Convergence Commentary

June 2023 Market Recap

Quick Hits:

- Market breadth showing signs of expanding beyond large cap AI
- The Federal Reserve paused but signals more rate hikes
- Mild inflation results, slightly better than expected
- Consumer sentiment reaches a four-month high point

Market-Moving Highlights

In our previous market commentary, we mentioned that "during different periods in the market, there are often companies that lead upturns. In the beginning phases, that can be concentrated among a smaller group, but history has shown us that the breadth of the market rally typically begins to widen as the uptick continues." June added traction to this notion, with sectors beyond large AI companies outperforming. Industrials and materials were two of the top three performing sectors. Furthermore, smaller caps and mid-caps outperformed large caps for the first time since February. While whether we are in an upturn remains to be seen, the expansion of breadth in June was a step in the right direction.

The Federal Reserve paused in June, but struck a hawkish tone, suggesting two more rate hikes (and possibly three) are coming. It is important to note that Federal Reserve expectations for the target rate are historically higher than the actual resulting rate hikes. With the pause, the Federal Reserve is most likely awaiting more market data to determine its next steps. Despite the signaled two-to-three 25 basis point rate hikes, the market is currently projecting a 71.9% likelihood of a rate hike in July and only an 11% chance for two consecutive rate hikes in July and September. It is also important to note that the fact that the Federal Reserve is strongly considering hiking rates further is not necessarily a bad thing, as it also means that the economy is performing better than expected.

Inflation results were mild in June, coming in slightly better than expected. Headline CPI came in at 4% year-over-year, better than the 4.1% consensus, while monthly CPI increased only 0.1%, as energy prices have declined. Core inflation, which excludes food and energy, came in at 5.3% year-over-year, better than the forecasted 5.4%. Many investment banks like JPMorgan hold a

view that inflation is decreasing faster than the headlines are suggesting and that most of the stickiness comes from increased vehicle prices and automotive insurance.

The University of Michigan Consumer Sentiment Index, which ranges from 0-100, improved sharply in June, rising from 59.2 to 63.9. The S&P 500 entering a bull market (20% increase from prior lows) has probably propelled this increase that came hotter than the forecast (60). The index is considered a leading indicator. As a leading indicator, it is believed to provide insights into future consumer spending patterns and overall economic activity. The Consumer Sentiment Index was at historical lows, and it is encouraging to see signs of recovery.

Index Performance

Index	1 Month	YTD	1 Year	5 Year
S&P 500	6.61%	16.89%	19.59%	12.31%
Nasdaq Composite	6.65%	32.32%	26.14%	13.93%
Russell 2000	8.13%	8.09%	12.31%	4.21%
MSCI ACWI ex US	4.54%	9.86%	13.33%	4.54%
Bloomberg US Aggregate Bond	(0.36%)	2.09%	(0.94%)	(0.36%)

In May, we saw over a 6% increase in the Nasdaq, driven by its tech-heavy allocation, while the S&P 500 was up 0.43% and the other three indexes we cover were in negative territory. June showed signs of breadth expansion with the S&P 500, Russell 2000, and even internationals being equal opponents to the Nasdaq. Since the S&P 500 is composed more evenly across sectors than Nasdaq, the matched performance signals further widening across sectors. The Russell 2000, which is composed of the smallest 2000 firms in the Russell 3000 index, signals small cap/mid cap breadth expansion. As mentioned in our previous market commentaries a lot of economic indicators are signaling a slowdown, with headlines sounding alarms of a recession for more than a year now. The recent market run has caused some of the investment banks to reassess their views. Goldman Sachs has decreased their chance of recession in the next 12 months to 25% from 35%. Soon after, JPMorgan joined Goldman Sachs, decreasing their projected chance of a recession to 25% from 40%.

S&P 500 Sector Highlights & Commentary

Best-Performing Sectors		Worst-Performing Sectors	
Consumer Discretionary	12.23%	Utilities	1.61%
Industrials	11.26%	Consumer Staples	2.79%
Materials	11.01%	Healthcare	4.26%

Looking at sector performance this month, the expansion in breadth becomes more evident. While consumer discretionary continues its strong performance this year, it is the industrials and materials sectors that are encouraging to see. The month of June saw mentions of industrials being a potential strong beneficiary of AI, as companies look for ways to incorporate the technology. Materials is perhaps a more surprising sector, with a focus on the role of materials such as lithium, copper, and other metals on the road to more sustainable energy. On the worst-performing sector front, utilities have suffered a decrease in energy prices. Consumer Staples and healthcare, being defensive sectors, underperformed this month. Nevertheless, even the worst-performing sectors are in positive territory.

What to Watch in July

7/5 - FOMC minutes
Considering that not much economic data has come out since the last Federal Reserve Interest Rate decision, it is most likely that hawkishness and date dependency will be reiterated.
7/7 - Non-Farm Payrolls, Unemployment Rate
The US economy unexpectedly added 339,000 jobs in May 2023, above market forecasts of 190,000. This was once again great for the economy but bad for the inflation fight. Leisure and hospitality are amongst the fastest-growing segments. Remember, in April the US economy added 253,000 jobs above market forecasts of 185,000. It will be interesting to see if we will get more added jobs than expected for the third month in a row in July.

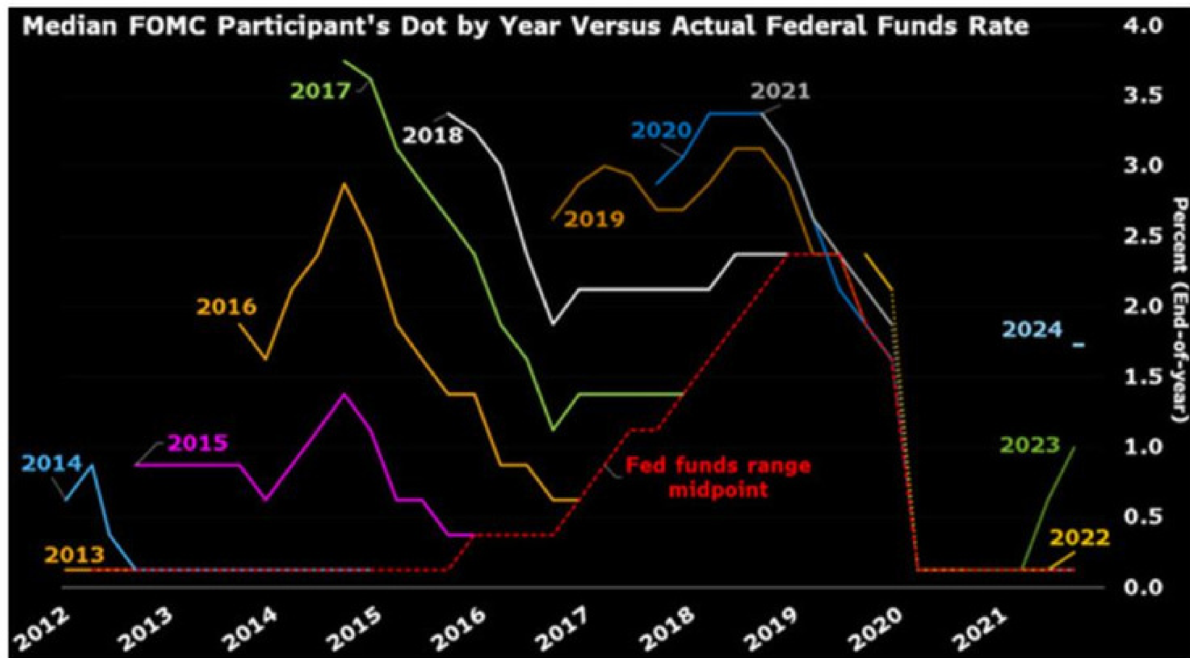
7/12 – CPI, 7/13 - PPI
Inflation continues to be closely watched and will play a significant role in the Federal Reserve's decision later in the month.
7/14 – University of Michigan Consumer Sentiment Index
As mentioned earlier, this index is a leading indicator with the highest increase in June in the last four months and investors will be looking for another positive reading to verify the new trend.
7/26 - Fed Interest Rate Decision
While the market expects a 25 basis point hike, the guidance, language, and anything related to what the Fed projects will continue to be a focal point for money managers.

Market Wrap

Despite the S&P 500 entering a bull market in June, investor sentiment remains mostly negative. There are fears that the recent rally was only driven by a few large cap AI firms, while most firms are suffering amidst the current rate-hike cycle, alongside a slowing economy. In the Goldman Sachs Exchanges: The Markets podcast, Sung Cho, the co-head of Tech Investing for Fundamental Equity for Goldman Sachs Asset Management, shared his views on why the rally skewed large-cap. He thinks that the major reason why the rally has skewed so many more large cap companies is that the major infrastructure players reside in the large cap space. Investors also know more about these big names. However, as the app ecosystem starts to take off you might see a lot of companies emerging from the small cap and mid cap space. We are also very early in the AI technology adoption cycle, and it is hard to see all of the major beneficiaries. If Sung Cho's views come true, we might see a stronger market breadth with regard to AI in the future.

In some of our commentaries, we noted that the market expectations for the interest rate hikes do not coincide with what the Federal Reserve says. The chart below might help explain why. The Federal Open Market Committee releases its dot plot and forecasts the coming years. Here is how the chart should be read:
Example (2017, green line) - In 2015, the expectations for the fed funds rate for 2017 was around 3.5%. The red dashed line is what actually happened, and you can see that the 2017 actual fed funds rate ended up being 0.5%. The continuous green line shows what the Federal Open Market Committee's expectations were for the future, always two years from the year on the x-axis.

The Dot Plot Has Not Been a Good Predictor of Actual Interest Rates



Source: LPL Research, Bloomberg, 06/15/23

Past performance is no guarantee of future results.

Sources

FOMC Recap: Connecting the Dots | LPL Financial Research (lplresearch.com)

Why the AI-driven tech rally has legs (goldmansachs.com)

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