Second Quarter 2023 – Investment Commentary

WEST SHORE BANK

Stock markets posted modest to strong gains last quarter buoyed by the bullish themes of declining inflation rates, the prospect that the Federal Reserve (Fed) is at the tail end of raising rates, the euphoria surrounding the promise of artificial intelligence, and the growing expectation of a soft economic landing, which is supported by the Fed's most recent economic projections. It was also a choppy quarter as several bearish headwinds served to often counter market optimism including higher interest and lending rates, tighter financial conditions, contracting corporate earnings, plummeting money supply, and persistently high core (excludes volatile food and energy) inflation rates.

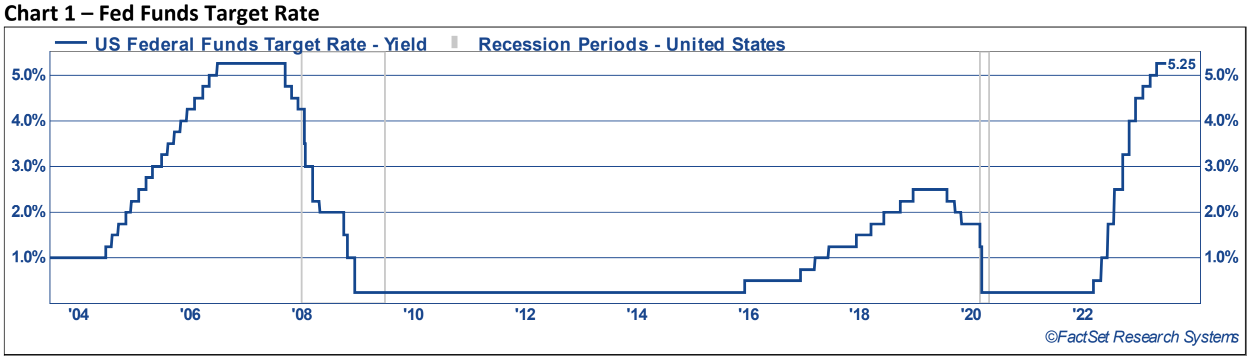
As the table below reflects, bulls ruled the quarter, especially tech stocks. S&P 500 and NASDAQ strength was supported by only a handful of stocks most of the quarter. The depth and breadth of market appreciation was much broader in the second part of June. Balancing the economic scale, we would give slightly more weight to the bearish side in the second half of this year as there is more volatility to come on the interest rate, economic, and corporate earnings fronts.

Table 1 – Equity Index Total Returns – as of June 30, 2023

Equity	1-Month	3-Month	YTD	1-Year	3-Year	5-Year	10-Year
NASDAQ	6.65	13.05	32.32	26.14	11.94	13.93	16.21
S&P 500	6.61	8.74	16.89	19.59	14.60	12.31	12.86
MSCI Developed	4.55	2.95	11.67	18.77	8.93	4.39	5.41
S&P 400	9.16	4.85	8.84	17.61	15.44	7.79	10.21
Russell 2000	8.13	5.21	8.09	12.31	10.82	4.21	8.26
Dow Jones Industrial	4.68	3.97	4.94	14.23	12.30	9.59	11.26
MSCI Emerging	3.80	0.90	4.89	1.75	2.32	0.93	2.95

Before pausing in June, the Fed began aggressively raising rates in March 2022 and has since raised rates ten consecutive times bringing the short-term rate from +0.25% to +5.25%. They are raising rates to bring inflation under control and to foster a better balance between supply and demand on the economic and labor market fronts. While both inflation and demand are trending lower, the pace of decline is moving more slowly than hoped. This raises the question of whether the Fed is truly close to the rate-hike finish line. The stock market certainly thinks so.

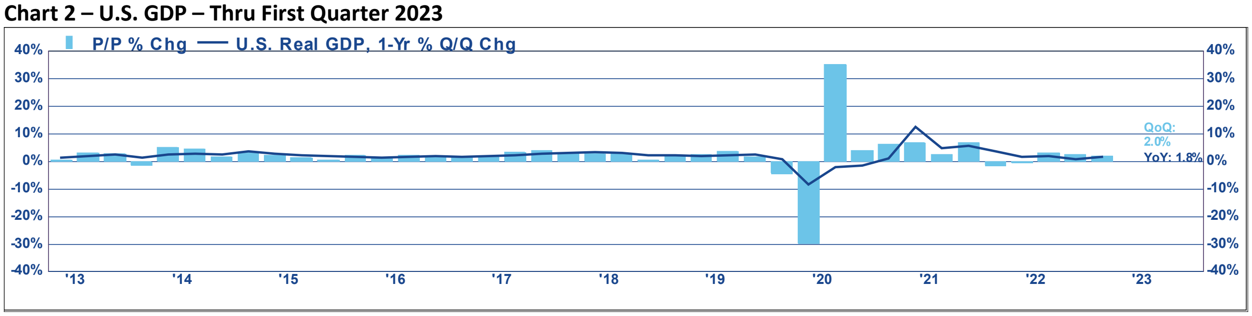
Chart 1 – Fed Funds Target Rate



The main reason the Fed paused in June is their belief that the recent banking turmoil will further tighten credit conditions and work as a quasi-rate hike. They are also waiting to see if economic data trends continue to point towards further weakening. Many economists and analysts, including us, argue that the Fed should pause and let the effect of rate hikes work their way through the economy and then adjust accordingly. If the economy does continue to weaken and inflation lessen, then perhaps short-term rates are properly restrictive. With upside economic surprises aplenty of late, the pause argument seems less plausible, but the economic jury is still out.

While rate hikes have worked to lessen demand in interest-rate-sensitive sectors of the economy like housing and manufacturing, more broad-based effects are proving more difficult. The U.S. economy grew faster than expected in the first quarter as the final reading showed the economy grew at an annualized rate of +2.0% vs the consensus expectation of +1.3%. Personal consumption expenditures (consumer spending) grew at a 4.2% annualized clip, government spending grew at a 5.0% pace, and these were offset by a -11.9% decline in business and private investment. Consumer spending accounts for 70% of the U.S. economy. Thus, it has a more weighted effect on the economy.

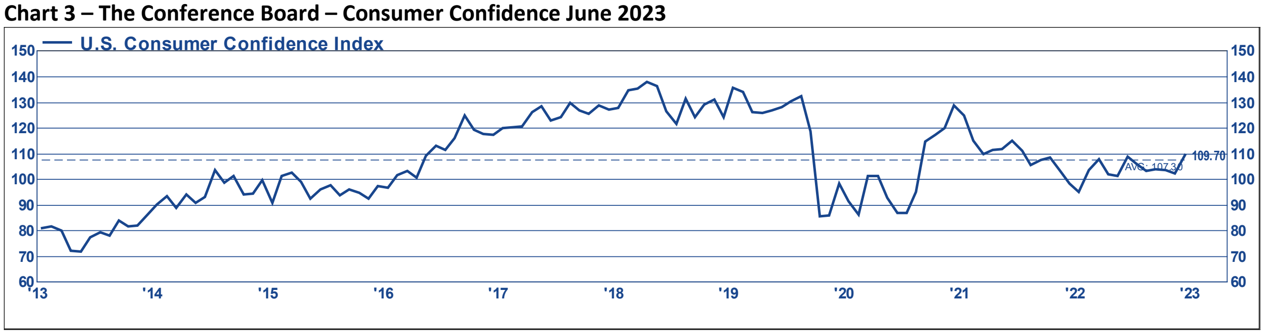
Chart 2 – U.S. GDP – Thru First Quarter 2023



Looking at the industry level, according to the Bureau of Economic Analysis report, “the value added of private services-producing industries increased +2.6%, government increased +2.7% and private-goods industries declined -0.07%. Overall, 15 of 22 industry groups contributed to the first-quarter increase in GDP.” Industries contributing the most to 1Q23 GDP were health care, retail trade, agriculture, real estate, hospitality, info tech, and government. Detractors included finance and insurance, durable goods, wholesale trade, and utilities.

Even the Fed’s most recent Statement of Economic Projections acknowledges the resiliency of the economy and inflation as they raised the 2023 GDP forecast from +0.4% to 1.0% , lowered the unemployment rate estimate from +4.5% to +4.1%, and increased the core inflation estimate from +3.6% to +3.9%. In fact, they also increased their projection for the short-term rate which now includes two more rate hikes this year. The short-term rate forecast was raised from +5.25% to 5.75%. Clearly, there is more work to be done on inflation and economic demand.

Chart 3 – The Conference Board – Consumer Confidence June 2023

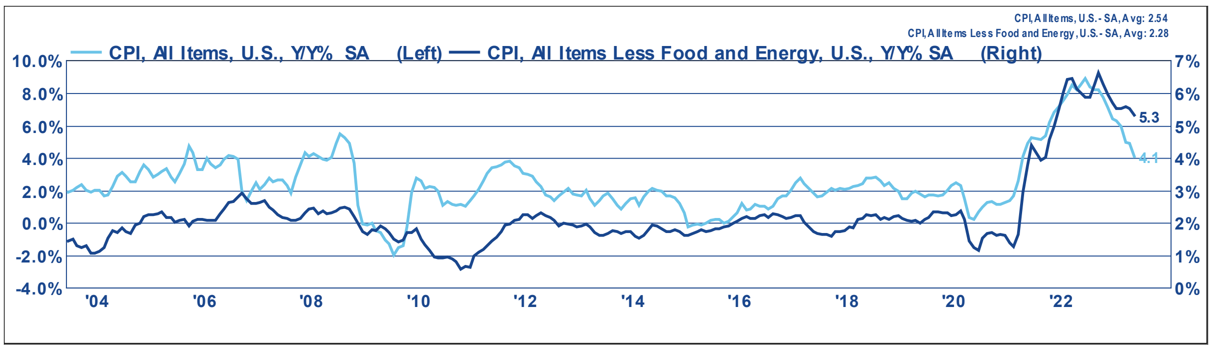


The labor market is one of the key areas the Fed is seeking to weaken as it is the engine that drives economic growth and, of late, inflation. There are signs the labor market is loosening but it remains resilient. Despite the +5.0% rate-hike increase, monthly job gains have averaged 341,000 over the last 12 months through May 2023. Job growth helps to boost consumer confidence and consumer spending, both of which have held up well.

With the persistently tight labor market, average hourly wage growth continues to remain high with monthly annualized wage rates in the 5%-6% range. Wage growth is closely watched by the Fed as wages are typically the largest expense for businesses and lowering wage growth is considered a key factor in bringing down overall inflation. Even with higher nominal wage growth, real wage growth (wage growth less inflation rate) remains muted due to above trend inflation.

When looking at inflation, there are two elements that are measured, headline and core inflation. Headline inflation incorporates all underlying components including volatile food and energy. Core inflation excludes food and energy but includes a fair amount of broad-based service industries and is closely monitored by economists, analysts, and the Fed.

Chart 4 – Consumer Price Index



After peaking at +8.9% over the 12 months ending June 2022, headline inflation has fallen to +4.1% in May 2023, a -54% decline. However, core inflation on the other hand peaked at +6.6% in September 2022 and has fallen to +5.3% in May 2023, only a -19.7% decline. Herein lies the issue, the Fed is trying to bring inflation down to their goal of 2% and it appears they still have quite a ways to go.

This stubbornly high core inflation is likely why the Fed raised their short-term rate projection for the remainder of 2023. The U.S. isn't the only country struggling to bring down core inflation as it remains elevated in Britain and the Eurozone as well. Both the Bank of England and the European Central Bank are forecasting additional rate hikes for this year.

Table 2 – Fixed Income Total Returns – Period Ending June 30, 2023

Fixed Income	1-Month	3-Month	YTD	1-Year	3-Year	5-Year	10-Year
Bloomberg High Yield	1.67	1.75	5.38	9.06	3.13	3.36	4.43
Barclays Michigan Muni	1.01	0.11	2.74	3.10	-0.69	1.92	2.88
Bloomberg Municipal	1.00	-0.10	2.67	3.19	-0.58	1.84	2.68
Bloomberg Aggregate	-0.36	-0.84	2.09	-0.94	-3.96	0.77	1.52
Bloomberg Inter Gov't/Credit	-0.68	-0.81	1.50	-0.10	-2.46	1.23	1.41

Stubborn inflation along with Fed short-term rate hike expectations drove interest rates higher across the entire yield curve last quarter and bond returns lower. We expect interest rates to continue to march higher, not only due to above trend inflation but also because of bond market technicals as treasury issuance is forecasted to significantly increase in the second half of this year to fund irresponsible government spending.

Because of higher interest rates and tenacious core inflation, we do believe the economy will continue to broadly weaken as it is more expensive to fund discretionary and household spending. Additionally, just as strong money supply growth vastly boosted the post-Covid economy and help to cause 40-year highs in inflation, the recent decrease in the money supply should start to have the opposite affect and help to lower inflation through tighter financial conditions albeit with less affect.

The Fed is in the late innings with rate hikes, which is why we remain neutral on our stock and bond allocations. Getting inflation under control and weakening the economy is a marathon and not a sprint. We are not quite ready to go overweight stocks or extend bond duration just yet.

Prepared by Perry Adams – SVP & Director – West Shore Bank Wealth Management – July 3, 2023
Sources: FactSet, The Federal Reserve, Bureau of Economic Analysis, The Conference Board, Bureau of Labor Statistics