ROBERTSON STEPHENS®

August 7, 2023 – Investment Commentary

Market Movements

U.S. equities experienced a notable decline last week, with the S&P 500 Index declining 2.26%, marking its most severe weekly downturn since March 2023. In local currency terms, the European STOXX Europe 600 Index ended 2.44% lower. The market volatility was likely driven by a combination of macro events, including:

1. Credit rating agency Fitch downgraded the United States credit rating,

2. Bank of Japan, which raised the effective cap on Japanese government bond yields, which went on to rise sharply, causing other global government debt yields to rise and compete with potential global investor demand,

3. U.S. economic data, which has been quite strong, something that usually corresponds to higher rates (to cool down inflationary pressures from aggregate demand activity) and

4. Expectations for higher levels of issuance by the Treasury Department seemed to help push yields higher earlier in the week (supply>demand requires higher yields to induce investors to buy)

The Fitch downgrade marked the second time a major rating agency downgraded the United States, with Standard and Poor having done so in 2011. Following the downgrade, markets saw significant movements in longer-dated treasuries. The yield on the benchmark 10-year U.S. Treasury note increased from 3.95% at the end of the previous week to almost 4.20% at one point last Friday.

What is Happening

Market Advance Continues, Small Caps Lead in July

The S&P 500 returned 3.2% in July, 20.6% year to date (YTD). Energy was the best performing sector (7.4%), followed by Communication Services (6.9%), which was led by Google and Facebook. The Russell 2000 (small cap index) returned 6.1%, while the equal- and market cap-weighted S&P 500, Russell 1000 Growth and Value all delivered similar returns.

Economy Remains Robust

The U.S. economy expanded 2.4% in 2Q23 and 2.0% in the first quarter. Consensus forecasts are for 0.5% growth in 3Q; however, the Atlanta Fed's GDPNow projection is 3.5%. The unemployment rate is 3.5%, far from recessionary levels. However, an increasing number of public companies beyond the tech industry mentioned during their second quarter earnings calls, for the possibility of layoffs.

Inflation Falls, Fed Hikes

Headline CPI has fallen from 9.1% a year ago to 3.0% in June 2023. On July 26, the FOMC raised the funds rate to 5.25-5.50%. Investors are assigning an 86% probability that it maintains its current Fed Target Rate of 525-550 whereas it's assigning only a 14% probability of another 25bps rate hike at its September 20th meeting.

Q2 (second quarter) Earnings Mark the Cycle's Trough

84.0% of the S&P 500's market cap has reported. The Q2 expectations are for revenues to grow +0.1% and earnings per share (EPS) to decline -3.5%, which is better than original expectations. In sum, earnings are contracting, revenue growth is stagnating, and guidance remains cautious. The Q2 earnings are forecasted by Wall Street analysts to be the worst quarter this year, with consensus growth forecasts of 0.4% and 7.8% in Q3 and Q4, respectively. We believe, in the absence of earnings growth later this year, the P/E multiple expansion market rally YTD will be difficult to sustain. The reason is that earnings growth year to date is basically flat, where the U.S. forward P/E ratio is above its long run average of 16x.

China

Last week, Chinese stocks rose as Beijing's supportive announcements offset concerns about the latest wave of disappointing economic data. The Shanghai Stock Exchange Index gained 0.37%, while the blue-chip CSI 300 advanced 0.7%. China's cabinet, the State Council, announced new measures to revive consumption. The wide-ranging policies focused on removing restrictions on consumption in sectors including autos, real estate, and services. In central bank news, the People's Bank of China (PBOC) pledged to support the development of China's real estate market.

Brazil's central bank initiates easing cycle

Brazil became one of the first global central banks to ease monetary policy after aggressively tightening to fight the post-pandemic inflationary surge. The Central Bank of Brazil lowered its benchmark lending rate and indicated that it expects to make rate cuts of the same magnitude going forward if expected inflation continues to moderate.

Portfolio Construction

There is an opportunity for both ballast and income in today's fixed income market. The U.S. 10-year Treasury Rate is at 4.09%, compared to 2.83% last year. This is close to the long-term average of 4.25%. If yields even fall marginally, there is a potential for high single digit total returns due to the current yield plus potential price appreciation (price up / yield down). While there has been greater volatility in the bond market as of late, we continue to focus on the current opportunity in the high-quality bond market (especially municipals for clients in high tax jurisdictions). We believe it's worthy of consideration, dependent upon your financial plan and goal, to construct a cross-asset portfolio of attractive risk-adjusted total return opportunities.