Market Update: Q2 2023

Intellectual integrity is one of our core values at HM Payson. In the context of investing, it means putting in the time, questioning assumptions, and making sound judgments free of influence or bias. It also means admitting what we don't know.

One year ago, the Federal Reserve was accelerating rate hikes in the face of stubborn inflation. The fight to tame inflation was on, as was the guessing game of how high, how fast, and how long rates would rise. It's tempting to play along and get caught up reading the economic tea leaves, but history and experience have shown us how difficult it is to predict macroeconomic outcomes, and the importance of being honest about that. The recent surge in inflation and massive shift in monetary policy are prime examples.

A Moving Target

The Federal Reserve Board of Governors is made up of preeminent economists with their fingers on the pulse of the economy. Yet one year ago they were predicting a Fed Funds rate of 3.8% by the end of 2023. Looking back two years to June 2021, they predicted a target rate of 0.6% by the end of 2023. Now, with the Fed Funds target rate already above 5%, the board is predicting more rate hikes and a year-end target rate of 5.6%.

Time will tell if the Fed hits its target, but that hasn't stopped countless pundits from predicting that aggressive rate hikes will push the unemployment rate higher and the U.S. into recession. However, recent economic data appears to undercut such forecasts: the June employment report showed continued job growth, rising wages, and steady participation rates. There are many indicators and variables at play, but one thing we do know is that the U.S. economy is extremely dynamic and incredibly resilient. And we also know that it is exceptionally difficult to forecast.

Key Takeaways

- Economic forecasts are challenging
- Mega Cap technology stocks dominated in the first half of 2023
- At HM Payson, we're focused on stock fundamentals
- Bonds are no longer boring

INDEX	Q2 2023	YTD	TRAILING 12 MOS.
S&P 500	8.7%	16.9%	19.6%
Russell 2000 Small Cap	5.2%	8.1%	12.3%
MSCI EAFE - International	3.2%	12.2%	19.5%
MSCI Emerging Markets	1.0%	5.0%	2.1%
Bloomberg US Agg Bond	-0.8%	2.1%	-0.9%

SOURCE: BLOOMBERG

Focused on Fundamentals

During times like these, when the masses are fixated on the broad direction of the economy, we like to narrow our focus to company-specific fundamentals. In the past year, we have been steering client portfolios toward high quality companies with exceptionally strong cash flow, fortress-like balance sheets, sustainable growth, and durable pricing power, while moving away from international equities and smaller U.S. stocks. In general, this positioning has played out well in 2023. Large-cap U.S. stocks, as represented by the S&P 500, have outperformed most broad indexes in recent periods.

SHARE OF THE S&P 500 INDEX ACCORDING TO MARKET CAPITALIZATION

SOURCE: REFINITIV

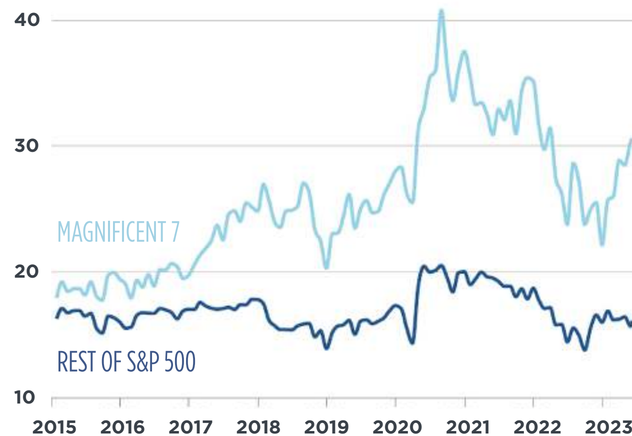
The Magnificent Seven

We're not alone in our pursuit of quality and stability – it has been a very popular strategy this year. Money has rushed to the largest and most profitable companies in the market. Apple, Microsoft, NVIDIA, Amazon, Tesla, Meta (Facebook), and Alphabet (Google) dominated performance and have come to be known in popular press as the Magnificent Seven. Due to their incredibly strong balance sheets and cash flow, they do not need to rely on banks or the bond market to fund growth, and are insulated from rising interest rates. Furthermore, they were beaten down in 2022, and the emergence of Artificial Intelligence has fueled positive sentiment and propelled the stocks higher.

It is not uncommon to have a small group of stocks dramatically outperform the market. However, these seven stocks' influence on total index performance is amplified because of their size. The S&P 500 Index weights stocks according to their market capitalization, which is the total market value of all the available shares. The image above captures the relative size of these seven companies versus the remaining 493 companies in the index. Remarkably, they make up over 27% of the S&P 500's total market capitalization.

The S&P 500 index rose sharply in the first half of 2023, pulled higher by the Magnificent Seven which accounted for 77% of the period's total return. Notably, the rally in the Magnificent Seven stocks was driven mostly by multiple expansion (i.e., improving sentiment), not earnings growth. As a result, the Forward P/E multiple for this group is considerably higher than that of the index's other 493 stocks, many of which have not kept pace with the index return this year. While this valuation difference is not unprecedented, we question whether it is sustainable.

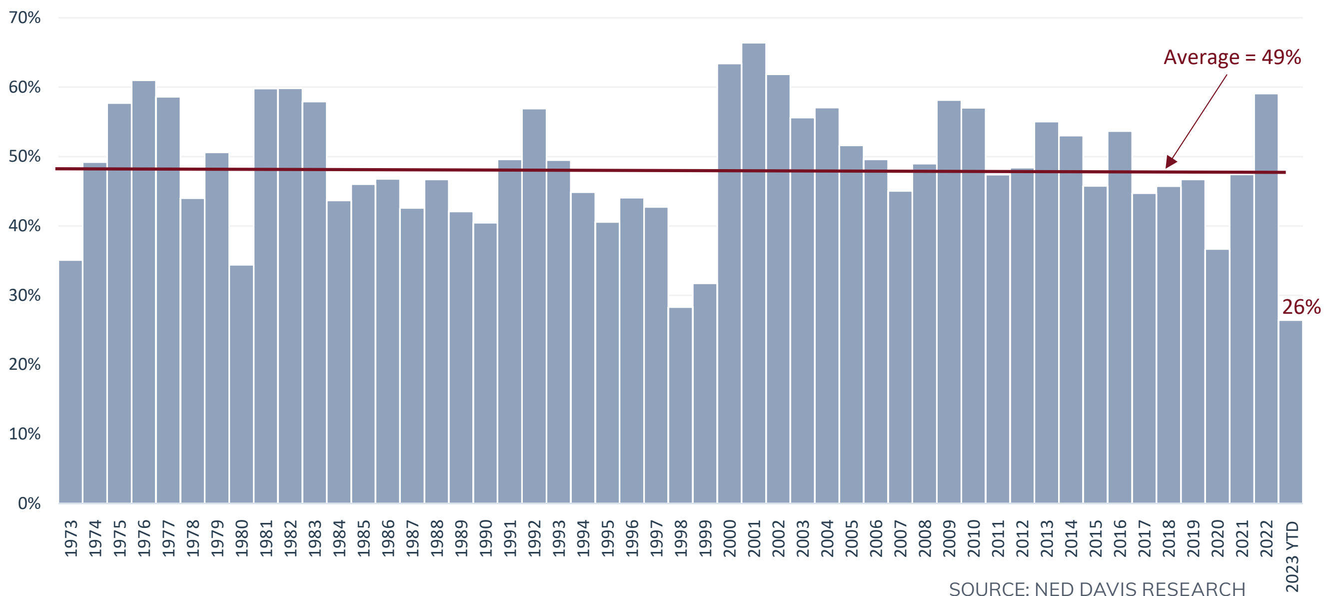
FORWARD PRICE-TO-EARNINGS RATIO, AS OF JUNE 2023



SOURCE: UBS, BLOOMBERG, FACTSET

As the bar graph on the following page shows, only 26% of stocks have kept pace with the S&P index return through late June. This lack of participation is striking. More striking is the fact that roughly 40% of stocks in the index lost value in the first half of 2023.

The recent lack of participation and concentra-



tion in the "market" index will not change our approach to stock selection. While HM Payson client portfolios have benefited from holding several of the Magnificent Seven stocks, chasing short-term stock performance is never a productive long-term strategy. In the short term, when stocks rise on sentiment alone, it can be hard to maintain valuation discipline. But our focus is on future earnings, not past performance. Stock prices cannot remain dislocated from earnings growth; and over the long term, valuation discipline tends to be rewarded.

Bonds are Back

As remarkable as the inner workings of the stock market have been in 2023, the bond market is finally competing for equal time in our investment meetings. Thanks to aggressive Fed rate hikes, short-term treasury bonds currently yield over 5%.

Our approach to the bond market has always been a function of client liquidity needs. We identify a client's near-term spending needs and select short-term bonds to protect capital and fund those needs. This year, we have shifted fixed-income portfolios toward short-term treasury bonds since they currently offer higher yields and more security than most other bonds. This positioning is not an attempt to 'outsmart' the bond market, but rather an alignment of our client-centered fixed income approach and current bond market conditions. It so happens that they align exceptionally well right now.

At the start of this letter, we highlighted intellectual integrity as a core value. When it comes to economic policy, geopolitics, law, currency movements or popular trends, we don't prognosticate… but we don't stick our heads in the sand either. We do the reading, ask the questions, and develop objective opinions; but we don't let those opinions become the primary driver of stock selection.

There are always temptations to over-analyze, predict macroeconomic trends, and chase performance; to stray from what you do best and assert expertise in uncharted areas. But responsible stewardship of client assets starts with intellectual honesty; and for us, that means steadfast adherence to a disciplined investment approach. We know what we do well, and we are committed to the values that have helped our clients thrive for nearly 170 years. As always, we appreciate the trust you have placed in HM Payson.

This newsletter is intended for educational purposes only. For financial planning advice specific to your needs or for further information, please consult your portfolio manager.