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Investment and Financial Consultants

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SECOND QUARTER 2023 ECONOMIC AND FINANCIAL MARKETS REVIEW

After a down year in 2022, there has been no shortage of issues for the financial markets to contend with during the first half of this year. Concerns about inflation, the Fed raising interest rates, the war in Ukraine, the banking crisis, the debt ceiling fight, and a potential recession looming resulted in a very uncomfortable period for investors. Despite these uncertainties, the major stock market indexes halted their 2022 declines during the first half of this year. The Dow Jones Industrial Average was up 3.80%, the S&P 500 Index finished up 15.91%, and the Bloomberg Barclays U.S. Intermediate Government/Credit Bond Index gained 1.50% during the first half of 2023.

While the fight against inflation, the Fed's interest rate policy, and the war in Ukraine have been top of mind for some time, a banking crisis came into focus during the second quarter of this year. Many banks invested their clients' deposits into long-term bonds intended to be held to maturity. However, as interest rates rose, these bond holdings lost value. This is because there is an inverse relationship between interest rates and bond prices. This is not a problem as long as the banks do not have to sell their long-term bonds at losses before they mature. However, when several large banks experienced unusually large withdrawals, they were forced to sell bonds to cover these withdrawals. When the word spread that these banks were losing money, additional bank clients removed their money quickly, due to fear that the banks would be unable to cover their withdrawals if they waited too long. As a result of this "run on the banks," several large banks became insolvent, and there were worries that this problem could spread to smaller, more vulnerable banks as well. However, currently, the primary damage seems to be concentrated in several banks with poor risk management practices.

Just as the banking crisis appeared to subside, Democrats and Republicans began fighting over raising the nation's debt ceiling before the Treasury department ran out of money to pay its bills. The debt ceiling is the self-imposed borrowing limit Congress sets for the country. If the debt ceiling was not raised in time, the U.S. government could not make payments to its creditors, pay government salaries to workers, or make Social Security and Medicare payments. In short, the country would default on its debts. This would be an unprecedented situation with dire consequences for the U.S. economy and the financial markets. Luckily, a debt ceiling bill was passed through Congress at the 11th hour to raise the borrowing limit and avoid what would have been a catastrophic outcome.

Due to the Fed's rate increases, the economy may enter a recession in the second half of this year. However, it is important to note that the stock market is typically forward-looking and a leading indicator of the economy. Therefore, even if there is a recession, the stock market decline that occurred last year may have already priced in an economic slowdown later this year. Just as the stock market has declined in anticipation of a potential recession, it would not be surprising to see it recover during an economic downturn as it anticipates an eventual economic recovery. This is precisely what happened during the 2020 recession caused by the economic shutdown during the pandemic.

One of the reasons for potential stock market appreciation could be that the Fed has indicated that they are in the process of ending their rate hiking cycle. The Fed has been raising interest rates since last spring in a very fast monetary tightening cycle. They did this to try to reduce inflation. When interest rates rise, it discourages borrowing and spending, which helps lower prices, but it also harms the stock and bond markets.

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This is the main reason that the stock and bond markets struggled so much last year. Although much of this depends on how much inflation declines going forward, if the Fed stops hiking interest rates, and ultimately lowers rates down the road, that would be very helpful for the stock and bond markets.

Finally, although the S&P 500 Index finished the first half of the year positive, most of the gains in this index were generated by a small number of large, growth stocks. These companies that drove the index higher during the year's first half were mainly technology stocks that will benefit from the emergence of artificial intelligence. The S&P 500 Index is market-weighted, meaning that the largest companies receive a more significant weighting when the index return is calculated. It is typically unhealthy when only a few stocks lead the market higher while the rest are flat or negative. Therefore, we are hopeful that the stock market gains will broaden during the second half of this year and that more companies will participate in an uptrend.

In the meantime, we continue to favor large-company stocks that have performed the strongest through recent up- and down-market environments. We have also become more optimistic about certain foreign stock markets than we have been in many years. Finally, we continue to recommend short-term bonds rather than long-term bonds because short-term bonds are less sensitive to interest rate fluctuations.

As always, we will continue to monitor ongoing economic and financial market conditions. In the meantime, please contact us if you have any questions regarding your portfolio or the financial markets in general.

* *Index returns were obtained from the Wall St. Journal and Bloomberg Barclays on July 1, 2023.*

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