# Q2 2023: Bull or Bear? Rise of the Magnificent 7

*By Peak Trust Company's Chief Investment Officer, Lisa Russell, CFA.* August | 2023

## HIGHLIGHTS

- The first half of 2023 has been anything but ordinary.
- On the surface, U.S. stocks continued to push higher during the quarter, but what is leading the market may not be sustainable.
- Although several signs suggest this market is a bull market, key industries and markets are grappling with telltale bear market issues.
- Looking forward, both bull and bear scenarios are possible, but given the market's strength, growing optimism, and rising real interest rates, the downside should not be dismissed.

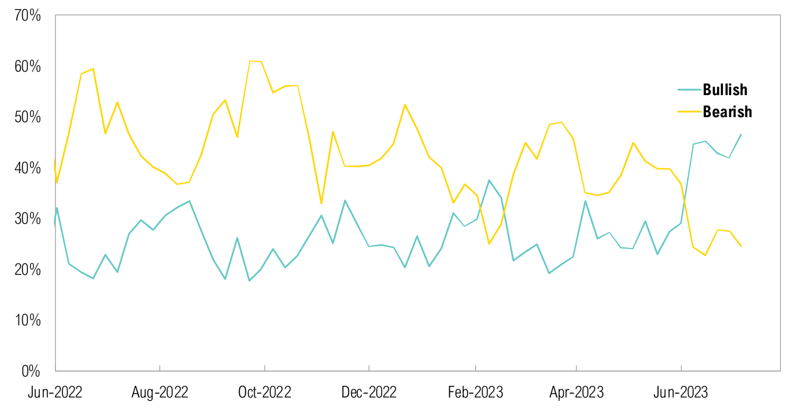
### Overview

The first half of 2023 has been anything but ordinary—from a banking crisis in March and a near-miss with a U.S. debt default due to the flurry of excitement in Artificial Intelligence (AI) and anything related to it. The tech-heavy Nasdaq Index finished the first half of the year up 32.7%—its best first half since 1983. The S&P 500 ended the first half of the year up 16.9% and is now up 24.4% from its October 2022 lows, which is comfortably above the 20.0% mark some would consider the threshold for a new bull market, while others prefer to hold back that label until new highs have been attained, and as of quarter-end, the S&P 500 was still about 7.0% shy of that milestone. Despite the impressive strength in the large-cap indexes, parts of the market have been left behind. Small-cap stocks, as proxied by the Russell 2000 Index, are up just 8.1% for the year, while banks (S&P Banks Select Industry Index) and public real estate (MSCI REIT Index), down 19.0% and up 4.8%, respectively, are trailing.

June marked the one-year anniversary of U.S. inflation reaching a four-decade high of 9.1% year over year. Since then, headline inflation has trended lower to 3.9%, while core inflation, which excludes the more-volatile food and energy components, has stayed stubbornly high, coming in at 4.9% for June. At the June FOMC meeting, the Fed held rates steady for the first time in the current hiking cycle, citing the need for the lagged effects of monetary policy to catch up. However, in his semiannual testimony before Congress, Fed Chairman Jerome Powell emphasized that there will be more rate hikes and quashed any hopes of rate cuts before the end of 2023: "A strong majority of the committee participants expect that it will be appropriate to raise interest rates two or more times by the end of the year."

**Bullish Sentiment Has Been Rapidly Increasing Over the Past Month**

AAII Reported Bullish and Bearish Sentiment, %



Regardless of what we call this market, optimism has replaced the broad despair that existed last year. The widely reported American Association of Independent Investors (AAII) sentiment survey, in which respondents characterize themselves as bullish or bearish, has shifted from 18% bullish and 61% bearish in the last week of September 2022 to 46% bullish and 25% bearish in the last week of June 2023. This is well above the historical average for bullishness, which usually hovers around 38%. The optimism has resulted in massive flows to market winners. According to BofA Global Research, technology equity funds experienced their biggest inflows on record for the first week of June.

The debt ceiling debate was also a defining event during the past quarter. After hitting the debt ceiling on January 26, politicians on both sides locked horns (and claws) in the debate on how to raise the ceiling. Then, with mere days before the U.S. was forecast to run out of cash, President Biden and House Speaker McCarthy finally reached a compromise. On May 30, Biden and McCarthy agreed to suspend the debt ceiling until January 1, 2025, which allows the government's debt to run higher.

Throughout the quarter (and the first half of this year, both a strong labor market and relatively strong consumer spending have hindered the Fed's efforts to slow the economy and bring inflation back to its 2% target. The unemployment rate is still near all-time lows, at 3.6%, per the June jobs report. The personal savings rate continues to tick upwards (reaching 4.6% in June), but the excess savings that U.S. consumers amassed during the pandemic—more than $2 trillion—have mostly been depleted, especially among lower-income groups and younger consumers. Some estimates indicate this pool of above-trend savings will run out by September. The pressure on the lower-income cohorts has also started to manifest as shifting consumption patterns.

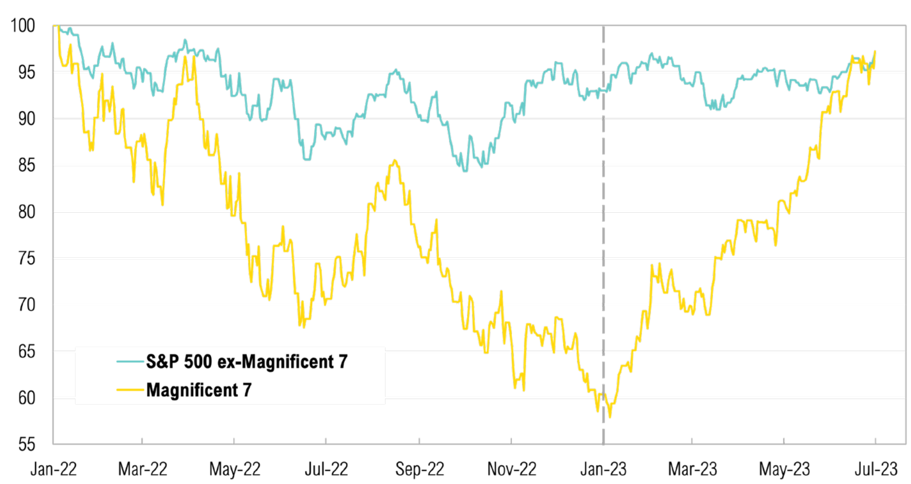
## Bull or Bear?

In January 2022, the S&P 500 began a slide that would ultimately become a bear market triggered by decades-high inflation. Ten months later, on October 12, 2022, the S&P 500 hit 3,588. By June 9, 2023, the market rallied 20% from the October lows, largely driven by a rally in a small group of AI-related tech stocks, triggering the debate as to what kind of market we are in. Although several signs point to a bull market, others suggest just the opposite, and investors are caught in the middle of a stampede of television talking heads who relentlessly alternate between promises of easy gains and predictions of impending doom.

The largest tech stocks in the U.S., a group of companies now collectively known as The Magnificent 7 (Meta, Apple, Alphabet, Nvidia, Amazon, Microsoft, and Tesla), have had a stellar year. These are the seven-largest listed U.S. companies, and together they have a collective market cap of $11 trillion—an astonishing amount equivalent to nearly half the GDP of the U.S. The Magnificent 7 were some of the worst performers of 2022, ending the year down more than 40%. In 2023, however, they have rallied and are up almost 70% year to date.

**After a Terrible 2022, The Magnificent Seven Have Outperformed in 2023**

Growth of 100




The buzz surrounding AI has been a key driver of the tech sector's recent rally, and The Magnificent 7 are at the center of this excitement. Although AI is by no means new, the November launch of *ChatGPT* rapidly accelerated investors' enthusiasm. Interestingly, even with the AI optimism, earnings expectations for 2023 and 2024 remain lower than they were coming into the year, down 4.7% and 2.5%, respectively.

The rapid evolution of AI technology is impressive as are its prospects for improving productivity, but there are still enormous questions surrounding monetization, as well as the implications for the broader labor market and the economy.

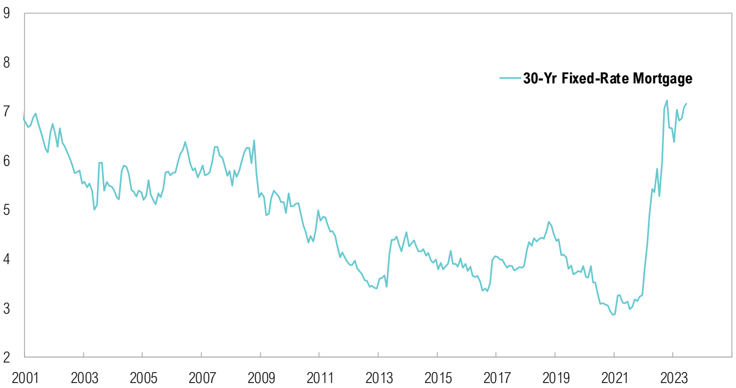
The tech sector might have led the recent rally, but the all-important financial sector remains a concern. Following the collapse of three regional banks earlier this year, the sector remains under scrutiny from investors and regulators. Regional banks, in particular, are bearing the brunt of banking sector stresses, as reflected by the poor performance of the SPDR S&P regional banking ETF, which is down more than 30% year to date. Furthermore, banks are also feeling the pressure from the cracks in the commercial real estate sector and concerns about increasing loan defaults.

The real estate sector is also exhibiting bull and bear dynamics. Helped by the Fed's aggressive rate-hiking cycle, 30-year fixed mortgage rates ended June at 7.15%. Homeowners who purchased their homes during the past decade when rates were at record lows (2.9% in January 2021) are probably staying put. As a result, the number of existing homes for sale dropped by 7.1% in May to 1.4 million—some of the lowest levels on record and well below pandemic levels. Despite the drag of higher rates, demand for new single-family homes continues to increase.

Elevated interest rates and a fundamental shift in the way people work and shop are taking a toll. During the past quarter, reports of large commercial properties (mostly offices) being marked down or returned to lenders increased. Furthermore, nearly $1.5 trillion in commercial mortgages are coming due in the next three years. Of these, 85.5% are interest-only loans, and given the Fed's aggressive rate-hiking cycle, interest rates have more than doubled for some commercial mortgage payments over the past two years.

**Inflation and the Fed Have Driven Mortgage Rates Up**

30-Year Fixed-Rate Mortgage, %




Bull and bear market forces are also evident at the highest levels of the economy. The services sector in the U.S., remains robust, bolstered by pent-up consumer demand and excess savings built up during the pandemic. Activity in that sector has expanded for six consecutive months, albeit at a modest pace. The ISM Services PMI recorded a June reading of 53.9. Spending on services increased over the past two years, outpacing spending on durable and non-durable goods by more than 7% since Q2 2021. Furthermore, personal consumption of services reached record-high levels in May, hitting $12.2 billion.

The U.S. manufacturing sector, on the other hand, offers a sharp contrast. The June ISM Manufacturing PMI recorded a reading of 46.0, marking the eighth consecutive month of contraction in that sector. More importantly, every component in the ISM Manufacturing PMI registered a reading below 50, which indicates contraction. Since 1989, this has only happened on two other occasions—in 2001, following the dot-com bubble, and in 2009, during the global financial crisis (GFC).

We also cannot ignore the 3-mo/10-yr yield curves that have been inverted since November 22, 2022. On the previous eight times this occurred, a recession followed 311 days later on average. The longest delay between inversion and recession was 487 days, which is what played out in the 2006 period. It is too early to tell if this time is different.

## Markets

Both U.S. and international equity markets rallied in June to end the month (and the quarter) in positive territory. The MSCI EAFE Index (International Equity) ended the quarter up 3.2%, and the S&P 500 posted a respectable 8.7% gain. The quarter produced mixed results for fixed income, as yields continued to march higher. The Bloomberg U.S. Aggregate Bond Index closed the quarter down 0.8%, while credit sensitive fixed income, such as high-yield bonds, finished higher by 5.4%.

As of June 30, 2023 the Boa Magnificent 7 are responsible for 73% of the S&P 500 YTD return. The S&P 500 returned 16.9% over the period with these stocks representing 12.3% of the return. This leaves the rest of the S&P 500 with a return of 4.6%.

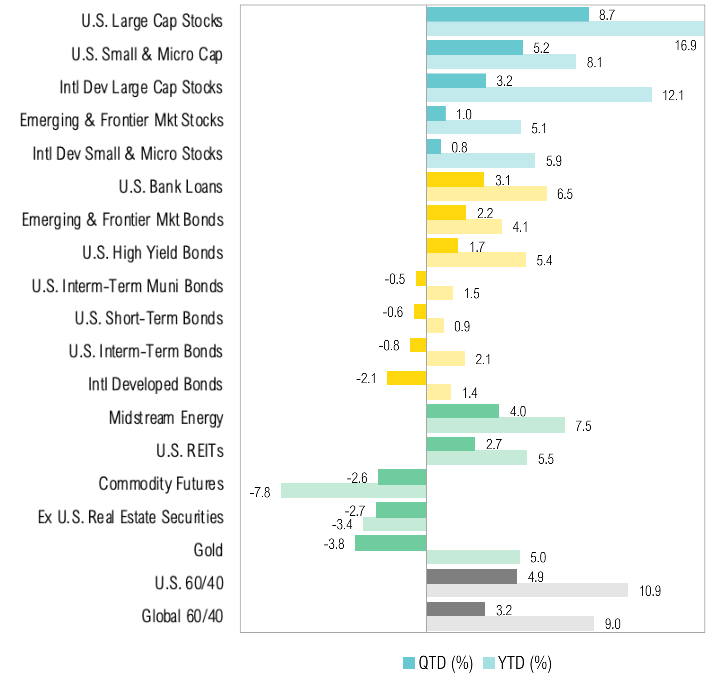
On the international front, Japan's inflation is nearing four-decade highs. Throughout the quarter, Japan remained steadfast in its ultra-easy monetary policy stance, despite concerns, the new governor of the Bank of Japan looks to be forced to adjust the country's longstanding monetary policy stance. The Japanese stock market has hit a 33-year high with the Nikkei 225 up

28.7% in Yen.

Following the reopening of China's borders in January after three years of COVID-19 restrictions, the country's much-anticipated economic recovery seems to be running out of steam. China's manufacturing sector recorded three consecutive months of contraction in the second quarter. Furthermore, inflation in China cooled to the slowest pace in two years, underpinning weak domestic demand. The MSCI China Index is down 5.5% year to date.

The United Kingdom continues to battle decades-high inflation levels. Inflation in the U.K. increased by 8.7% year over year in June, and the Bank of England responded with a 50 basis-point hike in its official bank rate, which is now at 5.0%. The FTSE 100 Index is up 8.5% year to date.

**Q2 2023 Key Market Total Returns**




Source: Bloomberg

## Looking Forward

If this is a bull market, conventional wisdom suggests that the run-up could go on for years and investors should join in or risk being left behind. This rally could, however, be just one of the many bear market rallies we have experienced in the past—one that has been extended by the unusual war chest of cash amassed during the pandemic. If that is the case, then investors should still run—but for the exits instead making it a particular difficult time for portfolio management.

Unlike the stream of overzealous bulls and bears parading across media channels, we can choose to entertain both potential scenarios; in fact, wise investors must do so. They should always construct portfolios that can withstand more than a single outcome, and today's economic indicators suggest this practice may be more important than ever.

That said, we continue to remain cautious. Despite signs that inflation is easing, we do not want to lose sight of the big picture: History strongly suggests that bad things happen, albeit with long lags, to markets after aggressive rate-hiking cycles. This is especially true in the context of high starting valuations and structural allocations to equities. Stocks might continue to shrug off higher rates for several more quarters and emerge even higher one year from now. If that happens, our portfolios that contain equity exposure will participate in the upside, though to a muted degree as they are not concentrated in The Magnificent 7. We can also see a situation in which stocks head lower given recent market strength, growing optimism, and rising real interest rates. Fixed-income prices should benefit from this scenario and are currently enjoying much higher rates. Our goal is to be prepared for either outcome.

# About Lisa

Lisa Russell started with Peak Trust Company in 2003 and currently serves as Chief Investment Officer. Lisa brings over 25 years of investment experience to the Peak team. She specializes in designing unique investment programs for high-net-worth clients and trust accounts. She is highly attuned to the tax consequences of investment actions.

Lisa holds a Master of Business Administration in Finance from Emory University and a Bachelor of Science in Business Administration from the University of Southern California. Lisa holds the designation of Chartered Financial Analyst (CFA), and is a member of the CFA Institute and the CFA Society of Seattle.

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Chief Investment Officer

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