REDHAWK®
WEALTH ADVISORS

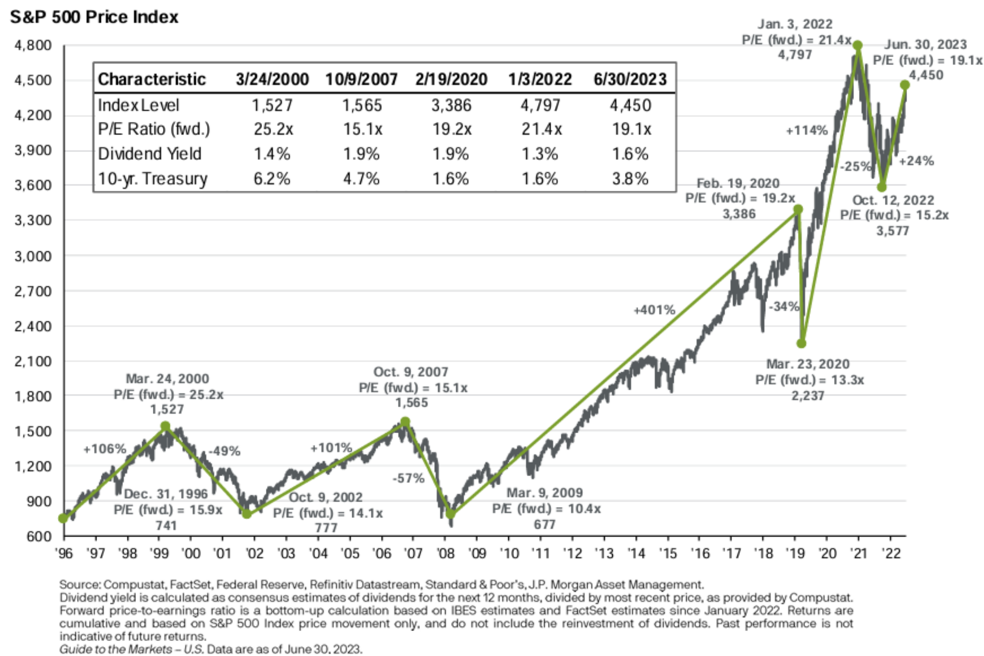
Redhawk Quarterly Commentary

June 30, 2023

Each quarter, Redhawk's Investment Committee provides a Quarterly Commentary. We look at what is transpiring in the investment landscape and provide our perspective on a variety of topics. These are not predictions, and it represents our perspective on important market and economic information designed to help make decisions affecting your long-term financial strategy. Our goal is to help you understand what is going on in the markets so you can more clearly define investment goals, diagnose unintended risks, and utilize portfolios that can achieve a better financial outcome.

Market Commentary

After falling most of last year, markets rose quickly in the first six months of 2023. Beginning in late 2022, markets sensed that inflation was receding and rose on expectations that central banks would cut interest rates by late 2023. Markets defied warnings from major central banks that interest rates would be higher for longer. This along with expectations about productivity gains from artificial intelligence (AI) fueled further rallies. In all, the tech-heavy Nasdaq had its best first-half calendar year performance since 1983. The S&P 500's market capitalization jumped over $6 trillion[1] and closed the quarter at 4,450 (see the chart below).

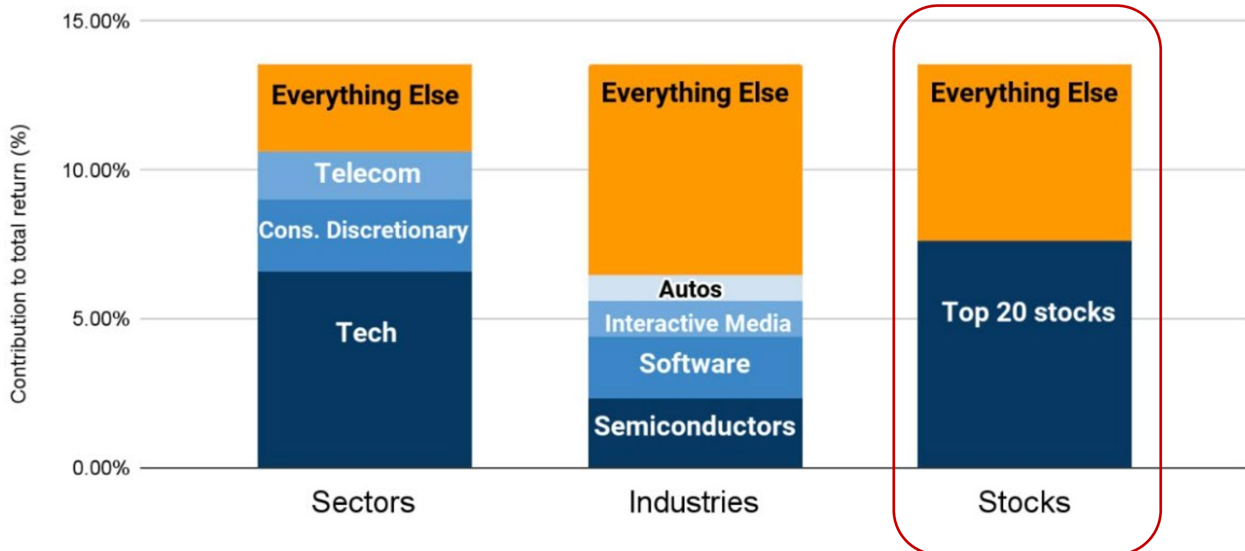


Characteristic	3/24/2000	10/9/2007	2/19/2020	1/3/2022	6/30/2023
Index Level	1,527	1,565	3,386	4,797	4,450
P/E Ratio (fwd.)	25.2x	15.1x	19.2x	21.4x	19.1x
Dividend Yield	1.4%	1.9%	1.9%	1.3%	1.6%
10-yr. Treasury	6.2%	4.7%	1.6%	1.6%	3.8%

Source: Compustat, FactSet, Federal Reserve, Refinitiv Datastream, Standard & Poor's, J.P. Morgan Asset Management.
Dividend yield is calculated as consensus estimates of dividends for the next 12 months, divided by most recent price, as provided by Compustat. Forward price-to-earnings ratio is a bottom-up calculation based on IBES estimates and FactSet estimates since January 2022. Returns are cumulative and based on S&P 500 Index price movement only, and do not include the reinvestment of dividends. Past performance is not indicative of future returns.
Guide to the Markets – U.S. Data are as of June 30, 2023.

Most economists expect a recession in the next 12–18 months and investors like clarity regarding the timing and severity. But until the resilient consumer and strong labor market falter, economists will likely have to wait a while longer for the anticipated recession, which might take a few more quarters to unfold. According to Strategas Research Partners, there has never been a market bottom before a recession began, further fueling investors' anxiety. Meanwhile, a look beneath the surface of the solid year-to-date performance of the S&P 500 supported investors' growing skepticism regarding the rally's durability. While the S&P 500 closed at a high for the year in Q2, just 51% of the companies in the index are above their respective 200-day moving average[2].

While the stock market overall was up this quarter, looking below the surface, there were relatively few winners. Like the first quarter, technology, telecommunications, and consumer discretionary (which includes things like apparel, autos, home improvement, and restaurants) were the big winners. Year-to-date, those three sectors accounted for almost 80% of the total return in stocks. At the industry level, the top four industries (autos, interactive media, software, and semiconductors) accounted for about 50% of returns. Even if you look at individual stocks, the top twenty contributors added over 8% to returns, and the other 7,911 securities only added another 6%[3] (see the chart below).



Source: Morningstar Indexes

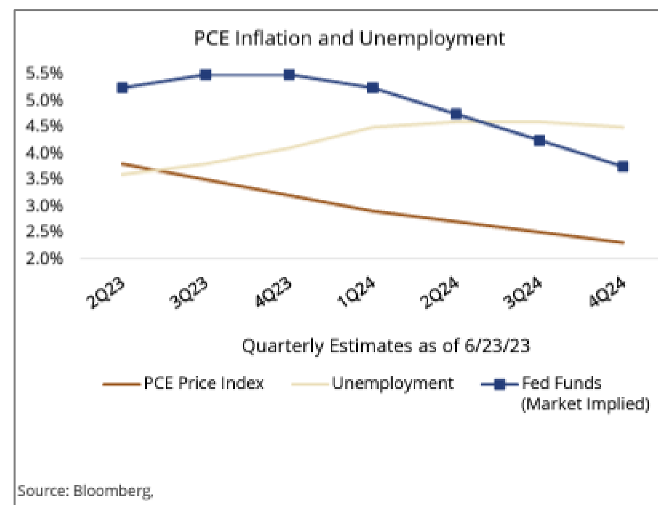
International equities also posted positive returns for June and Q2, except for China which lost almost 10% for the quarter. Returns were significantly lower for international and emerging markets equities than U.S. equities. In the second quarter, the MSCI All Country World Index ex-U.S. was up 2.4%, the MSCI European, Australian, and Far East Index were up 3.0%, and the MSCI Emerging Markets Index was up 0.90%.

The bond market faced the headwinds of rising interest rates and concerns about the stickiness of core inflation and the increasing probability that interest rates will stay higher for longer. The Bloomberg U.S. Aggregate Index was down 0.4% in June, and down 0.8% for Q2, the High Yield Index gained 1.7% in June and 1.8% for Q2, while the Global Aggregate ex-U.S. was up 0.3% in June but down 2.2% for all Q2.

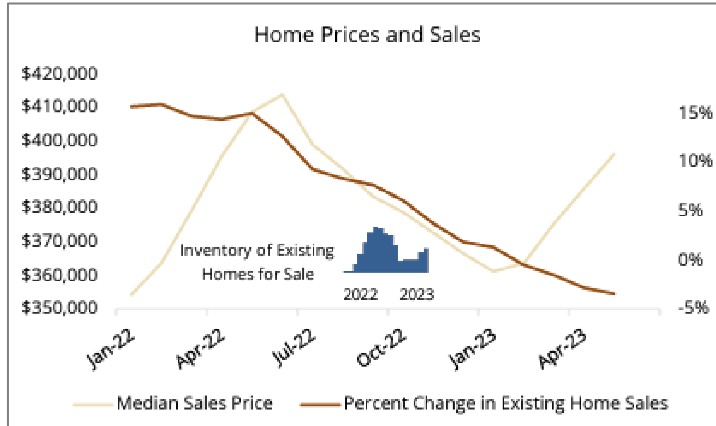
U.S. Market

U.S. equities ended the quarter higher, with the bulk of the gains made in June. The advance came amid moderating inflation and signs that the U.S. economy remained resilient despite higher interest rates. A revision to Q1 GDP growth indicated an annualized expansion of 2%, substantially more than the previous estimate of 1.3% growth.

The Federal Reserve (Fed) raised interest rates by 0.25% in May. However, they adopted a "hawkish pause" in June and did not hike rates. The "dot plot" of rate predictions indicated two further rate increases in 2023. The Fed's aggressive policy actions have affected the shortest portion of the yield curve much more than longer maturities. This implies the Fed will have successfully guided inflation to lower levels within the next 12 to 18 months, thereby orchestrating a path for lower interest rates (see the chart to the right)[4].



U.S. inflation, as measured by CPI, declined on a month-to-month basis to 0.1% in May, easing from a 0.4% increase in April amid a continued decline in the cost of energy. This brought down the annual rate to 4.0%, which was below expectations of 4.1%. The economy continued its resiliency and remained in good health. The U.S. unemployment rate increased in May to 3.7% from 3.4%, a larger than expected move but the labor market nonetheless remains historically tight.



Source: Factset

Higher interest rates have impacted the housing market, as evidenced by the limited inventory of existing homes for sale. Homeowners with low mortgage rates are less willing to sell given the likelihood they would have to finance the purchase of a different home at a substantially higher rate. Low housing inventory coupled with strong demand has pushed the median sales price higher (see the chart to the left).

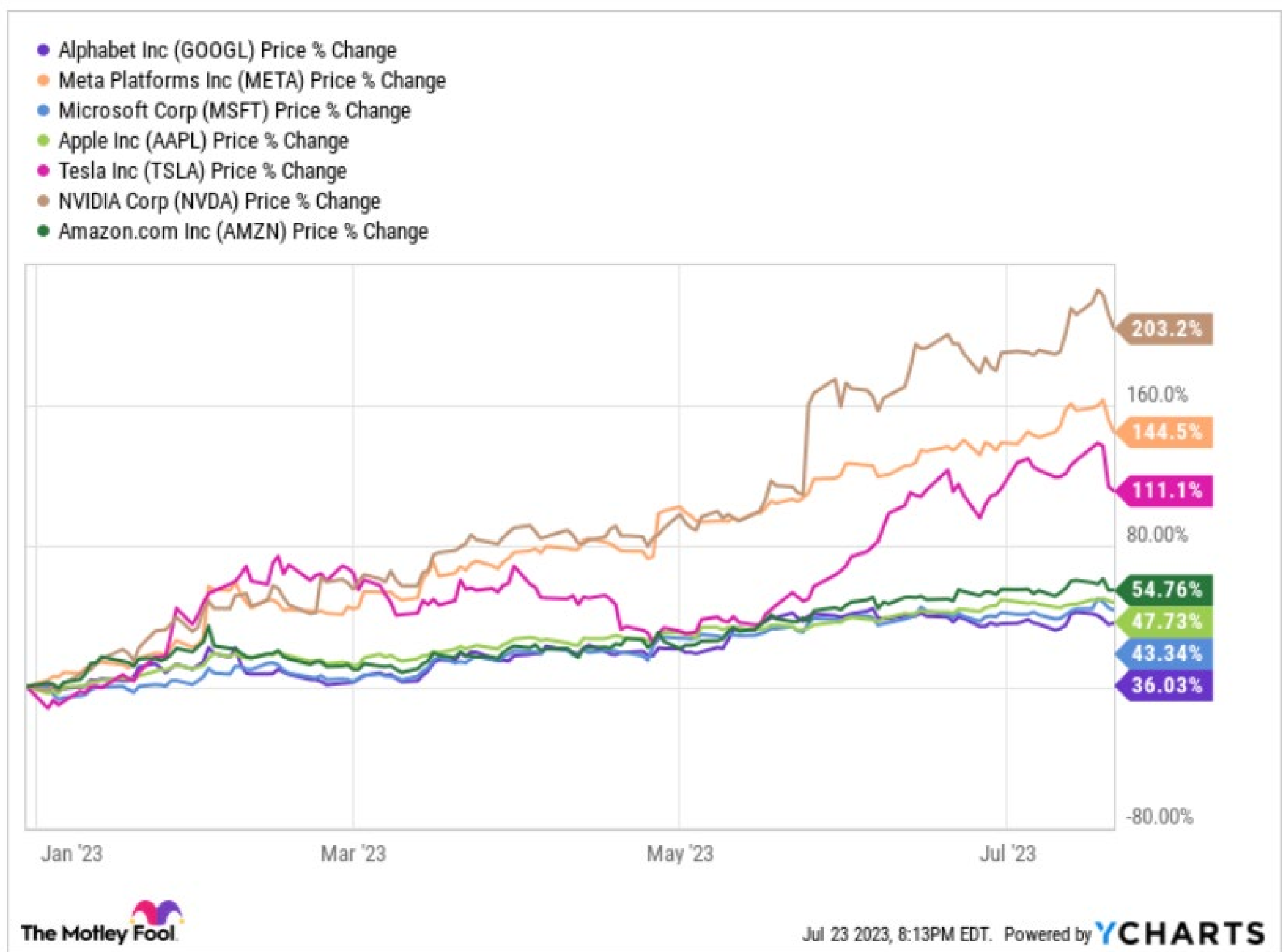
There was some investor caution around U.S. debt ceiling concerns at the beginning of the period. However, Congress approved legislation that suspended the debt ceiling in the first days of June, in a deal that included concessions on spending expected to have little effect on economic growth.

Stocks gained more ground as the first half ended. The broad U.S. equity indexes finished June on a positive note, and for the quarter, the large-cap S&P 500 posted an 8.7% return, the Russell Midcap was up 4.8%, and the small-cap Russell 2000 gained 5.2% (see the chart below)[5].

Major Benchmarks	1H'23	June	Q2	Q1	vs. 52-week High	vs. 52-week Low
NASDAQ 100	39.4	6.5	15.4	20.8	-0.7%	45.4%
Nasdaq Composite	32.3	6.7	13.1	17.0	-0.5%	36.7%
S&P 500	16.9	6.6	8.7	7.5	-0.2%	27.5%
Russell 1000	16.7	6.8	8.6	7.4	-0.2%	26.8%
S&P Midcap 400	8.8	9.2	4.8	3.8	-4.3%	20.0%
Russell 2000	8.1	8.1	5.2	2.7	-7.0%	15.0%
Dow Jones Industrials	4.9	4.7	4.0	0.9	-0.9%	20.1%
Russell MicroCap	2.3	6.6	5.3	-2.9	-13.7%	10.7%

Source: Nasdaq

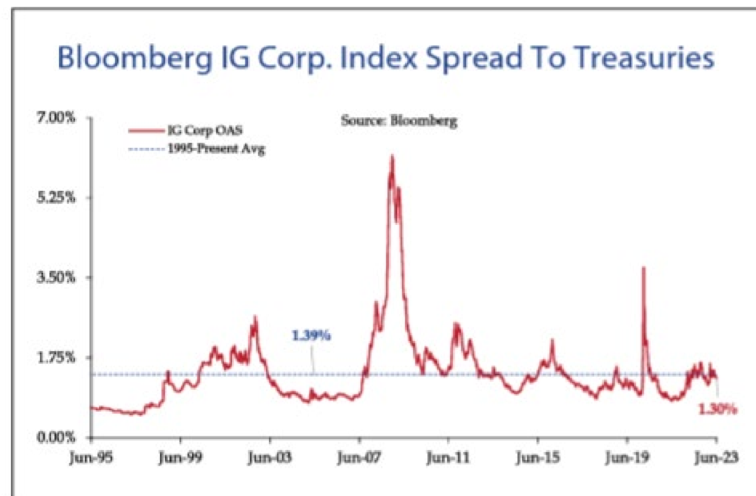
Growth stocks slightly outpaced value stocks in June, resuming their recent performance dominance, and for the entire quarter, posted a 12.5% return for the Russell 3000 Growth Index and just 4.0% for the Russell 3000 Value Index. In the second quarter, large, mid, and small-cap growth stocks dramatically outpaced their value counterparts. Most of the growth leadership for the overall market, has been driven by a handful of mega-cap stocks, commonly called the "Magnificent Seven" including Alphabet, Amazon, Apple, Meta, Microsoft, Netflix, NVDIA, and Tesla[6] (see the chart below). While their profits have grown, investor enthusiasm has driven these stock prices to significantly expanded price earnings multiples making other parts of the market looking much more reasonably priced.



Another driver for an attractive market during the quarter were corporate reports. Of the S&P 500 companies, 78% reported a positive earnings surprise, while 75% reported a revenue surprise. It was the best performance relative to estimates since the fourth quarter of 2021. The earnings season also saw a dramatic development and a heightened focus on artificial intelligence, with 110 companies mentioning AI on conference calls. This was a 41% increase from the prior quarter. The excitement over AI centers on its potential economic opportunities. One investment bank says AI may boost productivity by 1.5% annually for the next 10 years.

Fixed Income Markets

The 10-year U.S. Treasury Note marched higher during the quarter as the market took in macro-economic data and "hawkish" communication from the Fed. Ultimately, the 10-year finished the second quarter at 3.8%, up from where it started the quarter at 3.5%. Yields in the short-to-intermediate portion of the yield curve increased more than the Fed Fund's rate. This indicated the market is expecting higher interest rates for longer. The Fed continued its quest to tame inflation, as the economy remained stronger than expected. While inflation has come down, it was reported at 4%, which is twice the Fed's 2% target[7]. Corporate credit spreads tightened modestly during the first half of the year as investors were more optimistic about the economic landscape. Currently, spreads are right near historical averages (see the chart on the right).



The quality of high-yield bonds has improved, with nearly half the market carrying the highest rating (BB/Ba). One reason is that many companies with weaker financial profiles have opted to raise funds in the private credit and leveraged loan markets.

Corporate bonds came under some selling pressure in the wake of the banking sector turmoil since financials hold a large place in investment grade bonds. But overall, the sector has held some ground, with yields that hovered around 5% and spreads over Treasuries expanded to approximately 1.3%.

For the first half, markets had priced in rate cuts for the fall. As recession expectations have been pushed further out, rate cut projections are being projected for late 2024. The yield curve became more inverted over the quarter, with a 1% difference between the 2-year and 10-year rates. The curve has been inverted for now for a full year, so the measure continued to project falling rates in the foreseeable future (see the chart below).

Source: Bloomberg, as of June 30, 2023.

International Markets

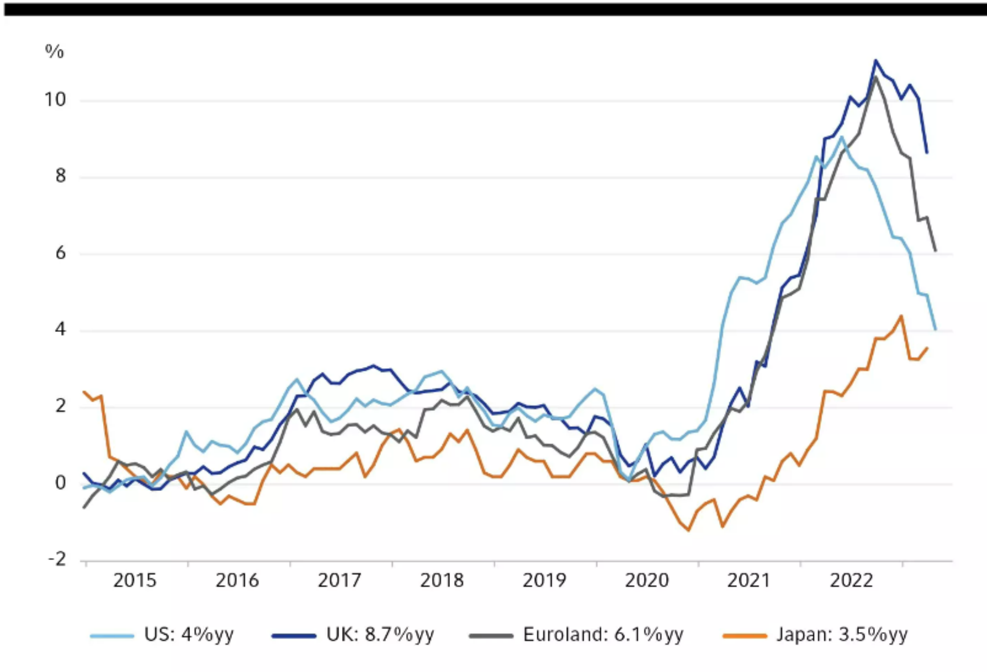
Most of the other major economies have slowed and at risk from aggressive central bank tightening. Growth in the eurozone buckled under a steep decline in bank lending, and persistent inflation forced the Bank of England to tighten further despite the lack of UK economic growth. China's growth impulse faltered following the post-pandemic lockdown surge. Japan remained an outlier, where monetary policy was still ultra-accommodative and gross domestic product (GDP) growth remained above trend.

Core inflation in Europe has been driven by the second-round effects of last year's big increases in oil and gas prices. Energy inflation has flipped from a high of 44% early last year to negative 2% in the 12 months to May 2023. This decline should drive a significant decline in core inflation in coming months.

UK core inflation lagged the declines in the U.S. and Europe. Wages are still rising, and the labor market remained tight due to falling participation rates and worker skills shortages resulting from Brexit.

The message from inflation trends is that the Fed is close to finished with rate hikes, and the European Central Bank (ECB) may soon be finished as core inflation started trending lower. The Bank of England (BOE), however, continued with the most challenging task as core inflation has not yet peaked. It's interesting to note that the futures markets have priced in more than 1% of further tightening by the BOE in early 2024. This may be an overestimate given that the overall economy is barely growing, but the BOE is likely to be the last major central bank to pause rate hikes[8].

GLOBAL INFLATION RATES HAVE PEAKED IN MAJOR ECONOMIES



Source: Refinitiv® DataStream®, as of May 23, 2023. yy = year-over-year, which means comparing results from a time in one year to the same time in the prior year.

Eurozone

After escaping recession over the winter, the outlook turned more negative. Technically, it can be argued that the recession has already arrived, given that GDP growth was reported as negative in both Q4 2022 and Q1 2023. The labor market remained tight, with unemployment the lowest since the euro was established and the growth of wages accelerated.

However, the ECB does not think it is in a recession, as it lifted the deposit rate to 3.5% in June and signaled that another hike is likely in July. Energy prices have had a significant impact on European inflation, and the energy Consumer Price Index (CPI) has fallen 1.8% over the past 12 months after surging 44% in the year to March 2022. Eurozone equities have performed broadly in line with U.S. equities so far this year.

Japan

Domestic spending in Japan started to pick up, with the reopening gathering some steam and inbound tourism returning. Wage growth continued to edge higher, and the stickier parts of inflation (i.e., services inflation) is approaching the Bank of Japan's 2% inflation target. The trade balance with the rest of the world also improved, in part due to the decline in the price of oil (Japan being a net oil importer), which should eventually reduce the pressure on the Japanese yen.

China

The Chinese economy has decelerated after a strong first quarter. Consumption remained the key focus this year, and the data continued to indicate the Chinese consumer is cautious. The excess savings in China are lower than in the developed world and are less likely to be spent, given these savings were accumulated without the support of fiscal stimulus.

Chinese property developers continued to see elevated credit spreads, and the recovery in the property market has been slow. Monetary policy remained very accommodative, given inflation in China is currently running below 1% year-over-year.

Economic Outlook

The economy continued to normalize as the Fed tightened monetary policy to slow inflation. The Fed's efforts have worked, but they may not be finished yet. The futures market expects one more rate hike, then a pause, then the beginning of a rate-lowering regime in 2024. For now, inflation is coming down but is still too high for the Fed to start lowering rates, and unemployment remains stubbornly low. Supply chains have improved and are now becoming a source of deflation. Lastly, for the broader economy, there has been some worry that consumer excess savings is running out and the use of credit is on the rise to battle inflation on goods and services.

Stocks, especially mega cap technology companies, rebounded extremely well during the second quarter as market participants expected a slowing of monetary tightening and advancements in artificial intelligence (AI) excited investors. While earnings estimates have been slowing, the slowdown has not been as drastic as some projected. This is a bullish sign for future corporate

earnings. It has been a respectable year for growth-oriented stocks, while dividend paying stocks have lagged. Some of the underperformance is due to the banking crisis, which hurt financial stocks, which are historically a consistent provider of dividends. In addition, as the business cycle continues to evolve and the stock market remains ahead of the general economy, market participants have shifted toward growth stocks versus slower-growing dividend payers. Meanwhile, bond yields have increased, giving investors the ability to invest in short-term instruments paying yields comparable to dividend-paying stocks.

The bond market appears to have hit a bottom and has started to claw its way back. The Fed's monetary tightening has increased short-term interest rates, which has made money markets and other safer, short-term bond investments attractive relative to stocks, something that has not been seen in a long time. At some point, the Fed will start to lower rates, which will cause bond yields to drop and bond prices to increase (bond yields and prices have an inverse relationship). Therefore, while bond yields are higher today, total returns in fixed income may be trending toward long-term averages, which should help reduce overall portfolio risk. Of course, all of this assumes that the Fed stays the course. If so, a normalization of the economy is likely, which is good for all market participants.

We continue to focus on managing both risks and return potential. We understand the risks facing both the markets and the economy and are committed to helping you effectively navigate this challenging investment environment.

Acknowledgements

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