Trinity
CAPITAL MANAGEMENT

TCM Investment Outlook & Strategy

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Highlights:

- ***Major global stock and bond market rebounded from prior year losses in the first half of 2023.***
- ***The U.S. economy continues to show moderate growth led by consumer spending and a strong labor market.***
- ***The rate of inflation in the U.S. has continued to decline so far this year.***
- ***The U.S. Federal Reserve raised the fed funds rate three more times in 2023 but paused rate-hikes at the June FOMC meeting.***

The new year brought a more positive tone to the global financial markets as major stock and bond markets recorded gains through the first half of 2023. The Dow Jones Industrial Average (DJIA) posted a year-to-date total return 4.8% through June 30, while the broader-based S&P 500 Index (S&P 500) rebounded from its 20% loss in 2022 to notch an impressive total return of 16.9% over the same time period. As we will discuss in the section on Equities, the strong performance of the S&P 500 was led primarily by a handful of large company growth stocks.

The bond market also bounced back from one of the worst years on record in 2022. High-grade fixed-income instruments posted modest returns for the first six months of the year with major high-grade bond indices registering total returns between 2-4%, depending on length of maturities.[1] The positive returns came from mostly interest income pay outs from the bonds but the longer maturing portfolios generated modest capital gains due to declining bond yields.

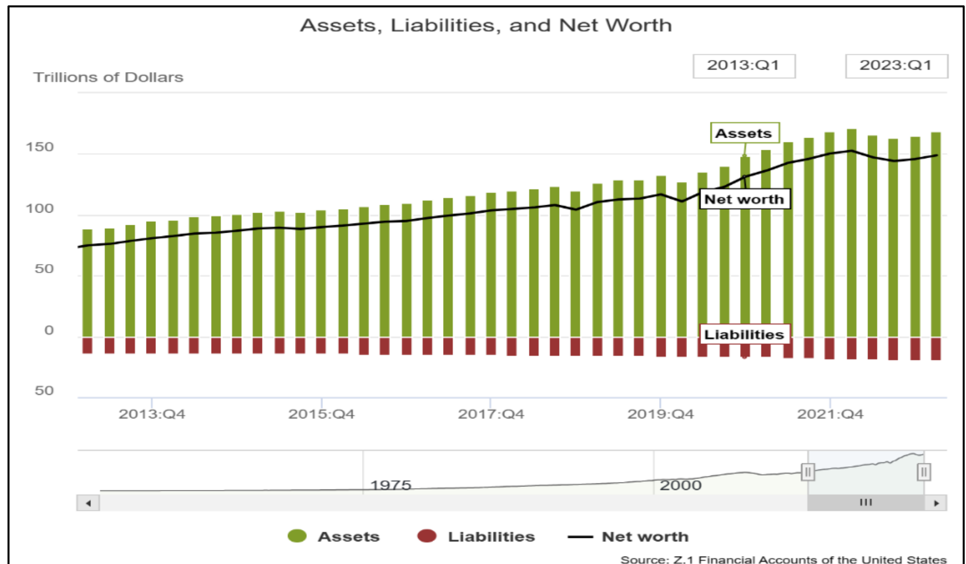
We believe the performance of the financial markets so far this year has been driven by a combination of a better-than-expected economic environment in the U.S., declining inflation rates, and investor anticipation of a shift in U.S. Federal Reserve's monetary policy.

U.S. Economy

Perhaps the most anticipated recession in history for the U.S. economy has yet to materialize in the first half of 2023. At the beginning of the year, many economists and market strategists were forecasting that the U.S. economy would slip into a recession by the second or third quarter of this year. Although certain components of the economy like manufacturing and housing have been in what some would describe as a recession since the third quarter of 2022, various broad-based economic indicators currently show that the overall U.S. economy grew in the first half of the year. It seems the weakness in the manufacturing and housing sectors has been offset with strong growth in the services sector, which is mostly driven by consumer spending. Despite higher interest rates and negative news headlines concerning the banking crisis in March, consumers have continued to spend on service areas like travel, hospitality, entertainment, and dining while pulling back on major purchases like homes, automobiles and household items.

One broad-based measure of U.S. economic output is the GDP (Gross Domestic Product) report issued by the U.S. Bureau of Economic Analysis (BEA). The BEA recently released their revised GDP estimate for the first quarter of 2023 which showed U.S. output grew by 2% during the quarter.[2] The latest estimate for second quarter GDP from the BEA is for an increase of 1.3%.[2] Although, GDP growth is definitely slowing from its 2.1% pace for 2022, we don't feel it is near falling to a recessionary level at this time.

Consumer spending is mostly responsible for the economy's growth in the first half of the year. Personal consumption expenditures accounted for 68% of U.S. GDP output as of March 31 while manufacturing only accounted for 10.9%.[3/4] Government spending accounts for balance of GDP output at about 21%. One reason consumers continue to spend may be the continued strong labor market. Jobs growth has been robust so far in 2023 as the economy has added over 1.5 million jobs through May and employers have raised wages by 3.4% year-over-year, according to the Bureau of Labor Statistics May 2023 report.[5] In the May labor report, the employment rate ticked up from 3.4% in April to 3.7% but still remains historically low. In addition, the overall financial health of consumers remains very strong. As you can see in the adjacent chart provided by the U.S. Federal Reserve, as of the first quarter 2023 household finances are in good shape with total liabilities at $19.6 trillion, as indicated by the red portion of the bar, while household net worth was $148 trillion as indicated by the green portion of the bar.[6] It is evident from the chart that consumers have not overextended themselves with debt over the past two years. Household debt payments accounted for only 9.6% of disposable personal income, as of the end of the first quarter, below the lowest levels recorded between 1980 and the onset of the pandemic in March 2020.[7]



We believe the overall financial health of consumers could continue to spur demand, especially in the services sector. While there is evidence that higher interest rates are starting to crimp consumer demand, it doesn't appear to us that the current level of interest rates for mortgages, car loans and other consumer credit sources will dampen demand enough to throw the economy into recession this year. While we still believe the U.S. economy will experience a mild recession at some point in the next 12-18 months, based on the strength of the labor market and the resilience of consumer spending, it looks like to us that a recession might not occur until sometime in 2024.

Another positive for the economy is the continued decline of inflation which has been on a downward path since peaking in June of 2022. Both the widely followed Consumer Price Index (CPI) and the lessor known Personal Consumption Expenditures Index (PCE) continue to fall. The PCE is closely watched by the Fed as an indication of overall inflation in the economy. The most recent report from the U.S. Commerce Department showed the PCE Index rose by .1% for the month of May and 3.8% for the previous 12 months.[8] While Fed's preferred "core" index, which excludes food and energy prices, was up .3% for May, this was a significant improvement from the April report and the lowest rate since April 2021.[8]

If inflation continues to subside, the Fed may be able to let off the monetary tightening gas pedal over the next few months. At the last Federal Open Markets Committee (FOMC) meeting in June, the Fed did not hike the Fed funds rate for the first time since beginning its monetary tightening strategy in March 2022. The Fed had increased rates ten times by a total of 5%, with the last rate-hike coming at the May 2023 FOMC meeting. Chairmen Powell indicated in the post meeting briefing that the pause would likely be temporary and suggested the possibility of more rate-hikes in the future. The closely followed Fed funds futures contracts, used to forecast future Fed rate hikes, is currently signaling an 87% probability of a rate-hike at the July Fed meeting. Many economists expect the Fed to raise rates one to two more times this year reaching a "terminal rate" of between 5.5% and 6% before pausing. Powell and other Federal Reserve board members, have continued to emphasize their desire to get inflation back down to its target rate of 2% which may mean a bit more monetary tightening this year. Regardless, it's looking more like the Fed is nearing the end of its 15-month rate-hike cycle. We believe this is a major positive for the economy going forward.

Equities

At the beginning of 2023, few market strategists predicted a 16% plus total return for the S&P 500 Index this year, much less for the first six months. Even the most bullish strategists were forecasting returns for the entire year in the 10-12% range. However, when you drill down into the details of the S&P 500 performance, you find that the majority of the gains were driven by a few of the largest growth stocks. In fact, about 80% of the S&P 500's return can be attributed to only seven of the largest S&P 500 stocks in the index as of June 30.[9] Most of these stocks are large capitalization technology companies that are involved in artificial intelligence (AI) applications. Investors drove up the prices of these stocks in the first half of the year based on the sentiment that AI will bring transformational productivity growth for many businesses over the next several years. While we believe AI applications will continue to be implemented in many industries over the next several years, the euphoria that has driven up the stock prices of many AI related companies may be somewhat premature since much of the growth potential may be years down the road. If you take the performance of these seven companies out of the S&P 500 Index, the return for the quarter is approximately 5%. The equal-weighted return for the S&P 500 Index, which is a broader measure of performance, was 7% for the first six months.[1] Although 7% is still a very nice six-month return for stocks, it pales by comparison to the cap-weighted return of the S&P 500 of 16.7%.

We are encouraged by the resilience of the U.S. economy and equity markets thus far this year. We believe this bodes well for the second half of the year particularly if corporate earnings can begin to rebound from two consecutive quarters of mild contraction. Investors seem to be ignoring the mild contraction in earnings perhaps due to expectations that earnings growth will resume sometime in the second half of the year and accelerate in 2024. Stock prices are typically forward-looking and tend to discount future economic activity. We believe the biggest determining factor of future corporate earnings will be the nature and extent of a potential recession for the U.S. economy. A so-called "hard landing" for the economy, entailing several quarters of negative GDP, would most likely send stocks prices lower, perhaps even testing the 2022 lows. On the other hand, if the economy avoids recession and experiences a "soft landing" as some suggest, then the all-time stock market highs reached at the beginning of 2022 may be in reach.

Consumer sentiment may be the key to future performance of equities as illustrated in the accompanying chart provided by Blackrock. Since 1978, whenever consumer confidence, as measured by the University of Michigan Sentiment Index, is low and at a turning point, stock prices have enjoyed a significant rally over the next several years. Historically, when consumers are feeling less confident about the economy and about where things are headed, that is often a great time to put money to work in stocks. Of course, past performance is not necessarily an indication of future performance, but it does give us some insight on where stock prices might be heading over the next few years. Consumer confidence has been improving since it reached a low point in June 2022. In June of this year, consumer confidence rose 9% to 64.4%, the highest level since the beginning

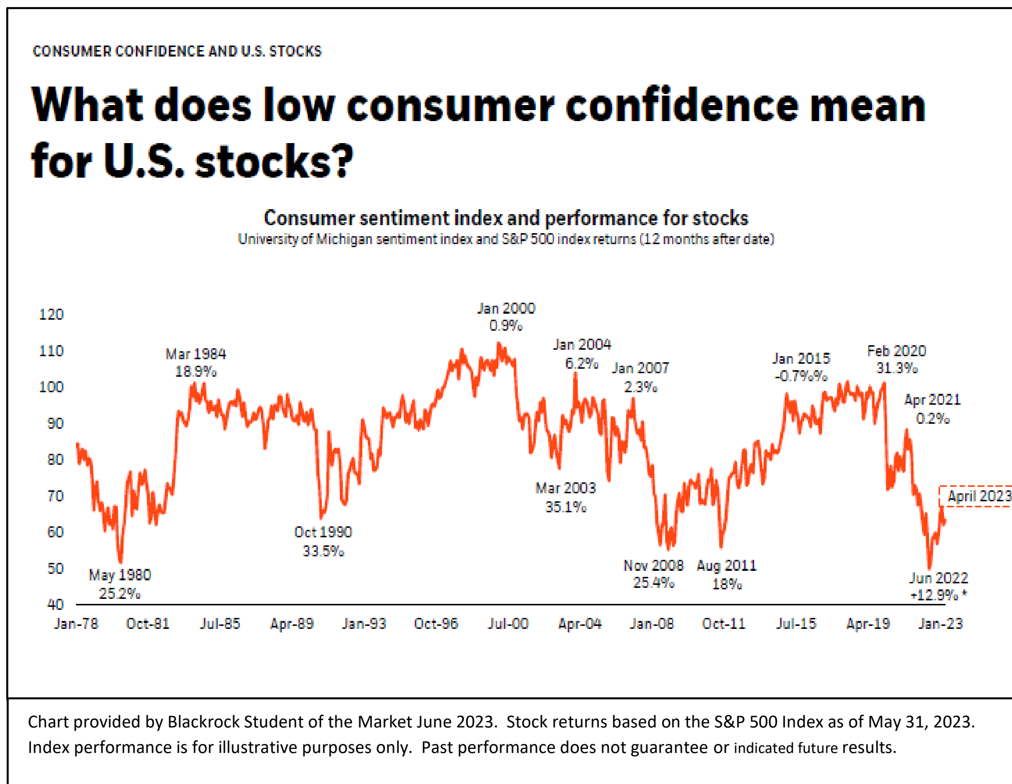


Chart provided by Blackrock Student of the Market June 2023. Stock returns based on the S&P 500 Index as of May 31, 2023. Index performance is for illustrative purposes only. Past performance does not guarantee or indicated future results.

of 2022 according the latest report from the Confidence Board.[10] It should be noted, however, that this rebound still leaves consumer confidence well below levels associated with past market peaks.

The rebound in equity markets so far this year has spurred many market strategists to declare the bear market in stocks officially over as the S&P 500 recently hit a level where it was 20% higher than the October 2022 lows. Although this is a significant recovery that cannot be ignored, it still leaves the S&P 500 approximately 8% below its all-time high reached in January 2022. Until the S&P 500 can exceed its all-time high, we are not quite comfortable declaring the bear market dead. We are concerned with the narrowness of the market advance as we discussed earlier. With the majority of the gains coming from just a few of the largest stocks in the index, we are reluctant to declare the end of the bear market. However, recently we began to see the market broaden out as more stocks began to participate in the rally. This is a good sign that equities could be in the beginning stages of a bull market. But we will need to see more evidence of the broad-based strength in equities before climbing on board the bull train.

In the near-term, we believe the risk for stock prices at this point may be to the downside. Currently, technical indications suggest to us that stocks are over-bought and could be due for a correction in the range of 3-5% range. Anything much greater than that would potentially indicate that the performance of the S&P 500 since the October 2022 market low has just been a bear market rally. But if stocks can hold key technical support levels over the next few weeks, it could be a good sign the bear market is over and a more constructive environment for stocks lies ahead. For now, we recommend holding cash reserves until there is further evidence supporting the potential for higher stock prices this year.

Fixed Income

At the beginning of 2022, interest rates across the maturity spectrum for most fixed-income instruments were at historically low levels. Short-term instruments like U.S. Treasury securities, bank CD's and prime money market funds offered yields below .5%. Intermediate and long-term yields weren't much better on highly-rated fixed-income securities. The 10-Year U.S. Treasury Note yield started 2022 at a yield of 1.6%.[1]

That all changed when the Federal Reserve launched their monetary tightening campaign in March 2022 and raised the Fed funds rate from .25% to where it currently stands at 5%. The Fed's actions forced interest rates higher for virtually every fixed-income instrument. That was bad news for bond investors as the rising rates pushed bond prices lower resulting in significant losses during 2022. Today, the higher yields are good news for fixed-income investors, as it gives them an opportunity to lock in what we believe are attractive interest rates and cash flows. With interest rates exceeding 4% across much of the yield curve, investors can potentially lock in interest income from newly purchased high-quality fixed-income instruments and potentially enjoy meaningful capital gains on their holdings. High-quality fixed-income instruments could also serve as a potential portfolio hedge if the U.S. economy falls into a recession in the second half of the year as some economists and market strategists forecast. We believe a weaker economy would potentially lead to falling interest rates and rising bond prices.

Strategy

We continue to favor high-quality, dividend-paying U.S. mid and large company stocks. These stocks have on average underperformed the growth stock sector of the market so far in 2023 but are starting to perform much better in June. We believe investors will migrate more toward these kinds of stocks as the economy slowly weakens for the rest of the year and dividend yields become more attractive. There are many high-quality dividend-paying stocks that now offer yields in excess of 3%. (Dividends are not guaranteed and are subject to change or elimination).

Small-capitalization (small-cap) stocks have also started to perform better recently and could present an excellent buying opportunity in the second half of the year. Small-caps have generally under-performed their large capitalization (large-cap) counterparts since 2020.[1] However, the valuations of small-cap stocks relative to large-cap stocks look attractive and the technical picture is starting to improve, in our view. Historically, when small-cap stocks start to outperform large-cap stocks it lasts for several years. However, if the economy weakens in the second half of the year under the weight of higher interest rates, it may pay to wait before adding additional exposure to small-cap stocks.

Commodity stocks on average have performed poorly in 2023, particularly, stocks in the energy, materials, and metals sectors. We believe investor concerns about rising interest rates and the potential of a recession have weighed on stock prices in this area. We see this as a good area of opportunity in the second half of the year and into 2024. We believe energy stocks present an excellent buying opportunity as the supply-demand picture remains favorable and investors once again seek exposure to the energy sector after taking profits in the first half of the year. Many oil and gas stocks are now paying dividend yields in excess of 4%. Although, dividends are not guaranteed, we feel the strong cash flows of many high-quality energy stocks not only support current dividend payouts, but provide the potential for dividend rate-hikes in the future.

We continue to remain neutral toward foreign stocks. The Eurozone officially entered a mild recession in the first three months of the year with GDP falling .1% during the quarter following a .1% decline in the 4th quarter of 2022, according to Reuters.[11] A recession is typically defined as two consecutive quarters of economic contraction. The good news is it appears the recession in the Eurozone will be mild and perhaps last only for a few quarters. At some point, we feel both developed country and emerging market country stocks will be attractive for investment however, we believe that now is not the time to add exposure to these asset classes.

For investors desiring fixed income exposure to generate cash flow as well as for portfolio diversification purposes, we continue to favor high-quality fixed-income instruments like U.S. Treasuries, high-grade corporate bond, bank CD's, prime money market funds, and tax-free municipal bonds. We view tax-free municipal bonds, with current yields ranging from 3% to 4.5% for intermediate and longer-term maturities, as very attractive for investors in higher tax brackets. Those tax-free yields calculate to a taxable equivalent yield for investors in a 35% tax bracket of 5.4% to 6.9%. As we mentioned in our January 2023 client letter, we continue to favor using a "barbell" strategy for the fixed-income component of a portfolio. This strategy involves investing a portion of the fixed-income allocation in short-term instruments, with maturities of less than 2 years, while investing the remainder of the allocation in longer-term bonds with maturities ranging from 10-20 years. The percentage in each maturity category depends on individual risk tolerance and cash flow needs. We would avoid most international and emerging market fixed-income holdings for now as a potentially stronger U.S. dollar and weaker overseas economic conditions could negatively impact prices. We would also avoid so called "high-yield" bonds. These bonds, which have lower credit ratings than high-grade bonds, tend to underperform in a recession as default rates typically rise.

The Bottom Line

We approached 2023 with a cautious attitude toward the financial markets based on concerns about the impact of significantly higher interest rates on economic growth this year. Like many advisors, we have been surprised by the strength and resilience of both the economy and the equity markets. Although we are encouraged by the strength, we remain concerned that at some point the higher interest rates and tighter credit conditions could depress economic activity. We believe these conditions could create more volatility in financial markets in the near-term. However, it is our view, that investors should continue to hold equity allocations according to their long-term investment objectives and ride out the volatility because once we get to the end of the Fed tightening cycle, we could begin to see a more constructive economic and market environment. We see any potential near-term weakness in stock prices as a good opportunity to selectively add to high-quality equities, where appropriate.

As always, we greatly appreciate your continued trust and confidence in us and we will continue to work to keep you informed of economic and market developments.

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Footnotes

[1] Thompson charts
[2] https://www.bea.gov/
[3] https://fred.stlouisfed.org/series/DPCERE1Q156NBEA
[4] https://fred.stlouisfed.org/series/VAPGDPMA
[5] https://www.bls.gov/news.release/realer.nr0.htm#:~:text=Real%20average%20hourly%20earnings%20increased,weekly%20earnings%20over%20this%20period
[6] https://www.federalreserve.gov/releases/z1/dataviz/z1/balance_sheet/chart/
[7] Wall Street Journal, "Why Economies Slowed More Since Central Banks Hit the Brakes," June 26, 2023
[8] CNN Business, "The Fed's Favorite Inflation Gauge Show Prices Rose .1% Last Month, June 30, 2023
[9] CNBC.com, "The Biggest Threat to a Major Pullback in Stocks is a Hard Landing for the Economy, June 20, 2023
[10] https://www.conference-board.org/topics/consumer-confidence
[11] Reuters, Euro Zone Saw Winter Recession, More Challenges Ahead, June 8, 2023.

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The Russell 1000® Growth Index measures the performance of those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values.

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