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# QUARTERLY MARKET OUTLOOK

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CETERA® INVESTMENT MANAGEMENT

## At-A-Glance

U.S. Gross Domestic Product (GDP) growth in the first quarter of 2023 was 1.3%. The Atlanta Fed is estimating second quarter GDP growth to be near 2%, ahead of consensus estimates of near 1%.

The Consumer Price Index (CPI) decreased to 4.1% year-over-year in May, but the Core CPI is higher at 5.3%. The Fed prefers core measures of inflation and wants to keep inflation near 2%.

The Fed finally paused its rate hikes in June after 10 consecutive rate increases over 15 months. Rates were increased only 0.25% in the second quarter, putting the current target range at 5.00% to 5.25%.

Stocks continued their upward momentum in the face of debt ceiling negotiations that went down to the wire. Investors are growing optimistic about possible rate cuts next year.

Bond investors seem content and are not demanding higher yields for a possibility of a recession. Credit spreads are slightly elevated but not at recessionary levels.

# 2023 MID-YEAR OUTLOOK

## Climbing a Wall of Worry

### Overview

In the second quarter, the S&P 500 index broke out of a bear market and entered a bull market, rising 20% off its low point in October. Much of the strength in markets was driven by megacap growth stocks, partially fueled by enthusiasm around artificial intelligence. A handful of stocks that make up a large weighting in the index accounted for most of the run-up, though participation broadened somewhat in the first few weeks of June.

While markets climbed higher, the quarter was not free of hazards. Congress needed to pass a bill to raise the U.S. debt ceiling but could not agree on the terms, which caused the U.S. Treasury Department to use what they called “extraordinary measures” to avoid a default. We did not think a default was a very probable outcome and markets agreed, largely dismissing this notion.

A lot of forward-looking economic data is pointing to elevated recession risks, and many are calling it the most anticipated recession in history. Yet, stocks continue to “climb a wall of worry,” as the old Wall Street adage goes.

Many are asking if this stock market rally is sustainable, and that is a good question. The rally has been narrowly driven by a few stocks in the index. You may have seen this in your account statements as many portfolios have failed to keep up with the indexes. Portfolios are generally more diversified than the S&P 500 index that is becoming more concentrated. Will a rising tide lift all boats, or will those high-flying stocks eventually sink?

While economic data may be signaling a possible recession, there are some optimistic signs as well. Some interest-rate sensitive parts of the economy that were hit first by high interest rates seem to be recovering, such as the housing market. This could give credence to the idea that we could see a rolling recession. A recession that is not broad-based but that rolls through different areas of the economy at different times. We think this could be too optimistic, but we do think this also supports our base case scenario of a mild recession.

With price-to-earnings (P/E) ratios arguably stretched in large cap growth stocks, we could see volatility in stock markets—something that has been absent recently. As such, we recommend diversifying within large cap stocks and continuing to diversify by investing in mid cap, small cap and international stocks which have better P/E ratios relative to their historical averages.

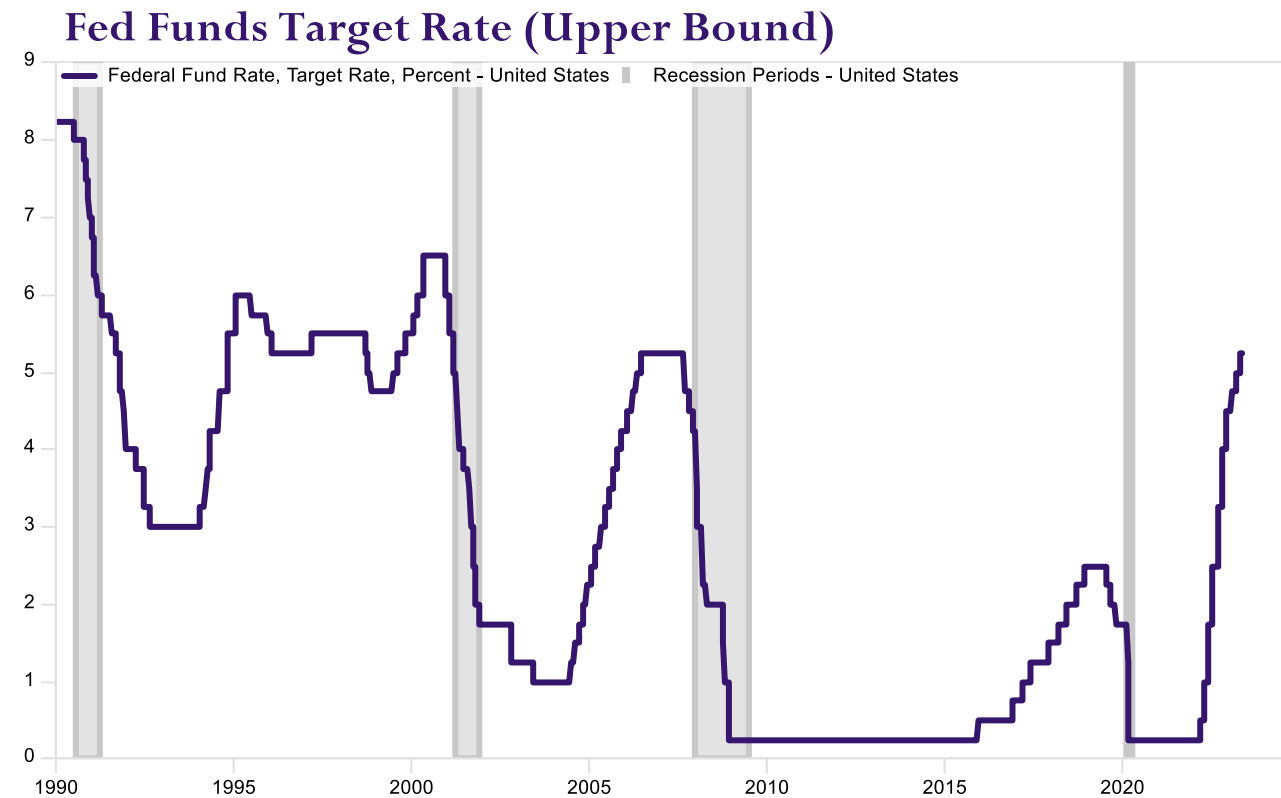
Your financial professional can help you stay on track and keep focused on your personalized long-term plans, helping you navigate through market volatility.

## Global Economy

The U.S. economy may find itself at an inflection point in the second half of 2023. The economy generally takes about a year to truly feel the impact of Fed rate hikes and the Fed only started raising interest rates in March 2022. As seen in **Figure 1**, the upper bound of the Fed's Funds rate is currently 5.25%. In June of 2022, the upper bound was only 1% and by last December it was increased to 4%. So, the economy has arguably only been feeling a small fraction of the rate hikes thus far. As we spoke in our last quarterly outlook, cracks are already starting to emerge as evidenced by the banking sector. With inflation running high long before the Fed acted, the Fed was forced to raise rates faster without the opportunity to gauge the impact of those hikes.

The speed and magnitude of the rate hikes present risks to the economy, which we will be watching closely. We will discuss some forward-looking economic indicators later in this section, but before we do that, let's focus on inflation, because that is the Fed's focus right now.

**Figure 1: Fed Rate Hikes**



Source: Cetera Investment Management, FactSet, Federal Reserve. Data as of 5/31/2023.

### ***Easing Inflation***

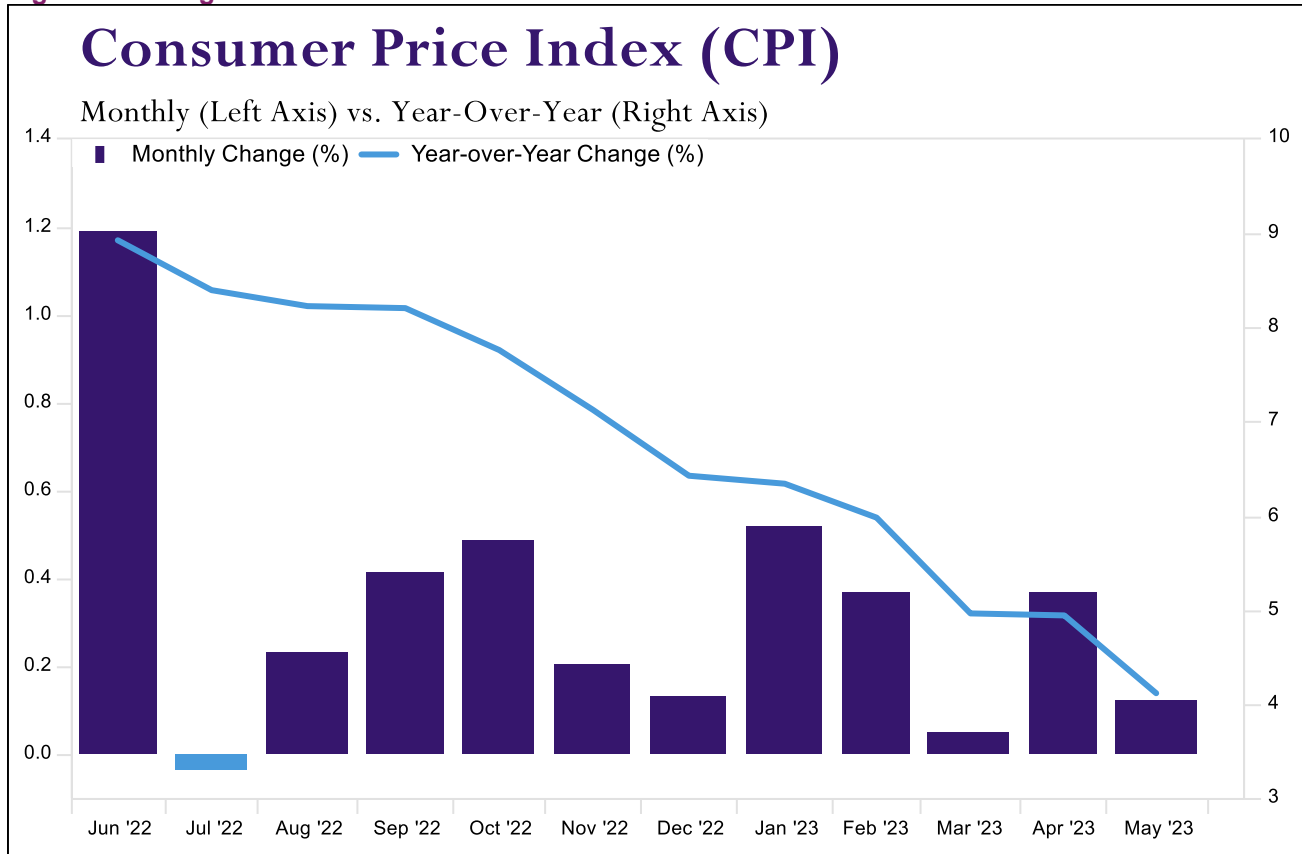
The good news is that inflation is easing. It is important to note that inflation is not declining, as that is often a confusing point for consumers who continue to see prices rise. The Fed is trying to control the speed of these price increases. Unfortunately, if you paid \$15 for a pizza a couple years ago and now it is \$25, it likely won't be going back down to \$15 again. The Fed is trying to prevent your pizza from going to \$30 next year.

As we explained before, inflation can be confusing, hard to measure, and it impacts everyone differently. We don't all buy the same basket of goods. Whether you rent a home or own a home makes a big difference as does the city you live in and the stage you are in your life. Often, the media refers to inflation on a year-over-year basis, but inflation was running hot a year ago and has since cooled.

If we look at rolling 12-month periods which are used to calculate a year, most recently, May of 2022 dropped off the 12-month calculation of the consumer price index (CPI) which led to a large decrease in year-over-year inflation. This is known as the base effect. From **Figure 2**, you can see that when June drops off the 12-month calculation that may also contribute to a significant drop in inflation.

If we change our focus to monthly CPI numbers, the last three months increased at an annualized pace of 2.2%, while if we annualize the last six months, we get 3.2%. This is above the Fed's 2% target but a little below the 4.1% that we have seen over the past year. For context, CPI inflation peaked at 9.1% year-over-year in June 2022. Inflation is running at rates lower than the annual rate in recent months. Also, if we smooth the data and take out the top 8% and bottom 8% of inflationary categories, mean CPI was near pre-pandemic levels in May. The Fed is aware of this but also needs to be cautious. Core inflation, the Fed's preferred forward-looking inflation measure, which excludes volatile categories food and energy, is not easing as much. That may soon change though as used car prices and rents are starting to slow. Rents tend to lag other metrics like home prices, so it may just take a little longer for rent prices to adjust.

**Figure 2: Easing Inflation**



Source: Cetera Investment Management, FactSet, U.S. Bureau of Labor Statistics. Data as of 5/31/2023.

### ***The Hawkish Pause***

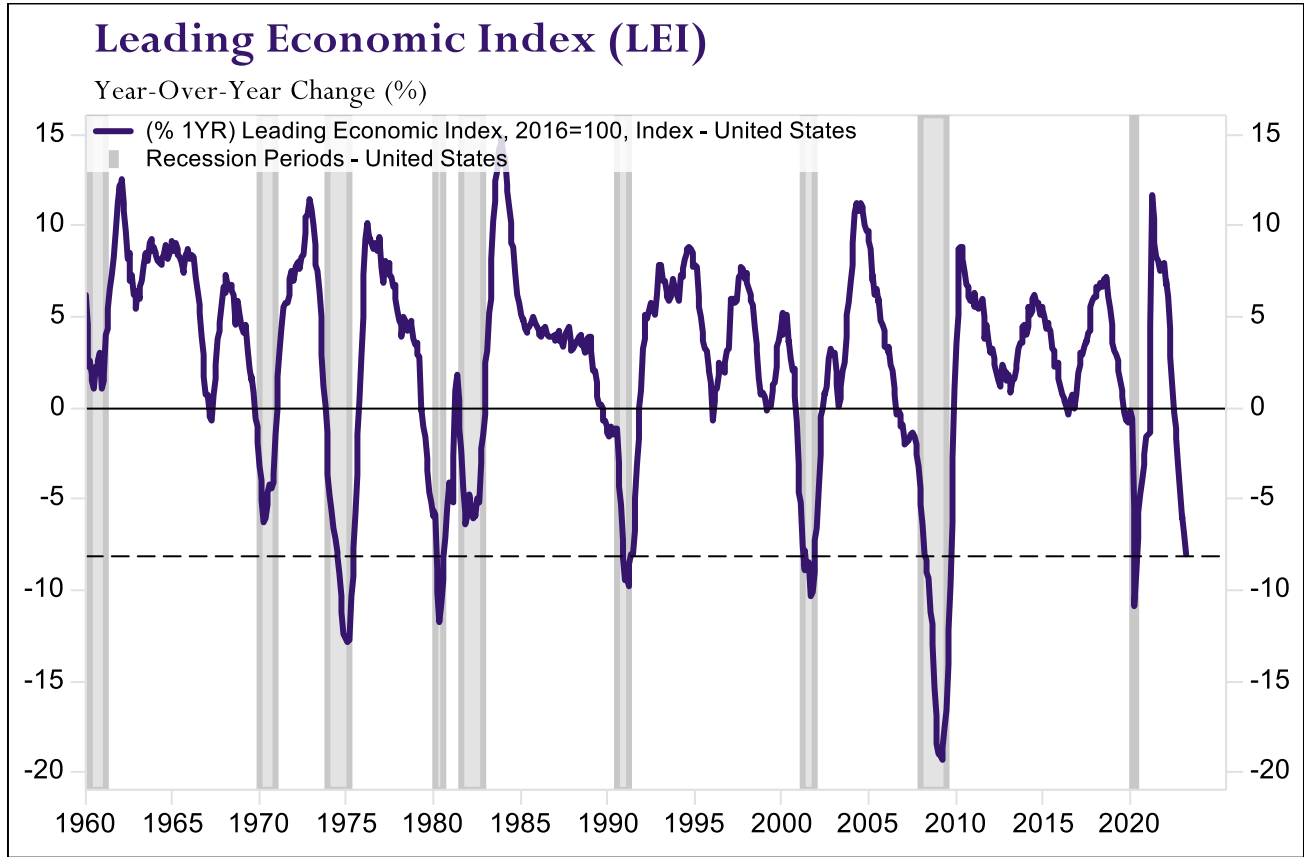
The Fed did what markets expected in June and paused their rate hikes, but still left the door open for future hikes. Last year the Fed may have telegraphed their plans as Fed Chairman Jerome Powell spoke often of the high and persistent inflation in the late 1970s and early 1980s. Early on, he seemed concerned about expectations and spoke sternly about the Fed's commitment to killing inflation. If consumers expected inflation to be higher in the future, they would buy more now rather than wait, and this would perpetuate more inflation. We never really saw this psychological element play out like it did in the 1970s. The other lesson, and maybe the most important one that the Fed may have learned, is regarding cutting rates too soon. The economy entered a recession and the Fed slashed rates from 20% to 9% in the middle of 1980. Unfortunately, we learned it was possible to still have high inflation in a recession, even with high unemployment—a phenomenon now known as stagflation. The Fed was forced to quickly raise rates back to 20% and the United States went into another recession in 1981 which lasted even longer.

It is hard to anticipate what the Fed may do in the face of new data, but if we look back to Fed speeches when they began hiking rates, it was clear they did not forget the past. The Fed may be reluctant to cut rates even if inflation data gets better and the economy enters a recession. Even with the Fed pausing interest rate hikes for now, a Fed policy mistake is still possible. Did they raise too much too fast? Will they cut rates soon enough or too soon? While there are parallels to the past, this time is different. Inflation is not as high as it was then, and the psychology of inflation never gained traction today. Customer surveys point that people fear a recession more than inflation.

### ***Reading the Tea Leaves***

If we look at leading economic indicators to determine if a recession is on the horizon, they are pointing in that direction. **Figure 3** looks at the Leading Economic Index (LEI). It is an index of leading indicators, comprised of 10 components, including but not limited to housing, consumer expectations, lending and the labor market. Every time we have been at the current level of this index, we have experienced a recession (since 1960), as indicated by the light gray bars in the chart.

Figure 3: Leading Indicators Flashing Red



Source: Cetera Investment Management, FactSet, The Conference Board. Data as of 4/30/2023.

We don't want to be overly pessimistic, though. While we do believe recession risk is elevated, we also believe that if a recession occurs, it will be mild. If the economy contracts, the labor market should weaken. However, the labor market is starting from a point of strength with an unemployment rate at very low levels. Also, some areas of the economy are already showing signs of recovery. New home sales are rising from their lows and auto sales are trending higher again. In the manufacturing sector, construction spending on new factories has surged, and input costs are falling. People are flying again, and TSA checkpoint passenger traffic is trending at 2019 levels. The economy is also seeing a boost from rising nonresidential construction. Up to this point, the labor market has been resilient despite monetary headwinds. Through the first five months of the year, the labor market expanded by more than 300,000 jobs a month, significantly above trend when compared to pre-pandemic levels.

We will continue to follow the economic data closely, as the next few months could be very telling as far as what direction the economy is headed. Again, we are anticipating a mild recession could arise from the effects of the strong pace of Fed rate hikes. At this stage, the Fed seems more concerned about repeating the mistakes made then and possibly making new mistakes today.

## Global Economy

Global economic growth expectations have increased since the first quarter, as world economies have been resilient. U.K.-based economic firm Capital Economics increased its global economic growth estimate by close to a half percent to 2.6%. Eurozone Purchasing Manager Indexes (PMIs) have been in expansion territory nearly all year. These are surveys given to business leaders to gauge what the future will be like for their businesses. As such, Capital Economics increased their economic growth prospects for the Eurozone again. This time from -0.1% to 0.1% economic growth in 2023. Forecasts for the U.K. improved from -0.4% to 0.1% and Japan went from 0.1% to 0.4%. The European Central Bank (ECB), however, could be a headwind for the European Union for some time. The central bank raised rates again in June and telegraphed to markets it isn't stopping anytime soon. Inflation is running hot in Europe, as CPI is over 6%. The ECB's policy rate is only 3.5% though, much lower than the Fed Funds rate.

Capital Economics expects that the U.S. is currently expected to grow at a pace of 2.6% for the year, up from the previous projection of 1%. This is much more optimistic than the Federal Reserve's expectations, which recently increased its projections from 0.4% to only 1.0%. Considering first-quarter GDP growth was around 1.3% and the Atlanta Fed estimates GDP in the second quarter to be near 2%, this could still indicate a recession may arise in the second half of this year. These are also relatively low global growth rates, so it would not take much deviation from these expectations to see a global recession. Again, economies do seem resilient, so at this point we would anticipate a mild recession if there were an economic setback.

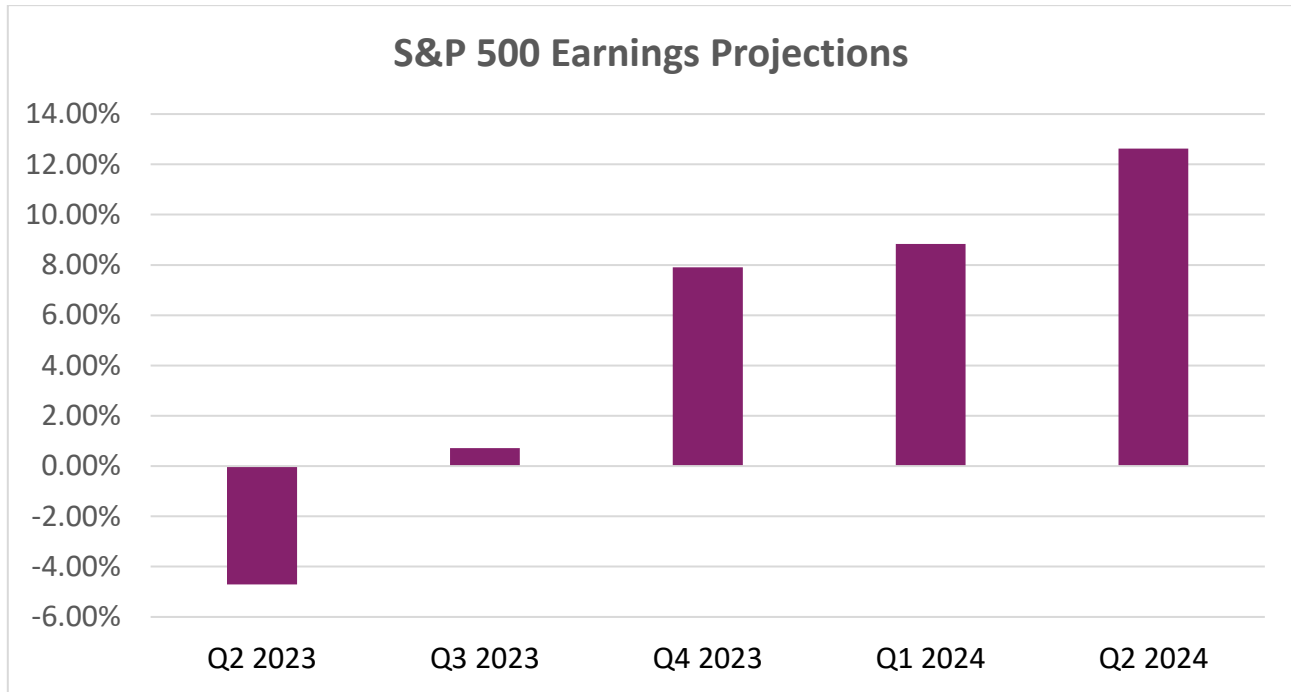
## Equity Markets

Stocks have largely defied gravity in the first half of 2023, rising higher as we could be approaching what many are calling the most anticipated recession ever. The old Wall Street adage that "stocks climb a wall of worry," seems to be appropriate. Investors currently expect the Fed to pause and not cut rates until sometime next year. Since markets are forward looking, this could explain a lot of the stock market enthusiasm, but are the markets too optimistic about potential rate cuts and not pessimistic enough about the reasons for these potential cuts?

We think investors *are* probably too optimistic, but also understand some of their enthusiasm. As we mentioned, inflation seems to be rolling over quickly and the economy and labor market thus far have withstood the barrage of rate hikes like a champion boxer taking punches. We saw cracks in the banking sector already and there may be more areas of the economy to feel the effects soon. Additionally, the Fed may still make missteps, lowering interest rates too fast or not fast enough. These are the risks, but let's turn to the earnings outlook for more clues as to what investors might be thinking.

The earnings recession looks to be ending soon. While second quarter S&P 500 earnings are expected to be negative for the third consecutive quarter, the third quarter is expected to turn positive (**Figure 4**). Earnings growth for the next three quarters after that are expected to be high single digits and low double digits. As inflation moderates, companies will likely keep their prices steady and lower input costs could mean higher profit margins. This could lead to upside earnings surprises as we discussed in our 2023 Outlook.

**Figure 4: Better Earnings on the Horizon?**



Source: Cetera Investment Management, FactSet. Data as of 6/15/2023.

If we dive into market dynamics, market breadth has been weak since early March, but this can change quickly. What we mean by weak market breadth is much of the S&P 500 returns early in this second quarter rally were driven by only a few companies that make up a large part of the index. This is why you probably have not seen your portfolio keep up with the S&P 500. Being diversified away from these top holdings has not helped over this short period of time. The index has become more concentrated, and the top 10 holdings make up over 30% of the S&P 500. While we did touch this level as recently as late 2021 and early 2022, this concentration hadn't been that high since the dot-com bubble in the early 2000s when tech stocks at the top became a large part of the index. Some are drawing parallels to the dot-com bubble and the exuberance for artificial intelligence (AI).

While it is an interesting parallel, price-to-earnings ratios are not at those levels. Looking at trailing 12-month P/Es the dot com bubble saw large cap growth P/Es over 45. Today, they are close to 30, but still above the 20-year average of 21.54. The good news is that large cap value, mid cap, small cap, and international stocks (including emerging markets) are near or far below their 20-year averages, meaning they are less expensive relative to their earnings.

What many called the lost decade from 2000-2009, was not lost if one was diversified in other asset classes. Large cap growth was one of the only major asset classes that was negative during that decade.

## Fixed Income

Starting with United States Treasury yields, the 10-year Treasury yield started the year around 3.8% and grinded lower on optimism around Fed rate cuts later in the year. It made its way under 3.3% in early April and has since been seesawing higher back to near where it started the year. While longer maturity bonds like 10-



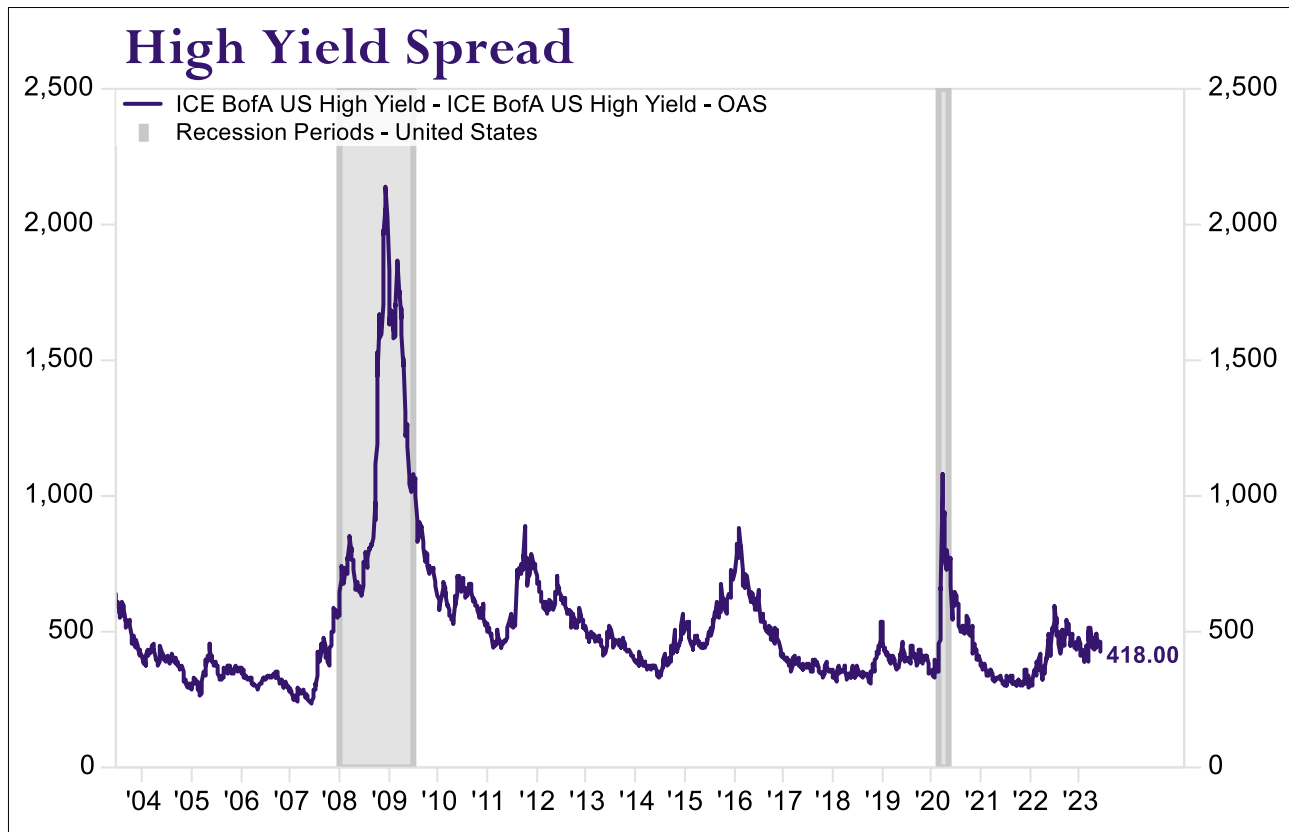
year Treasury bonds are influenced more by future growth and inflation expectations, shorter-term bonds like 2-year Treasuries are influenced more by the Fed. Many even look at the 2-year Treasury yield as an indication of where the market thinks the Fed funds rate will be a year in the future. It started the year at 4.4% and as of mid-June is at 4.74%. The market has been gradually pricing in a more aggressive Fed throughout the year, so that is why this yield has been rising. It is lower than the current Fed Fund rate because the market thinks there will be rate cuts over the next 12 months. If the Fed surprises markets with deeper cuts than the market anticipates, this could be a tailwind for these types of bonds as they appreciate in price when yields fall. This could be an opportunity for bond investors.

Typically, longer term bonds have a higher yield than shorter-term bonds, but as you can see from above that isn't always the case. The two-year Treasury yield has been higher than the 10-year Treasury yield since the summer of last year. This can be a sign a recession is coming as future economic growth prospects seem less than current ones. The inverted curve also hurts banks as they make money from longer-term bonds and mortgages and pay deposits at short-term rates. If a recession hits, longer-term and intermediate-term Treasury yields would likely fall, and bond prices would rise. All else equal, if yields stay where they are, investors can expect bond returns to be the current yields, which are higher than recent history.

Adding a credit component to this equation does change things. Treasuries are issued by the government and considered risk-free in the sense the U.S. shouldn't default on them. It can always issue more bonds to pay its debt. Some readers might be questioning this, because during the debt ceiling debates, this idea was put into question, but markets never seemed to doubt that the ceiling would be raised. Regardless, corporate and municipal bonds require extra spread over Treasuries to compensate for the possibility of default or credit downgrade.

Credit markets can also be a good gauge of the future stock market as credit spreads tend to widen before a stock market correction as bond investors demand more compensation for the increasing risk of a credit event. Looking at spreads in both investment-grade and below-investment-grade bonds, they are not indicating a stock market correction or recession. As seen in **Figure 5**, below investment-grade, or high-yield spreads are not at levels we traditionally see before a recession. The gray bands indicate past recessions (2008 and 2020). If we did experience a recession, we would expect these spreads to widen and the price of these bonds to fall in relation to their credit sensitivity.

Figure 5: High Yield Bond Spread



Source: Cetera Investment Management, FactSet, Bank of America Merrill Lynch. Data as of 6/14/2023.

Overall, we are cautious on high-yield bonds and would favor higher rated ones. Treasuries and investment-grade corporate bonds could be good opportunities if you expect volatility to pick up again in equity markets and a possible recession on the horizon. As mentioned in prior outlooks, the risk-and-return dynamics have changed since last year and the yields can better compensate bond holders for upward price movements. Although we would expect bond prices to fall over time, making bonds even more attractive. There is reinvestment risk in shorter-term bonds because as they mature it may not be possible to reinvest at the yields they were paying. We recommend being diversified within maturities for this reason. For those that have tactically invested in money market funds and cash-type investments for the higher rates, it may be time to consider moving out in duration more, or in other words increase interest rate sensitivity, and diversify the maturities as these rates will likely fall over the course of the next year. When money market rates fall, there is no price appreciation if the net asset value (NAV) is stuck at \$1. One should stay within their risk and return objectives when making these decisions.

### The Bottom Line

The clouds of uncertainty seem to be dissipating and investors are eagerly anticipating some sunshine. We appear to be near the end of the Fed rate hike cycle, although we could still get a couple more 0.25% increases if core inflation doesn't ease quickly. But inflation is trending in the right direction, and it is expected that lagging categories like rents will eventually catch up and bring down inflation even more. The biggest risk factor could be the Fed keeping rates higher for longer in the face of a recession, trying to avoid what happened in the early 1980s. We feel that while there are similarities, this time could be different. While a recession could be

on the horizon, we do think it would be mild. The labor market is strong, and we are in a consumer-driven economy. If people remain employed and don't fear losing their jobs, they will likely continue to spend money. The labor market should weaken if the economy contracts, but it is coming from a point of strength with very low unemployment. Volatility has been somewhat absent recently but may come back, so it is important to remain diversified and not start chasing stocks that have run up in price recently. Sticking to long-term risk-and-return objectives is important, and not getting caught up in market movements up or down is key. Momentum in both directions can cloud investor psychology.

As always, count on your Cetera financial professional to help you through these volatile times and keep you focused on your personal goals and objectives.

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A diversified portfolio does not assure a profit or protect against loss in a declining market.

## Glossary

The **S&P 500** is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The **ICE BofA US High Yield Index** tracks the performance of US dollar denominated below investment grade rated corporate debt publicly issued in the U.S. domestic market. Securities must have a below investment grade rating (average of Moody's, S&P, and Fitch) and an investment grade rated country of risk (average of Moody's, S&P, and Fitch foreign currency long term sovereign debt ratings). Each security must have greater than 1 year of remaining maturity, a fixed coupon schedule, and a minimum amount outstanding of \$100 million.