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REVIEW & COMMENTARY

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2nd Quarter 2023 Market Update

Almost every bull market has a phrase attached to it calling out the stocks that are leading that market. In the 1970s it was the "nifty-fifty," in the late 1990s it was the "dot.com era." More recently we had the "FAANG" stocks and this year we have what many have called the "Magnificent Seven." Although it sounds like a movie title, the Magnificent Seven refers to seven very large, mostly technology stocks that led U.S. equity markets in both the quarter and thus far this year. They include:

	Q2	YTD	Mkt Cap	% of S&P 500
Apple	17.6%	49.9%	3,050.9	7.7%
Microsoft	18.1%	42.0%	2,532.1	6.8%
Alphabet	15.9%	36.0%	1,551.0	3.6%
Amazon	26.2%	55.2%	1,337.5	3.1%
NVIDIA	52.3%	189.5%	1,044.9	2.8%
Tesla	26.1%	112.4%	829.4	1.8%
Meta Platforms	35.4%	138.4%	2,562.7	1.7%

Data as of June 30, 2023. Source: Telemet

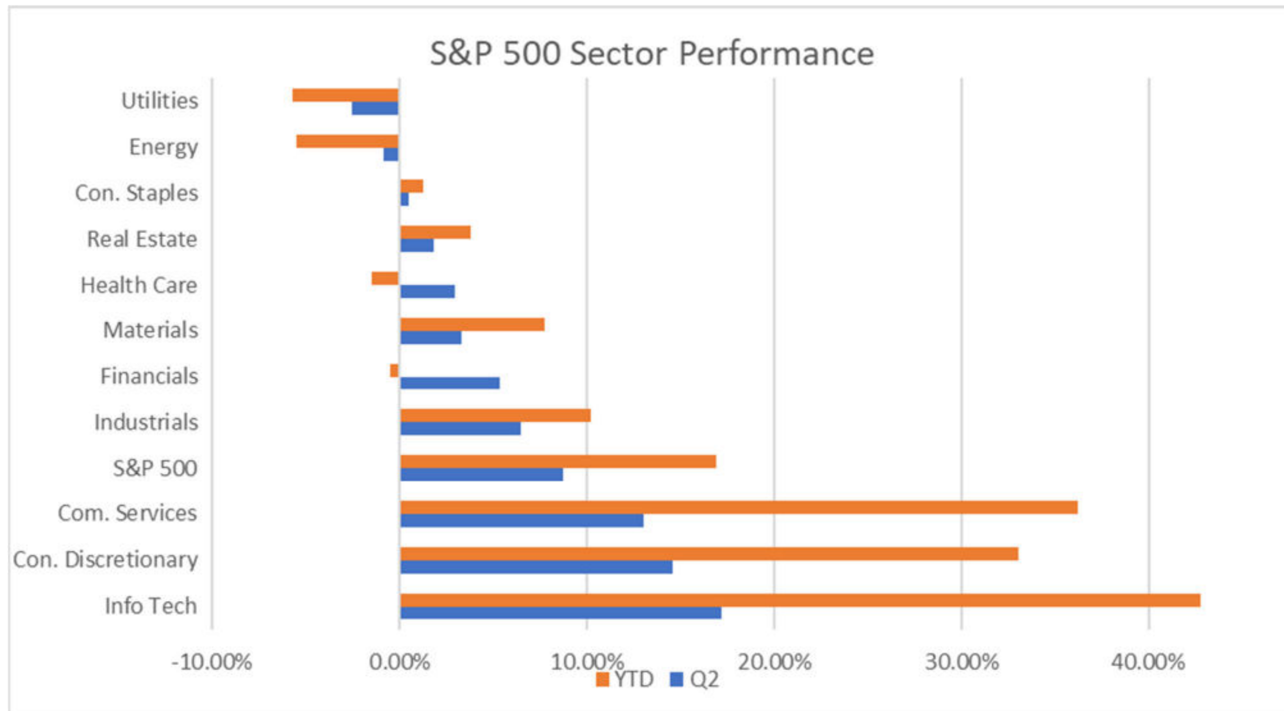
Although the three best performing S&P 500 index ("S&P 500") stocks in the second quarter were the three publicly traded cruise lines (Carnival Corporation, Norwegian Cruise Lines and Royal Caribbean Cruises), the performance of the S&P 500 was driven largely by the "Magnificent Seven" above. The S&P 500 rose 8.74% in Q2, giving it 16.89% gains so far in 2022. The Magnificent Seven accounted for 12.3% or 73% of the market's gains year-to-date. The seven stocks now make up about 28% of the S&P 500's total value, a level of concentration that may be of concern to investors going forward. The Magnificent Seven's performance was driven because they continue to show decent growth despite fears of an economic slowdown. In addition, they are financially strong companies with little need to depend on bank loans or debt markets for that growth, something good to see in a world of rising interest rates and turmoil in the banking industry.

Broader market indices tell a somewhat different story than does the S&P 500. This has to do with index construction more than anything else. The S&P 500 we usually quote is a market cap weighted index. Apple, the largest company in the S&P 500, makes up about 8% of the index. Fox Corp is the smallest company in the S&P 500. It made up 0.1% of the index on June 30th. The equal-weighted S&P 500, in which every stock has the same weighting, paints a different picture. It rose 3.99% in the second quarter and 7.03% year-to-date. The price-weighted Dow Jones Industry Index was up 3.97% in the quarter and 4.94% year-to-date.

By investment style, growth has dramatically outperformed value so far this year. The Russell 1000® Growth index has risen 29.02% through June 30 (with the top six stocks above accounting for 18.7%) while the Russell 1000® Value index rose 5.12%. (over)

Looking at the S&P 500 in a bit more detail, one finds that 159 of its members (or 32%) outperformed the 8.3% second quarter gains, while 66% of its stocks underperformed. The median stock, which happens to be Cooper Companies Inc., rose 2.7% in the quarter. The laggards in the S&P 500 were a more motley crew: Advanced Auto Parts, Catalent, Inc. and Market Access Corp. all fell substantially due to company-specific issues rather than industry group or sector issues.

As might be expected from the data above, the best S&P 500 sector both in Q2 and year-to-date was technology, followed by consumer discretionary, a sector that includes Amazon and Tesla. Communications services was third, driven by companies like Meta and Alphabet. The lagging sectors included energy and utilities, down for both the quarter and six months.



With the year's first half now in the history books, the question most of us have now is what happens next? Although July is historically a good month for equity markets, we are in the seasonally weaker six months of the year (May-Oct.) But overall, good markets in the first half of the year have historically led to good markets for the full year. In the 72 years between 1951 and 2022, the S&P 500 was up 52 times, or about 72%. When the stock market was up in the first six months of the year, it was up in the second half of the year 38 times, or about 53%. In 11 years, or 15% of the time, the S&P 500 was up in the first half of the year but down in the second half. In 13 periods, or 18%, the stock market was down in the year's first half, but up in the year's second half and, lastly, in 10 periods (or 14% of the time) the S&P 500 was down in both halves of the year. More to the point, in the 23 periods where the S&P rose 10% or more in the first half, in 19 years it was up in the second half as well. In only four periods of strong 10% plus first half growth was the S&P 500 down in the second half. And in no cases of 10% or more first half S&P 500 performance was the market down for the full year. These are pretty good odds.

	UP/UP	UP/DOWN	DOWN/UP	DOWN/DOWN
No. of years	38	11	13	10

Despite, or maybe because of, the strong first half performance, there remain several areas of concern going forward. The valuation of the S&P 500 is lofty by historical standards now. S&P/Capital IQ's latest estimate for 2023 earnings per share for the S&P 500 stands at 217.19. Based on the July 5th closing price of 4,411.59, the p/e on this year's earnings is 20.3x, high both compared to five- and 10-year averages of 18.6x and 17.4x respectively. Even using 2024's preliminary estimate of $243.07, 18.2x earnings is not a bargain. It should be noted that the same Magnificent Seven that led the market also have some of the highest p/e ratios among large stocks as the following table shows:

(over)

	P/E on 2023 Earnings	P/E on 2024 Earnings	P/E to 23-24 Growth
Apple	32.1	29.2	4.40
Alphabet	22.3	19.3	1.7x
Amazon	83.4	50.5	4.3x
Meta	25.5	20.5	1.9x
Microsoft	35.1	30.8	2.7x
NVIDIA	54.4	43.1	1.9x
Tesla	79.7	55.4	2.8x
S&P 500	20.3	18.2	1.5x

Source: Seeking Alpha/S&P/Capital IQ

In addition to valuation, markets continue to be schizophrenic about the direction of the economy. Some pieces of data point to a slowdown, maybe even leading to a recession, defined generally as two quarters of negative economic growth. Other statistics point to a growing, albeit slowly, economy. This affects the direction of interest rates. It has largely been assumed that Federal Reserve bankers were nearing the end of their rate hikes designed to slow the economy and control the inflation that rose to multi-decade high levels in 2022. While inflation is coming down compared to 2022 levels, it remains considerably higher than the Federal Reserve's own 2% annual target. In addition, private sector job growth in June as reported July 6th by ADP, a payroll processing firm, was 497,000, approximately double what was expected. Although the Labor Department's jobs data released July 7th was much weaker at 209,000 new jobs, the combined data appears to have dashed hopes that the rate-hike cycle was over and quickly caused interest rates to spike up once again with the two-year U.S. Treasury rate crossing 5%, the highest level in 17 years. Longer-term, higher rates and a big and growing federal budget deficit are things that should concern us all.

There are also global concerns that have the potential to be market moving. Chief among them are the various trade and national security issues developing between the U.S. and China. Secondly, the Russia-Ukraine conflict shows no signs of ending. Lastly, although nothing new, Mid-East turmoil seems to be increasing.

As always, we tend to believe the best offense is a good defense and we continue to seek stocks in growing companies with good defensive characteristics. We always welcome discussions about equity markets or investing in general.