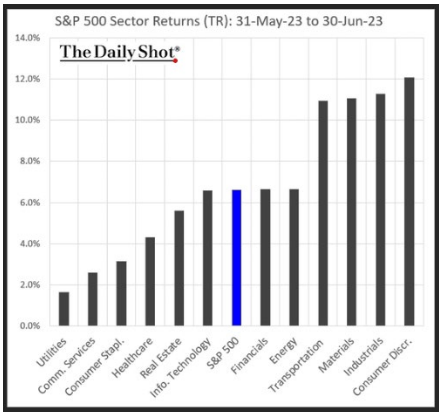
EQUITY MARKET UPDATE

As of 06/30/23 | Volume 12, Issue 6 | FFTAM.com

Stocks concluded the first half of the year with a strong rally. Investors were encouraged by the economy's resilience to higher interest rates. Several indicators show the economy is slowing, but the glide path appears to favor a "soft landing" compared to a deep and harsh recession. Inflation remains sticky, and central bankers around the world believe additional rate hikes are needed. Indexes are being propped up by a handful of mega cap US tech companies. Excluding those names from the equation results in a much weaker first half total return for investors.

June Rally Broad Based but YTD is Dominated by Big Tech

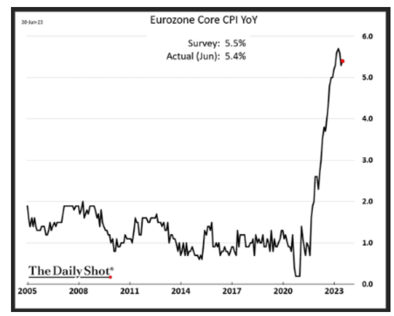
The S&P 500 rose 6.61% in June. Buying was broad based as all eleven sectors posted a positive total return. Confidence in the underlying strength of the economy enabled consumer discretionary (+12.07%), industrials (+11.29%) and materials (+11.05%) to lead the way. Big tech continued to rally, but the seven largest tech companies—Apple, Microsoft, Amazon, Meta Platforms, NVIDIA, Alphabet, and Tesla—only accounted for 30% of gains. This is still sizable, but it is much less than what we have seen in prior months. Year-to-date, the story is all about artificial intelligence (AI). The S&P 500 is up 16.88% with technology (+42.77%), communications (+36.24%), and consumer discretionary (+32.97%) the only sectors beating the index. The big tech companies listed above—Apple (+49.72%), Microsoft (+42.66%), Amazon (+55.19%), Meta Platforms (+138.47%), NVIDIA (+189.54%), Alphabet (+35.67%), and Tesla (+112.51%)—are responsible for 76.69% of all the money made in 2023! Without those companies, the S&P 500 is only up 3.93% on a market cap weighted basis. The divergence in performance can also be seen when comparing the equal weighted S&P 500 (7.02%) vs the market cap weighted results (+16.88%). The 987-basis point spread is abnormally wide and has only been seen a few times in history.



The Dow Jones Industrial Average rose 4.68% for the month. Lackluster results from Salesforce, Goldman Sachs, and Walgreens hurt the index versus the S&P 500. So far in 2023, the Dow is up 4.94%. The index has a lower allocation to technology and communications which have been the best performing sectors.

The NASDAQ gained 6.66% in June. Enthusiasm about potential advances in artificial intelligence and bottom fishing after several highflyers were crushed last year are fueling gains. Year-to-date, the NASDAQ is up 32.32%, its strongest six month start to a year since 1983. However, like the S&P 500, the gains are dominated in a handful of names.

Middle-to-small-sized companies vastly outperformed in June. The S&P 400 Mid Cap Index zoomed 9.16%, while the S&P 600 Small Cap Index jumped 8.23%. Greater cyclicality explains the win. So far in 2023, the S&P 400 Mid Cap Index is up 8.81%, while the S&P 600 Small Cap Index has gained 5.99%. Exposure to regional banks and a lower allocation to tech explains the shortfall compared to large cap indexes.



<u>International Stocks Increase Despite Weak Economic Data</u>

Eurozone inflation was 5.5%, a sharp drop from the previous month. The report showed signs once again that inflation is becoming more entrenched throughout the economy as core inflation (which strips out food and energy) increased slightly to 5.4%. Inflation inside of the service sector barely budged from the previous month's record high. Wages are growing at their fastest pace in history and exceed the levels seen in the United States. Eurozone Manufacturing PMI was 44.8, the twelfth straight month of contraction. Services PMI remained strong at 52.4, but it too decelerated from prior levels seen earlier in the year. Eurostat confirmed the Eurozone experienced a shallow recession as the economy contracted for a second straight quarter. The main culprit for the recession was weak export demand for manufactured products in Germany.

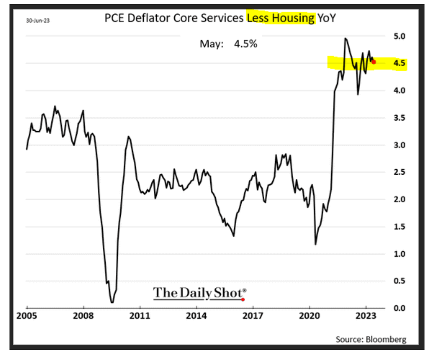
With inflation still running hot, the ECB raised interest rates again by 0.25% to 4.00%. ECB President Christine Lagarde was clear that the central bank has every intention of lifting rates further. In their post meeting statement, the ECB said, "the inflation outlook continues to be too high for too long." The stubborn inflation environment mixed with higher interest rates signals the Eurozone could be stuck in a stagflation environment for some time.

The Chinese economy reported mixed results after a brisk start to the year from COVID reopening. China's Manufacturing PMI contracted for a third straight month to 49. New export orders at factories weakened to a five-month low of 46.4 as economic conditions in the US and Europe tighten. Service activity was strong at 53.2, but momentum appears to be fading. Job growth is contained primarily to the service side of the economy as consumers engage in social outings and travel after three years of constant lockdowns to prevent the spread of COVID-19; however, youth unemployment hit an all-time high of 20.8%. After five months of small gains in the housing sector, activity plunged in June. Collectively, the data raises questions about the effectiveness of President Xi's modest stimulus measures. Wall Street expects additional targeted moves to jumpstart the economy, especially as China and the United States increase trade restrictions on semiconductors, cloud computing, and critical minerals for clean energy.

Concerns about a weaker than expected reopening in China and persistent inflation in Europe caused the MSCI EAFE and MSCI Emerging Markets Indexes to underperform their US counterparts with monthly gains of 4.58% and 3.83%, respectively. Year-to-date, the two indexes are up 12.16% and 5.02%.

<u>US Economy Shows Resiliency Despite Higher Interest Rates as Labor Data Strengthens</u>

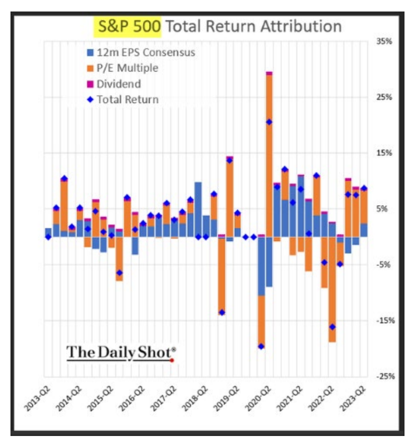
The labor market remains solid. Last month, the economy added 209,000 jobs. The unemployment rate fell to 3.6%, while the labor force participation rate held steady. Average hourly wages were up 4.4% from one year ago, an amount that far exceeds both Fed expectations and the pay raises seen pre-COVID. The JOLTS report declined to 9.824 million jobs available but unfilled. The figure equates to 1.79 job openings for every unemployed person. This is still strong compared to historical levels, but it is off the highs seen earlier this year. The demand for labor continues to outstrip supply in many industries which signals tightness in the labor force, but the intensity of competition to recruit and retain employees has waned. This is something the Fed is paying very close attention to because wage inflation is the most durable and hardest to defeat type of inflation.



Consumer inflation eased as prices jumped 4.0% from one year ago. Core inflation that removes food and energy prices rose by 5.3%. PCE data, the Fed's preferred measure of inflation, weakened with total prices climbing 3.8%, while prices ex-food and energy climbed 4.6%. The data presents a major challenge for the Fed. For the past six months, inflation has slowed significantly from the previous high-water marks; however, recent information shows the glide path downward is occurring much more slowly than forecasted, especially in service areas of the economy. Inflation readings remain well above the Fed's 2% target; therefore, the Fed must take a harsher stance on interest rates to defeat it. The savings rate is 4.6%, below the levels seen pre-COVID. Credit card balances are at record levels and growing briskly. Debt delinquency is increasing, especially in credit cards and subprime auto loans. Consumer spending was up only 0.1% last month, while retail sales grew 0.3%. Expenditures on services remain strong, especially for air travel, movie theaters, restaurants, and amusement parks.

Business investment remains weak. The ISM Manufacturing PMI was in contractionary territory for an eighth straight month with a reading of 46.0. New orders (45.6) have contracted for twelve of the last thirteen months, while prices paid plunged to 41.8. This signals that inventories are plentiful and supply chain conditions have healed for most goods. The ISM Service PMI (53.9) remains in expansionary territory and is the engine for the economy right now. Prices paid (54.1) for services remain very strong, while new orders (55.5) accelerated. Finally, home sales remain weak as 30-year mortgage rates hover around 7%.

The Fed responded to the data by not lifting interest rates at their June meeting. During the press conference, Chairman Jerome Powell refused to confirm whether the Fed was done raising interest rates. He said, "Any future Fed action will be data dependent." At the annual central banker forum hosted by the ECB, Mr. Powell indicated that two additional rate hikes are likely in the coming months. The market is now pricing-in another 0.25% hike at the July meeting, and the expectations for future rate cuts have been pushed out to mid-2024.



<u>Market Valuation Appears High Given Uncertain Economy</u>

The PE ratio on the S&P 500 is 18.93x 12-month estimated earnings. This is above both the 5-year and 10-year averages of 18.64x and 17.42x, respectively. It is also nearing the pre-COVID PE ratio of 19.40x. With interest rates at their highest levels in 16 years, the PE ratio appears elevated.

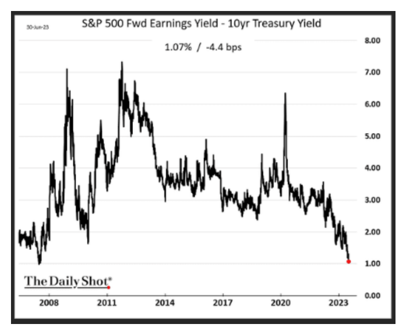
We are on the brink of another earnings seasons. The estimate is for profits to decline 4.7% from one year ago. If this comes to fruition, it will mark the third straight quarter of negative earnings growth which clearly qualifies as an earnings recession.

Looking ahead, analysts now see 2023 profit growth of 0.9% according to FactSet. Wall Street continues to reduce their earnings forecast. They are modeling 0.4% profit growth for the third quarter and a very healthy 7.9% growth rate in the fourth quarter. The first expectations for 2024 profits were released, and analysts are predicting growth of 11.7%. This does not jive with the fixed income markets that expect rate cuts starting in June 2024. Someone is obviously wrong because if corporate profits are growing double digits then why would the Fed need to soften monetary policy? The only explanation is investors continue to cling to hopes of a soft landing in which economic activity and inflation weaken but not enough to trigger a typical recession. This is asking the Fed to thread the economic needle; therefore, we conclude that additional volatility in asset prices is to be expected as we move through the remainder of the year.

Our Outlook & Strategy

The biggest challenge for stocks in 2023 still involves central banks navigating how to remove emergency stimulus policies needed during the depths of the pandemic without tipping the global economy into recession. A watchful eye also needs to be kept on the strength and durability of China's reopening from COVID lockdowns. With interest rates still moving higher, the perceived strength of regional banks and their ability to lend adds another wrinkle to an already complicated puzzle.

Higher interest rates increase the attractiveness of bonds, which should reduce the PE multiples investors are willing to assign to stocks. This places outsized stress on stocks trading at lofty valuations, especially those that cannot clear the earnings growth hurdles analysts have forecasted. Thus far, 2023 is not behaving according to textbook. Investor enthusiasm over the potential for artificial intelligence has caused a rally in the biggest tech companies. The top seven tech names—Alphabet, Amazon, Apple, Meta Platforms, Microsoft, NVIDIA, and Tesla—collectively trade at a forward PE ratio of 31.22x the next twelve-month earnings estimates. This is steep relative to the rest of the market (16.30x), and it appears especially rich versus US Treasuries and high-grade corporates. Investors are currently seeking shelter in these names as confusion about economic growth rises. They view these companies as perpetual growers with strong balance sheets. Given these firms' weight in the S&P 500, they are skewing overall market valuations to the upside.



The current valuation in the stock market is providing a historically thin equity risk premium that compensates stock investors for the excess risks taken compared to bonds. This tells us forward returns for equities will likely be below average mixed with higher bouts of volatility, especially for companies trading at above average valuations that cannot clear analyst growth expectations. Given that mathematical backdrop, we have chosen to take a more defensive tilt in our portfolios by boosting select positions in healthcare, utilities, and real estate. Their lower valuations and defensive business models should lead to relative outperformance in a volatile market environment facing numerous macro challenges.

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