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## KEY POINTS

- Stock markets extended their gains during the second quarter, while bond markets were mixed as overall market volatility declined. Looking ahead, we discuss why stock markets could continue to appreciate in the year's second half, and why gains will likely be lower relative to the first half of the year.
- The U.S. and European economies have proven more resilient this year than expected. Meanwhile, China's economic recovery lost steam in the second quarter. We discuss the economic outlook and expectations for inflation going forward.
- There has been increasing interest in how the prospects of generative AI may be boosting stock market performance, particularly for a handful of the largest technology companies. We answer the question of whether investors should change their portfolios to benefit more from the AI growth trend.
- Lastly, we discuss how two key considerations of our market and economic outlook inform how we recommend positioning portfolios.

## MARKET REVIEW

### STOCKS EXTENDED THEIR GAINS IN THE SECOND QUARTER AMID DIMINISHING MARKET RISKS

Global stock markets continued their recovery in the second quarter, resulting in the strongest return to the first half of a year since 2019.[2] Outsized gains in large-cap technology stocks have boosted broad market performance throughout most of the year; however, gains broadened to all sectors and small-cap stocks in June. Overall market volatility declined throughout the second quarter as the risks of a spreading regional banking crisis and debt-ceiling impasse receded. Moreover, markets were relieved after the Federal Reserve held rates steady at its June policy meeting, its first pause in hiking rates in 15 months.

### BOND MARKETS FACED HEADWINDS IN THE SECOND QUARTER AS INTEREST RATES CLIMBED

In the second quarter, except for Japan, interest rates generally increased across global developed markets, dampening overall bond returns. Short-term interest rates increased due to most major central banks raising their policy rates in the second quarter. Long-term interest rates increased amid continued economic strength and the easing banking sector stress. Furthermore, although the U.S. Federal Reserve paused raising rates in June, it did signal that it may continue to raise rates this year again as long as inflation remains elevated.

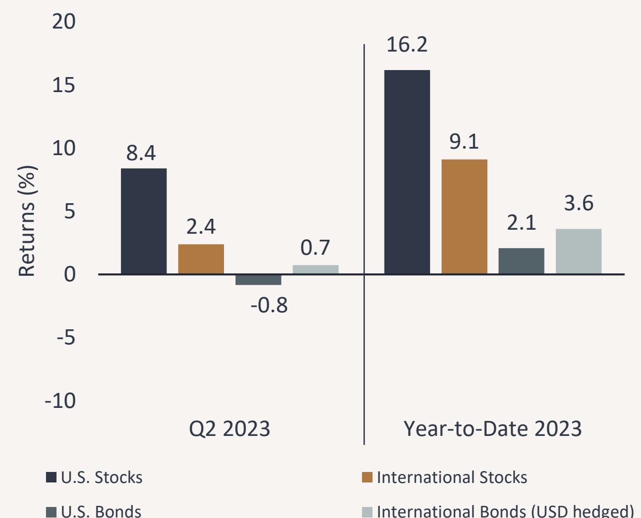


**FIGURE 1.** Stock markets extended their gains during the second quarter, while bond markets were mixed.

The U.S. stock market materially outperformed the international stock market in the second quarter due to its heavier composition in information technology stocks which were the best-performing sector.

The U.S. bond market declined for the quarter but maintained year-to-date gains. Meanwhile, the international bond market posted a positive return (in U.S. dollar terms) despite increases in global interest rates

SOURCE: MORNINGSTAR, RUSSELL, MSCI, BLOOMBERG. DATA AS OF 06/30/2023. SEE ENDNOTE 1 FOR ADDITIONAL DISCLOSURES.

# MARKET OUTLOOK

## STOCK MARKETS COULD CONTINUE TO GAIN BUT LIKELY AT A RELATIVELY MODERATE PACE

Stock markets could continue to appreciate in the year's second half, but gains will likely be lower relative to the first half of the year. Global stock markets, in aggregate, have rallied strongly this year and have entered "bull market territory" (i.e., up more than 20%) since the lows in mid-October 2022. (See Figure 2.) Together with declining earnings growth, aggregate stock market valuations have increased significantly; hence further price gain potential may be subdued.

However, the stock market rally (and ensuing higher valuations) has been fairly concentrated in large-cap, technology sector stocks that suffered the worst declines last year. As such, stock market gains could continue as the rally broadens to include more companies and sectors, particularly those that are profitable, have healthy balance sheets, and are the most undervalued. Broader stock market participation would likely occur if economic growth and elevated inflation continue, and interest rates remain at current levels for longer.

## BOND MARKET RETURNS ARE LIKELY TO STAY POSITIVE DESPITE CONTINUED UNCERTAINTY AROUND FUTURE INTEREST RATE INCREASES

Bond markets could experience declines if central banks communicate more future rate hikes than is currently expected. However, declines would likely be limited and short-lived as most central banks are closer to the end of their rate-hiking plans. In the U.S., the Fed has indicated they may hike rates a couple more times in the upcoming months. Although if inflation flares up again, they could hike more than twice and indicate that they will keep rates higher for even longer.

Notwithstanding near-term policy uncertainty, bond markets will likely deliver higher (positive) long-term returns going forward. Better future bond performance is primarily due to higher starting yields (e.g., 4.5% to 5.5%) that investors can currently earn on high-quality bonds. (See **Figure 3**.) Secondly, because the economy is likely to continue slowing and possibly enter a recession at some point, central banks will inevitably start to cut rates which would result in price appreciation of intermediate and long-term bonds.

### THE GLOBAL STOCK MARKET HAS ENTERED A NEW BULL MARKET AND VALUATIONS INCREASED

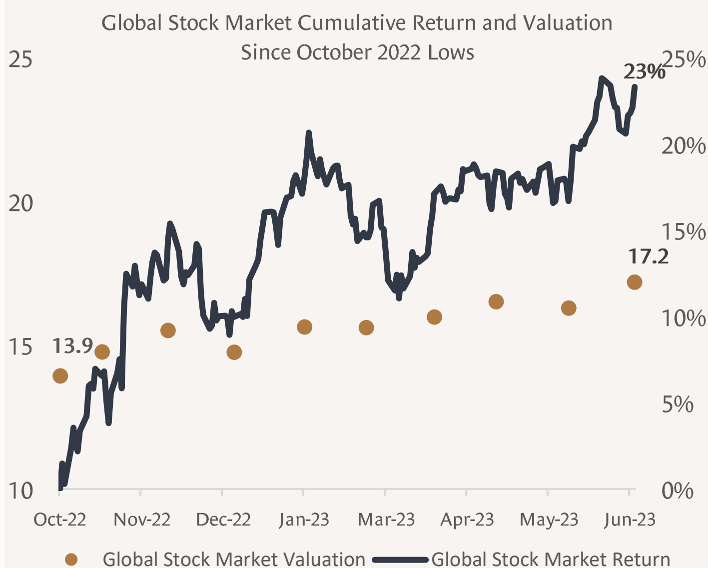


**FIGURE 2.** The global stock markets has experienced a 23.3% gain since the market bottom on October 12th, 2022. Together with declining earnings growth, global stock market valuation (price/earnings ratio) has increased materially from 13.9 to 17.2.

SOURCES: YCHARTS, MORNINGSTAR DIRECT. DATA FROM: 10/12/2022 TO 06/30/2023. NOTES: GLOBAL STOCK MARKET RETURN IS REPRESENTED BY CUMULATIVE PRICE RETURN OF THE MSCI ACWI IMI INDEX. GLOBAL STOCK MARKET VALUATION IS REPRESENTED BY TRAILING 12-MONTH PRICE/EARNINGS RATIO OF THE MSCI ACWI IMI INDEX.

### INVESTORS CAN EARN ATTRACTIVE YIELDS ON HIGH QUALITY BONDS

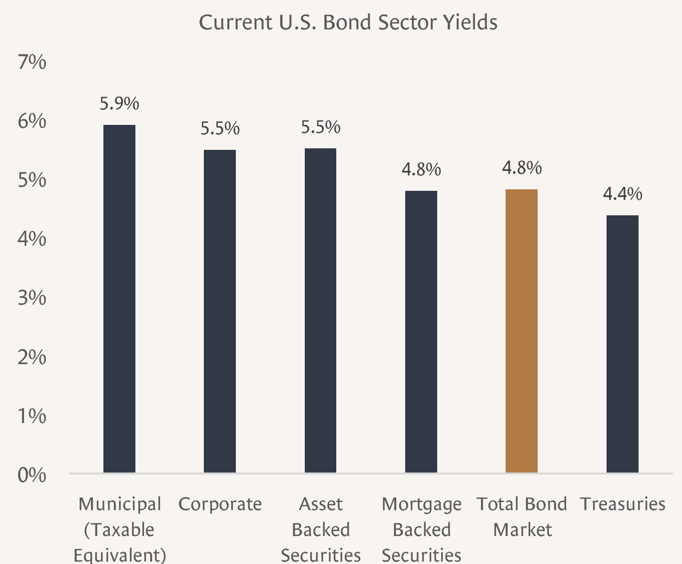


**FIGURE 3.** The significant rise in interest rates since early 2022 has presented an opportunity for long-term investors to earn higher income on across high-quality bond sectors.

SOURCES: BLOOMBERG, FACTSET. DATA AS OF: 06/30/2023. NOTES: YIELDS ARE YIELD-TO-WORST. MUNICIPAL BOND TAXABLE EQUIVALENT YIELD IS BASED ON A 40.8% TAX RATE. SEE ENDNOTE 3 FOR ADDITIONAL DISCLOSURES.

### THE U.S. ECONOMY HAS REMAINED SURPRISINGLY RESILIENT EVEN AS INFLATION HAS DECLINED

The U.S. economy has proven to be more resilient in the first half of 2023 than many expected, as continued strength in the labor market has helped support consumer spending, the primary driver of economic growth. Spending increased throughout the spring as consumers felt more optimistic about the economy, and demand for leisure and travel service activities has been strong so far this summer. On the other hand, more interest rate-sensitive areas of the economy, such as the manufacturing sector and the housing market, have continued to slow down.

However, despite a strong economy overall, core inflation is decelerating in the U.S. Core goods prices (i.e., excluding food and energy) have declined rapidly this year. Rent prices (i.e., shelter), the stickiest and most significant contributor to the Consumer Price Index, peaked at the start of the year and has started declining. Services excluding shelter, considered the most wage sensitive, has also started decelerating. (See **Figure 4**.) As such, the Fed appears to be (so far) successfully taming inflation without inducing a recession.

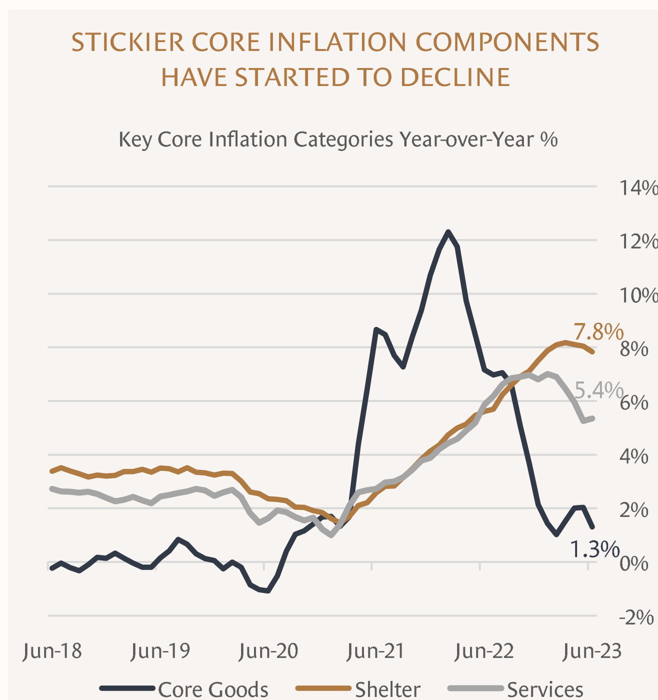


**FIGURE 4.** Core goods price inflation has been in decline since mid-2022; now however, shelter and service inflation have recently peaked and have started to decline.

OURCES: YCHARTS, BUREAU OF LABOR STATISTICS. DATA FROM: 06/01/2018 TO 06/30/2023. NOTES: CORE GOODS IS REPRESENTED BY US CPI COMMODITIES LESS FOOD AND ENERGY INDEX, SHELTER IS REPRESENTED BY US CPI SHELTER INDEX, AND SERVICES IS REPRESENTED BY US CPI SHELTER INDEX.

### EUROPE'S ECONOMY HAS HELD UP DESPITE RATE INCREASES; CHINA'S RECOVERY HAS STALLED

Europe's economy has also been surprisingly resilient despite the European Central Bank (ECB) and Bank of England (BOE) continuing to raise interest rates amid persistent inflation. Although the euro area technically entered a recession following its -0.1% gross domestic product (GDP) contractions in the first quarter of 2023 and the fourth quarter of 2022,[4] there has been little evidence of a sharp economic downturn. Moreover, leading economic indicators suggest that the euro area likely resumed growth in the second quarter. European consumer demand has held up better than anticipated amid continued low unemployment and growing wages.

China's economic recovery lost steam in the second quarter after a strong first quarter driven by the economy's reopening after COVID-19-related lockdowns. Economic activity has been weakening recently across both manufacturing and service sectors. (See **Figure 5**.) Continued geopolitical tensions have kept a cloud of uncertainty over the region. The good news is that inflation has been subdued in China, which has enabled the People's Bank of China to lower lending rates for consumers and businesses to stimulate the economy.

**FIGURE 5.** China's economic recovery lost steam in the second quarter after a strong first quarter driven by the economy's reopening after COVID-19-related lockdowns.

SOURCES: YCHARTS, CHINA FEDERATION OF LOGISTICS AND PURCHASING. DATA FROM: 03/01/2022 TO 06/30/2023. NOTES: CHINA MANUFACTURING IS REPRESENTED BY CHINA MANUFACTURING PMI INDEX, AND CHINA SERVICES IS REPRESENTED BY CHINA NONMANUFACTURING PMI INDEX.

# ECONOMIC OUTLOOK

## U.S. ECONOMIC MOMENTUM WILL SLOW AND INFLATION SHOULD CONTINUE TO DECLINE

The near-term outlook for the U.S. economy is generally positive entering the second half of 2023. However, consumer demand, business investment, and job growth momentum will slow as the lagged effects of all the prior interest rate hikes continue to set in. If the U.S. economy maintains its current course of a gradual slowdown, a recession--should the U.S. officially enter one--would probably occur further out in the future (e.g., 2024 instead of 2023). Moreover, a recession would likely be relatively short and shallow given the strength of the economy and the financial situations of most households and businesses.

Inflation in the U.S. will likely continue to moderate. Shelter inflation (i.e., rent growth) is expected to continue declining throughout the second half of 2023, while slowing momentum in labor markets should also gradually lower ex-shelter services inflation (i.e., wage growth). Moreover, despite recent improvements in the inflation picture thus far, the Fed will likely stick to its commitment of bringing inflation down to 2% and keeping it there. As such, the Fed will likely hike interest rates (by 0.25%) at least one more time this year and keep rates where they are well into next year.

## ECONOMIES ABROAD ARE LIKELY TO REMAIN CHALLENGED IN THE NEAR TERM

Similar to expectations for interest rate policy in the U.S., the European Central Bank and Bank of England will likely continue raising their interest rates in the year's second half by another 0.25% to 0.50%. Given the growth-dampening effects of higher rates, Europe's economic growth prospects will remain challenging. However, higher rates will further dampen inflationary pressures in Europe, barring an escalation in the conflict in Ukraine that pushes up energy prices again. Lower inflation should strengthen consumer confidence amid continued low unemployment and solid wage growth across the region.

Recent economic data out of China indicates slower growth may be coming in the second half of the year. However, weaker economic data may prompt Chinese policy leaders to introduce additional stimulus measures. These measures could include lowering taxes on companies and further cutting lending rates for consumers. Moreover, to meaningfully spur economic growth, China will need improved business and household confidence, which has been negatively impacted by a declining real estate market, high youth unemployment, and lingering anxiety over COVID-19 policies. Sentiment should gradually improve over time.

# ON THE MINDS OF INVESTORS

## ARTIFICIAL INTELLIGENCE – WHAT TO CONSIDER TO BENEFIT FROM THE AI GROWTH TREND

ChatGPT, the generative chatbot program launched in late 2022, has recently drawn mainstream attention to artificial intelligence (AI) – and, specifically, to Generative AI. Because Generative AI can quickly create new content such as images, text, and more, that resembles human-created content, there has been a lot of excitement about its potential applications and how it could impact the way we work and live. This has brought increasing interest in how the prospects of AI may be boosting stock market performance, particularly for a handful of the largest technology companies.  This begs the question of whether one should change their investment portfolio to benefit more from the generative AI growth trend.

First, investors need to keep in mind that the recent strong performance of large technology companies has not been solely because of future AI prospects. The outperformance for these companies this year has been attributed to much better-than-expected sales and earnings growth, a lot of which was not directly tied to AI. The other factor for their recent outperformance is that these companies significantly underperformed the market in 2022, when most were down 40% or more.

That said, large-cap technology companies will almost certainly accrue gains from AI going forward. Cloud computing service companies (like Amazon, Google, Microsoft, etc.) are positioned to provide AI model development infrastructure. Complementing this infrastructure, semiconductor companies (like NVIDIA, Intel, Taiwan Semiconductor, etc.) will support the rapidly increasing data processing demand of these AI models.

Still, investors should keep in mind that much like any major technological trend that has occurred in the past, many different companies and industries typically capitalize on it and accrue benefits to investors over time. Examples include the development of the microprocessor, the personal computer, the Internet, and the mobile phone. The continued development of generative AI is likely to be no different.

The continued impact of the AI revolution has the potential to be felt far beyond the large technology companies that are laying the groundwork today. Beyond technology infrastructure, a major part of the AI revolution will be the various software applications and tools built on the infrastructure. ChatGPT has been one of the first widely used applications of generative AI.

We're still very early in application development, but as the application ecosystem develops, we will likely start to see the entrance of many new software companies, and existing small and mid-sized software companies become the new market leaders. Moreover, there will also likely be new AI models and frameworks, resulting in even more applications built on various platforms.

Furthermore, the AI benefit will be felt well beyond companies (and investors)  in the technology infrastructure and software industries. Examples could include healthcare, education services, consumer goods companies, etc. AI can make businesses in various sectors more profitable if used to analyze data more effectively or make processes more efficient. Taken further, AI can help companies provide better client service, drive faster new product creation, and enable more effective marketing and advertising strategies.

In summary, we're still very early in the generative AI timeline. Looking ahead, many companies--most of which we've likely never heard of or don't even exist today--will stand to benefit from AI. Moreover, many businesses that could benefit may not be technology companies but non-tech industry leaders that effectively use AI to create value. Regardless, investors need to be humble enough to realize that it will be hard to predict which companies will ultimately be the winners in 5, 10, or 20 years down the road.

This is why long-term investors need to keep perspective amid the excitement around AI or other technological trends like robotics, cybersecurity, blockchain, clean energy, electric vehicles, etc. Rather than change one's investment portfolio and concentrate on a few companies and guess which will be the ultimate beneficiaries, it is better to stay broadly diversified in many companies across various industries, company sizes, and business lifecycle stages. This approach helps broaden the investment net to increase the chances of benefiting from technological innovation like AI.

## PORTFOLIO MANAGEMENT

Our recommendations around positioning portfolios are informed by two key considerations: the potential broadening stock market recovery, as interest rate hikes near their end but rates remain higher for longer; and the knock-on effects of slowing global economic growth and potential increased market volatility.

### MAINTAIN BROAD DIVERSIFICATION WITH A DEFENSIVE TILT WITHIN STOCK ALLOCATIONS

Despite the narrow stock participation for most of this year's stock market rally, we recommend that investors diversify their stock allocations across various sectors, company sizes, and countries. This diversification will better enable investors to benefit from further market gains when market participation eventually broadens. It will also better protect investors should the few stocks that have rallied the most (and hence may be more expensive) eventually go through a difficult stretch.

Furthermore, we recommend tilting defensively within stock allocations by allocating to more profitable and higher cash flow companies that are relatively less expensive. Profitable and cash-flow-heavy companies that can self-fund themselves (i.e., not rely on expensive debt financing) will likely perform well over the next few years amid higher rates. These companies can also better weather a potentially more challenging economic environment ahead.

### EMPHASIZE HIGH-QUALITY BONDS OVER HIGHER-RISK BONDS

We recommend that investors allocate most of their bond allocation to high-quality investment-grade bonds, given the outlook for potentially more challenging economic conditions. As the economy continues to slow, bonds issued by companies, governments, and municipalities with a lower probability of default should hold up well. Moreover, the higher yields currently available on safer bonds enable them to once again act as an effective diversifier against losses in significant down markets for stocks.

### AVOID SHORT-TERM MARKET TIMING AND REMAIN FOCUSED ON LONG-TERM GOALS

It may be tempting to change one's portfolio after a significant market run-up like the one we've experienced this year (more so since mid-October 2022). Perhaps you want to reduce a stock allocation for fear of a market correction, or *increase* a stock allocation because the market keeps going up. In our view, the action should not depend on recent market performance but instead on one's financial plan and changes to life circumstances.

Investors should review their portfolios to ensure their allocations are still appropriate for their long-term goals. We review client portfolios daily to ensure they are closely aligned with their strategic target asset allocations; if not, we rebalance them. Periodically we review portfolios with clients to ensure that the strategic allocation is still aligned with their long-term goals; if not, we make a change. We believe that a key to long-term financial success is not letting a recent bull market (or bear market) impact strategic investment decisions.

# SOURCES & ENDNOTES

[1] U.S. stock returns are represented by the Russell 3000 Index. International stock returns are represented by the MSCI ACWI Ex USA IMI. U.S. bond returns are represented by the Bloomberg Aggregate Bond Index. International bond returns are represented by the Bloomberg Global Aggregate Ex USA Hedged Index.

[2] Sources: Morningstar Direct, MSCI. Global stocks represented by the MSCI All-Country-World Investible Market Index Net Total Return USD, was up +13.25% in the first half of 2023, the highest first half year return since 2019 when it was up +16.1% in the first half of the year.

[3] Municipal Bonds are represented by the Bloomberg Municipal Index, Corporate Bonds are represented by The Bloomberg U.S. Corporate Index, Asset Backed Securities are represented by the Bloomberg U.S. ABS Index, Mortgage-Backed Securities are represented by the Bloomberg U.S. MBS Index, Total Bond Market is represented by the Bloomberg U.S. Aggregate Bond Index, and Treasuries are represented by the Bloomberg U.S. Treasury Index.

[4] Source: YCharts, Eurostat. Eurozone Real GDP quarter-over-quarter.

Past performance does not guarantee future results. Indices are not available for direct investment; therefore, their performance does not reflect the expenses associated with the management of an actual portfolio.

## IMPORTANT DISCLOSURE INFORMATION

Please remember that different types of investments involve varying degrees of risk, including the loss of money invested. Past performance may not be indicative of future results. Therefore, it should not be assumed that future performance of any specific investment or investment strategy, including the investments or investment strategies recommended or undertaken by Capstone Financial Advisors, Inc. ("Capstone") will be profitable. Definitions of any indices listed herein are available upon request. Please contact Capstone if there are any changes in your personal or financial situation or investment objectives for the purpose of reviewing our previous recommendations and services, or if you wish to impose, add, or modify any reasonable restrictions to our investment management services. This article is not a substitute for personalized advice from Capstone and nothing contained in this presentation is intended to constitute legal, tax, accounting, securities, or investment advice, nor an opinion regarding the appropriateness of any investment, nor a solicitation of any type. Investment decisions should always be based on the investor's specific financial needs, objectives, goals, time horizon, and risk tolerance. This article is current only as of the date on which it was sent. The statements and opinions expressed are, however, subject to change without notice based on market and other conditions and may differ from opinions expressed by other businesses and activities of Capstone. Descriptions of Capstone's process and strategies are based on general practice, and we may make exceptions in specific cases. A copy of our current written disclosure statement discussing our advisory services and fees is available for your review upon request.

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