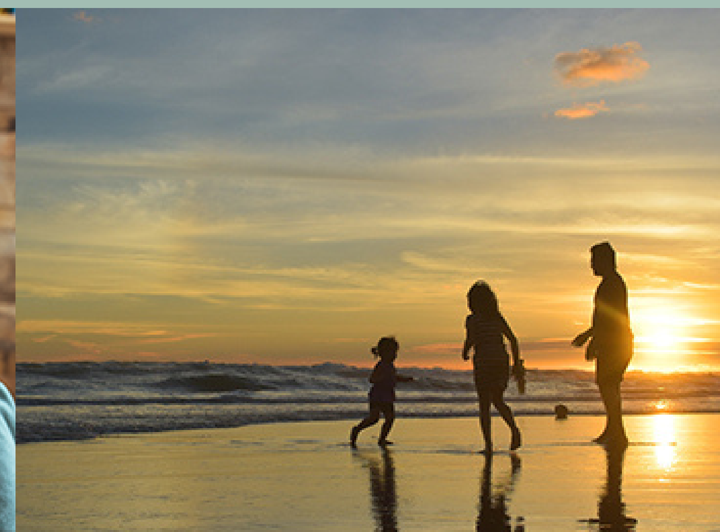


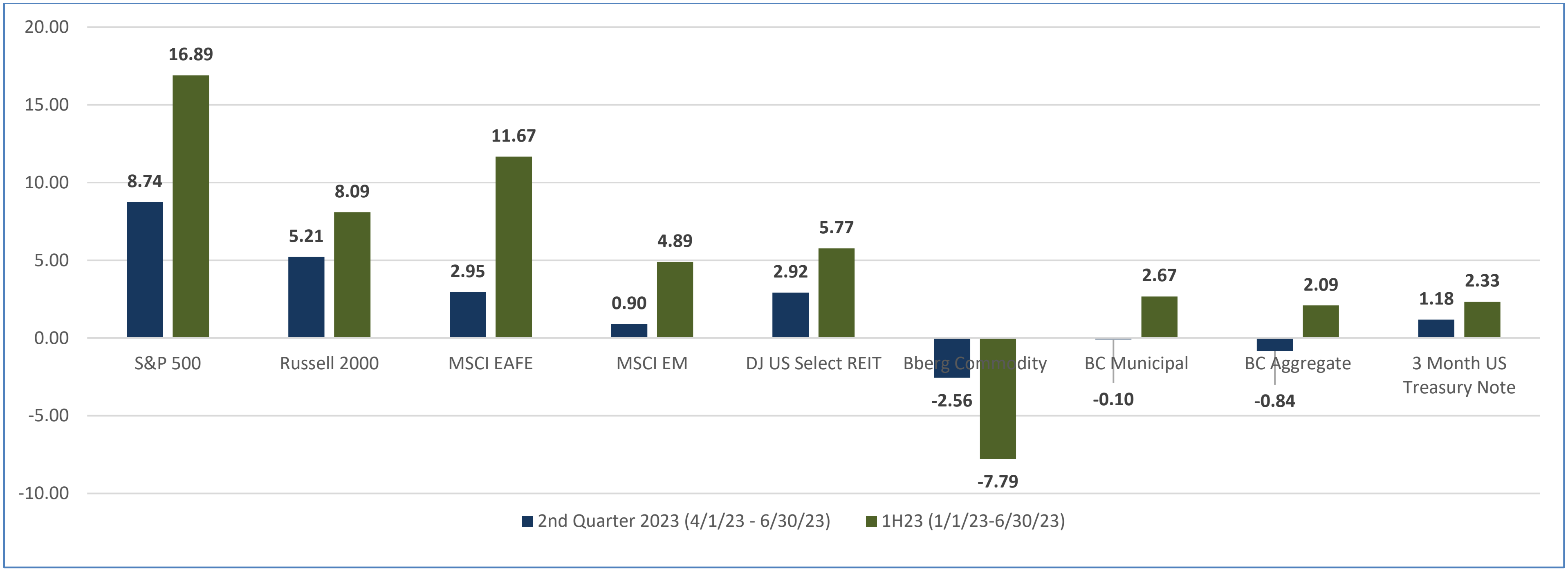


Just Like the 4th of July

Stocks Closed Out the 1st Half of the Year with Fireworks

Schneider Downs Wealth Management Advisors, LP

Q2 2023 Market Commentary



"America loves an underdog" is a phrase that has been in our country's lexicon, and embedded into our collective conscious, since our founding in 1776. Francis Scott Key's lyrics eloquently paint the picture of the scrappy upstart fighting the imperial powerhouse; the powerful verse "gave proof through the night that our flag was still there" still provokes a powerful emotional response all these years later. As I sit down to write this first-half recap of capital markets over the fourth of July holiday weekend, it seems appropriate to begin with a few words on our general love affair as Americans for the underdog. The American economy and its stock market certainly came into 2023 as the underdog; most economists were predicting a recession, and while market prognosticators thought a positive year was out there to be had for stocks, bullish sentiment was hard to find[1]. Americans, who normally love the underdog, seemingly "took a break" from that sentiment in the first half of 2023. The U.S. economy and S&P 500 responded to the general bearish sentiment by posting positive quarterly growth in the first[2] and second quarters[3] on the economic front and a strong ~17% return for the first half of the year. While there have been other bright spots in capital markets, international developed equities continued their strong performance and fixed income generated attractive income for investors and savers alike for the first time in almost 15 years. The dominant story of the first half of 2023 has been the resilience of the U.S. economy and strong performance of the S&P 500.

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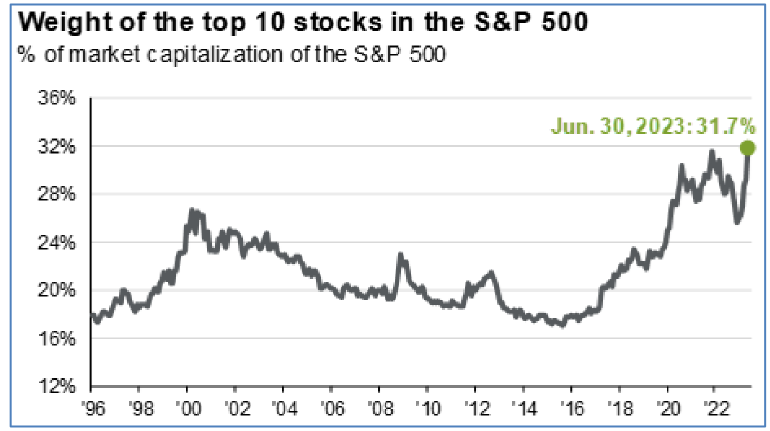
[1] SDWMA was more sanguine on U.S. small cap and mid cap stocks than large stocks due to valuations; a position we still hold. The power of the U.S. large cap market, driven by a handful of U.S. stocks has been truly remarkable.
[2] https://www.bea.gov/news/2023/gross-domestic-product-second-estimate-corporate-profits-preliminary-estimate-first
[3] https://www.atlantafed.org/cqer/research/gdpnow

As we head into the second half of the year, the looming question is whether the U.S. economy and the stock market can continue to outrun the bearish sentiment and daily deluge of economic indicators that suggest a slow down not only is likely, but imminent. "Will the underdog become the favorite?" is what we will be watching throughout the summer and into the fall. We will preview that and much more in the proceeding recap of surprisingly strong first half of the year in capital markets.



Given the restrictive set of financial conditions in the U.S., with the Federal Reserve hiking interest rates at the swiftest pace since the early 1980s and a divided government in Washington DC,[4] one could be forgiven in accepting the conventional wisdom that the U.S. stock market would struggle/muddle along in 2023. Instead, the market shook off three more interest rate hikes this year,[5] two high profile bank failures (in addition, a shotgun wedding was arranged by the Fed of First Republic to JP Morgan), and a persistently inverted yield curve, to the aforementioned ~17% performance of the S&P 500. There is no doubt that the S&P 500 is largely being moved by a handful of stocks that capture the "artificial intelligence" theme/exposure.[6] As the chart to the right indicates, the concentration of the top ten stocks in the S&P 500 is at a multi-decade high.[7] While not unusual for a few stocks to move a larger market capitalization weighted index, it is something that bears watching as the higher interest rate environment has the potential to put these more growth-oriented stocks under pressure in the second half. Value as a style underperformed growth[8], weighed down by exposure to financial stocks that were punished in lieu of the Silicon Valley and Signature Bank failures, as well as being deemed less of a beneficiary to the AI theme.

The lack of participation of value as a style (across market capitalizations) in the 2023 runup offers investors and allocators a place to diversify away from the concentration of "AI" powered stocks that dominate both the S&P 500 and make up over 50% of growth-oriented indices. While overshadowed by the strong performance of the S&P 500, U.S. mid cap and small cap stocks quietly rebounded from a tough stretch they experienced following the bank failures in early March. Both U.S. small cap and mid cap stocks were up high single digits for the first half of the year, and offer attractive valuations relative to the S&P 500 and on an absolute basis measured against their historical levels. If the market rally continues, we would expect laggards like value and small/medium stocks to ascend and catch up to high-growth stocks that moved the markets year to date. In a highly-concentrated market like we are experiencing in 2023, diversification is your friend. We believe exposure across style (e.g. growth and value) and market capitalizations (large, medium, and small) should prove beneficial in the months to come.

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[4] Democrats in control of the Senate and the executive branch and republicans in control of the House of Representatives and a conservative-leaning majority on the SCOTUS.
[5] https://www.forbes.com/advisor/investing/fed-funds-rate-history/
[6] The top 10 S&P 500 companies are based on the 10 largest index constituents at the beginning of each month. As of 5/31/2023, the top 10 companies in the index were AAPL (7.5%), MSFT (7.0%), AMZN (3.1%), NVDA (2.7%), GOOGL (2.1%), GOOG (1.8%), META (1.7%), BRK.B (1.7%), TLSA (1.6%), UNH (1.3%) and XOM (1.2%).
[7] JPM Guide to the Markets, June 30, 2023.
[8] which again is being powered by the expected benefits of artificial intelligence in the areas of increasing productivity and reducing fixed cost

International developed equities continued to build off of their strong start to the year, posting a solid ~3%[9] return for the quarter. Since the U.S. dollar peaked in valuation in the fall of 2022, international developed equities have outperformed U.S. large cap stocks by 530 basis points[10] (+31% vs. +25.7%) in the following nine months ending June 30th. This outperformance has gone under the radar in most areas of financial media for a variety of reasons. The first has to do with the composition of international markets versus U.S. markets. U.S. markets are much more tech heavy and thus have more "artificial intelligence" story angles to pursue. Let's face it, Nvidia "AI" semiconductor chips that power next generation computers to process at mind-numbingly fast speeds and ChatGPT's (Microsoft's OpenAI Chatbot) ability to generate everything from law briefs to effective breakup letters (in the voice of Shakespeare or any of the other great poets if one desires) are more interesting than Siemens AG's product suite designed to enhance efficiency in our electrical grid, operate manfucaturing plants and railroads more effectively through software, and a hardware/software solution in its Healthineers unit (see I already put you to sleep[11]). The second major reason for the lack of coverage is more behavorial in nature. For the past 30 years, which is about 75% of the time I have been alive, U.S. stocks have outperformed international stocks by a fairly healthy margin on a cumulative basis. This has created strong home country and confirmation (that past is also prologue) biases among investors that has left international stocks under-owned among U.S.-based investors. What might surprise these investors is that in three of the last five decades (70's, 80's, 00's), international developed stocks outperformed U.S. stocks.[12] Furthermore, at the beginning of the 30-year run in cumulative outperformance of U.S. stocks versus international, U.S. stocks were trading at a discount of roughly 0.5x the value of international – now U.S. stocks are trading at 1.5x premium to international stocks.[13] The set up for international stocks looks very attractive, and with the added benefit of diversification from the concentrated U.S. equity market, will continue to be an important component of our asset allocations moving forward.

The first half of 2023 has been a step forward in forgetting the difficulties of capital markets of 2022. Bonds are once again generating steady returns (mostly from income) and serving as a ballast amid equity volatility. Cash and short-term fixed income vehicles (U.S. t-bills and agency securities, money market funds, and bank CDs) are finally generating real returns/income for savers who were punished for the better part of 15 years during the "zero interest rate" era of U.S. Federal Reserve policy. Finally, stocks, U.S. and international alike, have generated solid (if not strong) returns year to date, and are positive on a one-year basis. All of these positive inputs have put client portfolios on track to recoup the losses incurred during 2022. However, investors would be foolhardy to believe that the second half of 2023 will mimic the first half. The U.S. Federal Reserve has signaled additional monetary tightening is likely, with one and possibly two interest rate hikes in the next six months. Inflation, which is well off of the 9% highs we experienced in June of 2022, remains stubbornly high at 5%, well above the Fed's 2% target. The U.S. equity market is fairly concentrated, being drive by an "AI" theme that is equal parts exciting (in what it can do for companies) and concerning (it has taken Nvidia, a $25.8 billion revenue, $6.8 billion EBITA company soaring to a trillion dollar market cap valuation).

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[9] MSCI EAFE, returns generated from Morningstar Direct

[10] MSCI EAFE TR and S&P 500 TR returns generated from Morningstar Direct; 10/1/22-6/30/23.

[11] One of my talented colleagues, Alissa Garcia, recently had a baby. In some of our video calls, her baby will wake up and I will talk about international equities (or derivatives and options) and magically the baby will go to sleep. I am available upon request to help with your kid or grandkids' sleeping needs 😊.

[12] The Journal of Portfolio Management, volume 49 number 6, June 2023, Cliff Asness, Antti Ilmanen, and Dan Villalon.

[13] The Journal of Portfolio Management, volume 49 number 6, June 2023, Cliff Asness, Antti Ilmanen, and Dan Villalon.

All of the above, plus the looming economic recession that has seemingly been around the corner for almost a year, weighs equally on our minds and shoulders. It serves as reminder to the theme of our last quarterly letter, “No Peaks, No Valleys.” We still believe in a steady and even approach to shepherding your and your family’s life’s work through the interesting times and markets we find ourselves in, so that you can pursue your passions knowing that the team at SDWMA has your back. As always, thank you for the trust you put in our team. We hope you are having a wonderful summer and can’t wait to hear about vacations, graduations, kids and grandkids as we set up time over the coming weeks and months as we check in to get updates and review your portfolios.