Vestor Capital
INVESTMENT & WEALTH MANAGEMENT

Economic and Investment Outlook July 12, 2023

Equity Market Update

Equity indexes have continued to strengthen in the second quarter, which is encouraging given all the headwinds the market has faced such as rising interest rates, bank failures and lingering inflation. Technology stocks continue to perform well as evidenced by the 32% gain in the NASDAQ composite. The large weighting of technology stocks in the S&P 500 has helped propel that index up 16% in 2023, vs. only a 5% gain in the Dow Jones Industrial average. The developed large-cap international index has performed well, rising 12%. Emerging market stocks, due in part to weakness in Chinese equities, have not fared as well but still have posted gains of 5%.

The long-forecasted recession has yet to materialize despite higher interest rates and continuing inflation. Historically recessions are accompanied by weakening employment, and we have yet to see any stress in the labor market. We believe that equities can continue to perform well if inflation continues to recede, and employment remains strong.

It pays to look through gloomy headlines as the sun does eventually come out. If you wait for the sun to rise before investing, you typically miss out on much of the gains. Investors see that we are nearing the end of interest rate hikes and inflation is receding and are investing in anticipation of better corporate earnings coming soon.

Total Return Performance for the Major U.S. and International Stock Market Indexes

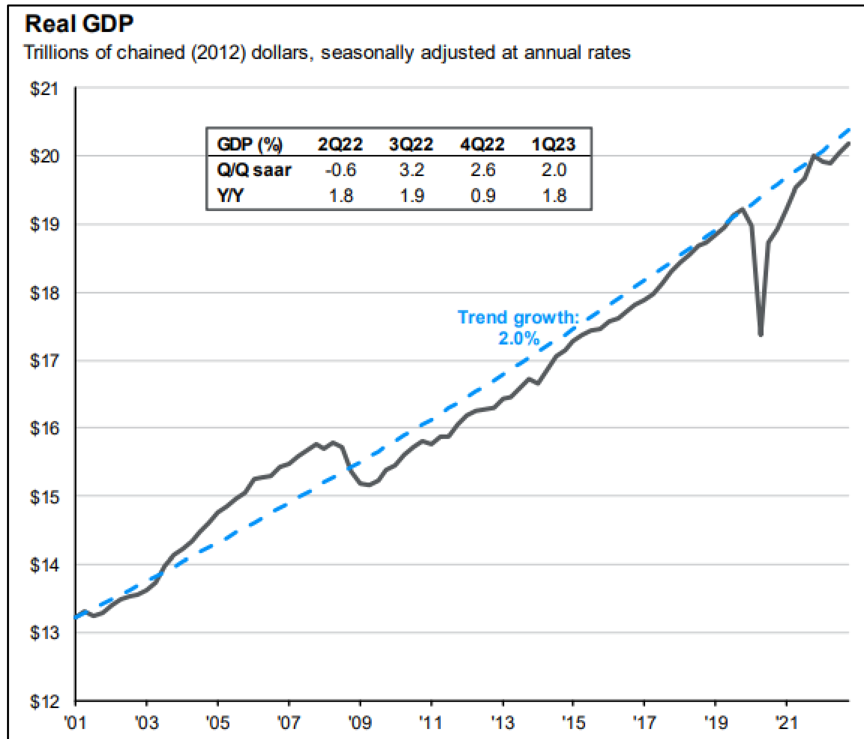
Equity Index	*YTD June 30, 2023*
United States	
Dow Jones Industrial Avg.: 30 Stock Composite	**4.94 %**
S&P 500 Composite: U.S. Large Cap	**16.88 %**
NASDAQ Composite: Technology Heavy	**32.32 %**
S&P 600 Small Cap: U.S. Small Cap	**5.99 %**
International	
MSCI EAFE Large Cap: Europe, Asia & Far East Large Cap	**12.16 %**
MSCI EAFE Small Cap: Europe, Asia & Far East Small Cap	**5.90 %**
MSCI EM Emerging Market: Emerging Market Countries	**5.02 %**

Source: Bloomberg, L.P.

Economy

While we are inundated with press accounts of prospects for an upcoming recession it is helpful to step back and look at the two most recent recessions which were much worse than we have seen historically as the 2007-2008 recession was caused by a historic bank crisis and the 2020 recession by a global pandemic. Nevertheless, even including these severe contractions we have averaged 2.0% GDP growth since 2000. Due to a large service orientation, our economy is very resilient as we are not as dependent on manufacturing as we were in the 1970's and 1980's. While the economy is not functioning at full capacity currently, we believe first quarter GDP growth of 2% was outstanding given all the well documented headwinds the U.S. economy is facing.

It is important to remember that growth is the norm and contractions the exception. Also, contractions, while painful, are typically short-lived. Finally, by the time the economy is in a recession, the stock market typically is already moving up in anticipation of better economic times ahead. For these reasons, it pays to not needlessly dwell on the bad news of the day, but rather look for early signs of recovery before they become apparent for all to see.



Source: JPMorgan Guide to the Markets 6/30/2023

Inflation

The June 2023 consumer price index showed inflation rose 3%, which is a dramatic decline from peak inflation of 9% in June 2022. Inflation has now fallen each month since June 2022 which is very encouraging. Despite this tremendous progress, monetary officials have warned that they may still raise interest rates as they won't be satisfied until inflation returns to 2%. We believe that this is misguided as it takes time for interest rate hikes to impact the economy and the FOMC should give the recent interest rate hikes time to work through the economy before considering additional rate hikes.

U.S. Equity Market Outlook

Over time equity markets advance due to companies growing revenues, margins and reducing their share count. The chart below illustrates that since 2000, S&P 500 earnings have grown 8.4% due to these factors. Of course, the multiple that is applied to earnings and dividends results in the total market return. If the earnings multiple expands, equities rise by more than EPS growth and if the multiple contracts, then equities rise less than EPS growth. While market pundits always focus on the market price-to-earnings (PE) multiple and scare investors if it is higher than average, we suggest focusing on corporate earnings growth instead. The price investors are willing to pay for corporate earnings can vary, but if an investor has a reasonable investment horizon, they will enjoy gains as corporate earnings grow over time. Too much emphasis is placed on the PE ratio and not enough on the fact that over time, corporate earnings growth leads to stock gains, and corporate dividends which both contribute to wealth creation.

S&P 500 year-over-year operating EPS growth

Share of EPS growth	2023*	Avg. '01-'22
Margin	8.1%	4.1%
Revenue	2.4%	4.0%
Share count	0.2%	0.3%
Total EPS	10.8%	8.4%

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Source: JPMorgan Guide to the Markets 6/30/2023

Artificial Intelligence (AI) Economic & Market Implications

Artificial intelligence (AI) at its core is simply using powerful computers and robust datasets to solve complex problems quickly. While this is not a new development, what has recently occurred is the convergence of vast amounts of data and powerful computers, enabling AI growth to accelerate dramatically. There is an endless list of current and potential applications of AI including flight scheduling, loan eligibility, healthcare management and customer service to name just a few.

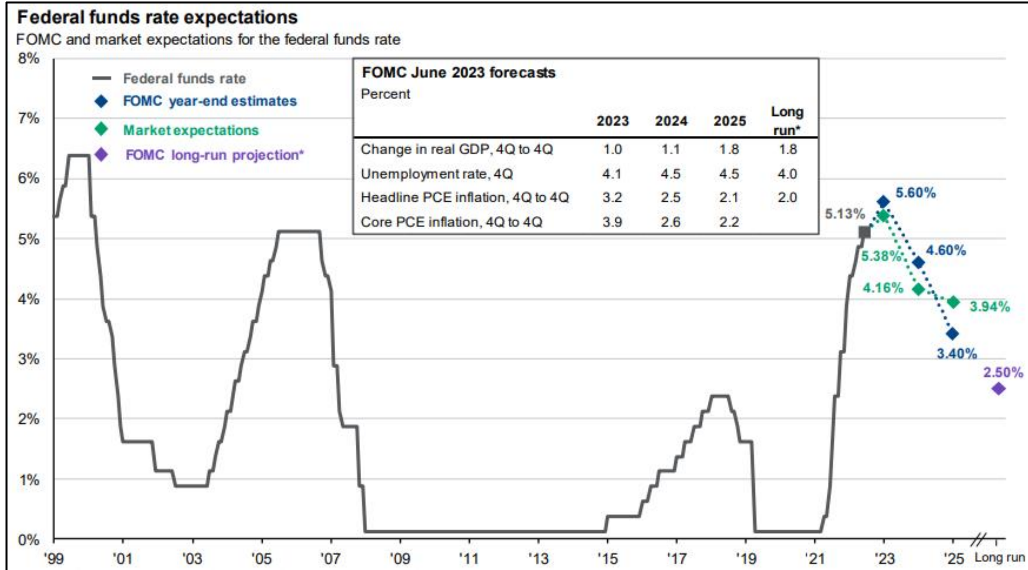
Companies will be able to make better decisions at a lower cost which is an attractive proposition. For this reason, there is an arms race to stay ahead of the competition or get left behind. The obvious near-term beneficiaries are semiconductor and software companies. But all companies that use AI will benefit from this tool through lower costs and better outcomes.

The question on people's minds is whether this is a transformative development similar to the internet or just a fad that will evaporate. We believe in the near-term companies that supply the tools will certainly benefit. These include semiconductor and software companies along with consultants. The spending will be significant and a number of large companies in the S&P 500 such as Nvidia, Microsoft, Alphabet and Amazon will benefit. How much their customers will gain from AI will be seen over the coming years if not decades. Early results from AI initiatives have been encouraging and we are optimistic that AI will help improve productivity which will ultimately accelerate economic growth. This in turn should lead to faster and higher profit growth which is a positive for equities and could prove to be the long-term game changer.

While there is always concern over job losses from new technologies, ultimately new higher value jobs are created which is beneficial to society. No one is ruing the loss of buggy whip manufacturers today and we imagine the same will be said years from now over lost jobs due to AI.

Fixed Income

The graph below highlights that while interest rates may rise a little more, the market expects rates to fall in the coming years and move to the FOMC's long-run projection of 2.5%. Bonds purchased today at higher interest rates will be worth more when rates decline, making now an ideal time to establish or add to fixed income.



	2023	2024	2025	Long run*
Change in real GDP, 4Q to 4Q	1.0	1.1	1.8	1.8
Unemployment rate, 4Q	4.1	4.5	4.5	4.0
Headline PCE inflation, 4Q to 4Q	3.2	2.5	2.1	2.0
Core PCE inflation, 4Q to 4Q	3.9	2.6	2.2	

Source: JPMorgan Guide to the Markets 6/30/2023

Summary

Inflation is falling and interest rate hikes are coming to an end. This creates a positive setup for equities and fixed income. If employment stays strong, we believe the long-awaited recession will likely not materialize which it seems the market has been telling us in 2023 due to its buoyancy. While there are concerns that only a handful of large technology companies are responsible for a significant portion of the market gains, note that these are substantial, very profitable companies with very bright futures. Also, we have begun to see a broadening of market participation as investors gain comfort that the economic picture is beginning to brighten.

We anxiously await commentary from management teams as they report second-quarter earnings over the coming weeks and expect a note of cautious optimism as business conditions are stabilizing. This would be a positive signal for equity markets. Fixed income investors are enjoying more generous coupons, and when interest rates begin to fall over the coming years will benefit from rising bond prices. There is certainly a lot to be encouraged about as we exit the interest rate hike cycle and business slowdown period and enter growth mode again.

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