to the year, the fixed income market largely fumbled in the second quarter. The Bloomberg US Aggregate index steadily fell off over the three months, ultimately posting a negative total return of -0.84% as rising yields pushed down prices faster than income could compensate. Looking at the Treasury curve, weakness was seen across the board, but negative returns accelerated as an investor moved out on the maturity schedule, with the 1-3 year bucket -0.60% and the 20+ year -2.35%. This is a noted reversal from the first quarter where longer dated bonds performed best. One of the few bright spots for fixed income markets was high yield bonds, where the ICE Bank of America US High Yield Index returned 1.63% in the quarter and 5.42% through the first half.

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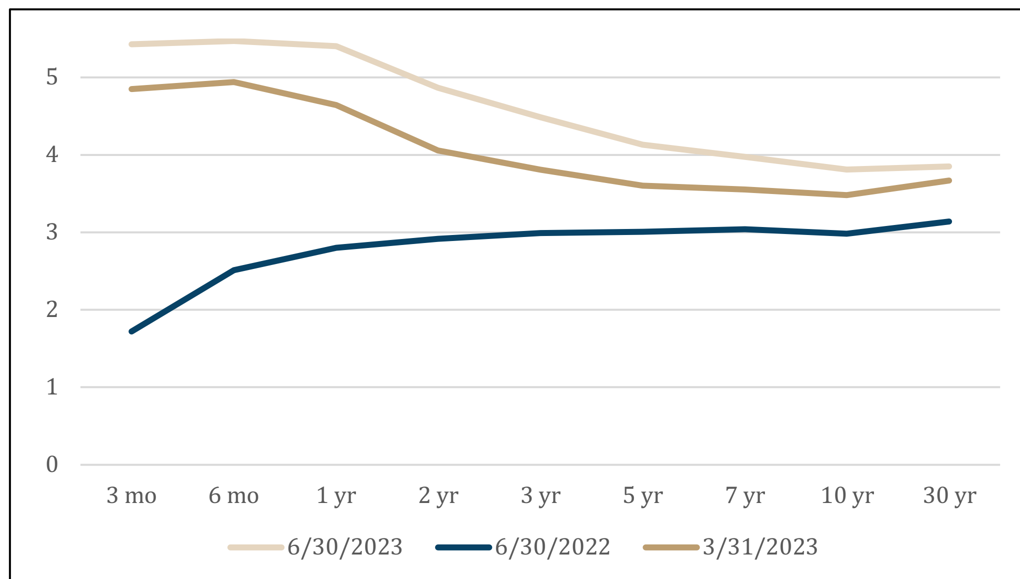
US Treasury Yields

The fed skips in June…

Yields moved higher across the curve during the quarter, as witnessed below. However, yields on the short end of the curve, even with the Fed choosing to skip a rate hike in their June meeting, moved more than those on the longer end of the curve. The aftermath is a curve more deeply inverted than when the quarter began, with the spread between the two-year yield and 10-year yield moving from -0.58 percentage points on March 31 to -1.06 percentage points on June 30. With the Fed loudly advocating for an additional hike, or two, it seems likely that the curve may become even more deeply inverted before this cycle comes to an end.

Yields up, curve inversion deepens…



Data from US Treasury

Commodities

Commodities continued to drift lower during the second quarter as weak economic data, especially out of developed European countries and China, heightened questions surrounding the growth outlook.

Commodity prices broadly struggling…

Energy, again, was a big loser in the quarter despite the best efforts of Saudi Arabia and OPEC+ to prop up prices. Oil fell by -6.65% and is now down nearly -12% for the year, even as announced production cuts from OPEC+ have now crossed 3.66 million barrels per day.

Copper, long seen as one of the more economically sensitive commodities, followed a strong first quarter with a -9% decline, resulting in prices roughly flat for the year. Of note, copper prices did rally nearly 5% in the final weeks of the second quarter.

Commodity	Qtr. 2 '23	Year to Date '23
CRB (broad index)	-0.51%	-1.25%
Oil	-6.65%	-11.98%
Gold	-2.57%	5.65%

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Economic Overview

Arguments for and against a looming recession…

The recession debate continues to rage on and, much like the previous quarter, there remains ample evidence on either side of the argument.

The final data points coming in for the second quarter have largely surprised on the upside and point to an economy that is chugging along. The Bloomberg Economic Surprise Index ended June at its highest level since the depths of the Covid lockdowns in 2020, showing how broad and unexpected the recent resilient economic numbers have been.

Economic surprises broadly coming in on the upside…

A sample of the broad-based upside surprises just in the final weeks of June:

- 1Q GDP revised higher to +2% (1.4% expected)
- Personal consumption +4.2% (3.8% expected)
- Jobless claims, both initial and continuing, coming in lower than expected
- ISM Service index re-accelerating to 53.9 (employment sub-component a major contributor)
- Second straight month of gains for the NFIB small business optimism reading
- Continued easing in inflation with June CPI +3% year over year (core CPI +4.8%)
- Housing data (starts, permits, sales) all turning higher

Economic numbers egging on an already hawkish Fed…

These positive data points are running into a Federal Reserve that is increasingly vocal about their desire to see a softening of the economy to further reduce inflation pressures. Added to the positive indicators above, the labor market continues to post a level of strength that would argue for further rate hikes. The latest payroll report showed non-farm gains of 209,000 month over month. All at the same time, the average hourly work week increased, the unemployment rate ticked down and average hourly earnings rose 4.3% year over year. Combine that with 9.8 million job openings and only 6 million job seekers, and the pressure to tighten remains.

None of the above points to an economy experiencing outstanding growth, but it remains surprisingly resilient. Coupled with positive real rates (interest rates above the rate of inflation) and the US is the economic envy of much of the rest of the world.

International economic picture less upbeat than domestic…

Perhaps no country has been more of a conundrum this year than China, which continues to suffer from their stringent Covid lockdown measures. After dipping into contraction territory earlier in the year, the Caixin manufacturing PMI is back in an expansionary reading at 50.5 for June. While the PMI has turned up, the more broad-based China High Frequency Economic Activity index has largely continued its steady deterioration from its high in February. With the domestic consumer inflation rate flat in the most recent reading, the Chinese government has cover to push further stimulus in an effort to revive the domestic economy.

China is not the only major international economy confronting issues, though. Germany and New Zealand have both seen consecutive quarters with negative GDP comparisons, indicating a recession in those countries. Looking more broadly: Of the 39 various manufacturing PMI surveys globally, only 11 are currently above a reading of 50 while the other 28 are in contraction and 22 of those 28 are weakening further.

To further compound the issues facing many of the international economies: Unlike the US, inflation looks to be accelerating. With only the US and Canada currently experiencing positive real rates (where short-term interest rates are higher than the inflation rate), it seems that global central banks still have a long runway for rate hikes even in the face of weaking economies.

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Investment Implications

Dual crises bring on a flood of liquidity…

With so many headwinds confronting the equity market, many investors are left wondering how stocks have managed to push higher throughout the year. One key to consider is the Silicon Valley Bank failure on March 10. A rally to begin the year virtually disappeared in February and March amid fears concerning the banking industry. With the failure of SVB, and others, regulators rushed to add liquidity to the system to fend off a bank run, and equities were off to the races. Another shot of fuel was the Treasury continuing to add liquidity through "extraordinary measures" in the run-up to the debt ceiling deadline.

Performance highly concentrated as advance fueled by P/E expansion…

As we've seen for so much of the past 15-year period, the added liquidity correlated with expanding price-to-earnings (P/E) multiples and benefits flowed to the growth-oriented sectors of the market. Performance was highly concentrated among the mega-cap (largely growth) names; the 10 largest companies in the S&P 500 were responsible for nearly 77% of the index's return in the first half.

Things began to change in the month of June, however, as liquidity began to drain from the financial markets. With the debt ceiling resolved, the Treasury no longer needed to extend extraordinary measures to keep from breaching the debt limit and began to rebuild their General Account. That, combined with the continuation of Quantitative Tightening, will remove roughly $800 billion in liquidity through the second half of the year. Perhaps coincidentally, at the same time the liquidity spigot was turned off, the nature of performance in the equity markets began to shift.

June performance a hint of a shifting performance landscape?...

Coming into June the traditional market-cap weighted S&P 500 had outperformed the equal weighted S&P 500 by 10.28% (+9.65% versus -0.63% respectively). The dispersion between the S&P 100 (the largest companies) and the equal weighted S&P 500 was even greater at +15.33% and -0.63%. The final month of the second quarter saw a broadening out of leadership, however, with the equal weighted index leading the way at +7.72% for the month followed by market-cap weighted S&P 500 at 6.61% and the S&P 100 +6.12%. A single month is not enough data to mark a change in trend, but the leadership characteristics witnessed in June were similar to what occurred in 2022 when declining liquidity was a fixture for most of the year. If we believe the Fed's rhetoric, and they've been clear and consistent, tightening conditions can be expected to persist for some time. Even when they stop raising interest rates, the massive use of their balance sheet to inject liquidity into the system (which had been going on since 2009) will likely resume its path of quantitative tightening. Against the backdrop of the domestic economic resilience described above, we would expect the June relative performance trend shift to continue.

Disconnect between stocks and bond…

The stock and bond markets are telling different stories. Interest rates are rising and the yield curve is staying inverted; mortgage rates have topped 7%. These all point to recession risk. Stocks and risk assets in general continue to inch higher in the face of these warnings. Divergences like this are unusual and don't last forever. We like the prospects of the stock sectors that are now showing signs of life, while we remain watchful for the kind of financial accident that can happen in tightening conditions.

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