Systematic Global Equities

Q2 2023 Update: Navigating Uncertainties

July 2023

Market Review

The second quarter of 2023 saw US equities climb higher powered by large cap growth companies leveraged to the AI (Artificial Intelligence) theme. A pickup in soft-landing expectations seemed to be among the more powerful tailwinds for equity markets. Labor market strength underpinned the broader consumer resilience theme. The soft-landing narrative was also supported by an improving housing market, despite the elevated rate backdrop. In addition, Q1 earnings and guidance came in above expectations, dampening some of the concerns about a meaningful reset to 2023 consensus estimates. The AI secular growth theme was a big bright spot, boosting performance for companies in the technology and communication services sectors. Despite the Q2 gains, there were plenty of bearish sentiment regarding even more rate hikes leading to a policy mistake, particularly given the lagged effects of monetary policy and the signaling from further yield curve inversion, collapsing money supply growth, and tightening lending standards. Other areas of caution included narrow market leadership, valuation, looming liquidity headwinds, and an underwhelming China recovery.

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Table 1 — Size, Style, and Sector Performance

Size	Apr 2023	May 2023	June 2023	Q2 2023	YTD 2023
S&P 100	2.18	2.47	6.12	11.12	22.38
S&P 500	1.56	0.43	6.61	8.74	16.88
S&P 400	-0.78	-3.20	9.16	4.84	8.81
S&P 600	-2.78	-1.77	8.23	3.36	5.99

Style	Apr 2023	May 2023	June 2023	Q2 2023	YTD 2023
S&P 500 Value	1.71	-1.91	6.88	6.64	12.13
S&P 500 Growth	1.43	2.50	6.38	10.59	21.24
S&P 400 Value	-1.07	-3.64	9.63	4.51	7.13
S&P 400 Growth	-0.51	-2.80	8.71	5.13	10.41
S&P 600 Value	-2.41	-3.74	8.52	1.94	5.04
S&P 600 Growth	-3.14	0.17	7.95	4.74	6.95

Sector	Apr 2023	May 2023	June 2023	Q2 2023	YTD 2023
Information Technology	0.45	9.46	6.59	17.23	45.57
Consumer Discretionary	-0.95	3.21	12.07	14.58	33.82
Communication Services	3.77	6.21	2.58	13.06	36.24
Industrials	-1.18	-3.17	11.32	6.25	9.73
Financials	3.18	-4.32	6.69	5.33	1.79
Materials	-0.14	-6.85	11.05	3.31	7.74
Health Care	3.07	-4.29	4.36	2.95	-1.48
Real Estate	0.97	-4.51	5.64	2.48	4.01
Consumer Staples	3.59	-6.07	3.24	0.45	1.31
Energy	3.30	-10.03	6.65	-0.89	-5.52
Utilities	1.87	-5.87	1.65	-2.53	-5.69
S&P 500	**1.56**	**0.43**	**6.61**	**8.74**	**16.88**

Source: Bloomberg, FactSet

Market Outlook

Amidst a general sense of macro uncertainty, the debate on recession rages on. While inflation has declined, it is still above the Fed's target rate. Labor markets appear healthy although some cracks are starting to appear. The Fed is poised to raise rates further even as the yield curve remains inverted. **Table 2** outlines three possible scenarios that can unfold in the coming months. While the hard landing and no recession scenarios have their proponents, the soft-landing scenario that includes the possibility of a mild recession seems to be gaining the most traction in the marketplace. Against the backdrop of mixed economic signals, most investors appear to be optimistic about the Fed's ability to avoid a deep recession.

Table 2 | **Recession Factors and Effects**

|	Hard Landing (Deep Recession)	Soft Landing (Mild Recession)	No Landing (No Recession)
Inflation	Disinflationary process slows	Eases and returns to pre-2022 levels	Inflations remains high despite aggressive fed policy action
Fed	Overtightens policy or acts too aggressively; subsequent cuts could be needed	Pauses rate hikes, then slowly lowers back down to neutral	Further hikes necessary and higher for longer rates
Labor	Spike in unemployment	Moderate increase in unemployment, but no spike; Job openings decline	Tight and resilient labor market; absorbs rate increases
Consumer	Broad pullback in spending and credit, and increased delinquencies	Mild spending declines	Spending remains resilient, driving sticky inflation
Economy	Steeply negative GDP growth	Moderate but positive growth	Positive GDP growth, but uncertainty around a recession persists
Market	Increased volatility and price pressure	Restored price stability	Increased volatility; potential for sideways/choppy price action

Source: Aperio

Inflation – Slowing but Still Elevated

While the headline Consumer Price Index (CPI) YoY inflation peaked at 9.1% in June 2022, and moderated to 3.0% in June 2023, the Core CPI index remains elevated at 4.8% (**Chart 1**). The PCE Price index (**Chart 2**) also remains well above pre-pandemic levels, suggesting the presence of sustained inflationary pressure. The PCE Price index is the Federal Reserve's preferred measure of inflation as they focus on core inflation and see it as a better predictor of future inflation than the headline CPI or overall inflation rate.
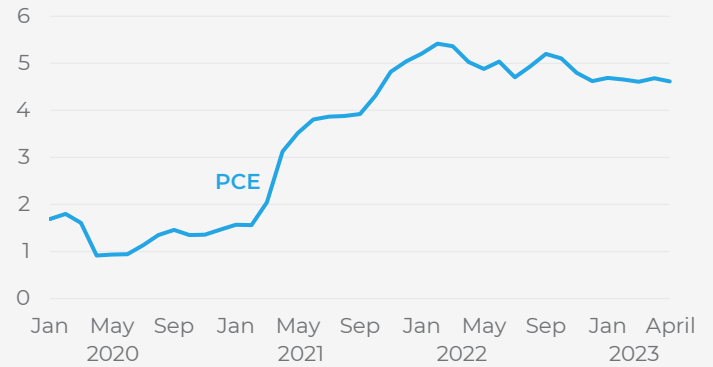
Chart 1 | **Headline and Core CPI**
As of June 2023
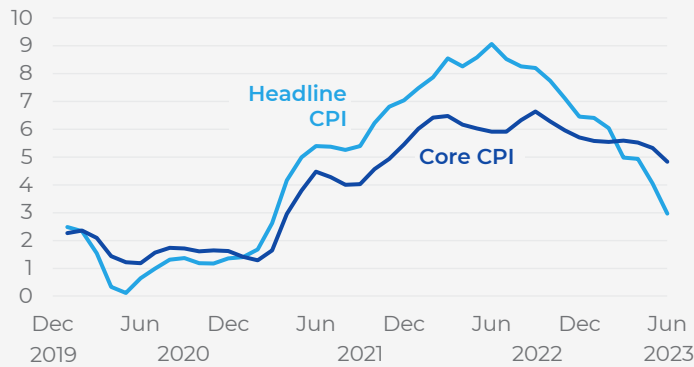
Source: U.S. Bureau of Labor Statistics, Bloomberg

Chart 2 | **Personal Consumption Expenditures Price Index**
As of April 2023

Source: U.S. Bureau of Economic Analysis, Bloomberg

Evidence of slowing inflation can be seen in the ISM Price Indices (**Chart 3**). For example, prices within the manufacturing sector are contracting; services prices are easing but not yet contracting. While this bodes well for the direction of inflation, there is another aspect that needs to be taken into consideration. A significant decline in both ISM prices components has historically presaged a recession.

Chart 3 | **ISM Manufacturing and Services Prices**
As of 5/31/2023, Shading denotes recessions
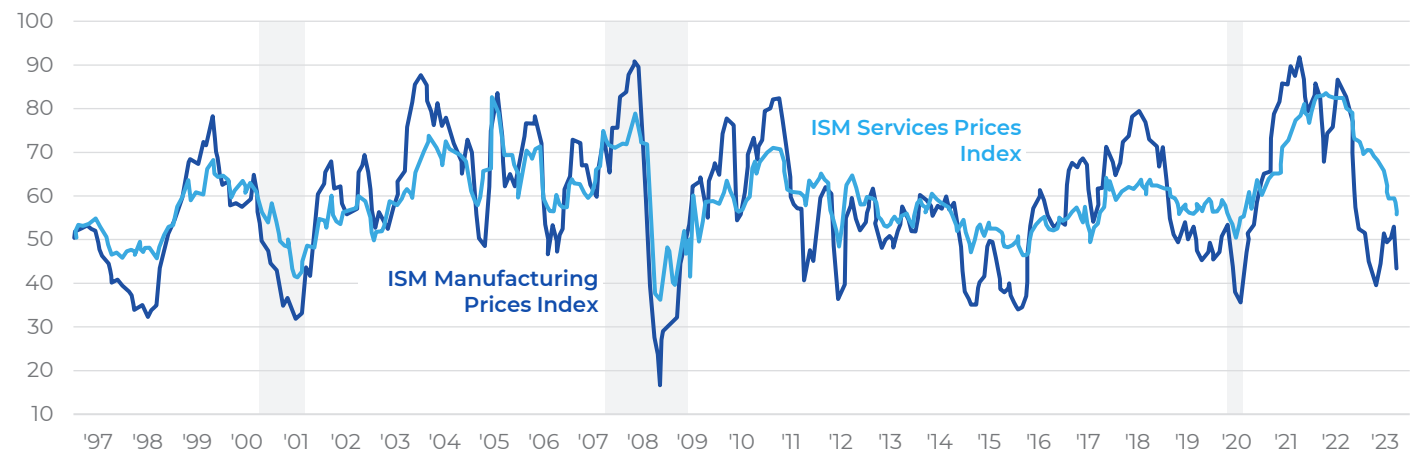
Source: Charles Schwab, Bloomberg, ISM (Institute for Supply Management)

Labor Markets – Robust but Starting to Show Cracks

Labor markets continue to remain resilient which implies that the Fed is likely to maintain policy at restrictive levels. While hiring trends have softened, average hourly earnings are strong and continue to exert price pressure (**Chart 4**). The combination of solid wage growth and a low unemployment rate suggests the Fed's job is not done (**Chart 5**).

However, the first cracks in the labor markets are starting to appear. Job cuts are trending up and labor shortage numbers are trending down (**Chart 6**). In addition, the job-finding rate—which shows how many individuals who were previously unemployed are now able to find a job—has weakened and is at its lowest since September 2021 (**Chart 7**). That's consistent with the average in the years leading up to the pandemic, but the magnitude of the decline from the recent peak is increasingly reminiscent of recessionary behavior. If the rate continues to move lower and jobless claims move higher, the cracks in the labor market may start to widen, giving way to weaker payroll growth.

Chart 4

US Hiring Slows, Yet Wage Growth Remains Strong
As of 2023, Shading denotes NBER-designated recessions
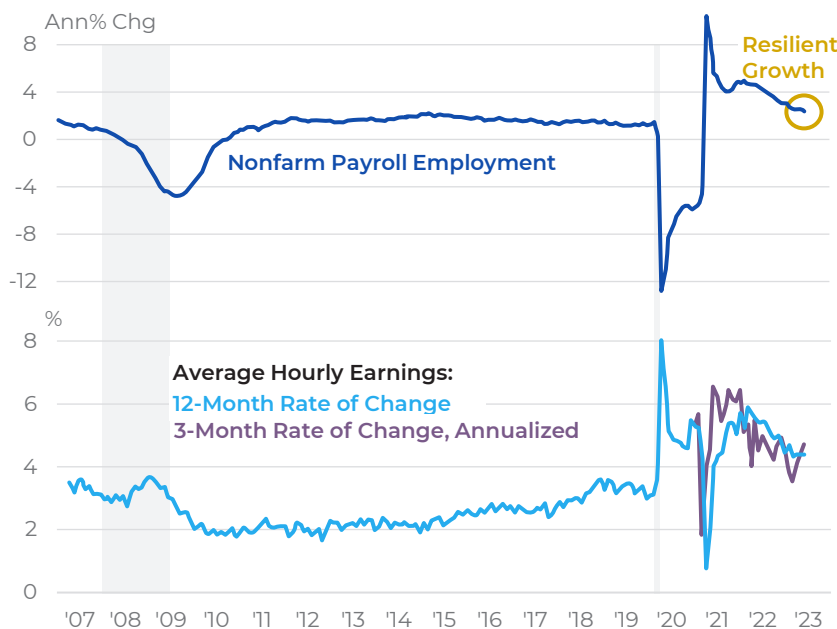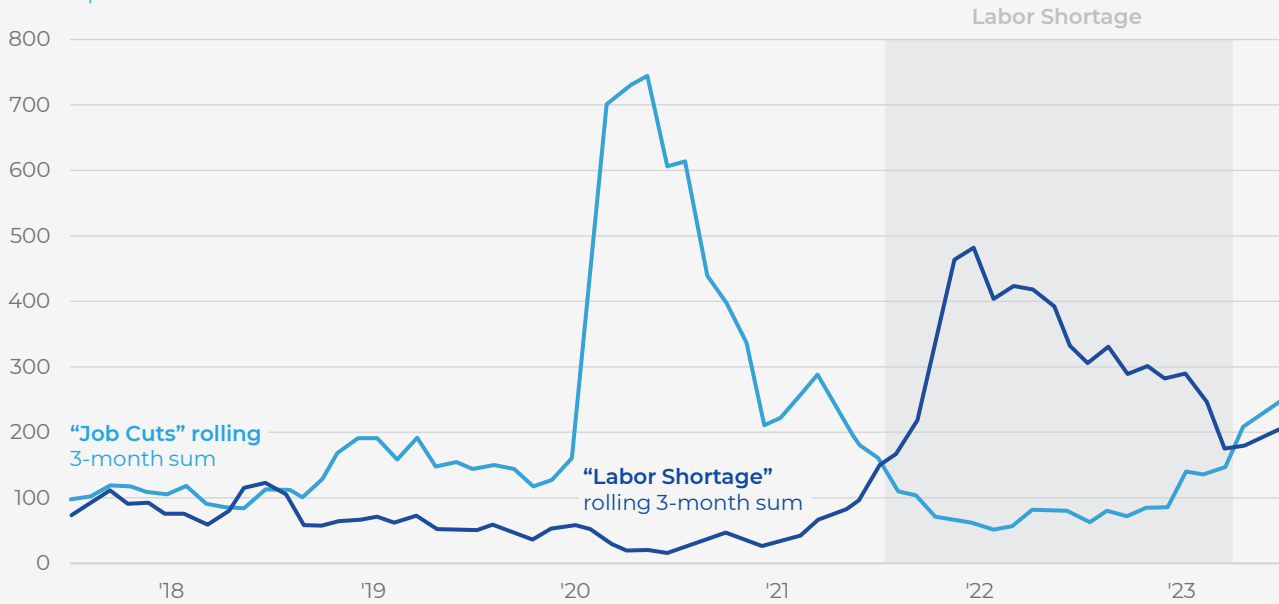

Source: © BCα Research 2023

Chart 5

U-3 Unemployment Rate
As of 6/30/2023, Y-axis is truncated for visual purposes, Shading denotes recessions
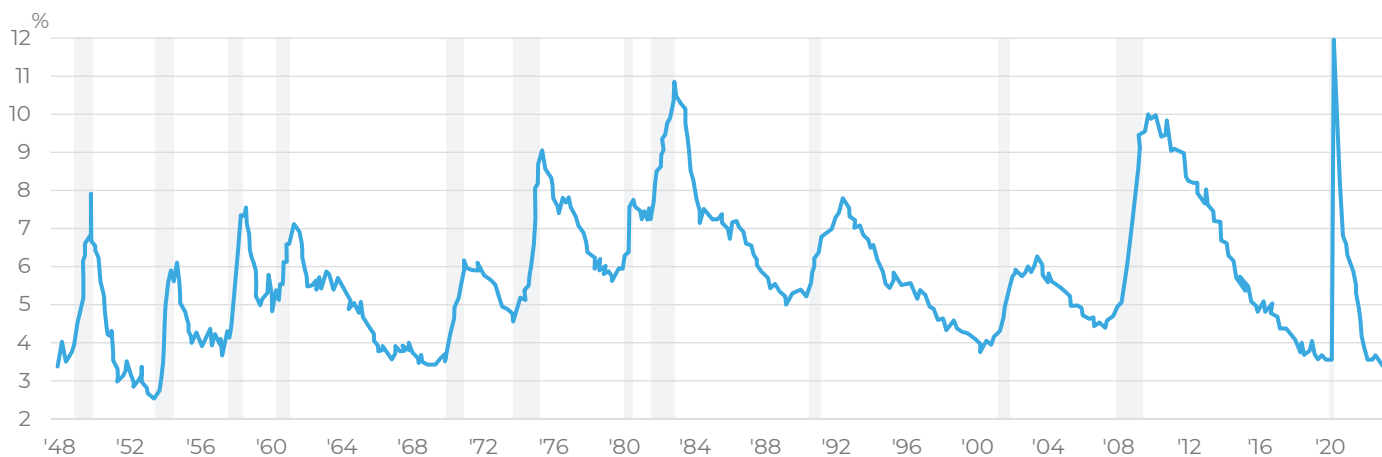
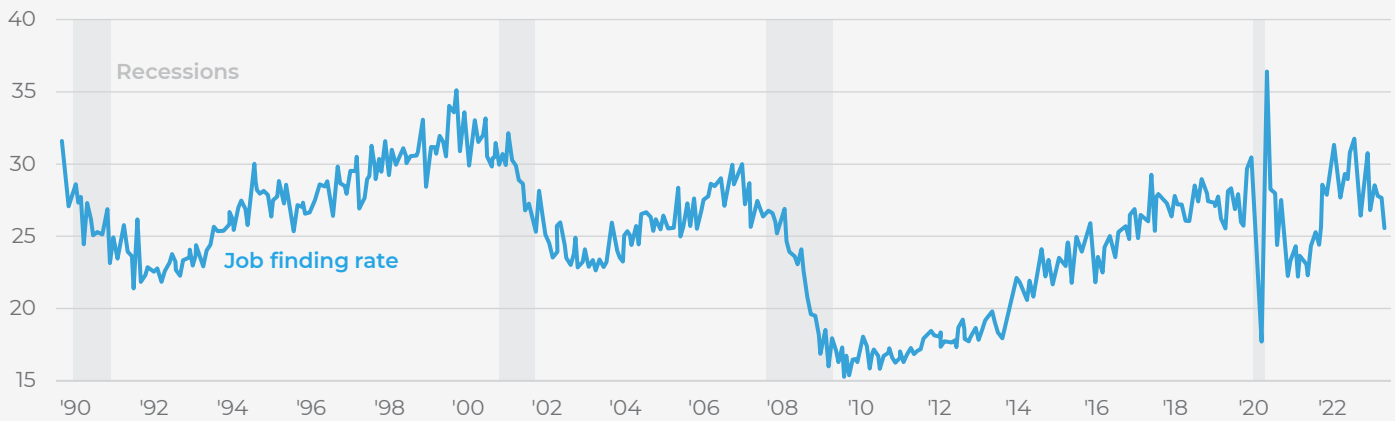Source: Charles Schwab, Bloomberg, Bureau of Labor Statistics

Chart 6 | **Shortages to Gluts: Jobs**
As of 6/2/2023

Note: Mentions on corporate shareholder communications for companies in MSCI World Index. "Job cuts" terms: job cuts, reduction in force, layoffs, headcount reduction, employees furloughed, downsizing, personnel reductions. "Labor shortage" terms: labor shortages, inability to hire, difficulty in hiring, struggling to fill positions, driver shortages.

Source: Charles Schwab, Bloomberg

Chart 7 | **Keep It If You Can Find It**
As of 5/31/2023

Note: Job finding rate is found by dividing the number of individuals who have transitioned from unemployed to employed by the total number of unemployed during the prior month.
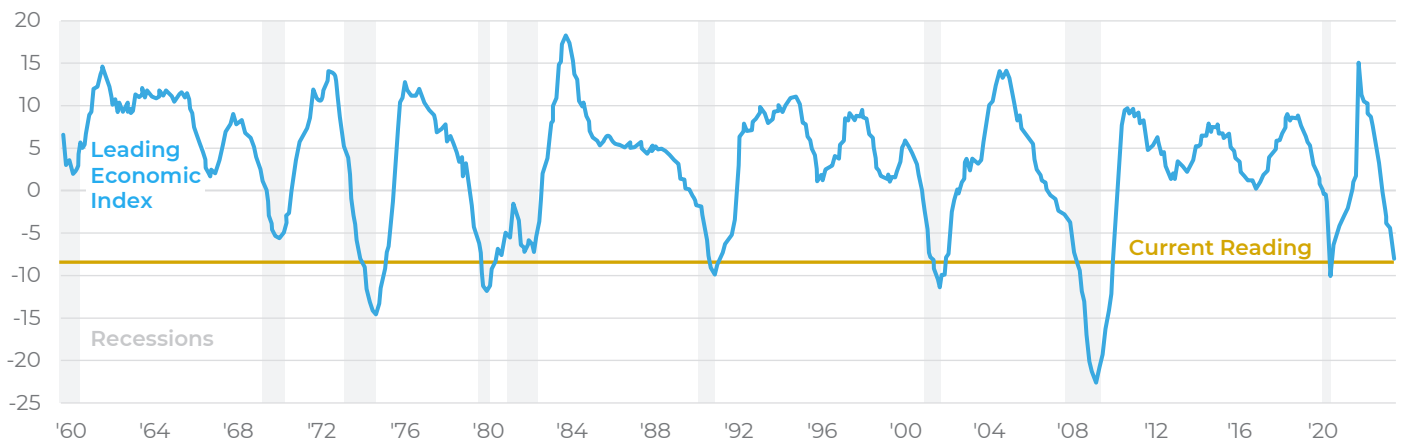
Source: Charles Schwab, Bloomberg

# Economic Growth – Growing but Starting to Slow

The Conference Board's Leading Economic Index (LEI)—which historically has a solid track record of leading economic tops and bottoms—is down nearly 10% from its peak 16 months ago (**Chart 8**). The GDP growth rate has been falling since the end of 2020, standing at 2.0% as of the last data point (**Chart 9**). The ISM Manufacturing and ISM Services indices have also dropped, indicating a slowing manufacturing and service sector (**Chart 10**). All these indicators suggest that while the economy is still growing, the rate of growth is starting to slow.

Chart 8 | **Leaders Still Lower**
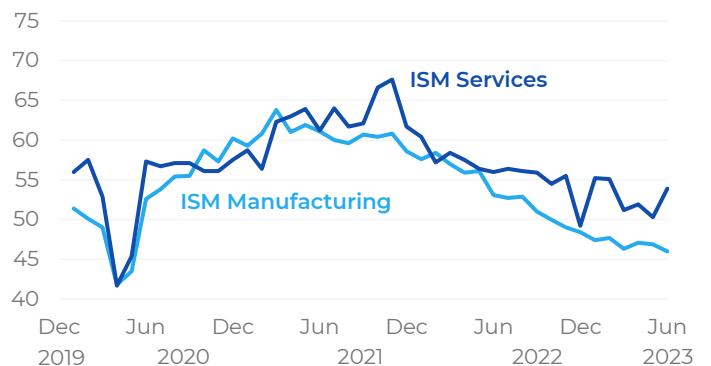16m % Change, As of 4/30/2023

Source: Charles Schwab, Bloomberg, The Conference Board

Chart 9 | **GDP QoQ Growth**
As of 3/31/2023
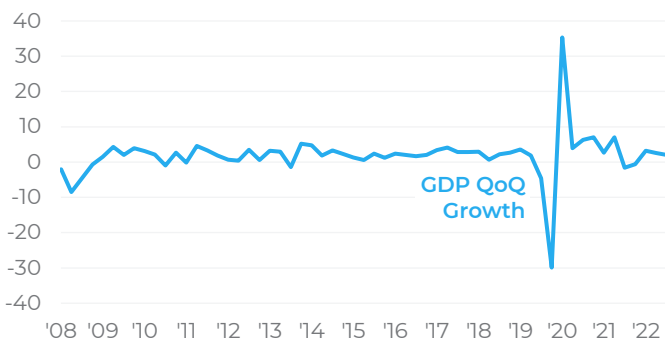
Source: U.S. Bureau of Economic Analysis, Bloomberg

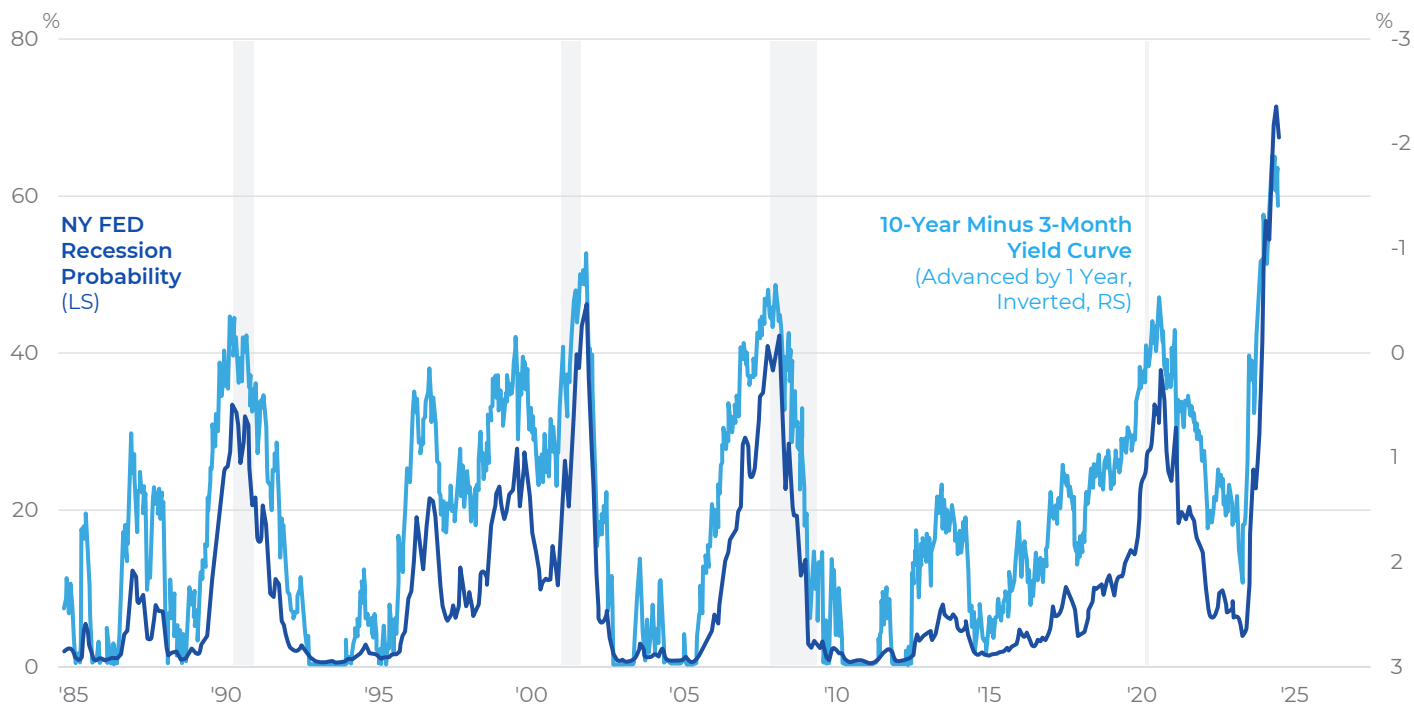**Chart 10** | **ISM Manufacturing and Services**
As of June 2023

Source: Institute of Supply Management, Bloomberg

Yield Curve – Continuing to Signal Recession

Chart 11 | **The Yield Curve is Flashing Bright Red**
As of 2023, Shading denotes NBER recessions

Source: NY Fed, Macrobond, © Clocktower 2023

The yield curve has remained inverted at historically high levels (**Chart 11**). **Table 3** shows the probability of a recession depending on the slope of the yield curve. As of June 30th, the spread between the three-month bill and the 10-year note had widened to 1.48%, indicating a probability of recession of around 70%. That's consistent with a Bloomberg survey of analysts that puts the probability of one occurring within the next 12 months at 65% (**Chart 12**).

Note: The yield curve spread is defined as the spread between the interest rates on the ten-year Treasury note and the three-month Treasury bill.

Source: Federal Reserve Bank of New York, "*The Yield Curve as a Predictor of U.S. Recessions,*" Arturo Estrella and Frederic S. Mishkin, June 1996

Table 3 | **Estimated Recession Probabilities for Probit Model Using the Yield Curve Spread**
Four Quarters Ahead

Recession Probability (Percent)	Value of Spread (Percentage Points)
5	1.21
10	0.76
15	0.46
20	0.22
25	0.02
30	-0.17
40	-0.50
50	-0.82
60	-1.13
70	-1.46
80	-1.85
90	-2.40

While some discussions suggest that the US may avoid recession, several indicators still point to heightened recession risks. The Treasury yield curve, across its various definitions, is at an unprecedented level of inversion. Though the yield curve is at its deepest inversion in 60 years (**Chart 13**), the timing of a potential US recession remains uncertain as yield curve inversions tend to be a longer-term leading indicator and recent economic data suggests the economy is still on firm footing.

Market Concentration & Artificial Intelligence (AI)

During the first half of 2023, 10 US stocks accounted for 79% of the S&P 500's gains (**Chart 14**). This group, including NVIDIA, Microsoft, Apple, and Alphabet Inc., is widely seen as a direct beneficiary of generative AI's potential to transform business productivity. NVIDIA—which posted the strongest total returns in the first half—manufactures powerful graphics processing units (GPUs) that are the backbone of the AI revolution.

It's not uncommon for the largest cap stocks to dominate performance among cap-weighted indexes like the S&P 500 or Nasdaq; but when the majority of member stocks are underperforming the index, concentration risks become elevated. As shown in **Chart 15** below, as of the end of the second quarter, a record low of only 32% of S&P 500 stocks outperformed the overall index over the prior three months.

The extremely narrow rally among US stocks reflects investor concerns over the Fed's attempts to slow the economy, which raises anxiety about the sustainability of earnings. The perceived AI winners are especially popular because they are seen to have structural engines for sustained growth that can traverse periods of macroeconomic difficulty with relative ease (**Chart 16**). Portfolios that had less than market exposure to these stocks suffered disappointing returns relative to the market. While Investors who held all these stocks at or above market weights have benefited from the trend, market concentration also creates risks. Investors who piled into the small group of AI-fueled names could get burned if valuations stretch too far, sentiment shifts and returns rapidly reverse.
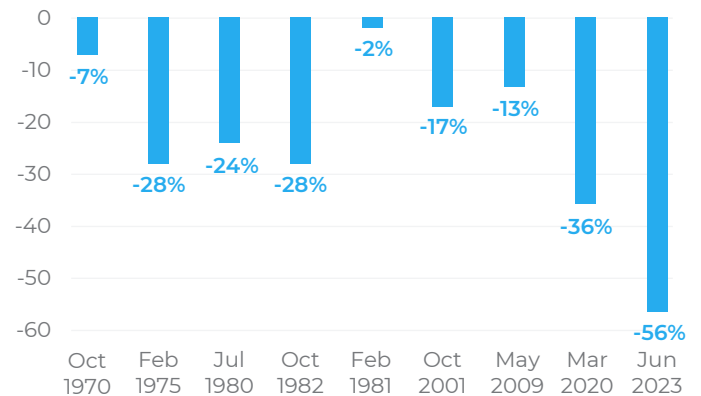
The euphoria around Artificial General Intelligence (AGI) and Large Language Models (LLMs) and the hardware and software needed to develop and maintain them appear to be the primary catalysts for the extreme concentration in market leadership. In a paper entitled Generative AI - Hope, Harrowing or Hubris?, our CIO discussed the economic and industry implications of AGI.   Perhaps AGI will dominate our economy for the next five or ten years in a way that justifies the market's allocation of capital to these companies. Perhaps these companies and their AI prospects are the only bright spots in an otherwise stagnant and directionless US economy. Or it could be that allocating to high-growth, expensive tech is a reflex investors have developed because of a perceived margin of safety in these liquid tech mega caps, conditioned as we have all become to the expectation that when needed, central banks will provide unlimited liquidity to stabilize risky asset markets. This cycle has repeated itself with increased intensity and frequency since the turn of the century.

Chart 12 — **United States Recession Probability Forecast**
Subtitle

United States Recession Probability Forecast
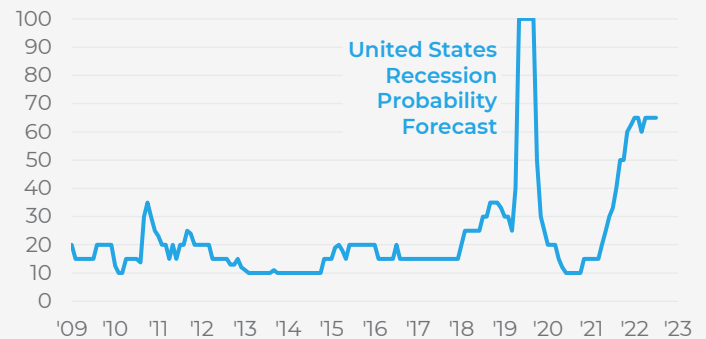
Source: Bloomberg

Chart 13 — **Normalized Yield Curve Most Inverted in History: Recession Yield Curve Inversions**
10Y-3M yield curve as % of 10Y, As of 6/9/2023

Oct 1970	Feb 1975	Jul 1980	Oct 1982	Feb 1981	Oct 2001	May 2009	Mar 2020	Jun 2023
-7%	-28%	-24%	-28%	-2%	-17%	-13%	-36%	-56%

Source: Datastream

Chart 14

10 Stocks Dominated US Market Returns in First Half
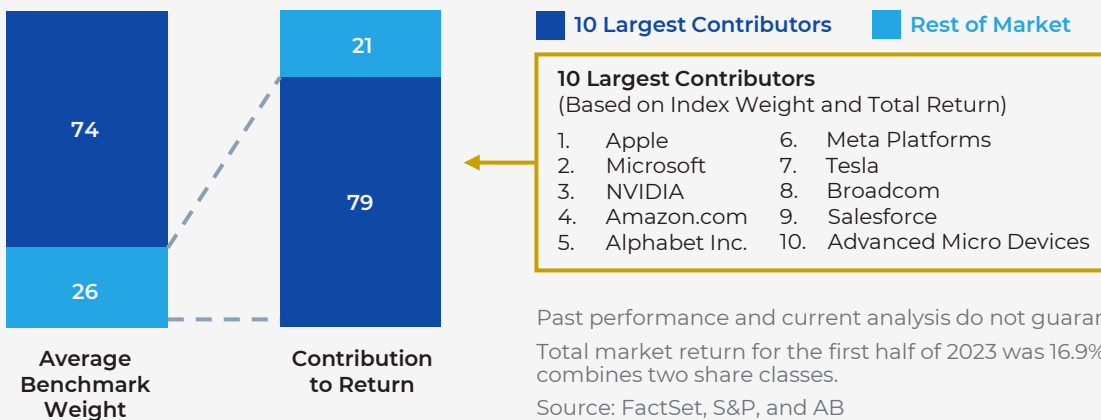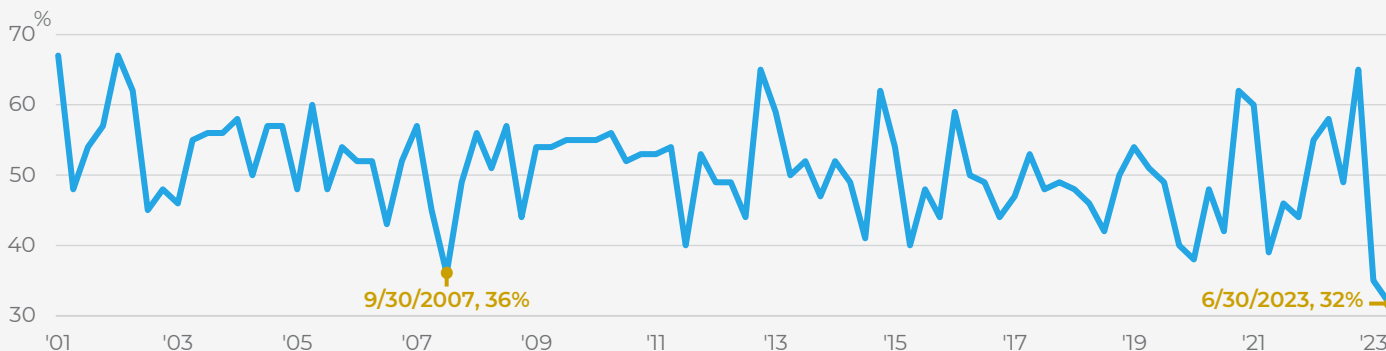**US Stocks: S&P 500**
Jan-Jun 2023 (Percent), As of June 30, 2023

■ **10 Largest Contributors** ■ **Rest of Market**

Average Benchmark Weight: 74 / 26
Contribution to Return: 79 / 21

10 Largest Contributors
(Based on Index Weight and Total Return)

1. Apple
2. Microsoft
3. NVIDIA
4. Amazon.com
5. Alphabet Inc.
6. Meta Platforms
7. Tesla
8. Broadcom
9. Salesforce
10. Advanced Micro Devices

Past performance and current analysis do not guarantee future results.

Total market return for the first half of 2023 was 16.9%. Alphabet contribution combines two share classes.

Source: FactSet, S&P, and AB

Chart 15

% of Stocks Beating S&P 500
Trailing 3M Rtns, As of 6/30/2023

9/30/2007, 36%
6/30/2023, 32%

Source: FactSet

Chart 16

The Rise of AI Has Fueled a Rally in Related Companies
Rebased to 100 as of 1/1/2023, Data as of June 2023

S&P
S&P ex AI

Source: HSBC Asset Management, Bloomberg

In conclusion, the data appears to be pointing to an economic slowdown. Based on the yield curve alone, history would suggest that the U.S. economy could be headed into a recession over the next several quarters, but it may not be too severe. The data points to a slowing economy but the depth of the slowdown will be strongly influenced by the Fed's ability to judge at which point they need to stop raising rates and perhaps even start cutting them. Equity markets peak about six months before the start of a recession, on average (**Chart 17**). A recession in late 2023 or the first half of 2024 could begin to be reflected in financial markets in the second half of 2023

Chart 17 | **Months Between Market Peak and Start of Recession**
Months, As of 2023
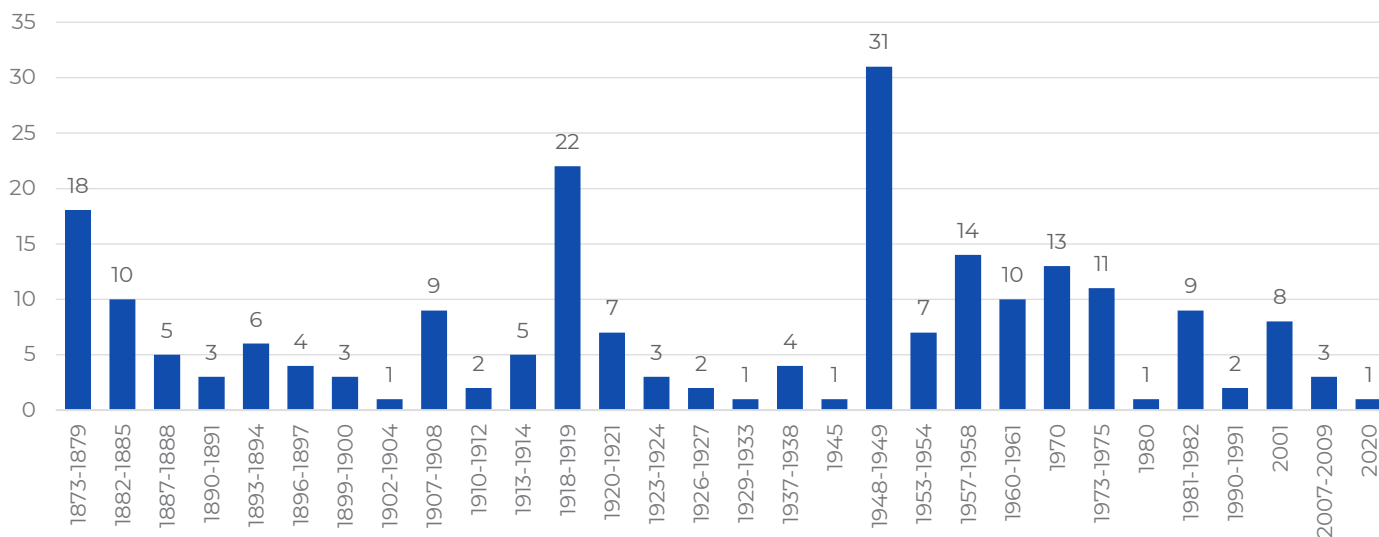
Source: S&P 500 vis Robert Shiller, NBER, Bloomberg

References: Bloomberg, FactSet, Qontingo, BCA Research, Alpine Macro, Charles Schwab, Aperio, Clocktower