The debate between bearish forecasters and bullish markets rages on. With inflation easing, labor markets strong, and the economy growing, so far you'd have to say the markets are winning.

DEFYING GRAVITY

Despite an almost universal chorus of forecasters calling for an imminent recession in the US, the S&P 500 continued to climb in the second quarter, gaining 8.7% and bringing its first half total return up to 16.9%. That is an eye-popping figure for six months delivered by one of the most unloved market rallies in memory.

It's worth noting that little of the S&P's gain for the first half came from an improving earnings picture. Wall Street expectations for the coming 12 months' corporate earnings rose only about 1% in the first half, after falling for most of 2022. So, the price gain in the S&P was driven almost completely by an increase in the multiple investors were willing to pay for a dollar of future earnings. This is the "P/E" or price-to-earnings ratio.

This increased willingness to pay up for a future dollar of earnings reflected investors' belief that market risks have declined. That perceived reduction in risk came from four sources: First and foremost, inflation has fallen substantially ***without*** rising unemployment and recession. This is the "soft landing" scenario that most forecasters (*mea culpa*) thought unlikely.

Second, as a result the Fed has eased up on the brakes, if you will, by sharply reducing the severity of its interest rate increases. Having raised rates by 0.75% five times in 2022 and then 0.50% last December, in February, the Fed raised short rates by just 0.25% and did so again in March and May. It then didn't raise rates at all in June. While the Fed says it may not be done with rate hikes, the market seems to think the worst is behind us. And remember: the Fed raising rates is historically THE primary risk to the stock markets.

Third, the banking crisis that took down Silicon Valley Bank, Signature Bank, and First Republic Bank in the first half appears to have been ringfenced by the aggressive interventions of the Fed, the US Treasury, and the Federal Deposit Insurance Corporation (FDIC). And so the perceived risk of a more general banking crisis has subsided.

Fourth and last, the Debt Ceiling Kabuki ended, as it always does, with Republicans and Democrats coming to an 11th hour deal that avoided a default on US Government debt. While the media and both political parties played up the dire, nay, *catastrophic* consequences of a potential default, the history of these congressional histrionics is that a deal is always struck. And so it was this time.

MARKET HALITOSIS

If you followed just the headlines for the S&P 500, the above might serve as a reasonable accounting of the market's stellar gains in the first half: perceived risk sharply down, price sharply up. But looking under the hood, a somewhat peculiar picture emerges.

The peculiarity is that the market has had extraordinarily "bad breadth" in the first half. This means that despite the overall index gaining 16.9% for the period, very few stocks in the index actually realized that gain. Indeed, 72% of the stocks in the index lagged the benchmark's return. How can that be?

The S&P 500 is a capitalization-weighted index. This means that the returns of a given stock are weighted in the overall index return according to its market capitalization. So, for example, in calculating the returns of the S&P 500 for the first half, the returns of market titan Apple stock accounted for 1,200 times the returns of tiny News Corp's. And therein lies the tale.

For the first half of 2023, just seven of the biggest stocks in the S&P 500 accounted for 12.5% of the benchmark's 16.9% return. That is, Apple, Microsoft, Nvidia, Amazon, Meta (formerly Facebook), Alphabet (Google), and Tesla accounted for nearly three-quarters of the S&P 500's return for the first half.

For perspective, if you calculate the first-half returns for the S&P in *equal-weighted* terms—where each stock's return is weighted the same as every other—the benchmark's first-half return drops by over half to just 7%.

TWO HEADWINDS

This bad breadth posed a serious challenge to active investment managers who, unlike passive index funds, don't simply mirror the composition of a given index. Active managers attempt to add value by picking more winners and/or fewer losers than the index and so outperforming the benchmark. In the first half of 2023 active managers faced two headwinds:

First, given that seven out of ten stocks in the index underperformed, active managers had many fewer opportunities to pick winners and many more opportunities to pick losers. Second, as noted above, the market's top performers were stocks with huge capitalizations—Apple, Amazon, *et al*—and so even if an active manager picked the winning names, they had to have a portfolio that was highly concentrated in those names and so extremely under-diversified.

The result is that active managers across the board materially underperformed the S&P 500 for the first half. This was true of our Arjuna 350 US stock strategy, which returned 14.4% vs. the S&P's 16.9%. The same was true for our Arjuna Global Impact stock strategy, which returned 11.6% vs. the MSCI World index return of 15.1%.

While we'll gladly take 12-14% in absolute returns for six months, we're not pleased with our returns relative to our benchmarks, which we've historically outperformed.

For context, we looked at the performance of 60 different ESG managers investing in US stocks, whom we consider our peers/competitors. Of them, only 14 outperformed the S&P and of those 13 were passive index funds that mirrored the composition of the S&P minus egregious ESG offenders (e.g., fossil fuel stocks). This confirmed our assessment that active managers, such as ourselves, simply had the deck stacked against them in the first half.

AI REVOLUTION

As close readers may have noticed, the S&P's returns for the first half were driven largely by technology or tech-adjacent stocks: Apple, Microsoft, Nvidia, Amazon, Meta, Alphabet, and Tesla (Elon Musk has been a pioneer in putting AI in cars). What they have in common is exposure to the artificial intelligence or AI revolution that is sweeping across all of the developed economies of the world. Indeed, the recent developments in AI technology have been characterized as a Fifth Industrial Revolution.

Demand for AI products, services and infrastructure exploded following the rollout of the ChatGPT large language model in November of 2022. By January of 2023, ChatGPT had become the fastest-growing consumer software app in history. As an example of the impact this had on tech stocks, Nvidia is the primary designer of the microchips that drive all AI software. Its stock was up 190% in the first half.

A host of market skeptics have seized on this to suggest that the market's strength in the first half isn't a reflection of improvement in the broad economy and held to their call for a coming recession.

LISTENING

We're obviously well aware of the poor breadth of the market's advance so far this year. But even the 7% equal-weight return of the S&P noted above is quite respectable for six months. So, it's not as if AI accounted for the *only* strength in the market. And if we listen carefully to the message the market is sending, it's hard not to be encouraged. A few examples:

Credit spreads are the difference between the yields of higher and lower quality bonds. When the risk of default is perceived as rising, those spreads widen as investors demand a higher yield from lower quality bonds. And default risk rises when the odds of a coming recession rise. As bond investors are far more risk-averse than stock investors, credit spreads are seen as a very sensitive indicator of the perceived risk of recession on the horizon. So far in 2023 credit spreads have rolled over and narrowed, signaling the perceived risk of recession among bond investors has declined.

As noted above, the P/E multiple that investors are willing to pay for stocks' expected future earnings has risen sharply in 2023, indicating that investors' confidence in those future earnings has risen substantially.

It's often said that the housing sector is the best leading indicator of future economic conditions. So, if a recession were on the horizon, you'd expect homebuilders' stocks to tank (as they did in 2022). So far in 2023 the S&P Homebuilders ETF (ticker XHB) has been on fire, rising 34%.

More broadly, three of the four best performing sectors in the market are cyclical in nature—Technology, Consumer Discretionary, and Industrials. They respond well to an improving economy. Three of the four worst performing sectors are defensive in nature—Staples, Healthcare, and Utilities. They prove more stable in a weakening economy. If a recession were on the horizon, cyclicals would be weak and defensives would be strong.

So, the debate between bearish forecasters and bullish markets rages on. With inflation easing, labor markets strong, and the economy still growing, so far you'd have to say the markets are winning.

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Chief Strategist

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