

Will the Market Sustain Its Upswing?

The bear may have entered hibernation in June, but can we now count a bona fide bull? That may be overselling it. Equities capped off a remarkable first half of the year by continuing to gain value even as the Federal Reserve (Fed) signaled that its inflation-fighting program could yield two more rate increases in 2023. But with a long-expected recession still failing to appear, investors seemed to focus, instead, on the possibility of a pain-free untying of 2022's post-COVID tangles.

“The equity market behaved surprisingly well given that it went from expecting rate cuts in 2023 to having them pushed out until 2024,” said Raymond James Chief Investment Officer Larry Adam. “A better-than-expected first quarter earnings season, decelerating inflation, growing optimism about a soft, non-recessionary landing and the AI-powered tech rally have been key drivers behind the recent upswing.”

The tech-heavy NASDAQ saw its best first half of the year in four decades, rising almost 30% year-to-date.

Despite these gains, near-term caution is warranted. The recent surge in investor optimism suggests the market may be due for a pullback. Meanwhile, bond yields – primarily at the front end of the yield curve – backed up in reaction to the Fed's increased hawkishness, and the yield curve remains deeply inverted, which suggests a coming recession.

We'll dive more into that and more on the other side of the numbers:

	12/30/22 Close	6/30/23 Close*	Change Year to Date	% Gain/Loss Year to Date
DJIA	33,147.25	34,407.60	+1,260.35	+3.80%
NASDAQ	10,466.48	13,787.92	+3,321.44	+31.73%
S&P 500	3,839.50	4,450.38	+610.88	+15.91%
MSCI EAFE	1,943.93	2,113.59	+169.66	+8.73%
Russell 2000	1,761.25	1,888.73	+127.48	+7.24%
Bloomberg Aggregate Bond	2,048.73	2,085.33	+36.60	+1.79%

*Performance reflects index values as of market close on June 30, 2023.

Inversion suggests recession

Yield curve inversions – when short-term yields are higher than long-term yields – can be an indicator of a looming recession. The average depth of the last four inversions that signaled coming recessions was -

60 basis points (bps) when comparing yields on 10-year Treasuries to 3-month Treasury bills. We currently sit at -172 bps. This could get potentially steeper if the Fed follows through with raising interest rates one or more times.

Perhaps more significant is the length of time the yield curve has been inverted. Before the last four recessions, the average time the yield curve was inverted was 189 days – including the 337 days before the Great Recession. The length of the inversion may signal a more meaningful degree of impact on the economy than the depth does. At 247 days through June 30, the length of the current inversion is well past the average.

Inflation cooling, but slowly, and housing stable

Indicators suggest shelter costs will start slowing down considerably, which may convince the Fed to make only one more rate increase before the end of the year. Inflation related to shelter costs is expected to slow at a faster pace during the second half of the year. Meanwhile, housing market data continues to indicate that the sector stabilized during the first half of the year. However, higher mortgage rates could hit the sector once again as the Fed continues its interest rates campaign.

Meetings signal U.S.-China de-escalation

Secretary of State Anthony Blinken's visit to China in June may be another step toward easier relationships between the world's No. 1 and No. 2 economies. The trip, taken ahead of a potential meeting between President Joe Biden and President Xi Jinping, suggests we have passed the peak of escalating rhetoric and counterpunches following tensions earlier this year. Treasury Secretary Janet Yellen has plans to meet with her Chinese counterpart in July.

Spotlight on India

India has enjoyed attention from financial markets as investors increasingly looked to it to surpass China as the world's growth engine. Prime Minister Narendra Modi's high-profile visit to Washington, D.C. – with accompanying sweeping agreements on trade and defense – suggests that India will eventually drop its nonaligned stance with regards to the West, China and Russia, and build closer ties to the Atlantic world. For U.S. interests, "friendshoring" offshore economic activity provides a compelling alternative to complicated relationships with Chinese manufacturing hubs.

It's been hot all over

Extreme heatwaves have flared across the northern hemisphere since April, and the U.S. Southeast ends June amid a dangerous rise in temperatures. China, Vietnam, Thailand, Spain, Portugal, Texas and Louisiana have hit record or near-record temperatures. July and August are likely to be even tougher. Water scarcity in high-temperature, high-population areas is a growing concern, pointing to a need for diversifying potable water sources. Wastewater reclamation and desalination are proven options, but the scale-up of both can be slow.

The bottom line

Though market sentiment seems driven by optimistic economic expectations, the Fed remains committed to tightening the money supply to battle inflation. Historically, the impact of an interest rate hike lags. Meanwhile, leading economic indicators and the yield curve are at levels historically consistent

with a recession. Unique characteristics from the COVID era – significant undersupply of labor and financial cushion left from massive government stimulus – have supported economic activity and pushed out the timeline of economic weakness.

At first blush this may read as a gloomy prognosis, but it comes from an understanding that when the market sentiment is grim, opportunity lies in finding a way forward. Likewise, when the outlook seems too cheerful, it's wise to check again the looming risks.

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