Convergence Commentary

August 2023 Market Recap

Quick Hits:

- Inflation met expectations
- Great earnings season, with 98% reported
- The markets have entered low-volume season
- 10-year Treasury rates spike

Market-Moving Highlights

Inflation in August came mostly in line with expectations, with headline CPI coming in at 3.2% year-over-year and 0.2% on a month-to-month basis. The increase from 3% in our previous commentary happened mainly because inflation dropped significantly around the same time last year, considering the comparison is made on a yearly basis. Core inflation was 4.7% year-over-year against a 4.8% forecast. The Federal Reserve is getting close to a point where they must balance risk between doing too much and doing too little. That is why the next inflation report on September 10th will be particularly important.

With 98% of companies having reported thus far, it has been a great earnings season with overall results beating sales by 1.5% and beating earnings by 7.9%, in comparison to the forecast. The gains were mostly driven by a resilient consumer. The theme of cyclical sectors showing strength continued in August. The consumer discretionary sector was the leader of surprises with a 21% earnings surprise, followed by technology (9.1%) and industrials (8.4%). At the end of the month, Nvidia, the company that is currently the best measure of the demand for AI hardware, beat estimates with revenues coming in at $13.51B against an $11.13B forecast. Overall, the second quarter results took another step towards validating the market rally this year.

August began the year's low volume season. Investors often take vacations and enjoy the summer, which results in lower trading volumes. This can cause volatility as investors will mostly react to headlines, especially bad news. Perhaps that is one of the reasons why August and September are known to be seasonally weak months. However, according to research when the first half results in a stronger gain than 10% for the S&P 500, the second half is positive 81.8% of the time with an average return of 7.7%. While a reminder that the market does not always go up, the market performance in August could be viewed as healthy consolidation after a fast run-up in June and July.

Treasury bonds spiked in August, giving stocks a competitor after a 5-year period of low yields. The 10-year yield hit 4.34% on the 21st, but then went back down to about 4.08% by the end of the month. The 4.34% level was the highest since 2007. The sharp rise of the 10-year yield was a little surprising after good inflation data and talks about rate cuts. One of the narratives that drove the increase was the strength of the US economy. If the economy is strong, why would the Federal Reserve need to cut rates? Additionally, as the federal budget deficit deepens, the Treasury issued $1 trillion of bonds this quarter. The increased supply drives the prices of treasuries down, which causes their yields to spike.

Index Performance

Index	1 Month	YTD	1 Year	5 Year
S&P 500	(1.59%)	18.95%	15.94%	10.52%
Nasdaq Composite	(2.05%)	34.86%	19.85%	12.58%
Russell 2000	(5.00%)	10.17%	4.65%	3.14%
MSCI ACWI ex US	(4.76%)	9.22%	12.49%	3.83%
Bloomberg US Aggregate Bond	(0.64%)	1.37%	(1.19%)	0.49%

In our previous market commentary, we mentioned that because of the great performance in June and July, earnings growth will be particularly important this quarter. Despite another great earnings season and good economic data, the performance in August has been weak across all indexes. Long-term rates such as the 10-year treasury have spiked, causing alarms over the high interest rate environment. Small cap companies of the Russell 2000 are particularly affected by the potential damage high interest rates can cause. Considering the recent run, the consolidation in August is understandable. Looking at developed markets, the focus was on the war in Ukraine, and the tensions between Poland and Belarus. On the emerging markets front, there seems to be a potential positive catalyst brewing as diplomats of China and the United States continue conversations specifically regarding trade. The Commerce

Secretary Gina Raimondo is going to China, which is a meeting that has not happened in seven years. However, there are still concerns over China's sluggish growth, and uncertainties whether the relationship will better.

S&P 500 Sector Highlights & Commentary

Best-Performing Sectors		Worst-Performing Sectors	
Energy	1.65%	Utilities	(6.13%)
Health Care	0.70%	Consumer Staples	(3.95%)
Technology	(1.51%)	Materials	(3.30%)

After two months in a row of positive returns in all sectors, the weak August gave the rally a breather. Energy was on the top of the list in July and is showing strength as oil prices rise. Production cuts by Saudi Arabia, refinery disruptions, and a hurricane season potentially further disrupting supply were some of the catalysts. Healthcare has shown signs of strength on a relative basis, with an unexpectedly high number of healthcare related jobs added in July. The resilience of US consumers continues to add strength to the consumer discretionary sector, despite fears over the restart of student loan payments. On the worst-performing sector front, defensive sectors continue to underperform. Utilities are known as a proxy to bonds, as they usually have stable cash flows and a predictable business. The competition from rising interest rates has put pressure on the sector. Similarly, euphoria over growth has led to a decreased interest in consumer staples and utilities. Regarding materials, declining inflation put some pressure on metal pricing, specifically lithium (-20%) and copper (-4%).

What to Watch in September

9/01 – Unemployment Rate, Non-Farm Payrolls, ISM Manufacturing PMI
The unemployment rate decreased to 3.5% from 3.6% in July, close to historical lows. The August reading forecast calls for a steady 3.5%. The US economy created 187,000 jobs in July, with around 100,000 job gains occurring in health care. The August reading is expected to be around 180,000. The ISM Manufacturing PMI edged higher in July to 46.4 after hitting a three-year low

of 46 in June. Investors will be hoping for signs of potentially entering an expansionary reading above 50.

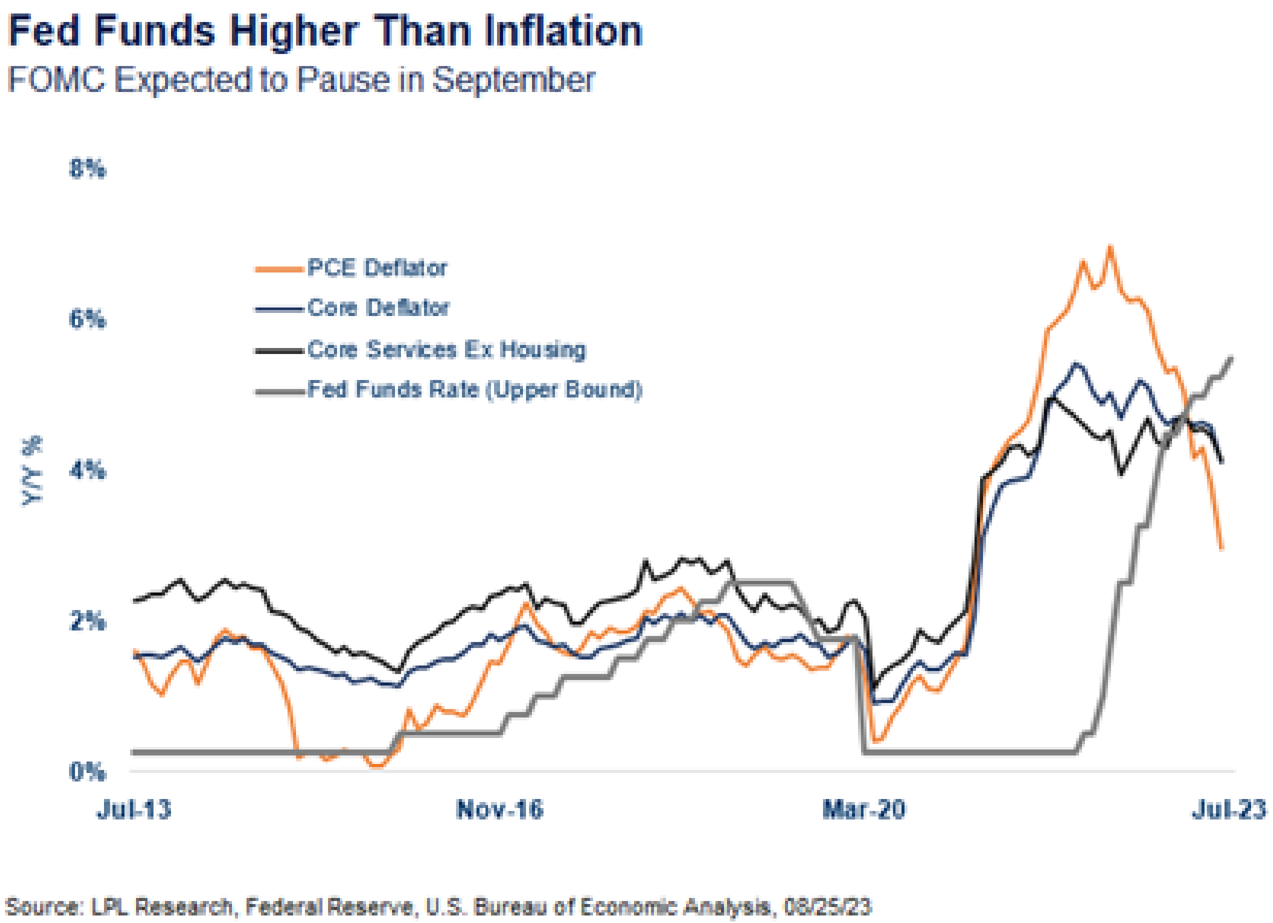
9/06 – ISM Services PMI
The July reading was slightly disappointing at 52.7, following a 53.9 in June. The decrease points to a slower increase in growth within the service industry. The consensus forecast is 52.4 for August.

9/10 – CPI and Core CPI
Headline inflation accelerated in July to 3.2% from 3% in June. The increase was mostly due to base effects as inflation started falling in July 2022. Core Inflation fell to 4.7% from 4.8%. Focus on inflation continues and this reading comes ten days before the September Fed meeting.

9/15 – Michigan Consumer Sentiment
The July consumer sentiment reading at 71.6 was revised to 69.5 in August, which is still the 2023 high. With the backdrop of economic data and the earnings season behind us, it will be interesting to see how US consumers view the economy.

Market Wrap

While the spike in the 10-year treasury might alarm some investors, the chart below is potentially indicative of how long the spike might last. A great estimation of whether policy is restrictive or expansionary is how it stacks up against the current inflation. If the policy rate (the gray line) is above the inflation rate (all the other lines), it is contractionary. If the policy rate is below the inflation rate, it is expansionary. We have just entered a contractionary policy period, and if inflation keeps falling, the policy will keep being more contractionary, even without rate hikes. In conclusion, there might not be a need for another rate hike and there might be a need for rate cuts, once the rate gets unnecessarily contractionary.



Sources

[Navigating Under Cloudy Skies | LPL Financial Research (lplresearch.com)](lplresearch.com)

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