Making Sense of Finance

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Second Quarter 2023 Review

STOCK MARKET

The S&P 500 index posted its third consecutive quarterly gain in the second quarter of 2023. Although market breadth improved as the quarter progressed, the "Magnificent Seven" group of large tech stocks are still comprising the bulk of the gain. This is evident in the continued outperformance of the tech laden Nasdaq Composite at 12.8% last quarter, compared to a lesser but still robust 8.3% increase in the S&P 500. Again, the lesser concentration of technology stocks in the Dow Jones Industrial Average caused it to be the lagging index last quarter with a gain of just over 3%. The advances in the technology behind artificial intelligence (AI) as well as increased AI usage potentially benefits many tech companies which has helped in keeping the tech rally going. Various factors led to overall market gains in the second quarter. Reported first quarter earnings were better than expected for most companies. Also, after raising the Fed Fund target rate by 25 basis points in May to a range of 5.00-5.25%, the Federal Reserve decided to take a pause on its rate hike campaign. Investors are hoping this may be the last one as inflation numbers are coming down. The most recent number reported for June shows an annual rate of 3.0%, much less than the same time last year, however still higher than the Federal Reserve target of 2.0%.

Eight of the eleven S&P 500 sectors had positive returns in the last quarter. The best performing groups were the same as the previous quarter: technology, communication services and consumer discretionary. As the reality of a recession got pushed further out to the future, stock sectors considered "defensive" due to their lessened sensitivity to the economy did worse such as consumer staples and utility stocks, which had slightly negative returns in the second quarter. Also, the energy sector lost ground last quarter as the price of oil and natural gas retreated (which was helpful in lowering the inflation rate). Four stock sectors remain negative year to date.

Foreign stock markets posted positive returns last quarter, however in the aggregate lagged the US markets when measured in US dollars. Valuations as

Making Sense of Finance

Everyone and their neighbor has an opinion. At Karagosian Financial Services, we have a combined 40 plus years of investment experience. We have seen the markets at their highest highs and lowest lows. Through this newsletter we attempt to convey our opinions on current events in the investment world and their likely outcomes. Forecasting is inherently difficult and our advice is geared toward making sensible and prudent choices based on logic and experience, and not based on emotion.

Contributors:

Seaver T. Wang

Christine Terry

1 Baltic Place suite 201D

Croton on Hudson, NY 10520

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measured by price/earnings multiples are lower than average in many foreign countries whereas in the U.S. the same multiples have climbed to above average in 2023. The MSCI EAFE index of developed country markets rose 1.9%. Eurozone countries such as France, Germany, and Spain gained while a glaring loser in the second quarter was the United Kingdom as they fight a persistently high inflation rate (currently 8.7%) with interest rate increases. The Japanese stock market continues to outperform the US market with double digit percentage returns in local currency terms. It has almost returned to its record high level last seen in 1989. Weakness in the yen somewhat dampens the return in US dollar terms. Japanese companies have been encouraged to spend more on research & development to grow their companies and increase returns to shareholders via dividends or stock buybacks. With Japan now out of a long-term deflationary environment, investors are more optimistic about stock market returns.

BOND MARKET

Bonds were slightly lower in the second quarter as measured by the Bloomberg Barclays US Aggregate Bond Index. Treasuries and investment grade corporate bonds declined. Most bond sectors had negative total returns as yields rose. However, riskier high yield low quality bonds had positive total returns. Municipal bonds this year have outperformed Treasuries resulting in historically low yields versus comparable term Treasuries.

Earlier in the year, investors anticipated a sooner than later rate cut by the Federal Reserve. None the less, concerns in the banking sector faded in the second quarter. Also, as the year has progressed, the anticipated rate cut appears to be pushed further out in time as the economy has remained mostly resilient (first quarter GDP's growth rate was 2%) and inflation, although the rate is declining, is still above the Fed's target rate. Except for the Bank of Japan, all major central banks raised their respective rates last quarter. The yield curve remains inverted (shorter term yields higher than longer term yields) which indicates a slowing economy in the future, but the timing of that occurrence is the key question.

OUTLOOK

The S&P 500 is currently just 5% below its all-time high, driven predominantly by large tech companies. Investors should not be easily seduced by these few companies without understanding the volatility involved. The top six companies in the index represent approximately 24% of the total and in 2022 averaged a -28% return. What has changed? Mostly just sentiment, in our opinion. The Fed's inflation fighting tactics do seem to be working and the U.S. economy continues to be resilient. One more rate increase is possible unless inflation cools to the 2% level (the Fed's stated target). Stocks are still the place to be, however, investors must stay the course in order to smooth out the volatility involved. The rest of the economy may have mixed results, in our view. For instance, the ISM manufacturing index remains below 50, indicating contraction in that sector and legacy entertainment companies may still find the transition to streaming content disruptive to earnings, exacerbated by the writers and actors strike in Hollywood.

With inflation down to 3%, Treasuries remain a solid option for risk-averse investors. Treasury bills and notes are yielding over 5% annualized, leaving a 2% real return. The short-term nature of these securities combined with the guarantee of the U.S. Treasury mitigates virtually all the risk. Conversely, higher interest rates are hurting commercial real estate. Headlines of offices and retail spaces remaining vacant could just be the beginning. It seems that on-line purchases and remote work are the new normal. Defaults could accelerate, however, residential real estate continues to remain robust. The days of all-cash offers and multiple bids over asking price seems to have faded. Still, general demand for housing does not seem to have fallen off much. Our hunch is that the economy could be in a holding pattern for some time as it digests all the excess, given the aforementioned. Though doom and gloom headlines are frightening and often not accurate, they do serve to prevent sudden bubble bursts, allowing management to address these issues before any actual catastrophe. Recall that most financial pundits predicted a recession for the year with many having now reversed course, leading to much of the market's performance this year.

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