Convergence Commentary

July 2023 Market Recap

Quick Hits:

- Great progress toward slowing inflation
- Positive earnings surprises, but only 58% reported so far
- Market breadth continues its expansion
- Fed meeting dovish for the first time this rate hike cycle

Market-Moving Highlights

In our previous market commentary, we mentioned that some investment banks believed that inflation is decreasing faster than the headlines suggest. This view came to fruition in July, with headline CPI coming in at 3% year-over-year, better than the 3.2% forecast. Monthly CPI increased 0.2%, in line with the consensus. Core CPI (ex-food and energy) came in at 4.8% against a 5.0% forecast. The inflation drop came in conjunction with personal spending increasing, which was a surprise. Overall, a great month for the war against inflation.

With 58% of the companies that have reported thus far, it has been a positive earnings season with overall results beating sales by 1.3% and beating earnings by 6.1%. A vast majority of financials have beaten the forecast, driving a rally in the sector and dampening fears. Google was the biggest winner from the big tech so far, rallying +10% after their earnings, driven by cloud, ads and potential growth in AI. AMD, Amazon and Nvidia are set to report next month. On the economic front, GDP quarterly growth rate came in at 2.4% against a 1.8% forecast, further lowering the chances of a recession.

Market breadth showed signs of further strengthening in July, with some of the 2023 underperformers such as energy and financials reemerging, while small caps had a strong showing. Emerging markets also showed strengths as geopolitical tensions with China have somewhat decreased in July, with more exchanges between diplomats from both countries. While the strengthened market breadth has quieted voices over market rally only being a mega-cap AI rally, new voices have emerged about whether the market went too high or too fast.

On the 26th of July, the Federal Reserve hiked the interest rates by 25 basis points, bringing the cost of borrowing to the highest levels since January 2001. However, the press conference after the meeting was taken as a positive for the markets, as Jerome Powell was less hawkish in his remarks. The central bank economists are no longer forecasting a recession. While reiterating data dependency, the language and tone suggested that there might not be any more hikes. The market is currently pricing an 80% chance of no hike in September.

Index Performance

Index	1 Month	YTD	1 Year	5 Year
S&P 500	3.21%	20.65%	13.02%	12.20%
Nasdaq Composite	4.08%	37.71%	16.82%	14.34%
Russell 2000	6.12%	14.70%	7.91%	5.09%
MSCI ACWI ex US	4.10%	14.36%	14.03%	4.35%
Bloomberg US Aggregate Bond	(0.07%)	2.02%	(3.37%)	0.75%

In June we noted signs of breadth expansion with the three indexes we cover being an equal match to the tech-heavy Nasdaq. July continued the trend with the Russell 2000 index (small caps) being the leader in performance two months in a row. Looking at developed markets, the energy crisis in Europe turned out to be less of a crisis than expected. Japan is experiencing a valuation expansion, as analysts cite underinvestment and new government policies incentivizing investment. Looking at emerging markets, while China's growth has been sluggish, India has been a pleasant surprise with companies such as Apple and AMD increasing their investment. Continued economic surprise in conjunction with a resurgence in consumer confidence is driving the market. However, there have also been voices of concern regarding the sustainability of this rally, which is why earnings growth will play particular importance this quarter.

S&P 500 Sector Highlights & Commentary

Best-Performing Sectors		Worst-Performing Sectors	
Energy	7.77%	Healthcare	1.07%
Communication Services	5.70%	Real Estate	1.33%
Financials	4.81%	Consumer Staples	1.07%

July marked the second month in a row this year when all of the sectors ended in positive territory. It was an encouraging sign to see year-to-date laggards such as financials and energy outperform – a sign that the mega-cap rally has been spilling into the broader markets. Communication services have rallied due to an increase in demand in the sector, while banks passing the stress test by the Federal Reserve have been a tailwind for the financials. On the 3rd of July, the world reached its highest recorded average temperature ever, which was one of the catalysts for the energy sector. On the worst-performing sector front, the continued uncertainty in real estate prices and a steep increase in mortgage costs caused real estate to top the list. Consumer Staples and healthcare continue to be an underperformer as flight to safety deteriorates.

What to Watch in August

8/01 – ISM Manufacturing PMI, Jolts Job Openings
The ISM Manufacturing PMI index measures contraction/expansion in the manufacturing sector. A measure below 50 indicates a contraction, while above 50 indicates an expansion. The index fell in June to 46, below forecasts of 47, signaling weakness in the manufacturing industry. The Jolts Job openings were falling slower than expected despite a very steep increase in rates, and it will be interesting to see whether the pattern continues.

8/03 – ISM Services PMI
The ISM Services PMI unexpectedly jumped to 53.9 in June, well above the forecasts of 51. The strength in services was a positive shock, and the market will seek confirmation in August.

8/04 – Non-Farm Payrolls, Unemployment Rate
After unexpectedly adding 339,000 jobs in May 2023, June Job openings were below forecasts at 209,000 vs 225,000. The current forecast is for 190,000 job openings in July. The unemployment rate is expected to remain steady at 3.6%.

8/10 – CPI and Core CPI
After great June inflation data, the current forecast for July is at 2.8% year-over-year headline inflation, and a 4.6% year-over-year core inflation. This reading may have a big say whether the July rate hike was the last one.

8/11 – Michigan Consumer Sentiment, PPI
The July consumer sentiment reading at 71.6 was the highest reading since October 2021, driven by the inflation progress along with stability in the labor markets. The consensus is a slight decrease to 70.9.

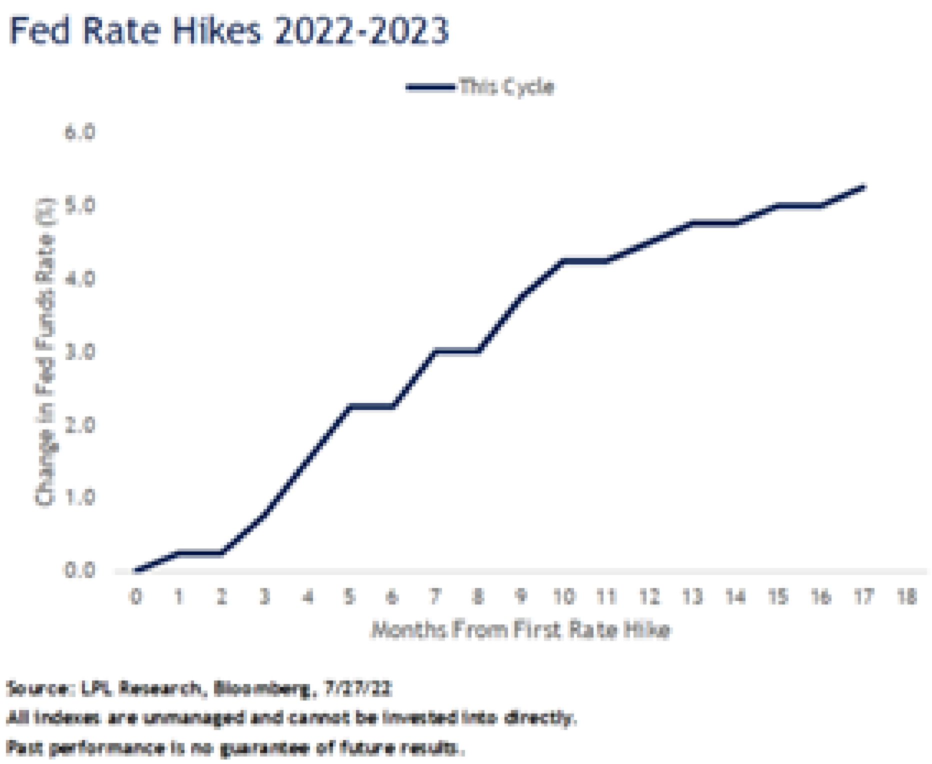
Market Wrap

July marks the third commentary in a row that is largely positive, demonstrated by improved market breadth, better than expected inflation, better than expected earnings, and a more resilient consumer. However, as the focus slowly shifts away from inflation, earnings growth will become more important. That is why earnings this quarter will be particularly important, as the market will seek verification for its run.

Even though we have had a great start to the year, we still have headwinds to face for the remainder of the year. It is important to remember that interest rate changes usually have a lagging effect. Therefore, the economy may not be feeling the full impact just yet. Additionally, student loan payments are to resume in October, which might put a dent into consumer spending, although it is unclear how material it is going to be. There is also a possibility of a government shutdown on October 1st since there is currently a stalemate for the budget negotiation for the next fiscal year.

Although these are the same headwinds we have experienced in the past and the market has easily overcome them and has trended higher. This information only puts more of an emphasis on the importance of the earnings reports for this quarter and next. Looking forward to August, earnings should be the main focus, as well as inflation data in the first half of the month. Despite the uncertainties, the current blend of positive surprises and an increase in demand for tech/AI are great to see.

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.



Sources

Fed Raises Rates, Shares Uncertain Policy Future | LPL Financial Research (lplresearch.com)

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