LORI L. LIFFRING, CFA ♦ MICHAEL L. BRIDGMAN, ChFC ♦ JUSTIN S. ANDERSON, MBA AAMS
GAYLAN C. ABOOD, CHAIRMAN EMERITUS

MARKET COMMENTARY

Stock indices continued their climb during the second quarter. Large cap stocks in the S&P 500 rose 8.74% during the quarter bringing their year-to-date return to an astounding 16.89%. Small cap stocks in the Russell 2000 Index gained momentum over first quarter and were up 5.21% for the quarter and 8.09% for the year so far. International stocks in developed markets only gained 2.95% and emerging market stocks gained just 0.90% making their year-to-date returns 11.67% and 4.89% respectively. The Barclays U.S. Aggregate Bond Index was down -0.84% for the quarter but its year-to-date return is still positive at 2.09%.

Technology, communication services, and consumer discretionary sectors continue to dominate in 2023 with posted year-to-date returns of 42.8%, 36.2%, and 33.1% respectively. Industrials were the next best performer but were far behind with a 10.2% return; 4 out of the remaining 7 sectors posted a negative return. Because these 3 sectors are about 47% of the S&P 500 Index, their returns have a significant impact on the Index returns and are making it look like stocks are performing much better than the average stock actually is. In a cap-weighted index, larger companies have a higher weighting and thereby impact. An equal-weighted S&P 500 index had a return of just 7.0%. Over 90% of the S&P 500 Index's price return which excludes dividends was due to just the top 10 companies (13.8% of the 14.9% return) meaning the remaining 490 companies contributed very little to returns. Further concerning is that David Lebovitz from JPMorgan cites that 90% of the return was due to multiple expansion, not earnings growth.

The strength in the stock markets during the second quarter was somewhat puzzling considering the widely held anticipation that a recession is coming. Some analysts like David Kelly of JPMorgan are extending their recession timeline past 2023. GDP growth for first quarter 2023 was 2.0%. The Fed's forecast for the full year GDP growth has been revised higher and is currently 1.1%. Kelly's full year forecast is much higher at 2.7%. Surprisingly, Brian Wesbury of First Trust who is often called a "perma-bull" because of his normal positive disposition, says he has "strong doubts" and believes "the US is headed for a recession". He notes that if monetary policy is tight enough to bring inflation down, it's going to hurt the economy.

Inflation has been coming down. The CPI was 4.1% in May versus a year ago when it was 8.6%. However, much of the reduction is in the volatile food and energy categories. The Core CPI which excludes these has only slowed from 6.0% to 5.3%. Shelter inflation has been the stickiest. David Kelly expects CPI will decline to 3.5% by the end of the year and be at 2-3% by the end of 2024. On the other side, Wesbury is concerned that "the recent optimism about inflation is overdone". He also notes that the only other times over the last 60 years that we have seen inflation drop as much as is needed to reach the Fed's target, it has been either during or right after a recession.

Looking only at stock index returns and employment, it would appear that a recession is far off. The unemployment rate is still near its 50-year low at 3.7%. In addition, David Kelly notes that wages are growing, household wealth is near highs and consumers are still spending, further lending support to the economy.

2023 BENCHMARK RATES of RETURN

INDEX	SECOND QUARTER	YTD
S&P 500	8.74%	16.89%
Russell 2000	5.21%	8.09%
International	2.95%	11..67%
Fixed Income	-0.84%	2.09%
JPMorgan Diversified*	3.32%	8.14%

*25% S&P 500 large cap stocks,10% Russell 2000 small cap stocks, 15% MSCI EAFE international stocks, 5% MSCI EME emerging market stocks, 5% REITs, 25% Barclays US aggregate bonds, and 5% each in short term Treasuries, high yield global bonds, and commodities.

We value our relationship with you, and we are always available to meet with you in person or by phone. Please do not hesitate to call or email us with any questions that you may have. Also, if your situation has changed, please contact your advisor so we can determine if any changes are needed in your account.

17330 WRIGHT ST, STE 205 | OMAHA, NE 68130 | P: (402) 697-1166 | F: (402) 697-9271
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David Kelly also notes that 60% of people live paycheck to paycheck and during the pandemic, the stimulus payments and reprieve from student loan payments gave them extra spending money that they incorporated into their lifestyle. Now that the stimulus spending has mostly ended, to keep up that lifestyle, people have had to reduce savings and/or incur debt. We saw that in May, personal income was up 5.5% over the past year. But consumer spending was up 6.0%. Spending by incurring debt cannot continue indefinitely. Now that the Supreme Court has ruled that the President did not have the authority to forgive student loans, those payments will resume in the fall. According to Education Data Initiative, the average monthly student loan payment is around $500. That $500 per month per payment will no longer be available to spend on goods and services which will likely have a negative impact on economic growth.

Corporate earnings bear watching. First quarter showed that companies beat expectations but estimates had been lowered during the quarter. Although above the lowered expectations, earnings declined -3.4% from the first quarter in 2022 even though revenues were higher. Inflation is helping revenues because companies have been able to raise prices but costs have been rising faster which has pressured profit margins and earnings. According to Zack's, second quarter earnings are expected to be down -9.7% from second quarter last year. Full year 2023 expectations are for earnings to be down -3.8% versus 2022 but then grow 10.9% in 2024 and 2025. Strategas Research cites that consensus earnings for 2023 are $221 for the S&P 500 but their projections are much lower at $200.

The Federal Reserve has been fighting higher inflation by aggressively raising short-term interest rates. The Fed raised rates another 25 basis points in May of 2023 but paused in June. The Fed Funds rate is now 5.0% to 5.25%. This is the highest level since September 2007. With inflation still elevated and employment strong, a hike in July is widely expected. And an additional hike before year end is still possible. Although recession may be avoided in 2023, many analysts think it will just be pushed off to 2024 and not completely avoided. As such, analysts are projecting that the Fed will have to cut rates in 2024 which is why the yield curve remains inverted. Strategas Research notes that rate cuts with unemployment below 4% are historically rare.

The 10-year Treasury bond yield rose this quarter from 3.5% to 3.8%. This move resulted in negative returns for the Aggregate Bond Index during the quarter. With short-term rates at attractive levels, we have been moving cash into money markets which are yielding 4.9% or more. These money markets are very liquid and can be easily sold if money is needed for other security purchases or distributions. Even though short-term rates are higher, we have also started to add back longer-term fixed income to lock in those rates for a longer time. When the Fed cuts rates as expected, the short-term securities will see a bigger negative affect and could fall below the current long-term rates.

The outlook for the economy in unclear. Strategas Research's US Recession Checklist shows 5 of their 8 indicators are reflecting recessionary conditions. The NY Fed's Probability of Recession in the next 12 months is at it's highest level in 40 years. The S&P 500 has had strong returns for the first half of the year stretching valuation measures above long-term averages. The market is priced for everything to go right so if earnings do come in closer to Strategas's estimate, or if inflation is stickier or there is another unexpected factor, stock prices could be vulnerable.

In this scenario, the "target outcome" or "buffer" ETFs can add protection to portfolios and still provide upside potential if stock prices rise. Dividend income is also attractive in equity and premium income funds. In these funds, managers own dividend paying stocks and sell out of the money call options to collect extra income. The dividends help with total returns or with income needs depending on the account.

Measuring risk tolerance and investing accordingly is important in this environment. Timing the market or chasing returns may work in the short-term but is more difficult over longer periods. We use Riskalyze software to help us measure your risk tolerance and make sure you have the appropriate risk in your accounts. If you would like to check or revisit your risk score or if you have any questions about your account, please do not hesitate to contact your advisor.

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The addition in February of John Goolsby as our Operations Manager was an important step in solidifying our plan to remain independent. As we implement strategies to grow, we want you to know that we remain committed to our clients and we appreciate the trust you place in Cambridge Advisors. If you have friends or family who would benefit from a relationship with Cambridge, please do not hesitate to share our contact info. We are accepting new clients right now and want to help the people who are important to you.