June Investment Outlook 2023

KLINGENSTEIN FIELDS
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Current Market Conditions

Markets Remained Relatively Directionless in May

May capital markets returns were unchanged to slightly down, continuing the general trend from April. The S&P 500 was up 0.4%, small capitalization U.S. stocks were down -0.9%, international developed stocks declined -4.1%, and emerging markets slid -1.7%. Year to date through May 31st, the S&P 500 is up 9.6%, small capitalization U.S. stocks are unchanged, international developed markets are up 7.3%, and emerging markets are up 1.2%. Large U.S. stocks have significantly outperformed smaller stocks this year, as a few large companies have significantly outperformed.

Interest rates in May increased slightly, with the yield on the two-year U.S. Treasury Note rising to 4.4% at the end of May. The yield on the ten-year U.S. Treasury Bond remained unchanged at 3.6%. The slight increase in interest rates contributed to slightly weaker returns in fixed income markets.

Where Has the Recession Been Hiding?

Throughout the course of 2022 and into 2023, investor concern centered on whether sharply rising rates would trigger a significant economic slowdown. Over the last six months, while the consensus view of the probability of a recession has stayed constant at around 60%-65%, the expected timing of when a recession might occur has been pushed out. Looking at the forecasted average Gross Domestic Product (GDP) growth rate for 2023 and 2024 illustrates the change in expectations that has occurred over the last year. As shown in the chart on the next page, despite falling significantly over the last year, views of average GDP growth hit a low in late 2022 and have since stabilized.

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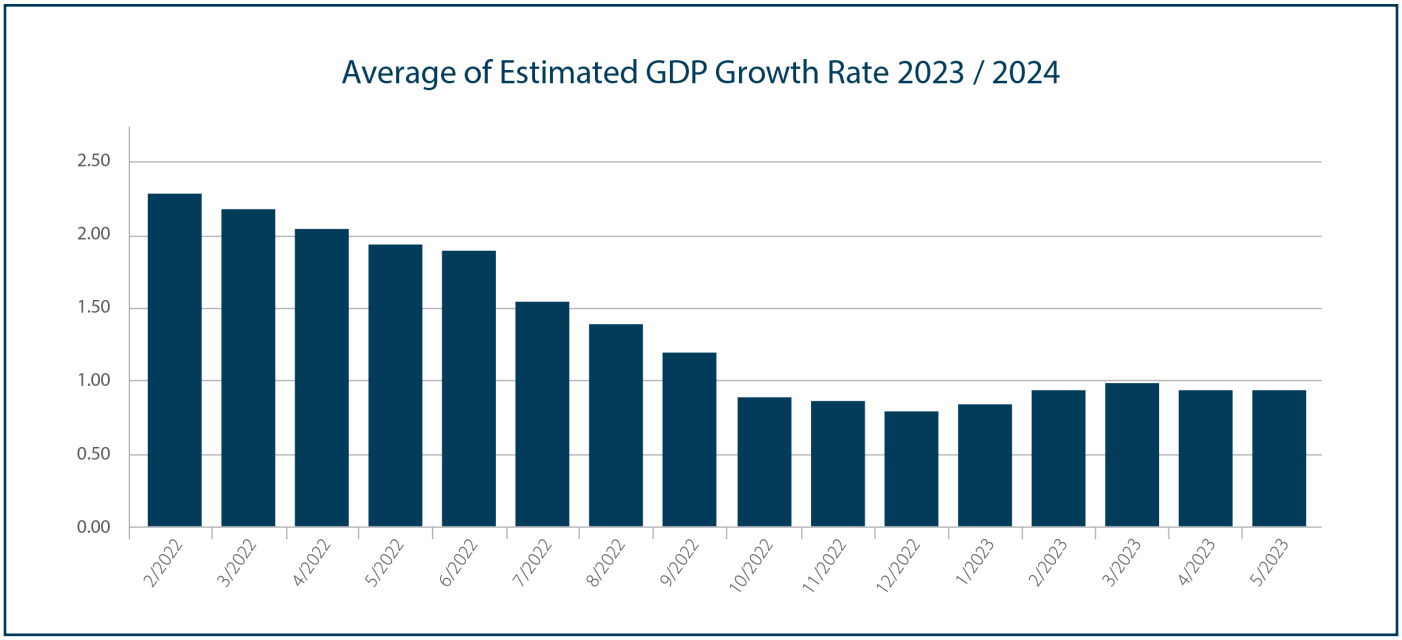

Source: Bloomberg, Klingenstein Fields Advisors

Several factors support the steadying economic outlook. Employment data remains healthy despite the significant interest rate increases over the past eighteen months enacted by the Federal Reserve Board (Fed). Labor market health has been surprising, since rapidly rising rates typically tend to slow economic activity more sharply across the board. While inflation remains elevated relative to history and is above the Fed's target levels, it continues to decline. Declining inflation reduces the need for the Fed to continue aggressively raising interest rates, mitigating the risk of a severe economic slowdown. Another rate hike by the Fed is possible, but the consensus view is rates are unlikely to increase much further. Lastly, consumer spending has remained healthy as personal income and asset values, including stock market holdings, have appreciated.

The Largest Ten Stocks Have Provided Most of the Returns This Year

It is worth exploring in more detail the performance of capital markets this year, since it is supportive of consumer sentiment and spending, which in turn helps support the economy. While the S&P 500 is up 14% above the December low through early June and is close to bull market territory, the vast preponderance of the market's performance is concentrated in a small number of stocks.

Over time the largest companies in the S&P 500, as measured by market capitalization, have taken on an increasingly significant role in how the index performs. As we can see from the chart on the next page, the top ten stocks represent a mere 2% of the number of companies in the index but account for 36% of its market capitalization. This weight is nearly triple the level of two decades ago. This means that

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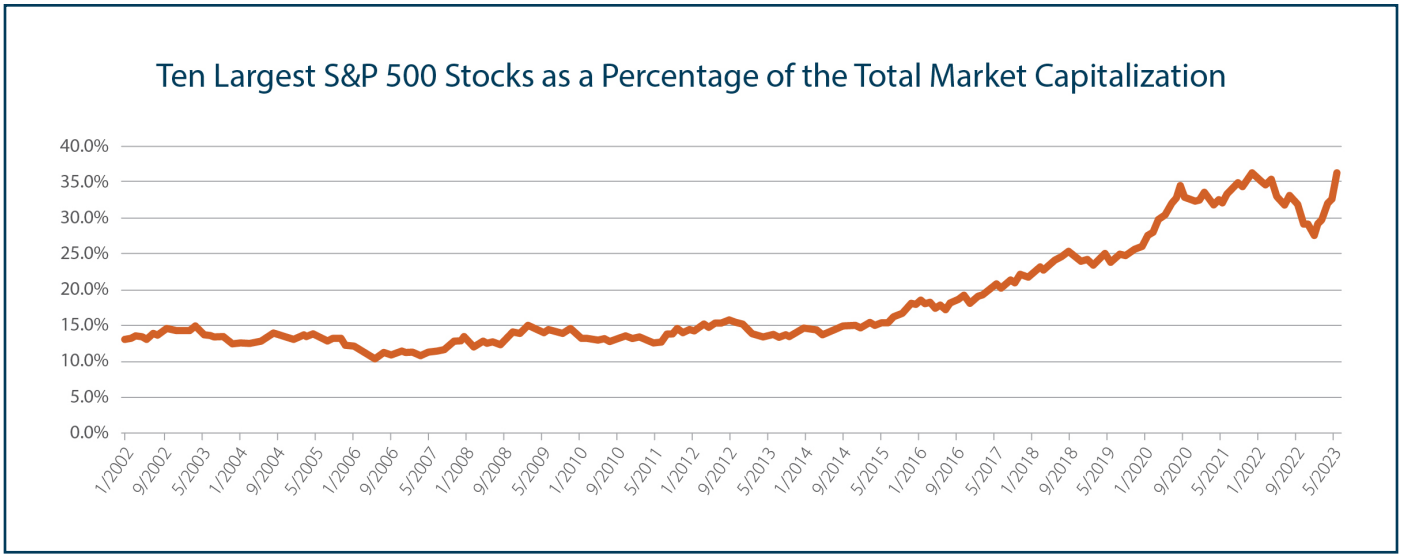

Source: Bloomberg, Klingenstein Fields Advisors

a small number of stocks are having an increasingly larger impact on the performance of the index. The top ten companies include Apple, Microsoft, Amazon, Nvidia, Alphabet (Google), Meta (Facebook), and Tesla.

The top ten stocks have performed so well this year that they have accounted for approximately 90% of the market's upside. In fact, if one were to create an index out of only the top ten companies, it would have risen 44% this year, as compared to less than 2% for the rest of the index combined. One tailwind buoying equity markets this year is Artificial Intelligence and Machine Learning (AI/ML). While AI/ML has been around for decades, recent improvements in both hardware and software have allowed it to capture the public's imagination and disproportionately drive up the stock prices of the larger companies mentioned earlier.

While the S&P 500's rally this year has been encouraging, for the markets to continue to increase from here it will probably require wider participation beyond a small number of very large companies. For that to materialize, it will likely require a broader recovery in economic fundamentals.

Economic Activity Encouraging but Risks Remain

Expectations for GDP growth are well below historical averages. In addition, there is still a very distinct possibility of a recession despite areas such as the labor market demonstrating resilience. While the risks to the economy are real, our view continues to be that, should we have a recession, it will be mild and short. Nevertheless, given the uncertainties, we expect near-term volatility to remain elevated relative to historical averages, especially after the recent run-up in the equity markets.

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Investment Strategy and Approach

Despite the near-term risks to the economy, we believe the market is increasingly looking through a potential recession and toward the next economic expansion. As such, we are not recommending material changes to investment policy. As always, we are looking for dislocations in the market to add to quality managers and stocks, and trim managers and companies where we feel the prospects have weakened or valuations have risen to an uncomfortable level.

What We Are Watching

We see inflation as continuing to come more under control, but geopolitical tensions, supply chain disruptions, potential actions by OPEC to raise oil prices, and other factors could create supply and demand dislocations that could cause a spike in inflation. While it increasingly appears that the Fed is close to ending their program of interest rate increases, if inflation were to spike, it could prompt the Fed to act more aggressively. On the other hand, more recently, investors have been pricing into the markets a scenario where the Fed begins to lower rates later this year. Should expectations related to interest rates turn out to be misplaced, the capital markets could come under renewed pressure.

It is encouraging that Congress has found a way to circumvent the challenges with the debt ceiling, averting a potential crisis. Despite the near-term solution, we are paying close attention to the fact that there are still fundamental issues that need to be resolved in terms of longer-term government resources, spending, and borrowing, since the compromise reached in Washington just kicks the can down the road until January 2025.

Geopolitics remains a key area that we are watching closely, as global tensions remain high, and a flare up or conflict could negatively impact investor sentiment. We continue to watch developments around the challenges to the U.S. dollar as a reserve currency. While we currently do not see a strong alternative to the U.S. dollar as a global reserve currency, there are many interested in unseating the U.S. dollar's role in global commerce. The banking crisis from earlier in March seems to have stabilized, but we continue to watch for signs of further instability that could crop up. Another factor we are watching is to what degree the banking crisis and its aftermath may tighten lending, which is, of course, a crucial element for continued economic growth.

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