2023 Mid-Year Update: Recessionary Resilience & Defying Expectations

July 2023

Building a Lifelong Partnership

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OCTAVIA
WEALTH ADVISORS

In our 2023 outlook, titled "Navigating Uncertainty," we outlined three broad themes that we believed would influence markets in 2023—continued volatility, moderating inflation, and a bear market bottom. The first half of the year has somewhat validated those views, but not in the ways we had anticipated.

Off to an Interesting Start

Despite widespread anticipation of an impending recession, we sit here halfway through a year that has defied those predictions, even in the face of ongoing geopolitical risks, a banking crisis, and the Federal Reserve continuing to raise interest rates. If 2023 has yet to humble those who seek to time the market, perhaps they missed that the S&P 500 was up 16.9% in the first half of the year, and the technology-driven NASDAQ advanced an impressive 32.3%.[1]

If we were to wrap up 2023 now and evaluate our themes for the year, we could technically declare victory, but while our themes were relevant, they did not come to pass quite as we drew it up. An AI "revolution," multiple banking failures, and a cautious reopening in China were not part of our base case. That said, our allocations are not built on short-term views, so as we lift our gaze toward the years to come, we are confident that our portfolio positioning remains consistent with maximizing the likelihood of success for our clients.

2023 Themes Revisited

1. Continuing Volatility

The financial world has undergone a significant shift from the low-rate, low-inflation, and low-growth environment of the past decade. We now find ourselves amidst higher interest rates, elevated inflation, and uncertain growth prospects. In this setting, we believe volatility will be more prevalent, and may not play out only as rising and falling prices. This year, volatility has taken the form of wide divergence between equity winners and losers. The likely result of greater volatility is that asset allocation will hold greater significance in the coming years than it did in the recent past.

IMPACT ON YOUR PORTFOLIO

Resiliency, risk management, and humility were central tenets to our asset allocation coming into 2023 and we believe those elements remain critical. Humility prompts us to admit that, while we actively keep a finger on the pulse of capital markets, we did not foresee either the regional banking crisis or the AI-driven market cycle. Moving forward, we maintain our long-term strategic asset allocations, while looking for opportunities to take advantage of market conditions and trends.

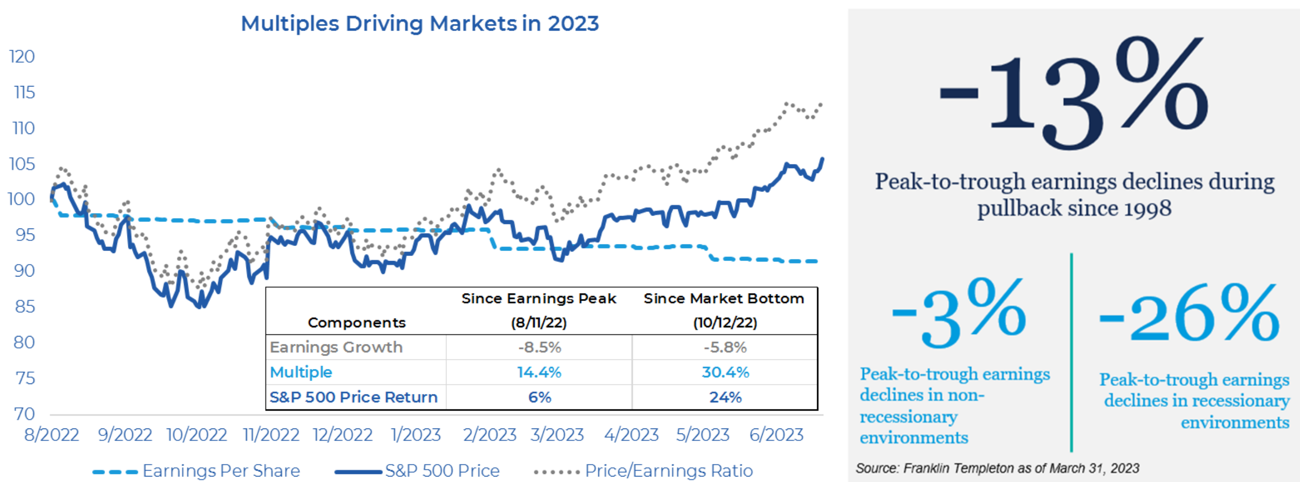
2. Moderating Inflation

Coming into 2023, our expectation was for a meaningful decline in inflation, but not a complete "solution" that would bring inflation to 2%. That has certainly been the case so far. June headline CPI reached 3.0%, down from a peak of 9.1% in June 2022.[2] Beneath the surface of that print, there are further positive indications. Shelter costs have remained high, making up 91% of the 3% increase in

inflation over the past year. If shelter CPI data catches up to real-time data, it is likely to dampen inflation further. Additionally, nearer-term data continues to decelerate, giving the Fed more flexibility. Over the past six months, "super core" inflation (CPI less shelter, food, and energy) has risen at an annualized rate of 2.8%,[3] potentially meaning that near-term inflation trends are better than CPI figures indicate.

3. Bear Market Bottom

The actions taken by the Federal Reserve in 2022 to curb inflation played a significant role in driving down bond and stock prices. As we observe the Fed approaching the end of its rate hike cycle, we believe that investors should shift their focus towards earnings as a key indicator for identifying the beginning of the next sustainable market rally. U.S. stock earnings reached their peak in August 2022 and have since declined by 8.5% as of June 30, 2023.[4] However, the market has rallied since October, largely due to investors' willingness to pay more for stocks (higher multiples). Since the 1990's, earnings have seen an average peak-to-trough decline of 13% in market pullbacks, ranging from -2% (fall 2018) to -39% (2008-2009).[5]



Components	Since Earnings Peak (8/11/22)	Since Market Bottom (10/12/22)
Earnings Growth	-8.5%	-5.8%
Multiple	14.4%	30.4%
S&P 500 Price Return	6%	24%

Source for earnings data: FactSet as of June 30, 2023.

Considering our view that any potential recession would be a mild, cyclical one, we have made significant progress in resetting the baseline for lower earnings. The crucial question that remains is whether earnings will soon reach their bottom and begin to grow, thus justifying today's higher multiples. Alternatively, it is possible that prices have expanded too rapidly due to optimism around the end of interest rate hikes and technological innovation. If so, multiples may have to contract to reach sustainable levels, especially if earnings growth is muted.

IMPACT ON YOUR PORTFOLIO

As we highlighted earlier this year, we have no ability to precisely call the market bottom. That said, we deemed it prudent to prepare for prices to rise, and indeed they have. Our decision to rebalance portfolios in February 2023 helped reallocate clients away from value (which outperformed in 2022) and towards growth, catching some of the upswing. However, our allocation to small cap stocks has underperformed compared to large. This discrepancy is due in part to the disproportionate impact of the

regional bank crisis on small cap indices, and to the strong rally of mega cap stocks that have driven markets this year.

This mega cap dominance has created a unique environment in which a small number of securities drive market returns. 56% of the S&P 500's rally through June 30 could be attributed to five stocks—in other words, 9% of the 16.89% return.[6] This level of concentration surpasses the 2020 rally, during which "stay-at-home" stocks widely outperformed other securities.

Year	Weight			Forward Return		
	Top 5	Top 10	Top 20	1-Year	3-Year	5-Year
1991	12.3%	20.0%	31.1%	30.5%	15.6%	16.6%
1992	12.3%	21.0%	31.5%	7.6%	6.3%	15.2%
1993	11.9%	19.2%	28.6%	10.1%	15.3%	20.3%
1994	10.7%	17.6%	27.0%	1.3%	19.7%	24.1%
1995	10.9%	17.8%	27.6%	37.6%	31.2%	28.6%
1996	10.8%	17.7%	27.6%	23.0%	28.2%	18.3%
1997	11.0%	18.7%	28.5%	33.4%	27.6%	10.7%
1998	11.1%	18.4%	29.3%	28.6%	12.3%	-0.6%
1999	12.5%	20.7%	33.1%	21.0%	-1.0%	-0.6%
2000	16.7%	25.3%	37.9%	-9.1%	-14.6%	-2.3%
2001	13.7%	23.2%	35.4%	-11.9%	-4.1%	0.5%
2002	14.7%	24.8%	36.6%	-22.1%	3.6%	6.2%
2003	14.4%	23.6%	35.4%	28.7%	14.4%	12.8%
2004	13.6%	22.8%	33.6%	10.9%	10.4%	-2.2%
2005	13.1%	21.2%	32.0%	4.9%	8.6%	0.4%
2006	12.4%	20.2%	30.5%	15.8%	-8.4%	2.3%
2007	12.6%	20.1%	30.7%	5.5%	-5.6%	-0.3%
2008	12.8%	19.9%	31.5%	-37.0%	-2.9%	1.7%
2009	13.9%	22.4%	34.3%	26.5%	14.1%	17.9%
2010	11.1%	19.4%	32.6%	15.1%	10.9%	15.5%
2011	11.0%	18.6%	30.5%	2.1%	16.2%	12.6%
2012	12.3%	20.2%	31.8%	16.0%	20.4%	14.7%
2013	12.0%	19.6%	31.0%	32.4%	15.1%	15.8%
2014	11.1%	18.1%	28.4%	13.7%	8.9%	8.5%
2015	10.9%	17.5%	27.0%	1.4%	11.4%	11.7%
2016	10.8%	17.7%	28.6%	12.0%	9.3%	12.6%
2017	10.9%	18.2%	29.3%	21.8%	15.3%	--
2018	12.3%	19.8%	30.1%	-4.4%	9.9%	--
2019	13.6%	21.0%	31.6%	31.5%	--	--
2020	15.5%	22.7%	32.9%	5.6%	--	--

Source: Bloomberg, as of 9/30/2020. Returns longer than one year are annualized. Past performance is no guarantee of future returns.

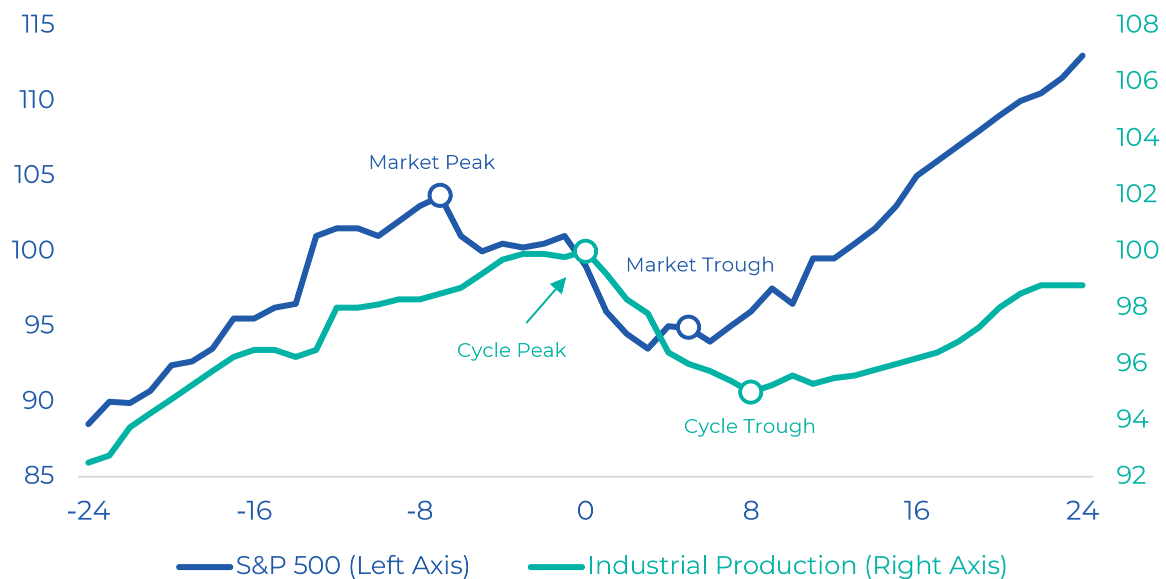
In the past, periods of higher market concentration have often correlated with lower forward returns. In some cases, the relationship is spurious – for example, concentrated stocks did not cause the market collapse in 2008-09. However, the tech bubble of 2000-2002 serves as a stark reminder that the market can become dominated by a small number of extremely overvalued stocks.

On June 30, 2023, the top 10 stocks in the S&P 500 made up approximately 31.7% of the index, one of the highest concentrations ever seen.

It is crucial to recognize that narrow markets can act as a catalyst both for upward movements, as witnessed this year, and for downward movements. We have observed since 1991 that markets with periods of narrow leadership often face greater challenges in the future. Intuitively, this makes sense, as upward momentum becomes reliant on a small handful of securities, and a letdown in any one of them can easily steer the market off course. In light of the current market leadership, we reinforce our previous statements regarding potential for future volatility and the importance of diversified portfolio positioning.

Defying Recessionary Odds

There is a saying in market research: "analysis of averages leads to average analysis." It appears that many forecasters fell prey to this approach, declaring 2023 to be a recession year based on historical data. However, no widespread recession has materialized, and the clock is running out in 2023. Our view remains unchanged from the beginning of the year: the likelihood of a future recession is rising based on a growing body of forward-looking economic data, but such a recession remains uncertain and its timing unpredictable.



Source: Capital Group. Data reflects average of completed cycles in the U.S. from 1950 to 2021, indexed to 100 at each cycle peak. Industrial production measures the change in output produced and is used here as a proxy for the economic cycle. Past results are not predictive of results in future periods.

With that said, the existence of the "recession red herring" has been well documented. Even if one could perfectly time recessions, markets tend to anticipate them both on the way down and on the way up, as shown in the chart above. Recessions are a normal part of the economic cycle, and rather than fearing them, we believe in constructing resilient portfolios that embrace their inevitability. Moreover, we note that recessions are not always catastrophic events (as with the GFC or COVID-19). In reality, economic fluctuations are a natural and healthy part of the economic cycle. Our strategic long-term allocations are designed to anticipate these embedded risks.

In closing, while 2023 has offered new and unexpected opportunities and challenges, our long-term outlook is presently unchanged. We continue to monitor economic and market data to shift allocations as appropriate.

[1] Morningstar Direct as of June 30, 2023.
[2] U.S. Bureau of Labor Statistics as of June 2023.
[3] U.S. Bureau of Labor Statistics as of May 31, 2023.
[4] Factset as of June 30, 2023.
[5] Franklin Templeton as of September 30, 2022.
[6] Morningstar Direct as of June 30, 2023.

Past performance shown is not indicative of future results, which could differ substantially.

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