KSTrust®
Wealth & Investment Management

Quarterly Economic Commentary

July 2023

Market Returns

	12/31/2022	6/30/2023	% Gain/Loss
Dow	33,147	34,408	4.90%*
S&P 500	3,840	4,450	16.90%*
NASDAQ	10,466	13,788	32.30%*

**Total Return Including Dividends*

By Jim Watts, KS Trust Senior Portfolio Manager

The first half of 2023 has been great for the markets, especially the tech-heavy NASDAQ. As you see on page 1, the stock market has performed well thus far. The "surging seven" US mega-cap growth stocks—Apple, Microsoft, Nvidia, Amazon, Meta, Tesla, and Alphabet—have risen by an average of 86% this year amid optimism about the impact of AI on their long-term prospects. These seven stocks alone account for 80% of the gains in the S&P 500 this year, so a positive market outlook from here is also contingent on these stocks holding on to or extending their gains. Remove the performance of these seven stocks from the S&P 500 performance, and you are right in line with the Dow. In addition, fixed income has been positive, with the 10-year Treasury up 1.8%, the current yield is 3.81%, US Bonds up 2.1%, yielding 4.81%, and municipals up 2.7%, yielding 3.52%, a welcome change from 2022.

This doesn't look like or feel like a recession. What's going on? Below, I have provided a portion of the UBS Daily House View for June 30, 2023.

"Since last summer, the consensus call has been that a US recession is just around the corner. The logic is clear—an aggressive run of Federal Reserve rate hikes should restrict demand and cool growth. Bloomberg's most recent survey of professional economists suggests that 65% expect a recession within the next 12 months. But the most anticipated recession in recent decades has become the most postponed for several reasons.

Policy is not overly restrictive. The Fed has raised rates by 500 basis points since March 2022, the fastest pace since the early 1980s, but by many measures, monetary policy is only moderately restrictive, and it has been that way for less than six months. For example, the real fed funds rate—the nominal rate minus core personal consumption expenditures (PCE) inflation —only turned positive this year. Financial conditions indexes suggest that monetary policy has become less restrictive in 2023. Meanwhile, based on the federal deficit as a percentage of GDP, fiscal policy has implicitly turned expansionary again over the past six to nine months. Fiscal policy has also indirectly positively impacted growth this year because recent industrial policies (e.g., Inflation Reduction Act, CHIPS Act) encourage private-sector investment.

The private sector is in fundamentally good shape. Household finances, corporate balance sheets, and labor demand are all stronger than is typical leading up to a recession, providing a cushion against growth headwinds. Ratios such as household debt to disposable income or corporate debt to GDP are not stretched—the household debt service ratio remains near a 40-year low of around 9%. Despite tighter lending standards, most companies have good credit access. More than 25 million jobs have been created since the current recovery started in May 2020, and according to the JOLTS survey, there are still more than 10 million unfilled positions. Although some prominent companies have announced significant layoffs since the fourth quarter, many more businesses still quote their biggest problem as finding workers, and most appear reluctant to shed workers.

So, will the postponed recession materialize? Growth is likely to slow further in the second half, but it is uncertain whether the economy will fall into recession. Current growth momentum is strong enough that it is unlikely that a recession will start before the late fourth quarter at the earliest, barring an adverse supply shock or credit event. The likelihood of a recession hinges most on monetary policy becoming more restrictive and eventually causing consumer spending to fall. That may take at least two more Fed rate hikes. Still, there is also the possibility that monetary policy is operating with an extended lag this cycle, and the tightening thus far will be sufficient to cause spending to crack.

For the overall positive narrative to hold together, an "immaculate disinflation" is almost a prerequisite, and from an investment perspective, equity markets are not priced for a recession materializing. With stocks already priced for the near perfection of a soft landing, we see better risk-reward in high-quality bonds over equities. Within equities, year-to-date gains have been concentrated in a small number of growth stocks, suggesting room for catch-up in less expensively valued laggards. And if a recession does materialize, it is likely that the more defensive and cheaper parts of the market will outperform."

The Fed, as expected, paused or "held" in June, with an indication that there will be at least two addition-

-al rate increases. The first one is expected to be at the July 25 – 26 meeting. Last week, Q1 GDP was revised up to 2.0%, showing a strong economy. Friday's CPI report came in as expected, dropping to a 0.3%, month over month (MOM) increase versus last month at 0.4%; home sales increased by 12%, and prices increased by 0.9% MOM, despite mortgage rates at 7.20% for 30-year fixed rates. All of this suggests that we are slowly taming inflation while continuing to experience economic growth, indicating that the Fed has it right. Right now, the Fed itself is anticipating rate cuts in 2024. Their Dot Plot forecast is showing a full 1.00% cut next year. We are not entirely convinced that perfection will prevail over the next six months.

As you have probably observed, prices at the pump have risen and fallen once again. Despite cuts from OPEC, oil prices have traded in a range from $80 to $65 this year, currently trading around $70 and $75 for Brent. In our 2023 expectations, I indicated that oil would trade in the area of $100 sometime during 2023. We have yet to see that, but with a strong economy, stronger than expected GDP, and returning growth in China, it is still possible.

Strong data and moderating inflation certainly have markets partying heading into the July 4th weekend. We see the potential for upward revisions to earnings in the near term, as growth is more substantial than expected. However, note the recovery in earnings that is already reflected in current forecasts. We are wary of overly stretched valuations as longer-term investors, mainly in the context of a Fed that will likely need to keep policy tighter for longer, given these strong growth trends. These two factors, higher earnings and lower valuations, could cancel each other out in the year's second half, leading to lower total returns for equities than what was experienced in this blockbuster first half.

As we see opportunities, we continue to move back towards a fully invested equity position. We anticipate the equity markets will become more balanced in performance for the remainder of the year. Growth will take more of a back seat, value / defensive companies will perform better, and we will finish the year with a high single or low double-digit return in the equity markets.

We are confident that interest rates are about to or already have peaked. We have taken advantage of higher rates and longer maturities to lock in a better income stream for our clients. Our focus has been on CDs and US Government obligations, two of the safest fixed-income investments available. Most recently, 5%+ is available from six months out to 18 months; beyond that, you see rates beginning to move lower on these two investments. However, there are several corporate bonds, primarily financial institutions, where you can get 5%+ out two to five years.

We appreciate each client's uniqueness and will always strive to do what is best for each individual client. Please do not hesitate to ask us questions or express your concerns. This is your money, and we are your stewards.

We are committed to maintaining a clear focus on building and preserving client's wealth and enhancing their quality of life, both now and in the future. Working in a fiduciary capacity, the KS Trust team provides a single point of contact for a full array of investment services.

Our team's collective knowledge and experience forges our ability to serve our clients more extensively and develop a clear path. It allows us to address the increasingly complex challenges of today's landscape and provide comprehensive financial advice with a clear vision for the future.

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