MARKET INSIGHT MONTHLY

July Update

MONTHLY COMMENTARY

UNITED BANK Wealth Management

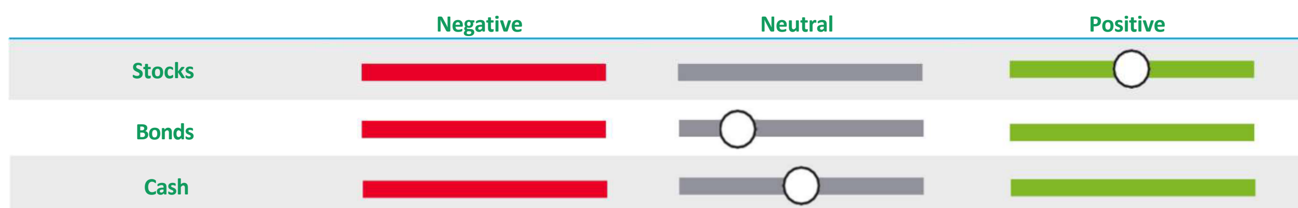
For well over six months, and throughout the majority of 2023, investors are breathing a collective sigh of relief. The combination of stabilized interest rates, declining levels of inflation and the prospect of a less restrictive Federal Reserve have contributed to a better investing environment. Despite appealing short-term interest rates generating returns of 5% or better, institutional investors have welcomed the “risk-on” equity sentiment. Investors have been buoyed by continued high employment, substantial wage and disposable income gains, and evidence that the Fed’s battle on inflation is finally being won with limited negative consequences. Additional modest increases to the Federal Funds Rate are not out of the question, but worst-case scenarios have yet to materialize—and may never. In fact, most outcomes have been arguably positive. By raising the Federal Funds Rate on ten separate occasions and 500 basis points since March of 2022, the Fed has all but eliminated the inflationary threat. June’s Consumer Price Index (CPI) inflation report (showing top-line annualized inflation has been reduced to 3.0%) and June’s Producer Price Index (PPI) (recording only 0.1% annualized inflation) are further evidence that inflation has been largely contained. As of this writing, the S&P 500 is approaching its all-time high, having increased in value by over 25% from its 2022 lows. The first half of 2023 has demonstrated the wisdom of staying the course in the face of uncertainty and distracting headlines.

INVESTMENT TAKEAWAYS

- Equity markets act as a barometer for forecasting future economic activity. Current stock performance can be used to predict likely economic activity over the next six to eighteen months. For example, in 2022, rising rates and inflation suggested slower economic growth and perhaps stagnate corporate earnings for the near future. Thus far in 2023, GDP growth has been subdued at a revised 2.0% Q1 growth rate, and corporate earnings have been generally flat. The forecast predicted by last year’s equity performance has been realized through the first half of 2023. Conversely, because stocks have generally performed well this year, GDP and earnings are likely to perform far better in late 2023 and into 2024. With this understanding, institutional investors are buying risk assets anticipating that increased growth and future earnings will align with higher equity prices.
- The yield curve is sending mixed messages. The short end of the curve (1 month to 2 years) continues to rise as a still restrictive Fed limits complete investor enthusiasm. Nearly every other segment of the yield curve is showing reasonable stability and yield consistency. We note that quality economic data has lifted rates towards the higher end of their trading ranges. The Fed Funds Futures market is now predicting rates will be stable through year-end, then decrease at some point in early 2024. United maintains a larger exposure to short- and mid-term fixed income instruments. This calculated action has led to increased income and reduced portfolio risk.
- We maintain our modest value bias within large-, mid-, and small-cap companies, which better protects portfolios during volatile periods, as was experienced in 2022. Companies with strong, less-leveraged balance sheets are often preferred during uncertain environments. With rates stabilizing, the growth segment has shown improvement. Mid- and small-cap companies are showing very attractive valuations despite unfavorable attention related to the domestic banking sector earlier in the year. We feel this topic is now dated and expect healthy future gains to materialize.
- International developed nations' equity markets have vastly outperformed those of emerging markets during the first half of 2023. The US dollar began to decline in the 4th quarter of last year as inflation started to subside. This led to lower relative rates in the US while most foreign countries were and still are experiencing high inflation and rates. This has prompted additional investor interest in international equities. We believe this is a temporary condition due to domestic inflation-fighting success. As global central banks achieve better inflation reduction, we expect the dollar to strengthen once again. We remain comfortable with our international exposure and will monitor international events for economic changes that may warrant allocation changes. We note that international valuations are becoming attractive.
- We continue to underweight our allocation to fixed income. However, the rate curve is becoming appealing, which may lead to re-positioning to our full baseline fixed income allocation. We continue to favor short to intermediate maturities.

BROAD ASSET CLASS VIEWS

Views on Stocks, Bonds, and Cash



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EQUITY ASSET CLASSES

With respect to equities, the first six months of 2023 can generally be characterized as healthy, favorable, and reassuring: Healthy, in that equity markets and investors are embracing the fact that no recession occurred, and corporate earnings have been stable. There has been no large-scale or even small-scale earnings decline, and, in some cases, earnings have surprised to the upside. Favorable, in that equity prices have generally increased. The S&P 500 rose north of 15%, and mid- and small-cap stocks rose in the single digits, as well. The battered Nasdaq has risen by more than 30% year-to-date. International developed markets benefitted from a recovery while emerging markets rose, albeit in a limited manner. Finally, performance has been reassuring, in that inflationary pressures have been reduced, interest rates are more stable, and increased communication between world leaders has improved the appearance of international stability. In the US, large-cap companies have fared better than smaller companies, and growth-oriented companies have outpaced value equities, reversing last year's trend. Typically, when growth overshadows value, investors are willing to take on more risk, indicating that economic conditions are generally more favorable, and less defensive positioning is needed. We are starting to see evidence of broader equity participation in value, mid-, and small-cap companies over the last month. This will likely lead to better equity returns across more, if not all, equity segments. We acknowledge that earnings growth will be limited in Q2 but expect that better second-half earnings may lead to double-digit earnings growth in 2024. Developed country international equities have performed well, which can be attributed to the weaker dollar rather than safer economic conditions. Although markets may endure occasional bouts of volatility, well-chosen companies and risk-managed portfolios provide excellent returns when held over several economic cycles. Full-year 2023 earnings are expected to grow in the low- to mid-single digits. We prefer US large-cap companies for stability and consistency, but mid- and small-cap companies are making a compelling case.

	Sector	Overall View	Relative Trend	Rationale
Market Capitalization	Large-Caps			US large-caps were among the leading global equity segments during the first half of 2023, with the S&P 500 rising over 15%. Despite dollar weakness over the past several months, the large-cap segment has once again proven to be a magnet for investors during both uncertain and prosperous times. While value-oriented stocks held appeal last year with markets under duress, growth companies have demonstrated resiliency and institutional interest. Continued rate stability should allow growth companies to make further progress.
	Mid-Caps			Mid-cap companies had a solid first half, rising over 8%, and have continued their trajectory into Q3. Equity price momentum was briefly curtailed in March and April with reports of potential turmoil in the banking sector. Our analyses indicated this would not be a long-term deterrent to mid-cap stocks. This has proven to be the case. We expect further progress within this segment with additional rate stability.
	Small-Caps			The small-cap sector, though up over 5%, was perhaps disproportionately impacted by the banking issues earlier in the year. While this segment had performed quite well through most of Q1, it fell in Q2, as small-caps are more heavily value-weighted due to larger financial sector exposure. We expect a full recovery in time as rates stabilize. We continue to overweight small-caps.
Style	Growth			Large-cap growth stocks have staged an impressive recovery since Q4 2022. Though not all growth stocks have performed equally, and much of the market's performance is heavily tied to several mega-cap companies, this sector has benefitted greatly from the perception that inflation is better controlled and therefore interest rates will eventually decline. The more stable the interest rate curve and the lower it travels, the better the outcomes for this segment. United maintains a healthy weighting to growth companies of all sizes.
	Value			United maintains a core value stock overweight to protect portfolios from risks—both known and unknown. The companies held in our value-based Large Cap Dividend Strategy maintain healthy balance sheets and remain preferred by experienced and disciplined investors. Our experience has proven that select value companies exceed expectations while simultaneously reducing portfolio risk.
Region	United States			We believe better relative performance will be generated from the US stock market over the foreseeable future, with consistent and reliable outcomes. Although large-cap US stocks have considerably outperformed, valuations remain reasonable given anticipated inflation and interest rates declining. However, both mid- and small-cap companies remain undervalued and appear increasingly attractive. The strength of the US employment environment has led to continued overall consumer health. Inflation is now much less of an obstacle and there is no question that the US has made significantly more progress in reducing both actual and prospective inflationary fears. We see the US continuing to take the lead in this regard and in propelling future growth.
	Developed International			Most global central banks representing developed nations followed the monetary policies of the US Federal Reserve. As such, both international monetary policy and the global fight to combat excessive inflation have lagged behind that of the US. Success has been gradual and foreign countries have been slower to contain inflation. For US investors, this is a double-edged sword. Lower relative rates have led to a weaker dollar. This leads to brief periods in which international equity markets outperform the US, as was seen in Q1. We expect a stronger dollar will eventually return, but not until there has been more success in reducing inflation globally.
	Emerging Markets			Although we favor emerging market equities over the long term, uncertainties stemming from international conflicts create obstacles to growth. Lack of stability has led to a lack of predictability, creating more hurdles. Investor sentiment changes quickly in this segment. Rather than speculate on political uncertainties, we will wait until conditions change before making changes to allocations. We continue to maintain our baseline weight.

FIXED INCOME

Limit Rate Sensitivity with Short-to-Intermediate Focus

The Fed's actions over the past sixteen months have been at least partially responsible for significantly lowering inflation. The June CPI report showed annualized inflation now running at exactly 3.0%. This is dramatically lower than the 9.1% reported during the summer of 2022. Economists can speculate as to how much of this reduction is directly attributed to the Fed, but top-line inflation is clearly much improved. Core inflation (which does not include the volatile food and energy sectors) has been less impacted by higher interest rates. Core inflation tends to be a better indicator of general economic activity and, as such, will ebb and flow more in line with consumer health and activity. Although much lower than last summer, core inflation stands considerably higher at 4.8%. Bond investors must weigh some complex factors when investing. The long end of the curve is still heavily influenced by current and future expectations of economic output, while the short end of the curve is dominated by Fed activism and capital market liquidity. The Fed has been restrictive, leading to high short-term rates, while the long end of the curve fluctuates based on economic data interpretation. The general stability of the long-end can be attributed to modest consumer-driven growth, but with the added "dark cloud" potential of a recession caused by the Fed's monetary policies impacting the short end of the curve. The Fed's "higher for longer" mantra remains in place. We believe an imminent recession is unlikely and continue to suggest a blend of high-quality, short-to-intermediate bonds in all fixed income portfolios. Quality companies and municipalities continue to perform well across the quality and size spectrum. High yield bonds issued by stable but growing entities continue to be a productive use of fixed income capital. We remain committed to a modest high yield position in both corporate and municipal bonds. United has reallocated funds previously devoted to intermediate-term securities to shorter-term, investment-grade securities to take advantage of considerably higher yields with lower duration risk. In tax-sensitive accounts, we favor municipal bonds, as infrastructure spending, strong state revenues, and the potential for higher personal tax rates provide support to municipal markets.

Positioning		Low / Medium / High	Rationale
	Credit Quality	High	The increase in rates has widened credit spreads over the past year. Spreads have been impacted by active Fed policy.
		Short / Int. / Long	
	Duration	Short	Concerns over rising rates have lessened with consistently better inflation reports. Yield curve inversion favors shorter bonds paying higher income.

COMMODITIES

Our precious metals view remains neutral. We are conscious of the influence being exerted on specific commodities, particularly gold, by US monetary policy. In 2022, Fed policy to fight inflation led to higher rates and a stronger dollar. This led to depressed gold prices. As inflation is rapidly declining in the US relative to most global regions, interest rate spreads are also declining against the dollar, which weakens US currency. In turn, this weaker dollar has led to higher precious metal prices. We feel the dollar will strengthen in time as global inflation is also more broadly reduced. Broad baskets of commodities have seen price reductions and have been stable for several months. Commodity indexes remain 10-20% below their highs from 2022.

Over the past year, the world has had to adjust supply and demand expectations due to the Russian invasion. Many countries are now sourcing commonly traded commodities from a variety of locations. WTI crude oil is currently trading near $75 a barrel, down around 35% from 2022 highs. Despite OPEC (Plus) intervention, energy prices are currently tied to global economic growth estimates and supply availability.

CONCLUSION

The Fed is not yet satisfied with the battle against inflation, but the heavy lifting has been completed. Although short-term rates remain high as a direct result of Fed activity, the rest of the yield curve has responded favorably to lessening inflation expectations. Historically, when rates are reduced, investors benefit from holding both equities and bonds. There are certainly several economic variables yet to be resolved. The promise of stable, if not lower, rates should result in improved economic growth and, ultimately, better financial market performance, much like we have seen in 2023 thus far.

Disclosures

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual security. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing.

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Economic forecasts set forth may not develop as predicted.

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