ECONOMIC & INVESTMENT PERSPECTIVES

MAY: STOCK & BOND RALLY STALLS
INCREASINGLY NARROW EQUITY LEADERSHIP

Figure 1: 5/31/2023 Returns (source: Bloomberg)

Conditional formatting: green (high) to red (low) for each time period

Bonds	ETF	Month	YTD	1YR	vs. 52-wk High	vs. 52-wk Low
US Aggregate Fixed Income	AGG	-1.1%	2.6%	-2.2%	-5.6%	5.8%
Investment Grade Corp Bonds	LQD	-1.8%	3.4%	-2.5%	-6.5%	9.4%
U.S. Treasury Bonds	GOVT	-1.1%	2.6%	-2.1%	-5.1%	4.5%
U.S. 20+ YR Treasuries	TLT	-3.0%	4.5%	-9.2%	-14.7%	12.1%
Muni Bonds	MUB	-0.6%	1.7%	0.7%	-2.3%	5.0%
US High Yield	HYG	-1.2%	2.7%	-1.5%	-6.7%	5.3%
Non-US Corp Bonds	IBND	-3.1%	1.7%	-4.7%	-5.7%	15.9%
Emerging Markets Bond LC	EMLC	-0.6%	5.2%	3.3%	-2.6%	11.7%
Global Equity						
ACWI Global Equity	ACWI	-1.0%	7.9%	1.2%	-1.9%	21.0%
ACWI Global Equity ex US	ACWX	-3.7%	5.1%	-1.2%	-4.8%	23.2%
International Developed	EFA	-4.0%	7.7%	3.6%	-4.6%	29.4%
Emerging Markets	EEM	-2.4%	0.8%	-8.3%	-11.7%	14.1%
Global Equity by Region						
United States	VTI	0.4%	8.8%	2.1%	-4.6%	18.5%
Europe	IEUR	-5.4%	8.7%	4.1%	-5.8%	33.9%
Asia ex-Japan	AAXJ	-2.8%	0.0%	-8.1%	-11.3%	19.2%
China	MCHI	-9.4%	-9.0%	-14.8%	-24.2%	23.5%
Japan	BBJP	0.7%	9.0%	4.7%	-3.3%	22.8%
Latin America	ILF	0.2%	7.6%	-2.3%	-13.9%	18.7%
US Equity						
US S&P 500	IVV	0.4%	9.6%	2.8%	-3.4%	20.0%
NASDAQ 100 QQQ	QQQ	7.9%	30.9%	13.7%	-1.7%	36.9%
US Large Growth	IWF	4.7%	20.9%	9.5%	-1.4%	27.9%
US Large Value	IWD	-3.9%	-1.5%	-4.7%	-8.3%	10.8%
US Eqwt S&P 500	RSP	-3.8%	-0.7%	-4.5%	-10.3%	11.8%
US Mid Cap	IJH	-3.2%	-0.3%	-2.7%	-12.0%	10.6%
US Small Cap	VTWO	-0.9%	0.0%	-4.6%	-13.9%	6.9%

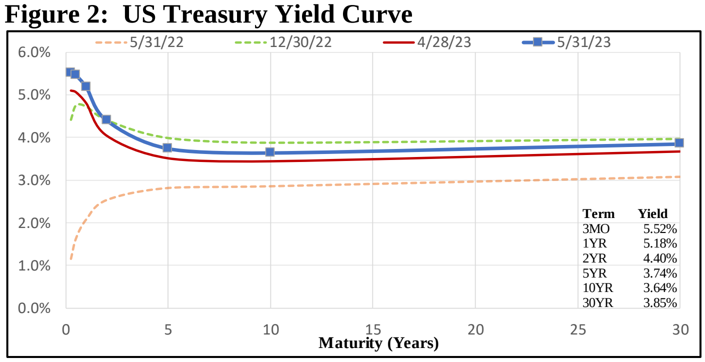
Global equity markets were mixed in May as investors digested the daily drama around contentious debt ceiling negotiations in Congress and the potential for an unlikely but economically catastrophic default on U.S. debt service obligations. Bond yields rose with the potential for further interest rate hikes. Performance highlights for the month and year-to-date (YTD) are below.

- Bonds: Bond prices fell in May as interest rates rose. The US Aggregate (AGG) index lost 1.1% (+2.6% YTD) with larger losses for long-term Treasuries (TLT) and investment grade corporate bonds (LQD). Non-US bonds in developed economies were weaker as the dollar strengthened; emerging market debt (EMLC) was down marginally but is still up 5.2% YTD.
- Global equity (ACWI) lost 1.0% in May (+7.9% YTD).
- US Equity: The broad market (VTI) gained 0.4% (+8.8% YTD), and the S&P 500 (IVV) was up 0.4% (+9.6% YTD). Positive returns have been concentrated in large growth (IWF), tech-oriented stocks and sectors, evidenced by the out-performance of the Nasdaq 100 (QQQ +7.9% in May, +30.9% YTD) versus the average stock return (RSP -3.8% in May, -0.7% YTD). Mid-cap and small stocks continue to under-perform.
- Non-US Equity: Developed markets (EFA) fell 4.0% in May (+7.7% YTD) as the recovery of European equities faltered (IEUR -5.4% in May, +8.7% YTD), but Japanese stocks were stronger (BBJP +0.7% in May, +9.0% YTD). Emerging markets (EEM) fell 2.4% (+0.8% YTD), led lower by China (MCHI -9.4% in May, -9.0% YTD) as their economic re-opening and recovery stalled amid slowing global growth.

Interest Rates and the Economy

The yield curve (Figure 2) plots the yields (Y-axis) for various maturities (X-axis) of U.S. Treasuries. Interest rates moved higher in May as continued economic strength (strong employment and corporate earnings) and inflation (declining but still too high) renewed expectations for further rate hikes by the Federal Reserve (Fed). The Fed raised their Fed Funds target rate to 5.00-5.25% early in the month; the futures market now indicates expectations for at least one more rate hike and that rates will remain higher for longer. The 10-year US Treasury yield rose to 3.64%.

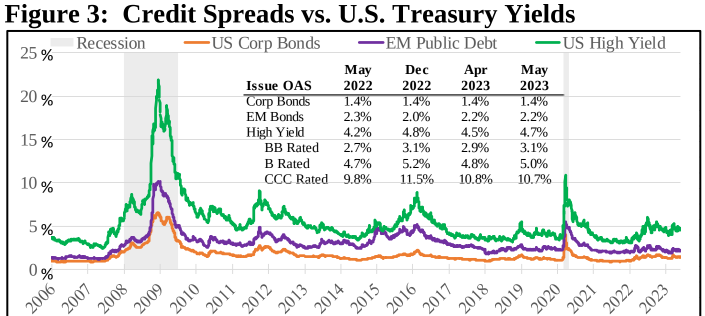
Figure 2: US Treasury Yield Curve



For bonds other than US Treasuries, we track the option-adjusted spread (OAS) between yields and Treasuries of comparable maturities (Figure 3). Low or narrowing spreads signal optimism, while high or rising spreads signal fear. Spreads steadied in May despite economic uncertainty and stress in the banking system.

- Investment grade corporate bond spreads are historically low at +1.4%, unchanged in May and versus a year ago.
- High yield (non-investment grade) spreads widened to +4.7% in May but have narrowed in 2023 after widening in 2022. The riskiest bonds (rated CCC & below) narrowed to +10.7% over Treasuries but are still wider than year-ago spreads.
- Emerging market spreads were steady at +2.2% and have been stable over the past year. Emerging market credit has out-performed US bonds recently with stable spreads and currencies.

Figure 3: Credit Spreads vs. U.S. Treasury Yields



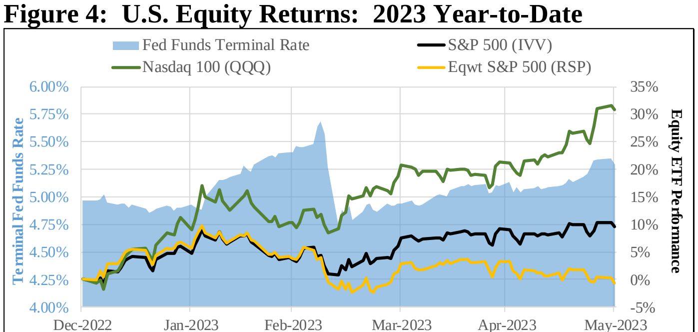
Source: Ice Data Indices, LLC via St. Louis Fed (FRED)

Increasingly Narrow Equity Leadership

Global equity markets have been surprisingly strong so far in 2023 despite significant headwinds, including elevated inflation, rising interest rates, bank failures, slowing economic growth, and geopolitical tensions (war in Europe). Additionally, partisan politics in the US regarding debt ceiling negotiations threatened to derail the supremacy and credit-worthiness of US Treasury debt, the world's safest investment asset, with potentially catastrophic economic consequences. Through all of this, equity markets have marched higher, but a deeper dive into the sources and breadth of those returns raises some concerns, especially within the US stock market. Figure 4 plots the year-to-date (YTD) returns for three index ETFs within the large-cap US equity market segment:

- **S&P 500 (ETF: IVV):** The index includes 500 of the largest and most important stocks in the US, weighted by each company's market capitalization (share price times the number of shares outstanding); therefore, the largest companies/stocks have the largest index and ETF weights.
- **Equal-Weighted S&P 500 (ETF: RSP):** This index includes the same stocks as the S&P 500, but each is weighted equally (1/500th or 0.2%) instead of by size (market capitalization); it is a good representation for the return of "the average stock".
- **Nasdaq 100 (ETF: QQQ):** The index includes the 100 largest stocks traded on the NASDAQ exchange. Most are also in the S&P 500, but QQQ is more concentrated (fewer stocks, larger weights by market capitalization) and is heavily tilted toward growth industries and sectors (tech, internet, biotech, etc.).

Figure 4: U.S. Equity Returns: 2023 Year-to-Date



Source: Bloomberg, Yahoo! Finance, CBOT Fed Funds Futures

As discussed in previous issues, stock returns in early 2023 were driven by changing interest rate expectations. The shaded blue area above plots changing expectations for the terminal (peak) Fed Funds rate (left axis). As interest rate expectations rose on stronger-than-expected employment and growth data in February and early March, stocks reversed earlier gains. Then, on March 10, something broke: High-profile bank failures brought interest rate expectations down (implying Fed rate cuts instead of more hikes). Stocks were initially spooked by the banking crisis but quickly resumed their uptrend, even as continued economic strength led interest rate expectations to rise all over again.

So far this year, the S&P 500 (IVV) is up 9.6%, but that stellar return masks what is going on underneath. *The average stock in the S&P 500 is actually down so far this year (RSP -0.7%)!* The strong "market" returns have been entirely driven by the largest, tech-oriented stocks which dominate the Nasdaq 100 QQQ (+30.9% YTD) and are heavily-weighted in the S&P 500 as well. Usually, when interest rates rise, growth-oriented stocks fall because so much of their perceived value is derived from future earnings growth, and the present value of those future earnings is a function of interest rates. Is something different this time? AI!

Artificial Intelligence (AI) has become the dominant driver of stock returns and news coverage, at least for now. Just a few months ago, none of us had ever heard of ChatGPT or had given much thought to AI as a near-term phenomenon, but today it is everywhere, and investors in ultra-large, tech-oriented stocks with huge systems and data resources have reaped the benefits. Bank of America Securities strategist Michael Hartnett has identified the stocks in Figure 5 as the "Magnificent Seven" of AI.

Figure 5: The "Magnificent Seven" of Artificial Intelligence

Stock	S&P 500 %Weight	Nasdaq 100 %Weight	YTD %Total Return	Sector
Apple (AAPL)	7.4%	12.1%	37%	Technology
Microsoft (MSFT)	7.0%	13.4%	39%	Technology
Alphabet (GOOGL, GOOG)	4.0%	8.2%	40%	Communications
Amazon (AMZN)	3.0%	6.7%	45%	Consumer Discretionary
Nvidia (NVDA)	2.7%	6.8%	175%	Technology
Meta (META, i.e. FaceBook)	1.7%	4.1%	119%	Communications
Tesla (TSLA)	1.5%	3.3%	63%	Consumer Discretionary
Total:	*27.3%*	*54.4%*		

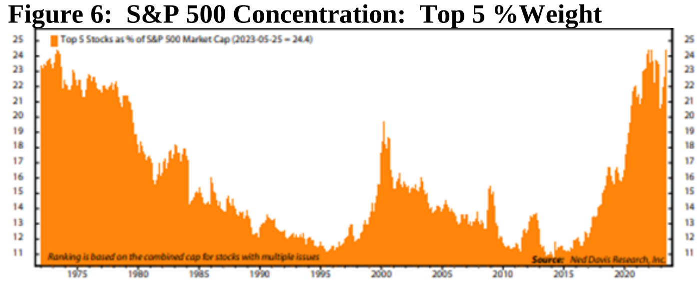
These stocks are so large (market capitalization) that they represent roughly 27% of the S&P 500 (IVV) by weight and more than 54% of the Nasdaq 100 (QQQ)! Their YTD returns are extraordinary, with Nvidia (specialized semiconductor chip manufacturer) up 175%, Meta (Facebook) up 119%, Tesla up 63%, and other tech behemoths (Apple, Microsoft, Alphabet, Amazon) up 37-45%. If you strip out the returns of these seven stocks, the US equity market is flat-to-down so far in 2023!

Bottom Line

Markets churned in May as stronger-than-expected earnings reports and economic data (job growth and record low unemployment) led investors to believe the Fed will raise rates further to slow the economy and tame inflation. Bond prices fell as yields rose, and US equity returns, while positive, continue to be concentrated in a handful of stocks, especially those with perceived advantages in the rapidly growing field of Artificial Intelligence (AI). The narrow breadth of equity returns is concerning, as most US stocks are flat or down this year, reflecting broader economic concerns (interest rates, recession risk, banking stability, etc.).

AI is truly revolutionary, and the large tech stocks are great companies with strong earnings prospects, but their meteoric returns have resulted in historically high concentrations within traditional equity indices and ETFs. As illustrated in Figure 6, the largest five stocks in the S&P 500 comprise 24% of the index weight, a 50-year high. As the chart indicates, such concentrations do not persist, implying eventual under-performance of those heavily-weighted stocks. Because market volatility is likely to return, diversification by asset class and exposures remain critical.

Figure 6: S&P 500 Concentration: Top 5 %Weight



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