Market Commentary

Hot Streak

July 2023

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Summary

- Markets continued their hot streak in July, and the S&P 500 posted its fifth consecutive month of positive returns, ending the month up 3.2%.
- With more than 85% of S&P 500 companies having already reported, Q2 2023 will likely be the third consecutive quarter of corporate earnings contraction.
- The day after Treasury issued its substantially higher borrowing estimates for Q3, ratings agency Fitch downgraded the U.S. from AAA to AA+, citing concerns of fiscal governance and a growing government debt burden.
- Poor fiscal dynamics are unlikely to abate any time soon as many of the factors driving higher deficits appear to be structural.

Overview

The markets continued their hot streak in July. Historically, July has been one of the top-performing months for U.S. large cap stocks, and this year proved no different. Over the past 100 years, U.S. large cap stocks have posted an average return of 1.98% in July, compared to the average 0.96% for the other eleven months of the year. The S&P 500 ended July up 3.2%.

With over 85% of the S&P 500 having reported, Q2 2023 will likely be the third consecutive quarter of earnings contraction

With over 85% of S&P 500 companies having already reported, Q2 2023 will likely be the third consecutive quarter of corporate earnings contraction. S&P 500 earnings estimates for 2023 and 2024 are down 4.7% and 2.5%, respectively, since the start of the year.[1] Furthermore, despite nearly 80% of companies reporting a positive earnings-per-share surprise (well above the 10-year average of 73%) and 65% of companies reporting a positive revenue surprise (also above the 10-year average of 63%), investors reacted more negatively to positive surprises than they have since 2011.[1] The share prices of companies that reported positive earnings declined on average about 0.5% in the two days before and two days after announcing their earnings—well below the 1% price increase that is the historical average for the same window.[1]

Apple lost $130 billion in market cap in the 48 hours after announcing earnings—a value equivalent to the market cap of IBM

Market reactions to earnings calls have also varied and have seemed primarily focused on guidance about the future. Despite beating estimates, Apple's share price dropped by 4% after it announced earnings. The company's sales declined in Q2, and management yet again provided no guidance. In fact, Apple hasn't provided guidance since Q1 2020, repeatedly citing uncertainty.[2] Apple lost $130 billion in market cap in the 48 hours after announcing earnings—a value equivalent to the market cap of IBM.[3] Amazon, which also beat estimates, saw its share price jump by a scorching 7.5% after management announced solid earnings and provided upbeat guidance.[4]

In contrast to the heat of the markets, inflation stayed cooler. July's 3.2% year-over-year reading was a slight uptick from 3.0% in June. Core inflation, which excludes the volatile food and energy components, dropped below 5.0% in June for the first time since November 2021 and ticked lower to 4.7% year-over-year in July (from 4.8% in June).[5] Despite signs that overall inflation is easing meaningfully, base effects will likely become

more challenging in the months ahead as the worst of the monthly inflation readings from 2022 fall out of the 12-month reference period. The labor market remains resilient. The U.S. economy added 187,000 new jobs in July, and the unemployment rate continues to hover near fifty-year lows, at 3.5%.[6]

The 5-year, 5-year forward inflation expectation rate rose to 2.47% on July 31—the highest level since August 2014

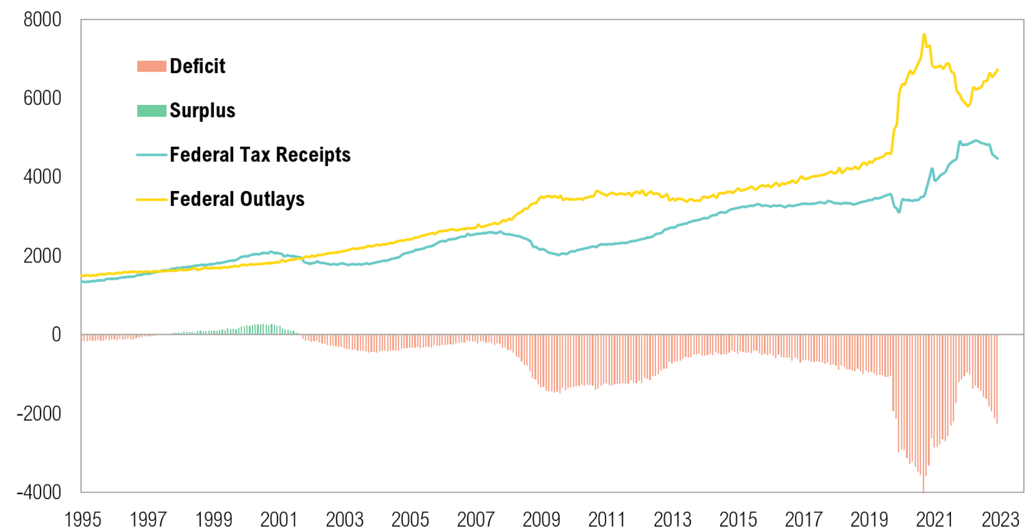
But is warming inflation on the horizon? The 5-year, 5-year forward inflation expectation rate (an estimate of inflation expectations for the five years that start five years from the present) rose to 2.47% on July 31—the highest level since August 2014.[7]

The Federal Reserve hiked interest rates by 25 basis points at the July 26 FOMC meeting. The FOMC is now on "summer break" and will not meet again until September 19, allowing Fed officials to assess the delayed impacts of increased interest rates.[8] Before the September FOMC meeting, two more reports on CPI and employment will be available, which will further inform their rate decisions. Several Fed officials have made it clear that they support at least one more rate hike this year. As Fed Governor Christopher Waller put it ahead of the July meeting:

> "*I see two more 25-basis-point hikes in the target range over the four remaining meetings this year as necessary to keep inflation moving toward our target… From there, I will need to see how the data come in.*"[9]

On July 31, Treasury announced a sweltering Q3 borrowing estimate of $1 trillion (up from a previous estimate of $733 billion)

On July 31, Treasury announced a sweltering third-quarter borrowing estimate of $1 trillion (up from a previous estimate of $733 billion). The jump in borrowing estimates is attributed to lower revenues and increased outlays. In its Fiscal Year 2023 Q3 Report, Treasury highlighted some challenges. Tax receipts in the April to May 2023 period were 40% lower than last year's record level, declining by $282 billion.[10] This is partly due to deferred tax payments from California because of storms and flooding earlier this year. California accounts for nearly 15% of all U.S. personal taxes paid and an even larger share of corporate taxes.[11] Decreased tax receipts also appear to be driven by the employee retention credit (ERC), a refundable tax credit designed to provide relief for businesses and employees affected by the pandemic. Thus far, nearly $400 billion in business tax refunds (mainly in the form of ERC) have been given back to business owners since January 2022, which has significantly boosted consumer spending.[12] Businesses have until April 2025 to claim ERC for 2020 and 2021.[13]



Source: Bloomberg

Excluding the $4 trillion borrowed in 2020 for the pandemic response, 2023's expected $2.7 trillion issuance will set a record

Furthermore, this year's 8.7% Social Security cost-of-living adjustment (compared to 5.7% in 2022), combined with an increasing number of Social Security beneficiaries and higher Medicare costs, together accounted for $181 billion in additional spending this year.[10] Interest on public debt is 25% higher, or $131 billion, more than a year ago due to higher interest rates. The banking sector crisis and the collapse of five U.S. banks earlier this year increased FDIC outlays by $52 billion.[10] Excluding the $4 trillion borrowed in 2020 for the pandemic response, 2023's expected $2.7 trillion issuance will set a record. On 1 August, the day after Treasury issued its substantially higher borrowing estimates for Q3, ratings agency Fitch downgraded the U.S. from AAA to AA+, citing concerns of fiscal governance and a growing government debt burden.[14] While reactions from government officials and industry experts ranged from dismissive to defensive to outright negative, the Fitch downgrade sheds light on the U.S. government's staggering national debt burden, which has long-term implications for economic growth.

Under President Biden, major programs such as the American Families Plan (2021), the Inflation Reduction Act (IRA) and the CHIPS and Science Act of 2022 have been rolled out, with proposed collective outlays of over $1 trillion, $400 billion, and $300 billion, respectively.[15,16] However, those numbers may understate the final cost of these programs, which hints at Fitch's fiscal governance concerns. For instance, according to the Penn Wharton Budget Model, due to the way instructions were written, the cost of the IRA is running three times greater than the amount appropriated by Congress.[17]

The Fitch downgrade sheds light on the U.S. government's staggering national debt burden, which has long-term implications for economic growth

Source: SpringTide, Noah Kroese

Hot Streak

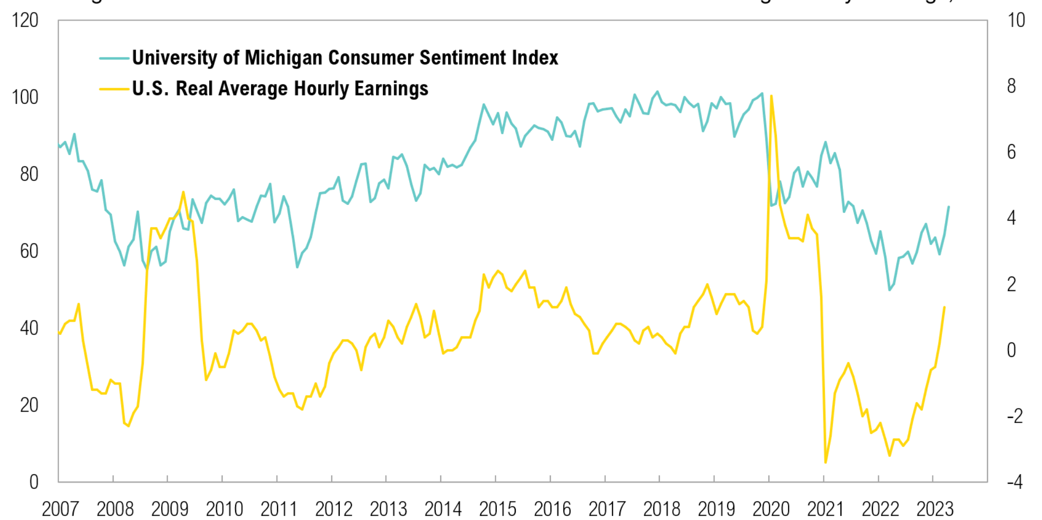
The Magnificent Seven gained a respectable 3.6%, outperforming the S&P 500 again

Under U.S. large cap stocks continued to bask in the sunshine throughout July, and the Magnificent Seven gained a respectable 3.6%, outperforming the S&P 500 again. Despite the gains, investors greeted the companies' earnings reports with mixed emotions. This year's "Summer Slowdown"—a seasonal phenomenon where the stock market tends to exhibit lower trading volumes and price volatility during the summer months—was reflected in the CBOE Volatility Index (or VIX), which measures market expectations for

volatility, reaching some of its lowest levels since the pandemic. Over the past five years, the VIX has averaged around 21.5, whereas its average in July was 13.9 (the lowest-ever VIX reading was 9.5, on September 29, 2017).

Real wage growth and sentiment bottomed out in June 2022 and have both been steadily ticking up since then

After 24 consecutive months of negative growth, real wages also turned positive for the first time in June, as wages outpaced inflation for the first time since 2021.[18] Recently, wages and consumer sentiment have been strongly correlated. Real wage growth turned negative in March 2021, and consumer sentiment (as measured by the University of Michigan Consumer Sentiment Index) started to decline in April 2021. Both real wage growth and sentiment bottomed out in June 2022 and have both been steadily ticking up since then. The University of Michigan Consumer Sentiment Index printed at 71.6 in July, the highest since October 2021, as consumers were buoyed by lower inflation, a resilient labor market and higher stock prices.[19]



Source: Bloomberg

Globally, July was the hottest month on record

Globally, July was the hottest month on record.[20] Pumping air conditioners across the U.S. sent demand for gas skyrocketing, and natural gas powerplants in the U.S. recorded all-time high levels of demand. On July 27, a record-breaking 52 billion cubic feet of natural gas was used.[21] Other commodities were also on a hot streak in July. West Texas Intermediate crude oil prices ended July back above $81 per barrel for the first time since April, rallying by more than 20% since the end of June. Gasoline prices also surged in the last ten days of July, rallying by 6.3% and pushing national average prices to the highest levels since November 2022. Already-low refinery capacity, driven even lower by heatwaves, combined with announcements of output cuts by OPEC, led to the rally in oil prices.[22]

Casting Shade

While headline data suggests the sun is still shining for many, it is evident that consumers are starting to feel the burn from higher rates. Consumer spending was a top contributor to Q2 2023 GDP growth, generating nearly half of the 2.4% quarter-over-quarter growth.[23] The personal savings rate (as a percentage of disposable personal income) ticked down to 4.3% in June, from 4.6% the month prior, and it remains well below the historical average of 8.9%, as measured since 1952.[24] The Johnson Redbook Index, a weekly measure of retail sales growth year-over-year, has been steadily declining since

December 2021.[25] It recorded three consecutive negative weekly readings throughout July. Apart from the pandemic in 2020 and the Global Financial Crisis, this is the first time that the Johnson Redbook Index has recorded a negative reading since 2006.

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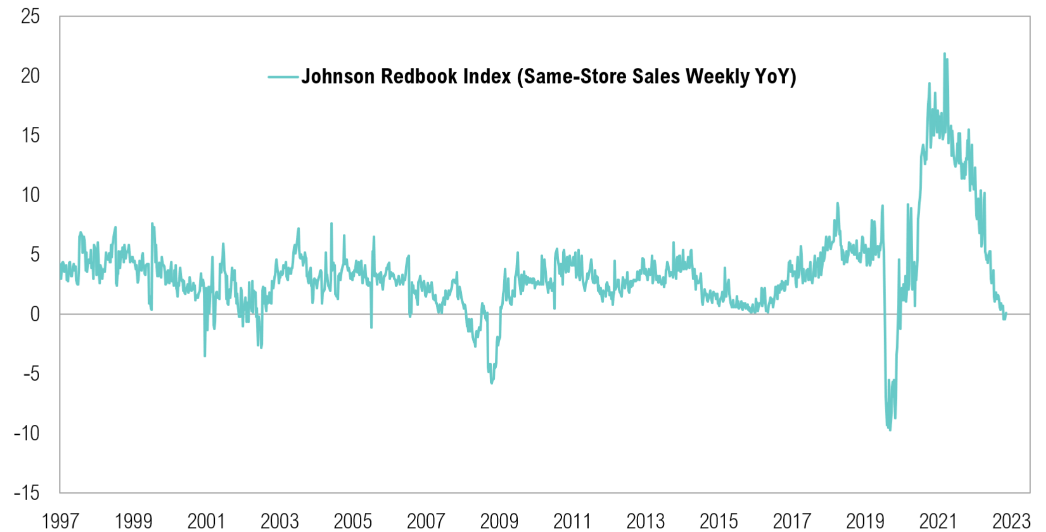
There Has Been A Steady Decline In Retail Sales Growth Since July 2022
Johnson Redbook Index, YoY %

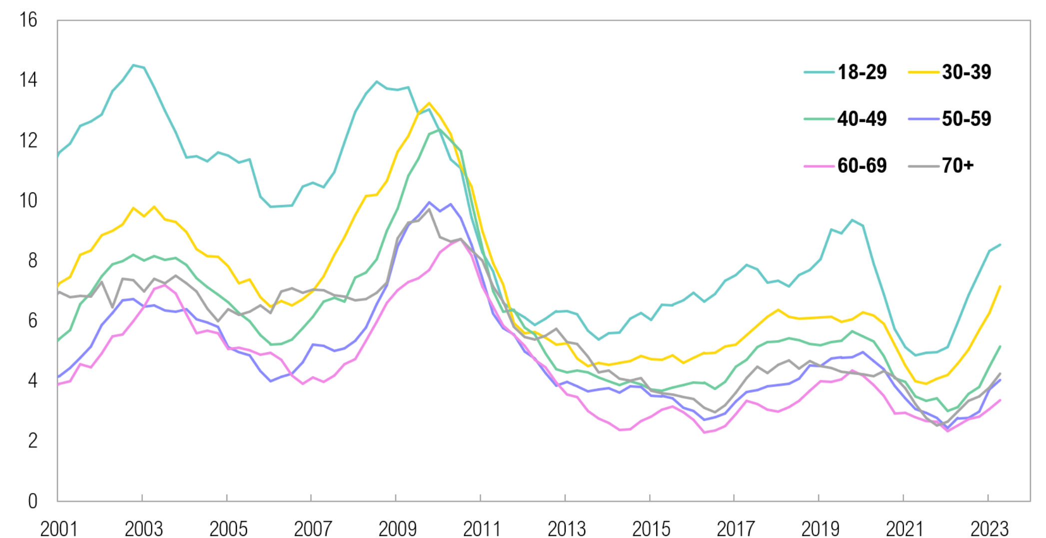


Source: Bloomberg

Revolving consumer credit (credit card debt) balances have surpassed $1 trillion for the first time ever, reflecting ongoing consumer spending alongside elevated inflation.[26] Total outstanding consumer credit expanded by $17.8 billion in June, hitting $4.9 trillion.[27] Non-revolving consumer credit (such as personal loans and vehicle loans), which had been slowing over the past few months, rebounded sharply from 0.3% in May to 6% in June—its highest since October 2022.[27]

Revolving consumer credit (credit card debt) balances have surpassed $1 trillion for the first time ever

Credit Card Delinquencies Have Picked Up Amongst All Age Groups
Transitions Into 90+ Day Delinquency for Credit Cards by Age, %



Source: Bloomberg

Credit card delinquencies have started to increase amongst all age groups, but most prominently among consumers between ages 18 to 40—the largest age cohort, consisting of more than 89 million of the 332 million people in the U.S. population.[28]

There has been a rapid increase in delinquencies as the average interest rate on consumer credit cards ranges between record-high levels of 20.9% and 24.7%

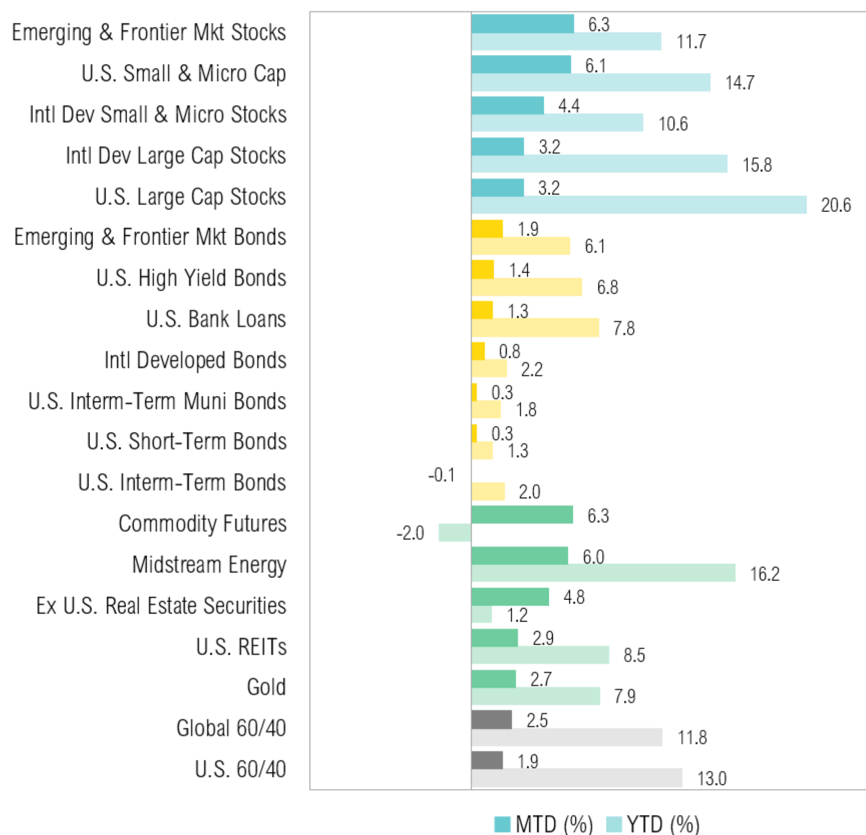
Credit card delinquencies for 90+ days have ticked up to 8.5% for those between the ages of 18 to 29 and 7.1% for those aged 30 to 39.26 For those aged 30 to 39, this is the highest level since 2011. The rapid increase in delinquencies is unsurprising, given that the average interest rate on consumer credit cards ranges between record-high levels of 20.9% and 24.7%.[29,30] The 18-to-40-year age group also has the largest outstanding student loan debt.[31] Rising credit card balances and high interest rates may start to place pressure on consumers, as the resumption of student loan payments in the coming months may place additional financial strain on those already feeling the heat.

Markets

July was another strong month in the markets, and only one asset class ended the month with marginally negative returns. U.S. small cap stocks ended the month up 6.1%, outpacing U.S. large cap stocks, which gained 3.2%. Equity markets elsewhere in the world also had a good month. The MSCI EAFE ended July up 3.2%, while emerging and frontier market stocks gained 6.3%. Fixed income had a muted, yet still largely positive, month. U.S. high yield bonds gained 1.4% throughout the month, while the Bloomberg U.S. Aggregate Bond Index, the only asset class with a negative return in July, ended the month down a marginal 0.1%.

The Bloomberg U.S. Aggregate Bond Index was the only asset class with a negative return in July

July 2023 Key Market Total Returns



Source: Bloomberg

Like dipping a toe into a swimming pool, the Bank of Japan seems to be testing the water by introducing more flexibility into its monetary policy. On July 27, the BoJ announced a tweak in its yield curve control policy to allow interest rates to move more freely, regarding the prior 0.5% cap on 10-year Japanese government bonds now as “the range of references, not as rigid limits” in market operations.[32] At 4.2%, core inflation in Japan

remains near forty-year highs. Inflation in the United Kingdom unexpectedly dipped lower to 7.9% in June, from 8.7% year-over-year in May. The Bank of England has hiked rates to 5.25% but expects inflation will not return to its 2.0% target until Q2 2025.[33] China has officially slipped into deflationary territory for the first time in two years, driven by weak domestic demand and rising economic and geopolitical concerns.[34] Youth unemployment in China has reached a record-level high of 21.3%.[34]

China has officially slipped into deflationary territory for the first time in two years

Apart from Japan, earnings growth across major global markets seems to be shrouded in shade at least for Q2. Globally, headline aggregate earnings growth for Q2 is 8.8% lower compared to a year ago. Earnings growth is down more than 14% for both emerging markets and Europe, and in the U.S. aggregate earnings fell 4.5% year-over-year in Q2. Japan is the lone positive standout. Its headline earnings growth was 10.9% higher than a year ago.[35]

Globally, headline aggregate earnings growth for Q2 is 8.8% lower compared to a year ago

Looking Forward

Although higher government debt levels could significantly hinder long-term economic growth, the short-term impact on economic growth is positive. For the U.S., poor fiscal dynamics are unlikely to abate any time soon since many of the factors driving higher deficits appear structural. So although the summer's hot weather streak will undoubtedly cool, the streak of record or near-record Treasury issuance may not. This will carry with it both opportunities and risks that span shorter and longer-term time periods.

Even with these major concerns, the investment implications stemming from headline-grabbing situations like a U.S. credit downgrade are often paradoxical as all the bad news may be fully accounted for in existing bond prices (and inversely, their yields). As such, we may be nearing a point where bonds could outperform other asset classes. Either way, we think it is a mistake to believe this is the start of an endless summer for the economy, and we expect more bumps in the road ahead.

Sincerely,
The SpringTide Investment Team

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Performance Disclosures

All market pricing and performance data from Bloomberg, unless otherwise cited. Asset class and sector performance are gross of fees unless otherwise indicated.

Asset Class Definitions

Asset class performance was measured using the following benchmarks: U.S. Large Cap Stocks: S&P 500 TR Index; U.S. Small & Micro Cap: Russell 2000 TR Index; Intl Dev Large Cap Stocks: MSCI EAFE GR Index; Emerging & Frontier Market Stocks: MSCI Emerging Markets GR Index; U.S. Interm-Term Muni Bonds: Bloomberg Barclays 1-10 (1-12 Yr) Muni Bond TR Index; U.S. Interm-Term Bonds: Bloomberg Barclays U.S. Aggregate Bond TR Index; U.S. High Yield Bonds: Bloomberg Barclays U.S. Corporate High Yield TR Index; U.S. Bank Loans: S&P/LSTA U.S. Leveraged Loan Index; Intl Developed Bonds: Bloomberg Barclays Global Aggregate ex-U.S. Index; Emerging & Frontier Market Bonds: JPMorgan EMBI Global Diversified TR Index; U.S. REITs: MSCI U.S. REIT GR Index, Ex U.S. Real Estate Securities: S&P Global Ex-U.S. Property TR Index; Commodity Futures: Bloomberg Commodity TR Index; Midstream Energy: Alerian MLP TR Index; Gold: LBMA Gold Price, U.S. 60/40: 60% S&P 500 TR Index; 40% Bloomberg Barclays U.S. Aggregate Bond TR Index; Global 60/40: 60% MSCI ACWI GR Index; 40% Bloomberg Barclays Global Aggregate Bond TR Index.

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