Market Review and Outlook

- Economic growth over the past quarter has once again defied expectations, inviting investors to chase advances and climb the wall of worry. However, analysts remain cautious about future earnings given that the rising tide has not necessarily lifted all boats.
- Stronger growth and still-sticky inflation convinced the Fed that at least one further rate increase may be necessary, and interest rate expectations and forward guidance have been revised higher as a result, dashing hopes for the start of rate cuts this year.
- Global growth has similarly held up well, but once again some of this is being disguised by higher inflation and nominal growth rates rather than healthier unit volume growth.
- While the situation in Ukraine continues to be globally distressing, relations with China have also deteriorated, leaving notable geopolitical risk firmly on the table.
- Looking beyond the cyclical volatility, we remain positive about many of the growth trends we are witnessing across the economy.

While three months can feel like a short period to see significant changes, it is always astounding to look back at the end of each quarter at what actually has changed. This has been particularly true since the pandemic, where each quarter has brought with it often quite radical swings in fiscal or monetary policy and big changes in global economic activity, financial markets, or even geopolitics. This past quarter was once again no exception.

At the start of the quarter, sentiment was still high that an economic recession was imminent. The regional banks were just the next domino to fall following the fastest Fed tightening cycle in decades, the housing market was already in swift decline, we had just experienced the worst bond market performance on record, and equity market sentiment was still extremely bearish following the 25%-plus declines through 2022.

Yet just a few months later, economists seem much less convinced about the possibility of a recession given that much of the economic data has continued to surprise to the upside. For example, U.S. nonfarm payrolls have shown no signs of slowing (rising 339,000 in May); new home sales also jumped by 12.2% in May and housing starts by 21.7%; and consumer confidence has also seemingly reached a bottom and is tentatively rising.

The stock market, meanwhile, finished 8.7% higher in the quarter and is up 16.9% over the first six months of 2023. According to one definition of bear markets—i.e., the bear market ends when the S&P 500 increases by 20% from the bear market low—the stock market entered a new bull market on June 8, though it is still roughly 8% below the January 2022 peak.

The progression of earnings estimates, however, suggests that market analysts have been more cautious in revising their estimates upward. While the release of the first quarter's earnings forced that quarter's expected growth rates higher (please see exhibit 1), this does not seem to have resulted in any knock-on effects into the other quarters. Therefore, analysts seem to be taking a see-it-to-believe-it approach.

We suspect that there are a number of reasons for this. The first is that higher nominal earnings have been driven more by price increases and inflation rather than volume gains. For example, over the 12 months from May 2022 to May 2023, total retail sales were up 1.6%. After inflation, however, unit volumes were actually 2.5% lower. Unsurprisingly, analysts are taking a more cautious approach to future earnings growth.

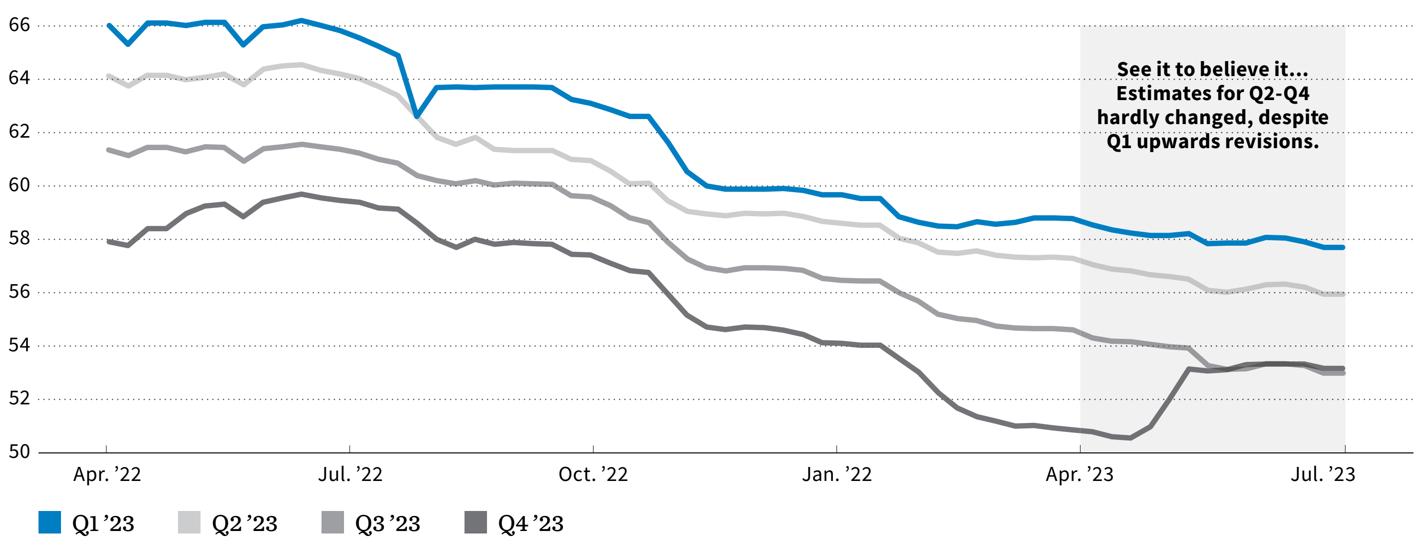
Second, it is likely that the bulk of the impact from higher interest rates is still not being fully felt, given that most households have fixed-rate mortgages and the corporate sector also wisely extended the duration of its debt when rates fell back to the zero lower bound during COVID. Yet, as long as rates stay high, or rise further through the rest of the year, this so-far muted rate impact is unlikely to remain benign.

Market Review and Outlook

EXHIBIT 1

Progression of S&P 500 Bottom-Up EPS Estimates

(2023, $/Shr)



Sources: I/B/E/S Refinitiv, William Blair Equity Research

Third, much of the market's recent euphoria is being directed at just a handful of AI-related tech stocks (and more recently some cruise stocks that are rebounding from COVID lows). Therefore, while the market-cap-weighted index increased by 16% in the first six months of 2023, an equally weighted measure rose just 6%. The breadth of these changes did notably start to improve in the last few days of the quarter.

From the Fed's perspective, with growth still quite strong and core inflation still at 5% and (so far) moderating only slowly, it is once again having to drive rate expectations higher. At the start of the quarter, financial market participants were expecting the Fed to lower rates in the second half of 2023 by 50 basis points. Today, rates are expected to rise a further 25 basis points by year-end, with the peak rate now expected to be 5.4% and the low in the coming few years expected to fall to only 3.9%. The message from the Fed is very clear—it will not go down as another Arthur Burns Fed, which failed to adequately quell inflation, but is intent on replicating the Volcker Fed of doing whatever it takes to return inflation to its 2% target no matter the cost.

Conversely, economic growth in China has significantly underperformed expectations. As the extreme lockdowns from the pandemic have ended there, many were anticipating a surge in pent-up demand being exercised similar to what took place across the Western world. So far that has not been the case, as a nation of savers continues to want to save, to the extent that the authorities there have had to start taking further stimulus measures, such as lowering interest rates.

The economic performance of the emerging markets has also held far better than expected, as these are normally the most sensitive to rate increases in the United States. The result is that we have not seen a major flight to safety in the dollar, and instead some dollar weakness over the last few months.

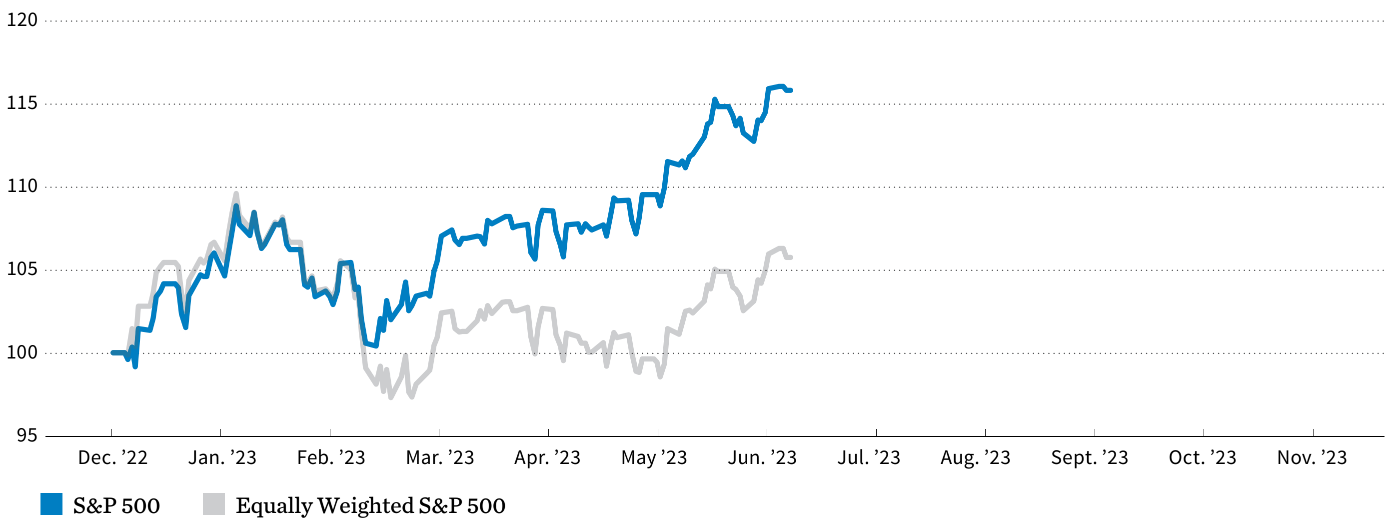
Geopolitically, the situation in Ukraine remains relatively stable, and perhaps is even improving with the exit of Russia's warmonger-in-chief Yevgeny Prigozhin, head of the mercenary Wagner Group. However, the situation in China has clearly escalated to the point where a series of officials, from Secretary of State Blinken to Treasury Secretary Yellen, have been dispatched to try to restore some level of

Market Review and Outlook

EXHIBIT 2

S&P 500 vs. Equally Weighted S&P 500

(Indices Rebased to 100 Year End 2022)

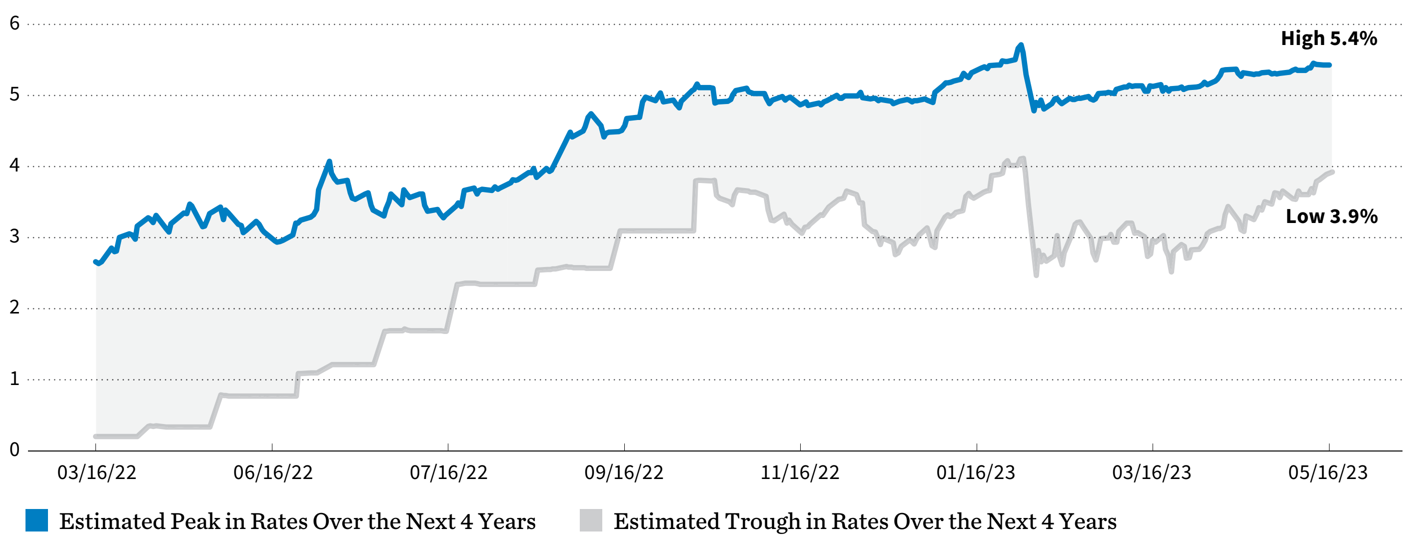


Sources: Bloomberg, William Blair Equity Research

EXHIBIT 3

Progression of Expected Range for Fed Funds Rate in Next 4 Years

(Fed Funds Futures Pricing, %)



Sources: Bloomberg, William Blair Equity Research

Market Review and Outlook

diplomacy among the two nations. In the meantime, many Western investors and companies continue to disengage with China, fearing the impact to growth of any further heightening of geopolitical tensions.

Looking a little further out, while we remain healthily cautious about the near-term cyclical growth dynamics and see this as a strong argument for continued active portfolio management, we also remain positive on a number of secular changes taking place in the economy—particularly in the technology arena—which we believe will positively, and structurally, impact growth in the coming years.

Wealth Planning Tip

Ancillary Probate:

Ancillary probate occurs when property is owned in a state outside one's residence. It adds expense and complication to the settlement of an estate and can be avoided. Using a revocable trust to hold the title to the property (in both the state of residence and the other state(s) where property is owned) will avoid probate with the property. Going through probate is not the worst thing, but minimizing it or avoiding it is preferable. We recommend you examine your own situation and address it with your legal counsel if this issue is present.

Index		YTD	Q2	1Y
S&P 500	US Large Cap	16.89	8.74	19.59
DJIA	US Large Cap	4.94	3.97	14.23
Russell 3000	US All Cap	16.17	8.39	18.95
Russell 2000	US Small Cap	8.09	5.21	12.31
MSCI EAFE	Developed International	11.67	2.95	18.77
MSCI EM	Emerging Markets	4.89	0.90	1.75
Bloomberg Barclays US HY	US High Yield	5.38	1.75	9.06
Bloomberg Barclays US Agg	US Core Bond	2.09	−0.84	−0.94
Bloomberg Barclays Muni	US Muni Bond	2.67	−0.10	3.19
MSCI US REIT GR	US Real Estate	5.46	2.66	−0.09

Source: Bloomberg