Macro Fundamentals have Improved, but we are Not Out of the Woods Yet

ASTORIA PortfolioAdvisors

Major Indexes Gain in First Half of 2023

Despite uncertainty around monetary policy and economic fundamentals raising recession risks, all three major equity indexes were up in the first half of 2023. The Nasdaq Composite Index rose 32% on the back of an AI-technology inspired rally, posting its best first half of the year since 1983. US growth stocks (+21.1%) were among the best performers, followed by US large-caps (+16.8%) and US value (+12.0%). Bonds also produced positive returns as high yield credits rose 4.5%, investment grade corporates gained 4.3%, and the US Aggregate Bond Index was up 2.3%. Commodities were mixed given gold increased (+5.1%) while crude oil, broad-based commodities, and silver decreased (-9.4%, -8.6%, and -5.1%, respectively).

Exhibit 1: Trailing Returns as of June 30, 2023

	Index/ETF	1-Mo	YTD	1-Y	3-Y	5-Y
Equities	US Mid-Caps (SPMD)	9.11%	8.85%	17.59%	15.39%	7.38%
	US Small-Caps (SPSM)	8.15%	5.96%	9.75%	15.17%	5.44%
	US Value (IVE)	6.77%	12.04%	19.75%	16.61%	10.37%
	US Large-Caps (SPY)	6.48%	16.79%	19.45%	14.59%	12.21%
	US Growth (IVW)	6.25%	21.11%	17.97%	11.63%	12.80%
	Broad-based Emerging Markets (IEMG)	4.62%	6.59%	2.87%	3.80%	1.48%
	International Developed Equities (IEFA)	4.21%	11.63%	17.55%	8.83%	4.28%
US Fixed Income	High Yield Credit (HYG)	1.78%	4.48%	7.85%	2.03%	2.50%
	Investment Grade Corporate Bonds (LQD)	0.81%	4.26%	1.96%	-4.34%	1.94%
	Municipal Bonds (MUB)	0.56%	2.25%	2.80%	-0.55%	1.80%
	Treasury Inflation Protected Notes (TIP)	-0.34%	2.05%	-1.55%	-0.37%	2.31%
	US Aggregate Bond Index (AGG)	-0.37%	2.26%	-1.01%	-4.05%	0.72%
	US Treasury 7-10 Year (IEF)	-1.26%	1.97%	-3.28%	-6.13%	0.49%
Commodities	Crude Oil (USO)	4.82%	-9.36%	-20.92%	31.35%	-12.00%
	Broad-based Commodities (BCI)	3.92%	-8.61%	-10.90%	16.95%	4.19%
	Gold (GLD)	-2.22%	5.09%	5.83%	2.13%	8.48%
	Silver (SLV)	-3.33%	-5.13%	12.08%	7.09%	6.63%

Source: FactSet. Data as of June 30, 2023.

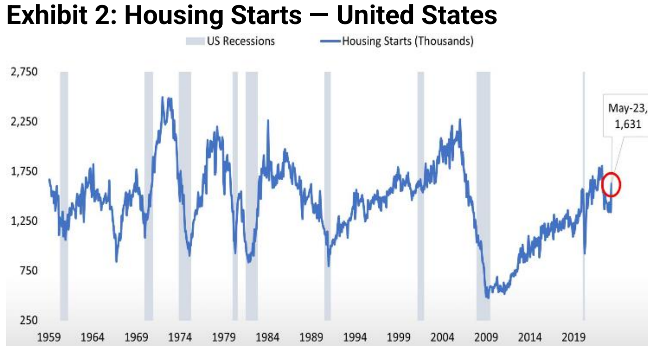
Fed Skips in June but Signals More Hikes

At the June FOMC meeting, the Federal Reserve left interest rates unchanged for the first time after 15 consecutive months of tightening, causing the fed funds rate to remain in the 5.00–5.25% range. It's believed the decision to skip will allow officials more time to assess future data. According to the updated dot plot, policymakers see two more 25 bps rate hikes before the end of 2023. Though headline inflation has come down notably, more essential core measures remain stubborn. Annualized core CPI and PCE measures for May lie at 5.3% and 4.6%, respectively, and are still far from the 2% target. Moreover, economic resilience has boosted GDP growth forecasts, and unemployment has not increased as much as the Fed previously expected given the latest JOLTS Job Openings, ADP Employment, and payroll data have all come in stronger than expected. At last week's monetary policy forum in Portgual, Fed Chariman Jerome Powell stated, "We believe there's more restriction coming…what's really driving it is a very strong labor market." He also expressed he does not see inflation returning back to 2% this year or next year, suggesting rates may be elevated until 2025.

Housing Market Shows Strength

Housing starts have historically acted as a strong indicator of both consumer health and willingness to spend. They were 1,631K in May, notching their highest level since April 2022. The housing market has showed impressive resilience in 2023, and this upward trend suggests that the US economy may remain strong.

Exhibit 2: Housing Starts — United States

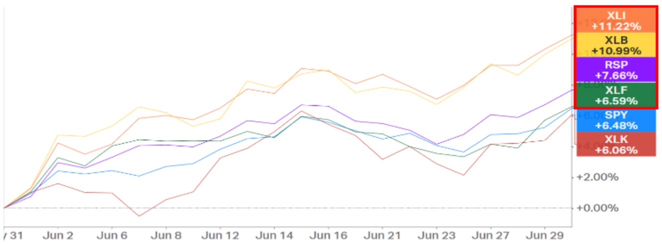


Source: FactSet, US Census Bureau, Astoria Portfolio Advisors. Data as of June 20, 2023.

Will Market Breadth Continue to Improve?

A common way to measure market breadth is to compare the performance of the S&P 500's standard market-cap weighted index (SPY) and its equal weighted counterpart (RSP). Breadth broadens when the latter outperforms the former. This occurred in June, with industrials (XLI), materials (XLB), and financials (XLF) outperforming this year's best performing sector, tech (XLK). Does this suggest a positive path ahead for equities?

Exhibit 3: June Performance — Select ETFs

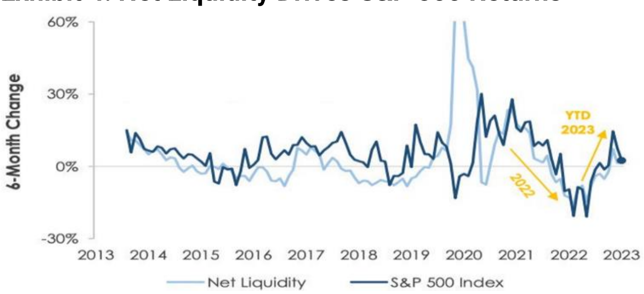


Source: Koyfin. Retuns from May 31, 2023 through June 30, 2023.

Declining Net Liquidity Suggests a Slowdown

Aside from the pandemic, net liquidity and S&P 500 returns have historically shown a strong correlation, which has strengthened since the start of 2022. In 2023, net liquidity has been artificially injected into the economy via government programs like the student loan payment moratorium, SNAP, and Medicaid, and the S&P's unexpected YTD rally has indicated this. However, the upcoming liquidity forecast paints a gloomy picture as each of these programs has already ended or will be ending before the conclusion of 2023. If this trend holds, will the market see a downturn in the coming months?

Exhibit 4: Net Liquidity Drives S&P 500 Returns



Source: MarketDesk, Federal Reserve. Net Liquidity = Fed Balance Sheet - Treasury General Account - Reverse Repurchases (O/N & Foreign).

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2023 has been a confusing year for markets. Investors have generally brushed off the S&P's +16% YTD rally, presuming it to be merely green shoots in a bear market with a seemingly inevitable correction coming. As Q2 comes to an end, however, it may be time to acknowledge some improvement in macro fundamentals and sentiment. We haven't seen investors this bullish since 2H 2021 at the height of the post-pandemic rally. While leading indicators and the yield curve still forecast upcoming weakness, GDP, housing, and manufacturing indicators appear to be bottoming-out and, in some cases, starting to improve. It's certainly easier to be more constructive now than it has been in the past year, but it's important to note that we are not out of the woods yet. As far as earnings revision breadth is concerned, the numbers look promising in a vacuum, but it has historically peaked in June and troughed in November; in other words, what we believe to be improving earnings revision breadth could merely be a cyclical trend. Looking at the bigger picture, the yield curve remains inverted and in the 1st percentile of historical data, the CAPE Shiller P/E ratio remains at 20-year highs, lending standards continue to tighten, and fiscal support and liquidity are fading fast. Ultimately, we still advise relatively defensive portfolio positioning, but we believe it is safe to start transitioning T-bills to municipals and corporates, and to begin nibbling on stocks, particularly those in higher quality segments both in the US and international. We also recommend extending duration to longer than the benchmark as long-term bonds should outperform in the event of a market correction as the short-term end of the interest rate market will bear the brunt of the hit. We are bullish on international markets, some of which are up 10-15% YTD trading at half the P/E ratio of US markets. As always, we advocate an allocation to alternatives, a focus on high-quality, and diversifying across factors.