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2Q23 Review - What if they threw a party for the Recession, and it didn't come?

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For the past several months, a majority of the market pundits and economists have been anticipating that the United States would enter into a recession, so much so that often it was characterized as the most widely anticipated recession of all time. Nonetheless, the stock market's invitation (along with Recession's invitation) to the recession party must have gotten lost in the mail as it continued to be resilient in the first half of 2023, even in the midst of the Federal Reserve's continued interest rate increases, bank failures, and a potential U.S default spurred on by the debt ceiling debate in Congress. In light of this, the Morningstar U.S. Markets Index has returned 16.52% year-to-date and 8.49% for the second quarter. The S&P 500 index was up 16.89% and 8.74% for the year-to-date and 2nd quarter, respectively. Even fixed income indexes, after experiencing the worst year in decades in 2022, are up YTD in the low-single digits.

Exhibit 1. Investment-Style Returns

	Morningstar Index Market Returns	2016	2017	2018	2019	2020	2021	2022	2023		
									1st Qtr.	2nd Qtr.	2022 ytd
Growth	U.S. Growth	3.16%	29.52%	0.78%	35.90%	44.65%	24.79%	-36.70%	14.79%	11.64%	28.15%
	Large Growth	1.79%	31.15%	2.94%	33.81%	38.86%	21.47%	-40.36%	17.56%	12.80%	32.61%
	Mid Growth	6.46%	25.67%	-3.16%	36.01%	46.17%	14.97%	-32.37%	9.71%	6.48%	16.81%
	Small Growth	9.61%	23.77%	-5.67%	27.60%	43.52%	-1.00%	-33.13%	10.20%	7.34%	18.29%
	US Market	12.44%	21.47%	-5.05%	31.22%	20.99%	25.78%	-19.43%	7.40%	8.49%	16.52%
Value	U.S. Value	20.79%	14.23%	-7.51%	25.09%	-1.31%	23.98%	-0.72%	0.18%	3.86%	4.05%
	Large Value	18.91%	15.09%	-5.90%	25.70%	-0.62%	21.49%	0.26%	0.72%	4.06%	4.81%
	Mid Value	25.21%	13.02%	-10.63%	24.81%	-3.76%	29.02%	-2.39%	-1.28%	2.50%	1.19%
	Small Value	27.96%	8.40%	-16.61%	19.96%	1.01%	31.79%	-6.60%	-1.40%	4.01%	2.56%

Source: Morningstar

The Technology sector, specifically the mega-cap technology stocks (Apple, Microsoft, Google, Nvidia, Amazon, Tesla) that account for a significant weight in most market cap weighted indexes, was the primary driving force of the market's returns year-to-date. The stock prices of most of the largest weightings in the benchmarks were at their one-year lows at the end of 2022. To neutralize the market cap weighting influences when examining the equally weighted S&P 500 return, the YTD return would be 5.96%, which illustrates the fairly concentrated outperformance of most market cap weighted benchmarks. It isn't unusual for performance to start to "broaden out" as more stocks play "catchup" to the concentrated outperformers.

Growth-style investing continues to outpace value-style with most of the divergence being attributed to value benchmarks' underweight in the best performing sector, technology, and relative overweight in the financial sector, one of the weakest performing sectors so far this year. The excitement surrounding generative artificial intelligence (A.I.) has been the primary driver, taking some stocks to stratospheric valuation levels. As stated previously in our last quarterly newsletter, generative A.I. has the potential to

boost productivity and economic growth and is perhaps the most disruptive technological innovation since the initial start of the internet or Google's search engine, but it is in its early innings of development. Many of the lesser-known beneficiaries of generative A.I. have been developing products for their own proprietary data, so it's likely as investors start to broaden their research within the segment that the market will broaden out. There are a number of ways to participate in this new "boom" that should last for years via the companies providing the "picks and shovels" to build out the infrastructure, in addition to the obvious beneficiaries.

Exhibit 2: Bull / Bear Markets Since 1974

Duration of Bull Markets since 1974

Dates		Calendar	S&P 500 Price		
Start	Ending	Days	Start	Ending	Return
10/3/1974	11/28/1980	2,248	62.28	140.52	125.6%
8/12/1982	8/25/1987	1,839	102.42	336.77	228.8%
12/4/1987	9/1/2000	4,655	223.92	1520.77	579.2%
10/9/2002	10/9/2007	1,826	776.76	1565.15	101.5%
3/9/2009	2/19/2020	3,999	676.53	3386.15	400.5%
3/23/2020	1/3/2022	651	2237.4	4796.56	114.4%
10/12/2022	ongoing	258	3577.03	4455.59	24.6%

source: factset / Maclura Investments

Duration of Bear Markets since 1974

Dates		Calendar	S&P 500 Price		
Start	Ending	Days	Start	Ending	Return
11/28/1980	8/12/1982	622	140.52	102.42	(27.1%)
8/25/1987	12/4/1987	101	336.77	223.92	(33.5%)
9/1/2000	10/9/2002	768	1520.77	776.76	(48.9%)
10/9/2007	3/9/2009	517	1565.15	676.53	(56.8%)
2/19/2020	3/23/2020	33	3386.15	2237.4	(33.9%)
1/3/2022	10/12/2022	282	4796.56	3,577.03	(25.4%)

source: factset / Maclura Investments

During June, the market reached a level that a bull market was officially declared. While definitions are constantly being redefined, the declaration of a bull or bear market is a binary event and not based upon subjectivity. In our previous quarterly market commentary, we stated that the market likely established a bottom on October 12, 2022, when the S&P 500 closed at 3,577.03, and thus establishing the potential ending date of the bear market that started on January 3, 2022. An "official" declaration of a bull market can only be done retroactively after a broad stock benchmark has risen 20% from recent lows and ends when the market declines by 20% after a period of rising greater than 20%. The starting or ending date would be established at the peak or trough of the market for the designation of the bull or bear market. This past June 8th, the market was confirmed to be in a "bull market" after it rose above the 20% ceiling, with the starting date of October 12, 2022.

Just because the market is now officially in a bull market does not mean that the market returns will be linear in an upward direction. Since 1974, there have been six bull markets, excluding the current bull market. During three of those bull markets, the S&P 500 had two to three drops of greater than 15%, only to reach new highs before the bull market ended. Interestingly, of the seven times the market has pulled back greater than 15% during a bull market, five of those times were greater than a drop of 19% and very close to marking the end of the bull market.

A quote attributed to Mark Twain that I often think of while reflecting on history and projecting the future is, "History doesn't repeat itself, but it often rhymes." And by rhymes, I'm considering what factors could negatively impact the market to cause a pullback greater than 15%. One of those factors may be the investor's need to reconcile the Federal Reserve's message of "high for longer" on interest rates instead of expecting a pivot by the Fed to reduce interest rates to help strengthen a slowing economy.

At the June Federal Reserve meeting, the open markets committee left the federal funds rate unchanged at the current range (5.00 – 5.25%), giving investors the false impression that the interest rate increases were done. But all confusion in the interpretation of the Fed's actions was put to rest during Chairman Powell's press conference where he stressed that short-term interest rates had reached a level that the cadence of interest rate increases could be slowed down, not stopped, as the committee's focus on higher-than-desired inflation continues to have work to come down.

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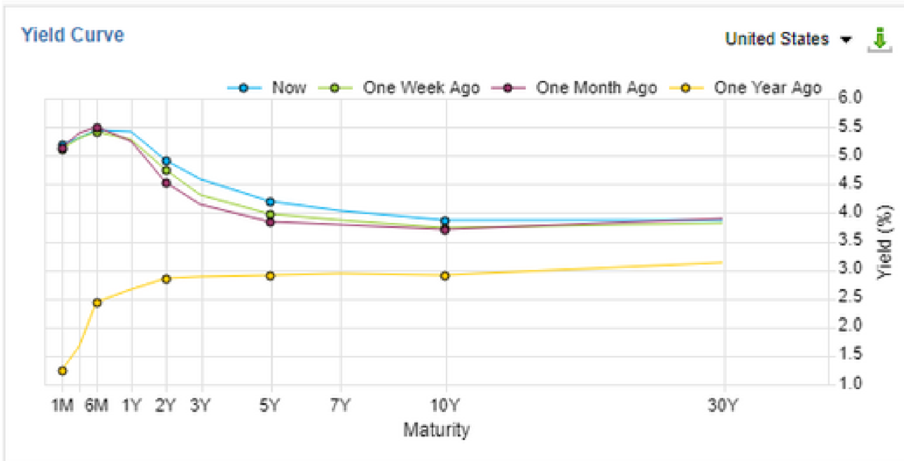
When examining the current yield curve for US Treasuries, the market is anticipating that long-term rates will level off at around 4%, implying that eventually the Fed will start to cut rates as inflation subsides or the economy slows into a recessionary environment. I suspect that interest rates will remain elevated, and the Federal Reserve will continue to raise short-term rates another 50 basis points, resulting in a fed funds rate range goal of 5.50 – 5.75%. by the end of the year.

Exhibit 3: U.S. Government Yield Curve



Source: Factset

The second factor that could have a negative impact on the market is the impact that higher interest rates are having on private and public companies that have floating rate debt. The capital markets have been at a virtual standstill over the past year as banks were reluctant to syndicate debt deals in a rising interest rate environment. As the floating rate debt is reset at higher levels, it is placing additional pressure on smaller, emerging businesses that may not be mature operationally to be able to handle the higher interest expense payments.

After a dearth of capital market activity, there is a heightened likelihood that the market is in the initial stages of the largest restructuring corporate debt activity that it has been seen in a while. This may seem a contrary conclusion when paired with the layoff news coming from the investment banks over the past six months due to the significant drop off in capital market activity. Nonetheless, there was a significant amount of Leverage Buyout (LBO) activity during 2018–2021, and most of those bonds will need to be restructured and recapitalized in 2024–2026. Companies flush with cash will certainly benefit in this scenario, consolidating industries more than ever before, with investment banking companies benefiting from the increasing deal flow.

The final potential factor that could be negative for the market, excluding the possibility of a black swan event (an unpredictable or unforeseen event), is a recession. While the media may point to the increased bankruptcies that may come as a result of the higher corporate debt restructuring discussed above, I have doubts that a recession is imminent in the next 12 months with the amount of fiscal spending in the queue. The latest Federal Reserve release projects that GDP will grow near 1.0% for 2023, up from the projected 0.1% estimate established at the beginning of the year.

While there is a lot of news about electric vehicles and green energy, the world still runs primarily on crude oil, and the cost of crude oil has remained relatively subdued around $70 a barrel, even after OPEC announced additional production cuts to help bolster crude prices. Typically, high oil prices are what drives economies into a recession, and current levels are hardly recession-inducing prices. Nonetheless, the "tit-for-tat" trade spat between the United States and China could further complicate the strength of the economy as specialty materials (rare earth materials) replace crude oil as the potential economic driver. For the past several years, this trade conflict has significantly increased the "nearshoring", "reshoring", and "friendshoring" of manufacturing to eliminate the "unknown" risks to companies' supply chains, but it will take time to fully insulate from this risk.

Even as more rare earth materials mining takes place outside of China, the vast majority of the refining capacity of the rare earth materials remains in China. Meanwhile, companies will need to adapt to the supply chain constraints that continue to hamper certain areas of the economy, specifically within the specialty metals market.

In the short-term, there is enough fiscal spending and cash within the economy to keep a recession at bay, however, inevitably, the economy will ease into a recession. Before implementing the "economic growth at any price" policy mentality of the world central banks with quantitative easing and zero interest rate policies to deal with the great recession of 2008-09, a recession was a time to prune the inefficient areas of the economy to make it stronger in the future. Having a well-diversified portfolio in companies that have strong balance sheets and solid competitive positioning should benefit investors when the recession finally shows up late to its party. In the meantime, this market's invitation to the recession party will probably still be "lost in the mail" until next year, if not longer.

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