Retirement Market RECAP Q2 2023

HANYS Benefit Services

So far, so good

While concerns of a recession loomed over the heads of investors entering 2023, both capital markets and the U.S. economy have been notably resilient through the first half of the year. Economic indicators show a downward trend in inflation without an accompanying rise in unemployment, showing signs the Federal Reserve's (the Fed) interest rate hiking cycle is working. Simultaneously, a growing interest in the capabilities and prospects of artificial intelligence has helped fuel an equity market rally, providing much-needed optimism for investors following a volatile and uncertain 2022.

However, there continues to be uneasiness in fixed income markets. A highly inverted yield curve and an expectation that the Fed will hold the terminal rate longer than anticipated has made investors feel they are not out of the woods yet. It appears unlikely the Fed will cut rates in 2023, as Chair Jerome Powell continues to echo an aggressive stance against inflation. Additionally, growing geopolitical tensions between the U.S. and China, further political instability within Russia and a potential recession in Europe continue to darken the backdrop of a globalized economy rather than illuminate it.

U.S. equity markets performed exceptionally well in the second quarter, following strong performance in the first quarter. The S&P 500 gained 8.74% in Q2, resulting in a year-to-date (YTD) gain of 16.89%. However, the equity market gains continue to be extremely concentrated. As Lauren Solberg of Morningstar explains, "the largest, growthiest tech names, including Apple, Microsoft, and Nvidia — were responsible for nearly all gains through May."[1]

Solberg continues, "Prior to June, without the supersized returns from these stocks, the overall market would have been flat, making for the most concentrated market in history." Nvidia has been a "key beneficiary" of the AI boom in recent months, most notably through its AI enterprise platform, NVIDIA AI.[2] Nvidia's performance in the first half of 2023 has been astonishing, with a gain of 189.5% YTD, while other beneficiaries of the AI buzz have also experienced outsized performance, with Advanced Micro Devices and Marvell Technology up 75.87% and 61.39%, respectively.[3]

Given the concentration of participants in the equity market rally, it may not be surprising that large-cap stocks fared better than mid- and small-caps. However, mid- and small-cap performances were still positive in Q2, with gains of 4.76% and 5.21%, respectively. Moreover, U.S. large cap equity outperformed its foreign peers in Q2, reversing a recent trend. The MSCI EAFE index, comprised of developed international stocks, appreciated by 2.95% during the quarter, compared to the S&P 500's 8.74% gain. International developed equities have experienced strong performance over the last nine months against the backdrop of stronger than expected economic indicators and a mild winter. Emerging markets continued to struggle relative to other equity markets, gaining just 0.90% for the quarter, driven by the stagnation of the post-COVID reopening in China.

While stock market gains thus far in 2023 have provided investors with optimism, fixed income markets paint a murkier picture. The Bloomberg US Aggregate Bond Index declined by 0.84% in Q2, hindered by a deeper inversion of the yield curve. However, a standout performer in fixed income was high-yield bonds, gaining 1.75% for the quarter and 5.38% YTD. High-yield bonds are more speculative in nature (below investment grade) with ratings of BB or lower. These bonds typically display higher correlation to equity markets than other fixed income securities. This higher correlation was beneficial during Q2, as the asset class participated in the broader "risk on" market rally.

Fixed income markets will continue to be influenced by the actions of the Fed more directly than other markets due to their sensitivity to interest rates. At the June Federal Open Market Committee meeting, it was announced that there would be a pause in the cycle after ten successive hikes, leaving rates at 5.00% to 5.25%. However, "a strong majority of committee participants

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[1] Solberg, Lauren "14 Charts on New Bull Market for Stocks, Mixed Return for Bonds in Q2" *Morningstar.* July 3, 2023. https://www.morningstar.com/markets/14-charts-new-bull-stocks-mixed-market-bonds-q2

[2] Ibid.

[3] YCharts, NVIDIA Corp (NVDA). https://ycharts.com/companies/NVDA

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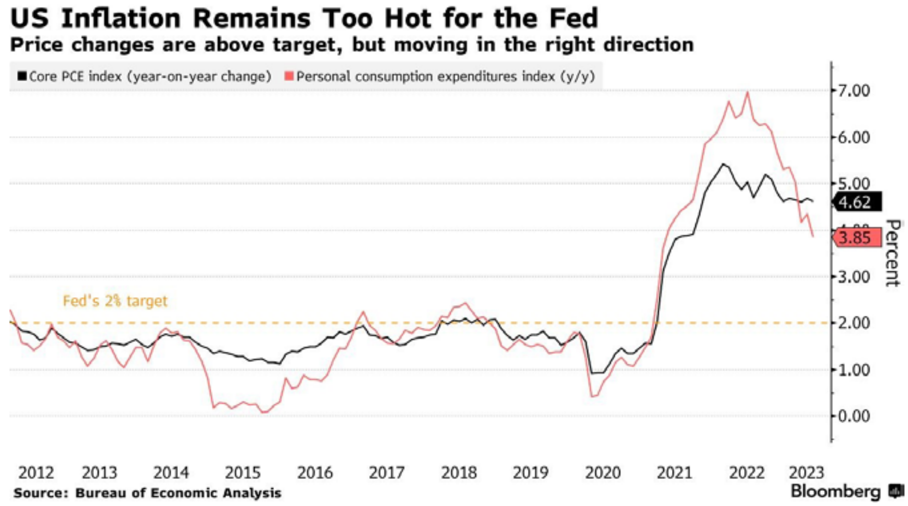
expect that it will be appropriate to raise interest rates two or more times by the end of the year," according to Chair Powell. "Inflation pressures continue to run high, and the process of getting inflation back down to 2% has a long way to go."[4]

These remarks were in sharp contrast to fixed income traders' hopes that there would be potential rate cuts in 2023. It is important to note the Fed still has a long way to go to reach its target of 2% inflation. As the graph details, while a trend of downward inflation readings is apparent, there is still considerable room for improvement, most notably in Core PCE,[5] the key gauge on which the FOMC has focused since the start of the hiking cycle 15 months ago. Fixed income markets will continue to keep a close eye on further rate hikes by the Fed, but also the period in which rates remain elevated to their peak level, known as the terminal rate.

Through June 2023, capital markets have provided a much more optimistic first half than what was experienced in 2022, with considerably less volatility. The U.S. economy continues to be robust, thus far eluding an expected recession, and a soft landing is becoming a more likely outcome for investors. However, the fight against inflation is not over. While headline equity market performance is strong, markets continue to be extremely concentrated. The coming months will be of vital importance to better quantify the unique dynamics of this market regime and determine whether a true "Goldilocks scenario" can be achieved.



[4] Saraiva, Cartarina, Soto, Alonso & Kennedy, Simon. "Powell Says Likely Need Two or More Hikes to Cool Inflation" *Bloomberg*. June 29, 2023. https://www.bloomberg.com/news/articles/2023-06-29/powell-says-two-or-more-hikes-likely-needed-to-cool-inflation#xj4y7vzkg

[5] Matthews, Steve. "Fed Minutes to Offer Hints on 'Awkward' Pause-and-Hike Message" *Bloomberg*. July 5, 2023. https://www.bloomberg.com/news/articles/2023-07-05/fed-minutes-to-offer-hints-on-awkward-pause-and-hike-message

EQUITY AND RETIREMENT INDICES	3 MO	YTD	1 YR	3 YR	5 YR	10 YR
S&P 500 TR USD	8.74%	16.89%	19.59%	14.60%	12.31%	12.86%
Russell 3000 TR USD (Broad Market)	8.39%	16.17%	18.95%	13.89%	11.39%	12.34%
Russell 1000 TR USD (Large Cap)	8.58%	16.68%	19.36%	14.09%	11.92%	12.64%
Russell Midcap TR USD	4.76%	9.01%	14.92%	12.50%	8.46%	10.32%
Russell 2000 TR USD (Small Cap)	5.21%	8.09%	12.31%	10.82%	4.21%	8.26%
MSCI EAFE NR USD (Int'l Equity)	2.95%	11.67%	18.77%	8.93%	4.39%	5.41%
MSCI Emerging Markets NR USD (E.M. Equity)	0.90%	4.89%	1.75%	2.32%	0.93%	2.95%
S&P United States REIT TR USD (Real Estate)	2.65%	5.45%	-0.06%	8.91%	4.50%	6.27%
Morningstar Lifetime Mod. TR 2020	1.78%	6.18%	1.78%	2.96%	4.28%	5.39%
Morningstar Lifetime Mod. TR 2040	3.71%	9.22%	3.71%	8.16%	6.13%	7.70%

FIXED INCOME INDICES	3 MO	YTD	1 YR	3 YR	5 YR	10 YR
ICE BofA 3M US Trsy Note TR USD	1.18%	2.33%	3.69%	1.32%	1.61%	1.02%
ICE BofA 1-3YR US Trsy TR USD	-0.57%	0.97%	0.13%	-1.05%	0.95%	0.77%
BBgBarclays Long Term US Trsy TR USD	-2.30%	3.72%	-0.94%	-3.96%	0.77%	1.52%
BBgBarclays US Aggregate Bond TR USD	-0.84%	2.09%	-6.82%	-12.09%	-0.88%	1.80%
BBgBarclays US Treasury US TIPS TR USD	-0.68%	1.49%	0.11%	2.34%	2.73%	1.72%
BBgBarclays High Yield Corp TR USD	1.75%	5.38%	9.06%	3.13%	3.36%	4.43%
BBgBarclays Global Aggregate TR USD (Global Bond)	-1.53%	1.43%	-1.32%	-4.96%	-1.09%	0.20%

ICE BofAML – Intercontinental Exchange Bank of America Merrill Lynch; BBgBarc – Bloomberg Barclays; S&P 500 – Standard & Poors; MSCI – Morgan Stanley Capital International
Sources: Morningstar as of June 30, 2023

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