CARSON | Investment Research

# Mid-Year Outlook '23

## Edging Closer to Normal

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# Edging Closer to Normal

Stocks have had a very impressive rebound so far in '23, on the heels of one of the worst years ever last year. As we noted six months ago, we thought the odds were high for potential surprises this year, with most of those being to the upside. We were among the few not expecting a recession this year. Our upside scenario has played out so far, and as a result, we are upgrading our return expectation for stocks from 12-15% to 21-25% for 2023, on the back of solid momentum for stocks and the resilient U.S. economy.

Thanks to many of the vicious headwinds from last year turning into tailwinds, not to mention the excitement over potential breakthroughs in AI research and their implications for the economy, stocks and bonds have bounced back nicely. We are happy to say we believe that the potential for further gains this year is quite likely, going along with a resilient economy.

## The First Half

- **Likelihood of a recession has decreased**
- **Consumer remains extremely strong**
- **Bank crisis, debt ceiling drama weren't a drag**

After stocks and bonds both lost nearly 20% in '22, not many were expecting a positive 2023. The majority of strategists and economists expected negative returns for stocks, and it was only a matter of time before an anticipated recession arrived.

Well, as we enter the second half of the year, we are reminded of the old joke, "Why did God make economists? To make weathermen look good!" Many are now punting their expectations of a recession to '24, and we expect the second half of this year to see improving economic trends, along with the potential for more stock gains amid modest bond returns.

One of the main reasons we have not seen a recession this year is that the consumer remained extremely strong. The economy created another 1.5 million jobs over the first five months of the year (on top of more than 5 million last year), and it's no surprise that the consumer is still spending thanks to a healthy employment backdrop.

Adding to the good news, although housing outright crashed last year – taking away from GDP for a record eight consecutive quarters – we are now seeing real signs of improvement in this area over the past several months. Meanwhile, manufacturing has likely bottomed out globally, with very strong improvement in Europe. Speaking of Europe, stock indices in many countries reached all-time highs earlier this year, and most are up close to 20% on the year, something virtually no one was expecting this time six months ago. Even Japanese stocks have hit their highest level since the early 1990s.

The big winners in the first half of the year were technology and communications sectors, the two big losers last year. One of the knocks on the bull market this year has been that there weren't many stocks participating, with mainly large-cap technology accounting for most of the gains. One of our big themes for the rest of this year is that as investors begin to realize there may not be a recession in '23, we could see a broadening out of sectors participating in a continued rally. We expect to see a strong second half from small caps and cyclical value (industrials, energy and potentially financials) as the economy surprises to the upside.

Two of the bigger news events from the first half of the year were the regional bank crisis in March and the debt ceiling drama in May. Fortunately, both events appeared to be blown out of proportion. We said it then and say it now: The banking crisis resulted from a few banks taking undue risks, and it was never going to be a systemic issue. Overall, the banking system is on firm footing, with most banks well positioned – especially the largest ones. And while the debt ceiling drama made for wonderful nightly news views, we never expected anything more than a resolution in the 11th hour, with both sides taking credit. There was too much to lose as we head into an election year to let our country default.

## Moving back to normal

- Strong bounce-back in 2023 after abnormal '22
- Inflation still elevated, but expected to head lower
- Q1 earnings largely beat expectations

Six months ago, we titled our 2023 Investment Outlook "The Edge of Normal." We expected things to inch back to normal, but also acknowledged that it wouldn't happen quickly. 2022 wasn't easy for anyone, as multiple headwinds impacted stocks, bonds and the economy. We had 40-year highs in inflation, the war in Ukraine, the most aggressive Fed in a generation sending interest rates soaring, global supply chains in disarray and Chinese lockdowns significantly impacting chip production.

What happened in 2022 wasn't normal, and it led to the worst year ever for a 60/40 portfolio (60% in stocks and 40% in bonds). To get back to normal, we needed those events to dissipate, and so far that is happening in 2023. Inflation as measured by the consumer price index was above 9% in June '22, and it just hit 4%, with lower levels still looming. Core inflation remains elevated, but that is expected to head lower in the second half as official housing inflation decelerates.

Now, the Fed's new preferred measure of inflation – core services excluding housing – is also elevated, but the good news is that it's no longer accelerating. Plus, there are signs that even this measure is headed lower in the second half of 2023, which is why the Fed is close to the end of hiking. Supply chains are quickly moving back to pre-pandemic levels of efficiency, and China has reopened and appears to be serious about it this time. Unfortunately, the war in Ukraine shows no signs of ending, and we lament the loss of life, but it is no longer the shock to the global economic system it was last year.

Another positive sign: First-quarter earnings season saw most companies beat earnings and revenues estimates, while many announced surprising upside guidance. Small caps did even better, beating estimates by a wider margin than their large-cap counterparts. If we were heading toward a recession, we'd expect to see the more domestic by nature small caps show more stress. Fortunately, that wasn't the case.

Lastly, we were among the few to note six months ago that a lower U.S. dollar (which helps multi-national companies' earnings) could be a tailwind to better earnings. The potential for that to still be a big driver in '23 remains in place.

As we move into the second half of '23, we recognize that tail risks could arise at any time. Top of mind are geopolitical conflict, supply chain issues and reductions in the workforce, but black swan, market-moving events are, by definition, unanticipated. Fortunately, the underpinning of the global economy remains firm, and we'd expect whatever is thrown at it to do little more than cause some near-term volatility.

As Warren Buffett once said, "The stock market is a device for transferring money from the impatient to the patient." Many were impatient and sold late last year, only to regret that decision this year. There will be more scary headlines and market volatility in the second half of '23, but have faith that better times will indeed come. As we noted in our Outlook six months ago, the Dow started trading in 1896, and the one constant is that it has always eventually come back to new highs. We don't think this time will be any different.

**Let's now look at some key trends and events and what they could mean for the second half of '23.**

## Economy

# Our LEI Currently Says "No Recession"

- **Our leading economic index shows the economy is right on trend**

One challenge with economic data is that it can often send conflicting signals, making it hard to parse and come up with an updated view of the economy after every data release.

One approach combines this data into a single indicator, i.e., a **"leading economic index"** (LEI). It's **"leading"** because the idea is to give you an early warning signal about economic turning points.

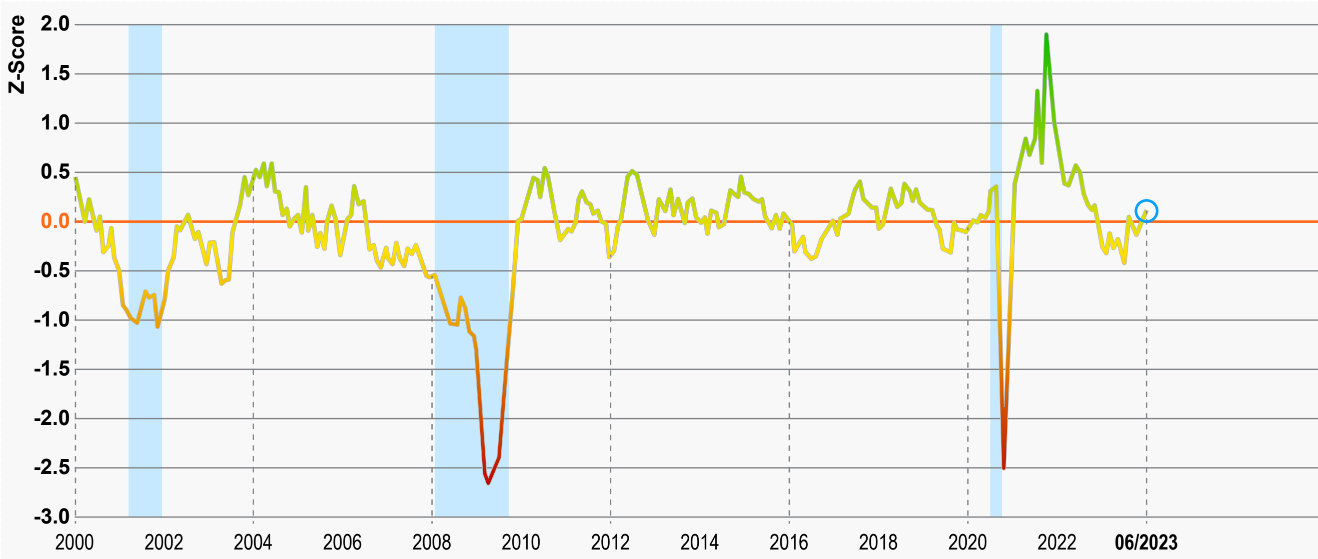
Last year, our leading economic index signaled that the economy was growing below trend and that the risk of a recession was high. Note that it didn't point to an actual recession – just that "risk" of one was higher than normal. In fact, our LEI held close to the lows we saw over the last decade, especially in 2011 and 2016 (after which the economy, and even the stock market, recovered).

Right now, our leading economic index is indicating that the economy is growing right along trend **|Figure 1|**.

**|Figure 1|**
**The US economy is currently growing along trend**

Propriety Leading Economic Index - USA

Shaded areas indicate U.S. recessions




Source: Carson Investment Research, 05/30/2023



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# Employment Data Continues to Beat Expectations and Defy Recession Forecasts

- Employment growth has beaten expectations for 14 straight months
- 1.5 million jobs added through May 2023
- Unemployment steady at 3.7%

The best indicator of a resilient economy right now is a resilient labor market. Employment growth has now beaten economists' expectations for 14 straight months, showing how underestimated the labor market and the economy are.

**Our Leading Economic Index, which currently says "No Recession"**

For the first time, we are publicly releasing our own proprietary leading economic index. We produce an LEI for the U.S. and 29 other countries, each one custom built to capture the dynamics of those economies. The individual country LEIs are also subsequently rolled up into a global index to give us a picture of the global economy. These were all developed more than a decade ago and form a key input into our asset allocation decisions.

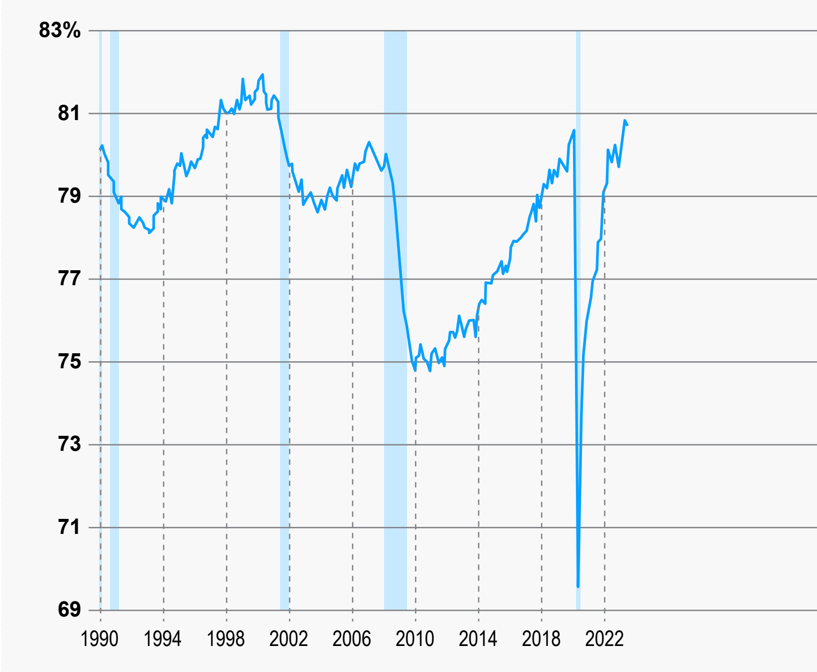
Specifically for the U.S., our index includes 20+ components, including consumer-related indicators (which make up 50% of the index), housing activity, business and manufacturing activity and sentiment and financial markets. This contrasts with other popular LEIs, which are premised on the fact that the manufacturing sector and business activity/sentiment are leading indicators of the economy. This worked well in the past, but is probably not indicative of what's happening in the economy right now.

Our LEI captures whether the economy is growing below trend, on trend (a value close to zero) or above trend. It can also capture major turning points in the business cycle – for example, it declined ahead of the 2001 and 2008 recessions.

|Figure 2|

**The best labor market since the late 1990's**

Employment - Population Ratio (25-54 years)




Source: Carson Investment Research, FRED, 05/30/2023
Shaded areas indicate U.S. recessions

Over the first five months of the year, the economy added 1.5 million jobs. That, in a nutshell, tells you how the economy is doing. For perspective, the average annual payroll growth between 1940 and 2022 was 1.5 million. During the last expansion (2010-2019), average annual payroll growth was 2.2 million. That's why many economists are now revising their forecasts for the economy and reducing the odds of a recession this year.

The Silicon Valley Bank meltdown in March raised concerns about a labor market slowdown amid a banking crisis, but payroll gains since then don't suggest any weakness.

Unemployment is at 3.7%, not far from where it ended last year. Better still, the employment-population ratio for prime-age workers (25-54 years), which accounts for labor force participation issues and an aging population, is now at 80.7% |Figure 2|. That is higher than at any point between 2002 and 2022. This is truly remarkable, and points to a labor market that is the strongest we've seen since the late 1990s.

# Should We Worry About the Consumer? Not Yet

- Credit card balances are slightly higher, owing to inflation
- Disposable income grew 2.9% in Q1
- Strong employment gains and wage growth have helped overall incomes outpace inflation

It seems strange to discuss whether we should worry about the consumer amid such a strong labor market. However, there has recently been a lot of concern over rising credit card debt. Household debt hit $17.05 trillion in the first quarter (Q1), a 0.9% increase from the prior quarter. However, most of that was from mortgage originations. Credit card balances were actually flat in Q1, at $986 billion.

The fact that credit card balances are higher than where they were in 2019 ($927 billion) should not be surprising, given we just experienced a lot of inflation. Prices rose at the fastest pace in 40 years, so you should expect card balances to increase. However, incomes rose as well.

When thinking about debt, the key question is whether households are able to service that debt. A good measure of that is to look at debt service costs as a percentage of disposable income. As of Q1 2023, that's at 9.6% **|Figure 3|**, slightly lower than before the pandemic and well below the historical average.

There's even better news: Disposable income grew 2.9% in the first quarter of 2023 – significantly higher than the 0.9% increase in total household debt, let alone interest costs!

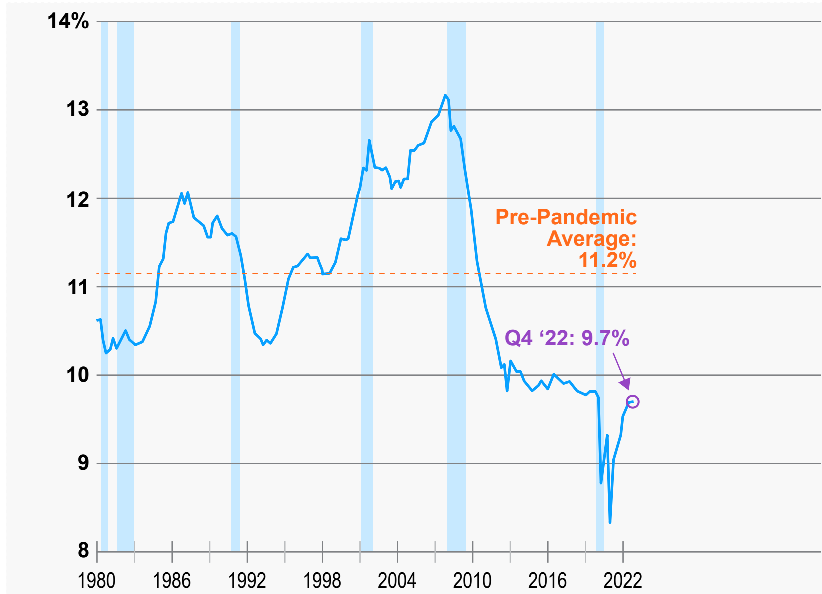
Disposable income has grown at an annualized pace of 10% over the first five months of this year. Meanwhile, inflation is running just about 4%, meaning households are seeing real income gains (incomes adjusted for inflation).

Part of the surge in disposable income includes the large boost to Social Security income due to inflation adjustments in January. Also, tax brackets were adjusted higher, resulting in more money in

**|Figure 3|**

**Debt service much less of a burden now**

Household Debt Service Payments (Percentage of Disposable Personal Income

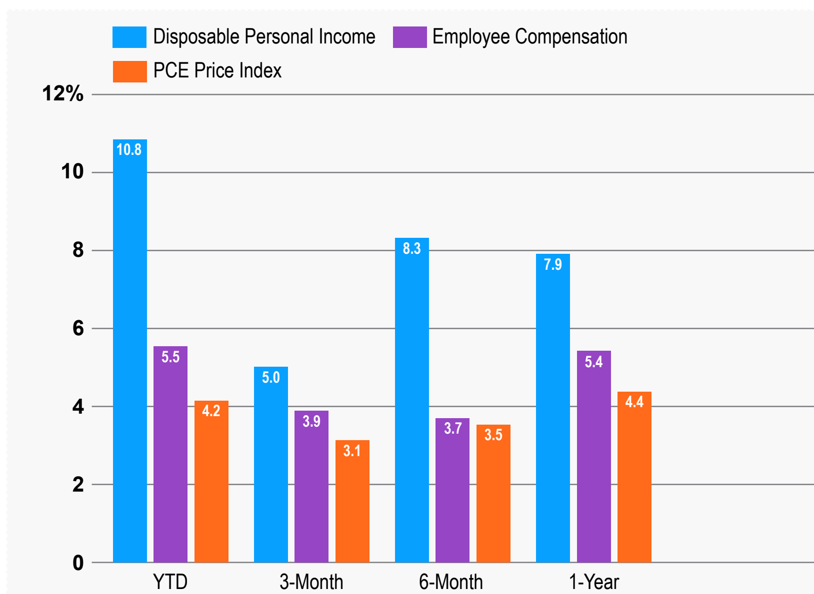



Source: Carson Investment Research, FRED, 05/30/2023
Shaded areas indicate U.S. recessions

**|Figure 4|**

**Disposable income gains outpace inflation**

Growth Rate (Annualized, as of April 2023)




Source: Carson Investment Research, FRED, 05/30/2023

household wallets. But even if you exclude these one-off increases, employee compensation has grown at an annualized pace of 5.7% this year through May **|Figure 4|**. Strong employment gains and wage growth have helped overall incomes outpace inflation.

Rising real incomes is essentially why consumption has run strong this year. Consumption continues to run along the pre-pandemic trend, even after adjusting for inflation **|Figure 5|**. Meanwhile, the savings rate has also started moving higher, rising from a low of 2.7% in June 2022 to 4.6% in May 2023.

Spending driven by rising real incomes means consumers don't feel the need to borrow to the extent they did before the pandemic. Credit utilization rates measure credit card balances as a percentage of available credit. As you can see in the following chart **|Figure 6|**, utilization rates for both credit cards and home equity lines of credit are well below pre-pandemic averages.

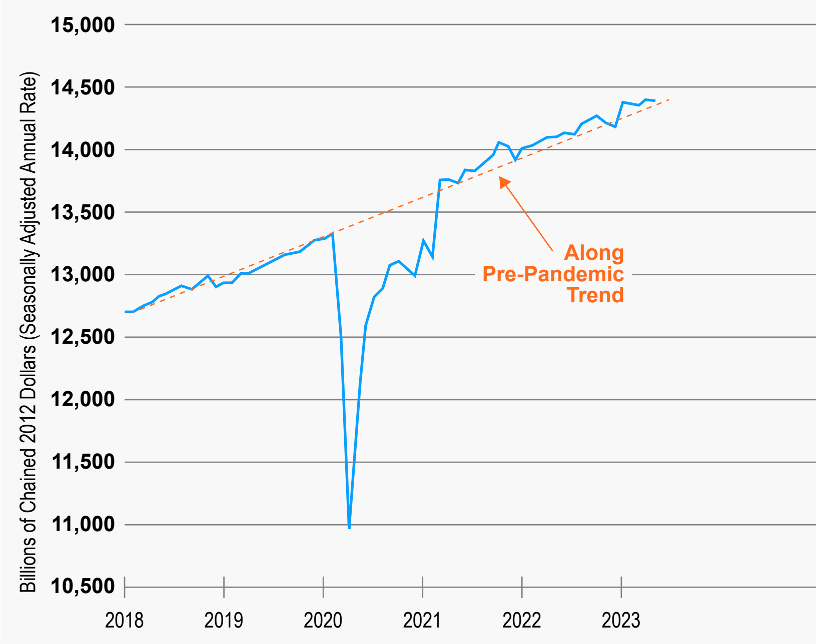
Even the debt delinquency data doesn't show many signs of consumer stress. Things have improved recently compared to last year. As of the first quarter, the New York Federal Reserve's quarterly report on household debt and credit[1] showed that the percentage of loan balances that were more than 90 days delinquent was stable around 1.5% **|Figure 7|** on the following page. That's down from 1.9% a year ago and quite a bit below the 3% average in 2019. Even third-party collections are at record lows, with just over 5% of consumers having collections against them as of the first quarter, down from 6% a year ago and below the 2019 average of 9.2%.

## The Housing Turnaround

- Signs of a turnaround after housing collapse
- New home sales up 31% since November 2022
- Strong demand, low inventory pushing new homebuyers into the market

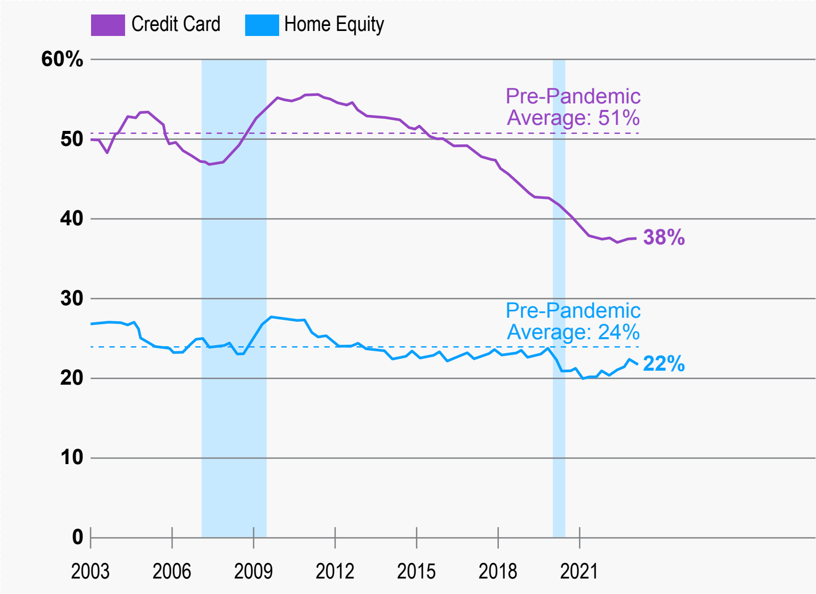
Residential investment makes up less than 5% of the economy[2], but it's been a drag on economic growth for eight straight quarters **|Figure 8|** on the following page). The cause shouldn't be a surprise – the Federal Reserve (Fed) began its most aggressive policy tightening cycle in 40+ years as it looked to get on top of inflation. That sent mortgage rates from 3% to 7% in less than a year, freezing the housing market. Affordability collapsed due to higher rates and elevated home prices.

**|Figure 5|**
**Consumer spending remains strong**
Real Personal Consumption Expenditures
(Jan 2018 - Apr 2023)




Source: Carson Investment Research, FRED, 05/30/2023
Dashed line shows the 2018-2019 trend

**|Figure 6|**
**Consumers yet to stretch their borrowing capacity**
Credit Utilization Rate (Percentage of Available Credit)




Source: Carson Investment Research, NY Fed, 05/30/2023



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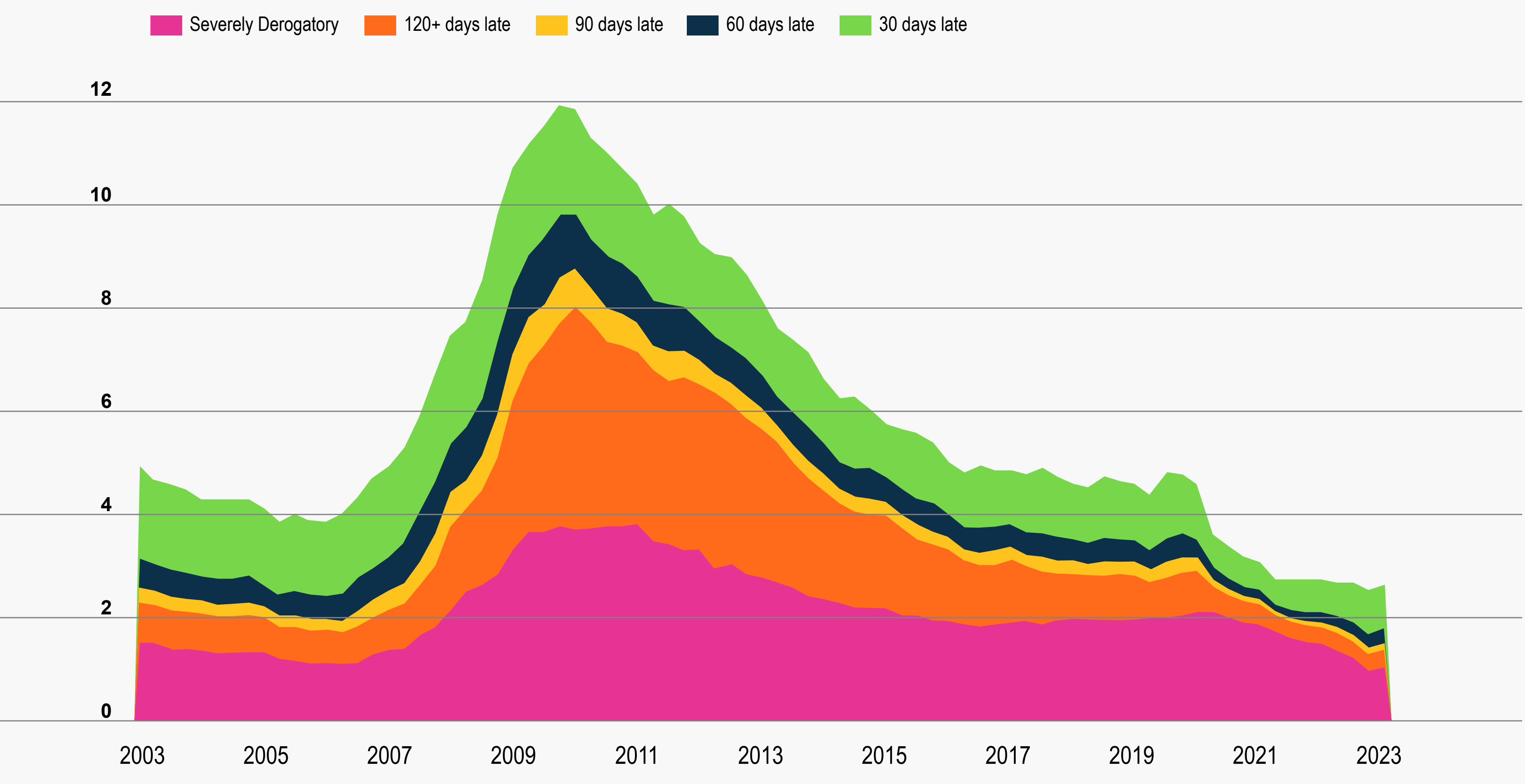
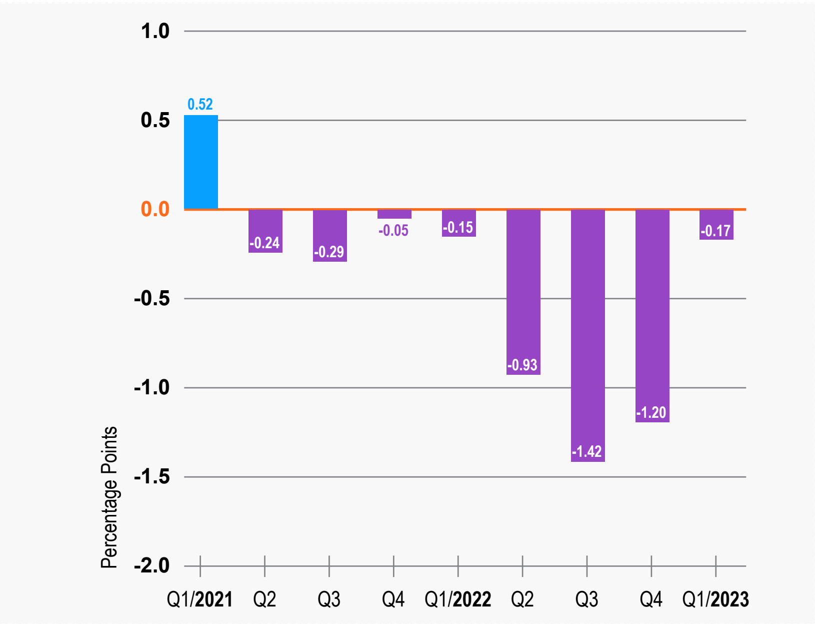
**|Figure 7|**
**Total Balance by Delinquency Status**




Source: NY Fed Consumer Credit Panel/Equifax

**|Figure 8|**
**Housing's been a drag on the economy for too long**
Contribution of Residential Investment to Real GDP Growth (Q/Q, Annualized rate)




Source: Carson Investment Research, FRED, 05/30/2023

However, things are looking up and, as with employment, defying expectations. Housing starts and permits appear to be turning around, even as builders' confidence recovers. New home sales are up 31% since last November, when mortgage rates first hit 7% **|Figure 9|** on the following page.

Strong demand and low inventory in the existing home market are pushing new homebuyers into the new home sales market. This is good for builders as well as economic growth, as a new home contributes to GDP via design, construction, sales transaction costs as well as furniture and appliances.

## A Manufacturing Revival in America on the Back of Technology

- Non-residential construction has seen a boom
- Tech/EV space has led the charge
- AI race should keep sector strong

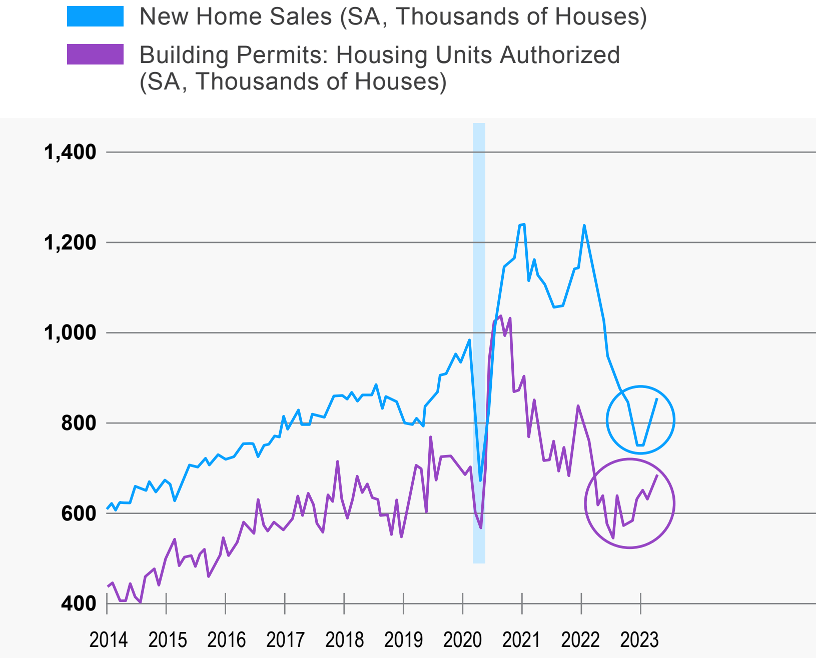
Manufacturing sentiment surveys suggest purchasing managers are cautious. However, there is a bigger and more positive story going on in America right now. Even as residential construction sagged last year and is in the early stages of a recovery, non-residential construction has seen a boom. This has come almost entirely on the back of manufacturing construction, driven mostly by a boom in the computer/electronic/electrical sector – specifically, semiconductor chip and electrical vehicle battery plants.

Over the past year, inflation-adjusted construction spending has increased 84% through April. Construction specific to the Tech/EV space has surged a whopping 233% **|Figure 10|**.

We believe this is one of the biggest positive stories in American industry right now. Things really took off last year on the back of Congress passing the CHIPS Act and the Inflation Reduction Act, both of which pumped money into the space and brought in more private investment. And it's probably set to grow, amid all the talk and excitement over artificial intelligence. Powerful processors are crucial to running AI, and orders have been surging, as evidenced by chip maker Nvidia's blockbuster quarterly sales outlook. Their profits jumped 26% in the first quarter while sales grew 19%, both beating expectations by wide margins. Better still, they forecast next-quarter sales 50% above what analysts estimated.

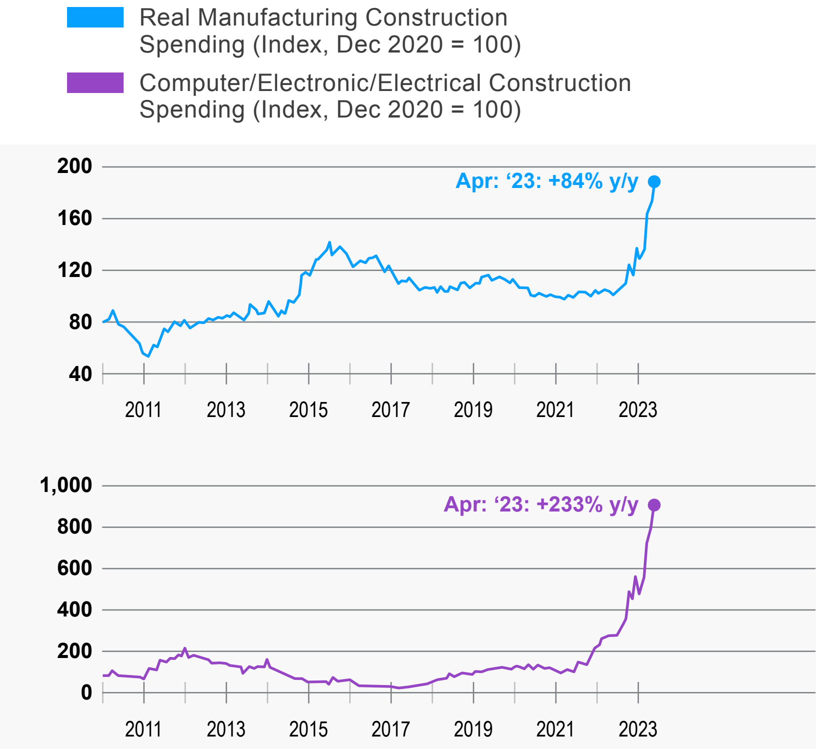
Earlier this year, most of the employment chatter was related to Technology sector layoffs. At the time, we wrote that Technology companies were simply retrenching after a decade – and, really, the past three years – of going on a massive hiring spree. However, the pace of layoffs in this sector is easing already. Now, with everyone looking to get a jump-start on AI, we're likely to see an arms race of investment into this space over the next several years, including hiring. That's going to be a big positive for investment and productivity.

**|Figure 9|**
**Housing finds a floor, and looks to be turning around**




Source: Carson Investment Research, Factsheet, 05/30/2023
Shaded areas indicate U.S. recessions

**|Figure 10|**
**Manufacturing construction surged after last summer**




Source: Carson Investment Research, NY Fed, 05/30/2023

# The International Outlook is Mixed

- Non-U.S. markets seeing steady recovery
- Japan a standout due to ultra-low interest rates
- Emerging markets still waiting on Chinese rebound

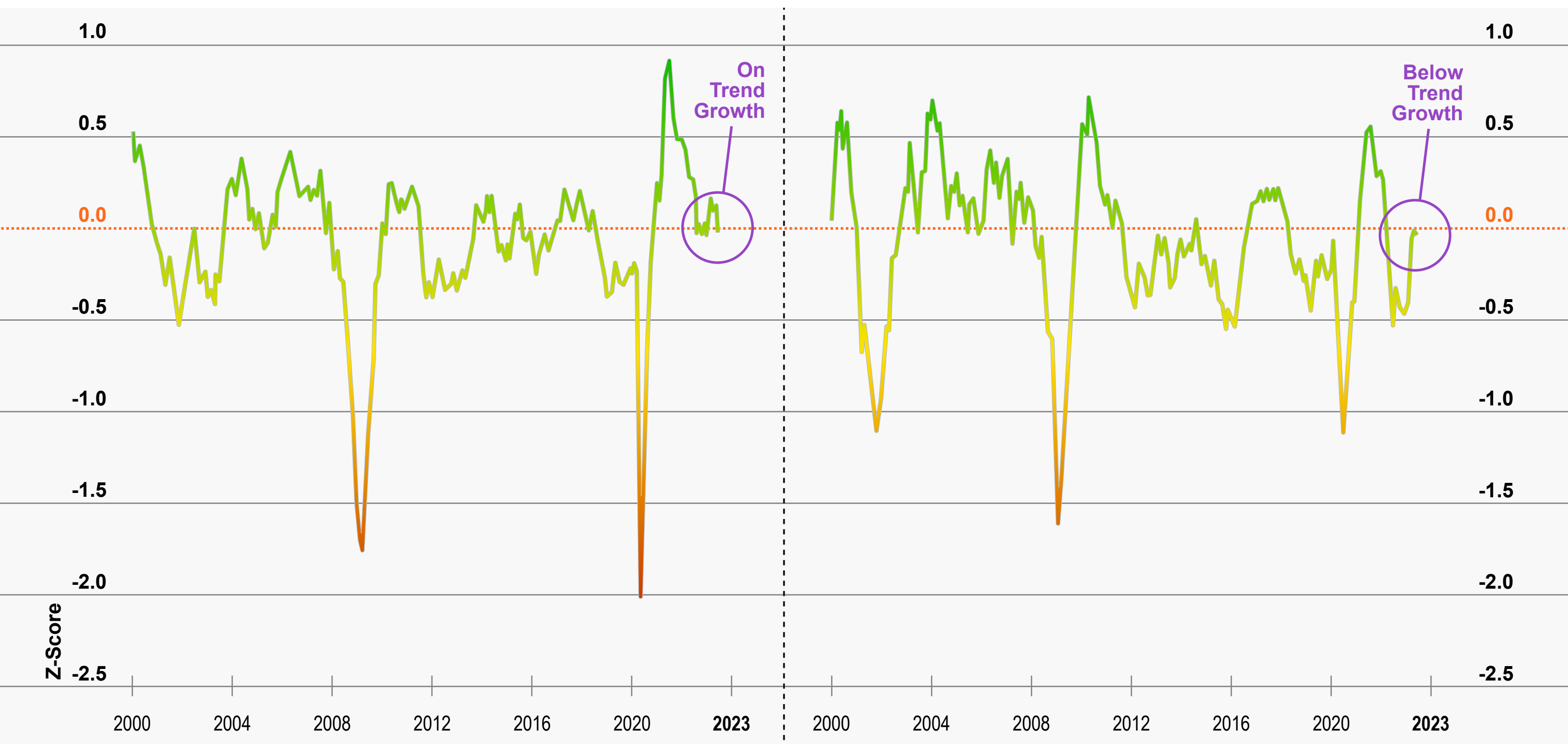
As with the U.S., we have leading economic indices for 29 other major countries in the world. This allows us to understand what is happening with the global economy, and even different segments of it.

Our leading economic index for developed markets (excluding the U.S.) suggests these countries are experiencing a steady post-pandemic recovery, with Japan being a standout this year **|Figure 11|**. The only headwind is that inflation remains stubbornly persistent, keeping most of their countries' central banks on the hawkish side. The Bank of Japan is a notable exception, keeping interest rates ultra-low even as core inflation hits the highest level in four decades – they still believe inflation will eventually move lower, and are willing to wait it out.

Emerging markets are still waiting on the Chinese rebound as its economy reopens **|Figure 12|**. Reopening created an initial tailwind for Chinese economic growth, on the back of consumption, but it looks like authorities are not going all-in on stimulus to boost the industrial sector as they have in the past. A big reason is that authorities are worried about adding to the unsustainable debt burdens facing local governments and firms, especially in the real estate sector. As a result, our leading economic index for emerging markets suggests economic growth is still below trend.

**|Figure 11|**
**Proprietary Leading Economic Index - Developed Markets**

**|Figure 12|**
**Proprietary Leading Economic Index - Emerging Markets**




Source: Carson Investment Research 05/30/2023

Source: Carson Investment Research 05/30/2023

## Equities

# We Expect More Gains

- **Stocks off to stronger-than-expected start in 2023**
- **Back-to-back losing years are rare**
- **Stocks up more than 20% since October 2022**

Here's what we said in our Outlook six months ago: Just because 2022 was a poor year for stocks doesn't mean the same will be true for 2023. That has played out, with stocks off to a very good start. We now expect stocks to produce a total return of between 21-25% in 2023, up from our original call for gains between 12% and 15%. Additionally, we believe the potential leaders for the rest of this year will be small caps and cyclical value names (industrials, energy and potentially financials) as the economy avoids a recession and other sectors begin to participate, versus only tech and communications doing most of the leading in the first half.

There were a few reasons we expected better returns in 2023, including our base case of no recession, a pullback in inflation as well as the rarity of one poor year for equities following another one – especially in the third year of a presidential cycle.

We also recognized that almost everyone else was calling for a second consecutive tough year for equity investors. What stood out the most to us was a Bloomberg survey that looked at 25 strategists and found that the median was for negative returns in 2023 – in other words, back-to-back losses for stocks, something that can happen but is extremely rare. The only other times stocks fell two or more years in a row occurred in the Great Depression, the recession of 1973-74, and a three-year losing streak during the tech bubble of the early 2000s. We didn't think we were in a similar environment as those periods, hence our positive upside outlook for 2023.

With stocks up more than 20% from the October '22 lows, we are seeing some cautious optimism creep in. A recent Gallup poll asked what the best long-term investment would be, and stocks/mutual funds came in at the lowest level since 2011. Given how poorly stocks did last year and the constant barrage of negative news, maybe this isn't a surprise, but from a contrarian point of view, this is another reason to think the path is higher for stocks. Additionally, the Bank of American Global Fund Manager Survey found that fund managers showed their highest overweight to bonds since March 2009, with a good deal of skepticism toward stocks. March 2009 wasn't the worst time to take the other side of this lopsided allocation.

So, sentiment remains skeptical, bullish from a contrarian perspective, but momentum is the other positive. An object in motion tends to stay in motion, and historically, we've seen this in equity markets once they get moving.

# The New Bull Market

- On track for a bull market
- Third year in presidential cycle is typically strong
- Potential for more gains by end of year

If you've followed the Carson Investment Research Team, then you know we moved to overweight stocks in December and were on record as early as late October saying it was pretty likely the bear market was over. Nonetheless, the media like to use the definition of a new bull market once stocks gain 20% off their lows, which could also trigger further momentum. We found that the previous 13 times stocks rose 20% off a 52-week low, 10 of those times the previous lows were not violated **|Figure 13|**. The average return 12 months later was close to 18%. The only time we didn't see a gain was in the 2001-02 bear market.

**|Figure 13|**

**A New Bull Market Should Have Bulls Smiling Very Soon**

New Bull Markets Start (20% Off Bear Lows) and What Happened Next for the S&P 500

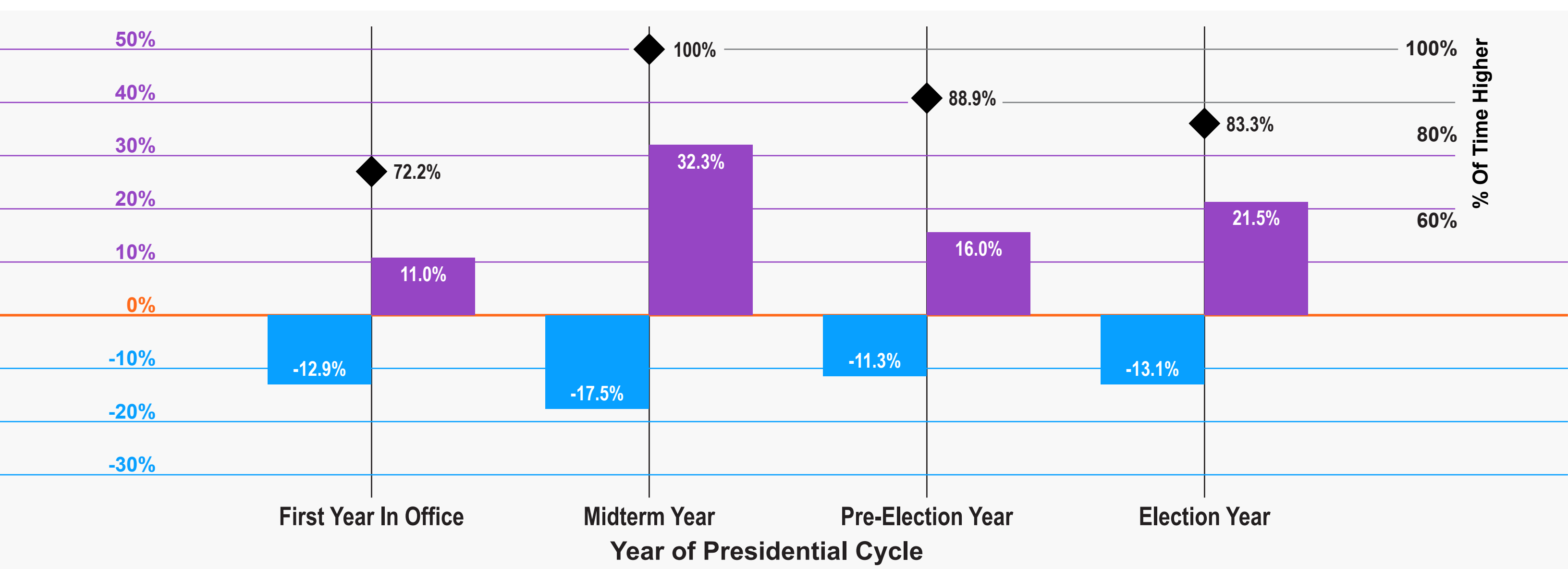
| Start of Bear | End of Bear | Bear Market Return | Up 20% from Bear Market Lows | Trading Days to New Bull Market | Real Bear Lows | 1 Month | 3 Month | 6 Month | 12 Month |
|---|---|---|---|---|---|---|---|---|---|
| 8/2/1956 | 10/22/1957 | (21.6%) | 7/25/1958 | 191 | Yes | 1.6% | 8.5% | 18.8% | 27.8% |
| 12/12/1961 | 6/26/1962 | (28.0%) | 12/5/1962 | 112 | Yes | 2.0% | 3.8% | 12.2% | 17.7% |
| 2/9/1966 | 10/7/1966 | (22.2%) | 2/14/1967 | 88 | Yes | 2.2% | 5.6% | 7.5% | 2.4% |
| 11/29/1968 | 5/26/1970 | (36.1%) | 9/28/1970 | 87 | Yes | -0.9% | 8.6% | 19.2% | 16.3% |
| 1/11/1973 | 10/3/1974 | (48.2%) | 11/5/1974 | 23 | Yes | -12.0% | 5.1% | 18.6% | 17.8% |
| 11/28/1980 | 8/12/1982 | (27.1%) | 9/14/1982 | 22 | Yes | 11.1% | 13.7% | 22.5% | 34.4% |
| 8/25/1987 | 12/4/1987 | (33.5%) | 3/8/1988 | 64 | Yes | -1.2% | -1.6% | -1.4% | 9.1% |
| 3/24/2000 | 9/21/2001 | (36.8%) | 12/5/2001 | 52 | No | -0.5% | -0.5% | -12.2% | -22.5% |
| 3/24/2000 | 7/23/2002 | (47.8%) | 8/22/2002 | 23 | No | -13.4% | -5.0% | -13.5% | 3.2% |
| 3/24/2000 | 10/9/2002 | (49.1%) | 11/21/2002 | 31 | Yes | -3.9% | -10.2% | 1.9% | 10.9% |
| 10/9/2007 | 3/9/2009 | (56.8%) | 3/23/2009 | 10 | Yes | 2.5% | 8.5% | 29.4% | 42.7% |
| 10/9/2007 | 11/20/2008 | (51.9%) | 12/8/2008 | 11 | No | 0.0% | -20.7% | 3.2% | 20.0% |
| 2/19/2020 | 3/23/2020 | (33.9%) | 4/8/2020 | 12 | Yes | 6.5% | 14.6% | 24.3% | 50.1% |
| 1/3/2022 | 10/12/2022 | (25.4%) | 6/8/2023 | 164 | ? | ? | ? | ? | ? |
| | | | Average | 64 | 10 of 13 marked the lows | -0.5% | 2.3% | 10.0% | 17.7% |
| | | | Median | 41.5 | | 0.0% | 5.1% | 12.2% | 17.7% |
| | | | % Higher | | | 53.8% | 61.5% | 76.9% | 92.3% |

Source: Carson Investment Research, YCharts, 05/30/2023

**|Figure 14|**

**Midterm Years Tend To See A Big Bounce Off The Lows**

Returns A Year Off The Lows For The S&P Price Index Based On The 4-Year Presidential Cycle




Source: Carson Investment Research, Factset, 05/30/23 (1950 - 2022)

## Room for More Gains

The bear market last year saw stocks fall 25%, more than we anticipated, but weakness in a midterm election year is quite normal. We expected a correction of between 15-18% after the more than 120% rally off the March 2020 lows, but a litany of negative events pushed stocks lower. The good news is that yet another bear market ended in the bear-killer month of October, and there is potential for more gains.

Looking at the four-year presidential cycle, the average midterm year sees a pullback of 17.5%, which is the largest out of the four years. That's the bad news; the good news is a year off those lows, we see stocks gain more than 32% on average **|Figure 14|** on the previous page. This could bode well for potential strength into mid-October and the one-year anniversary of the bear lows. Then add in the fact that November and December have historically been strong for stocks in a pre-election year, and the fuel is there for more gains in '23.

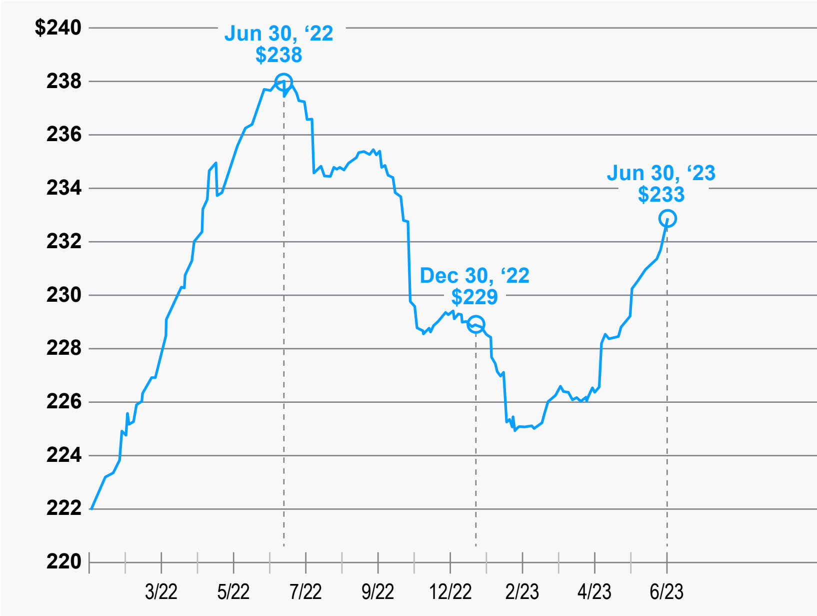
## Earnings Estimates Revised Higher, and Interest Rate Headwinds on Valuations are Dissipating

- Earnings expectations have been rising since January
- Likely at or nearing an end to rate hikes

Earnings expectations for the S&P 500 have been steadily rising since January, in contrast to what happened in the second half of 2022. They've accelerated higher since mid-April, after the last earnings season got underway. Currently, they're higher than where we started the year **|Figure 15|**.

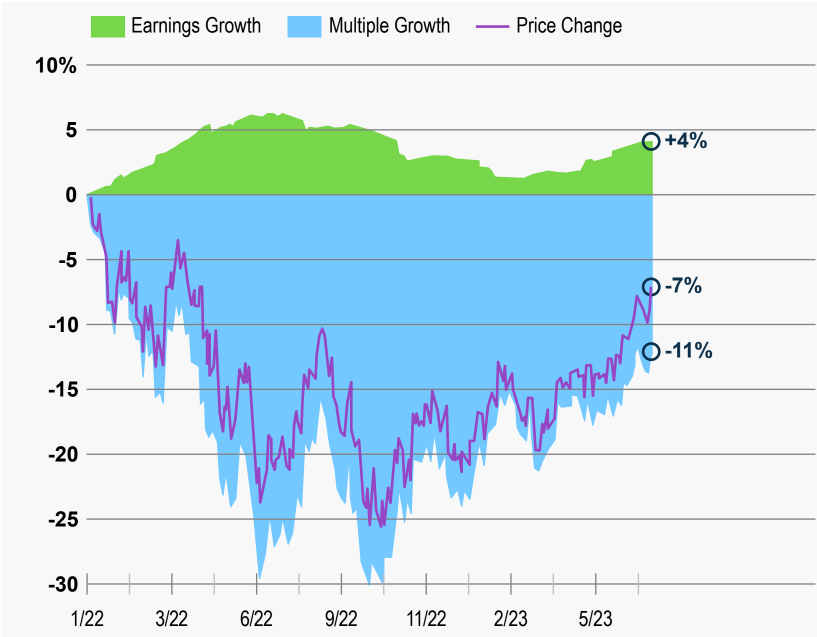
On June 8, 2023, the S&P 500 was up 20% off its low on October 12, 2022, after falling 25% from its peak on January 3, 2022. This put the index 10% below its prior peak. Decomposing the return into earnings and valuation multiple changes over this entire period, we can see how the 2022 pullback and subsequent recovery have been driven by changes in valuation. The contribution from earnings has been positive throughout. Over the entire period, valuation multiples contracted and dragged the index return down by 11 percentage-points, and when combined with a 4 percentage-point contribution from earnings growth, you got the index return of -7% **|Figure 16|**.

**|Figure 15|**
**Earnings expectations are rising again**
S&P 500 Index - Next 12 Months Earnings Per Share




Source: Carson Investment Research, Factsheet, 05/30/2023

**|Figure 16|**
**Multiple swings driving price volatility**
S&P 500 Index: Price, Earnings and Multiples Cumulative Percentage Change (Jan 3, 2022 - Jun 8, 2023)




Source: Carson Investment Research, Factsheet, 05/30/2023

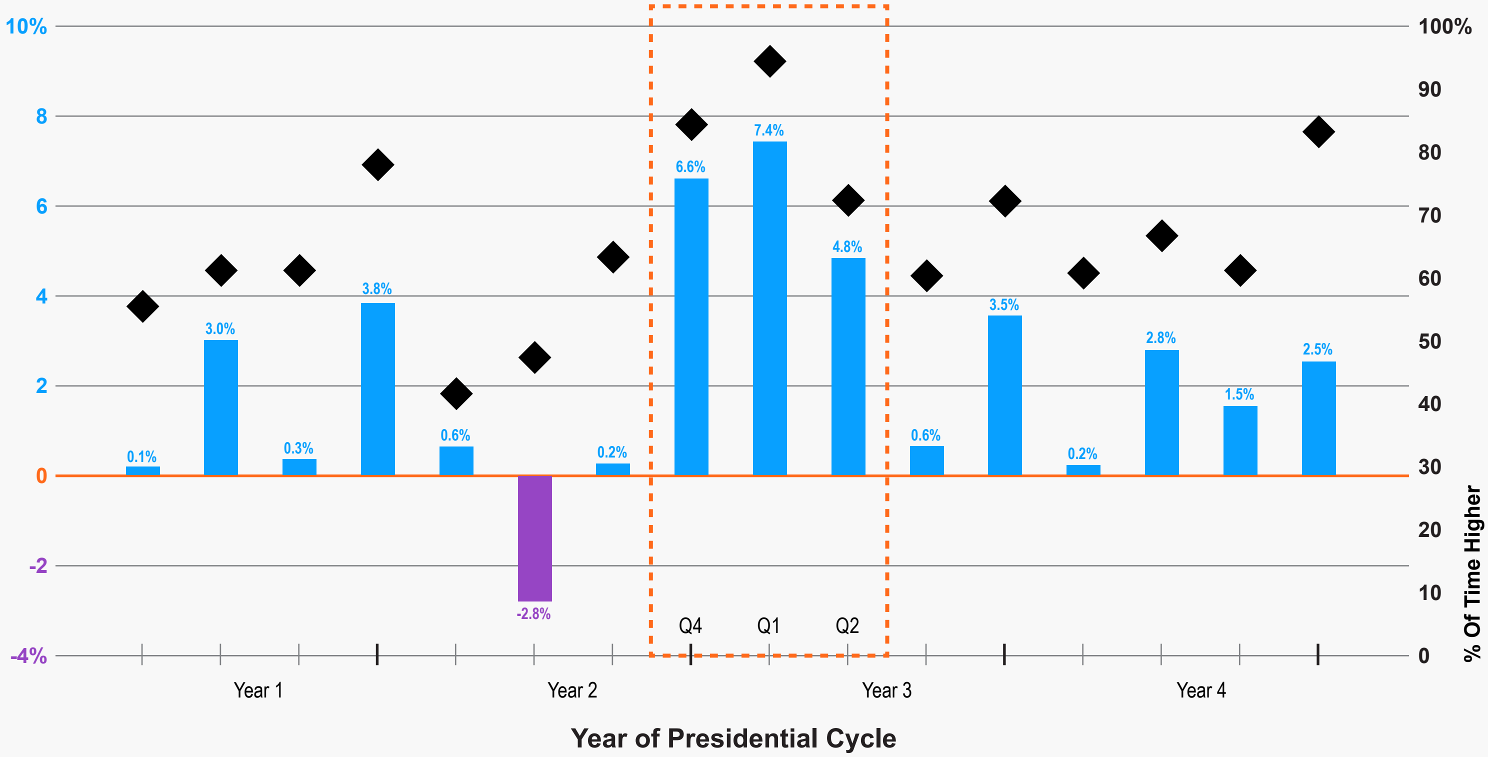
The multiple contractions in 2022 were driven by the rapid surge in interest rates. The good news is that we're probably close to the end of rate hikes. Our view is that rates are likely to remain where they are for a while. But rates are unlikely to rise from 5% to 10%, or even 7%, unless we get another major inflation shock.

This means a major obstacle that hindered stocks last year is dissipating. Removing this headwind is yet another positive factor for stocks as we head into the year's second half.

## Was Strength Really a Surprise?

Did you know that the fourth quarter of a midterm year and the first two quarters of a pre-election year are historically the best three quarters out of the entire presidential cycle? Given stocks gained over 7% in the first two of those three quarters, and gained another 8.7% last quarter, maybe the bigger surprise would have been for stocks to fall **|Figure 17|**. This was another chart we've shared a lot, and another reason we expected strong gains this year. Stocks typically take a break in the third quarter of a pre-election year, but the fourth quarter tends to favor the bulls.

**|Figure 17|**
**The Three Strongest Quarters Did It Again**
S&P Price Index Quarterly Performance By Presidential Cycle (1950 - 2022)




Source: Carson Investment Research, Factset, 05/30/2023 (1950 - 2022)

## Interest Rates

# Higher for Longer

- **Still not expecting a recession in 2023**
- **Inflation falling thanks to lower gas, grocery, used car prices**
- **Fed's measure of "core" inflation remains high**

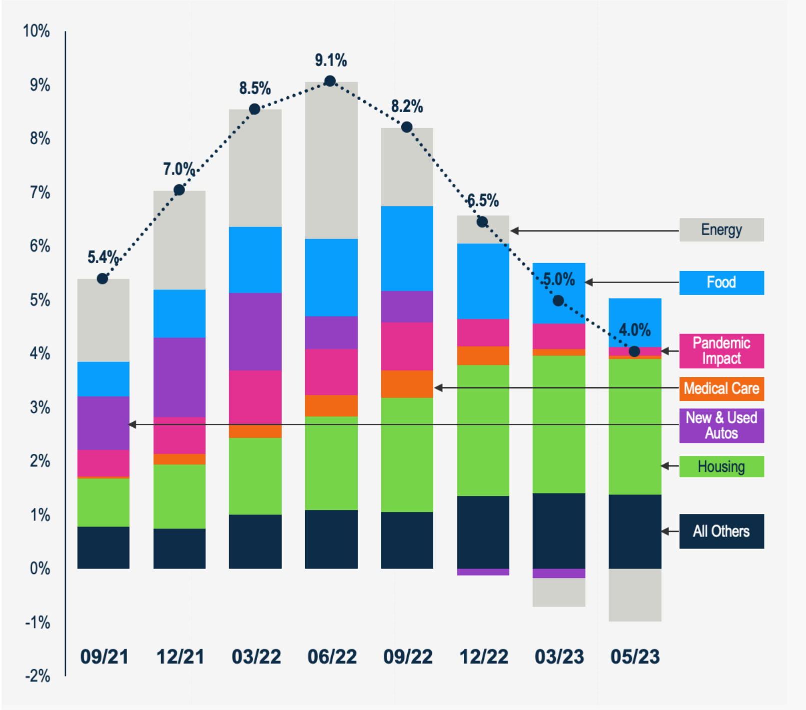
We started the year expecting no recession, and as we discussed earlier, we remain in that camp. At the same time, strong economic data coupled with persistent inflation means the Federal Reserve is unlikely to cut rates this year. As a result, we are maintaining our expectation that the Bloomberg U.S. Aggregate Bond Index will produce a total return of 4-5% in 2023, close to its starting yield at the beginning of the year.

We cannot talk about bonds without talking about monetary policy, and that leads directly into the inflation picture. On that front, we have good and bad news. Let's start with the good news.

Inflation has seen quite a rapid pullback since last June, with the consumer price index (CPI) falling from a year-over-year pace of 9.1% in June 2022 to 4.5% as of May **|Figure 18|** on the following page. At the beginning of the year, we discussed how lower energy, used car and rental prices will pull inflation lower in 2023. The first two have played out, while the third is at an inflection point.

The biggest drivers of falling inflation so far have been lower energy prices and food prices. This has been visible all around us, with nationwide average gas prices falling from above $5.00 a gallon to about $3.60 today. Lower natural gas prices have also translated into smaller utility bills. On the food price front, grocery store items have seen prices fall for three months now.

**|Figure 18|**
**Inflation pulls back on lower energy, food and used car prices**
Contributions to CPI Inflation (YOY)




Source: Carson Investment Research, BLS, 05/30/2023
Pandemic impacted categories including car and truck rentals, furnishings and supplies, apparel, airline fares, lodging away from home including hotels and motels. Housing includes rent of primary residence and owners' equivalent rent. Medical care includes care commodities and services.



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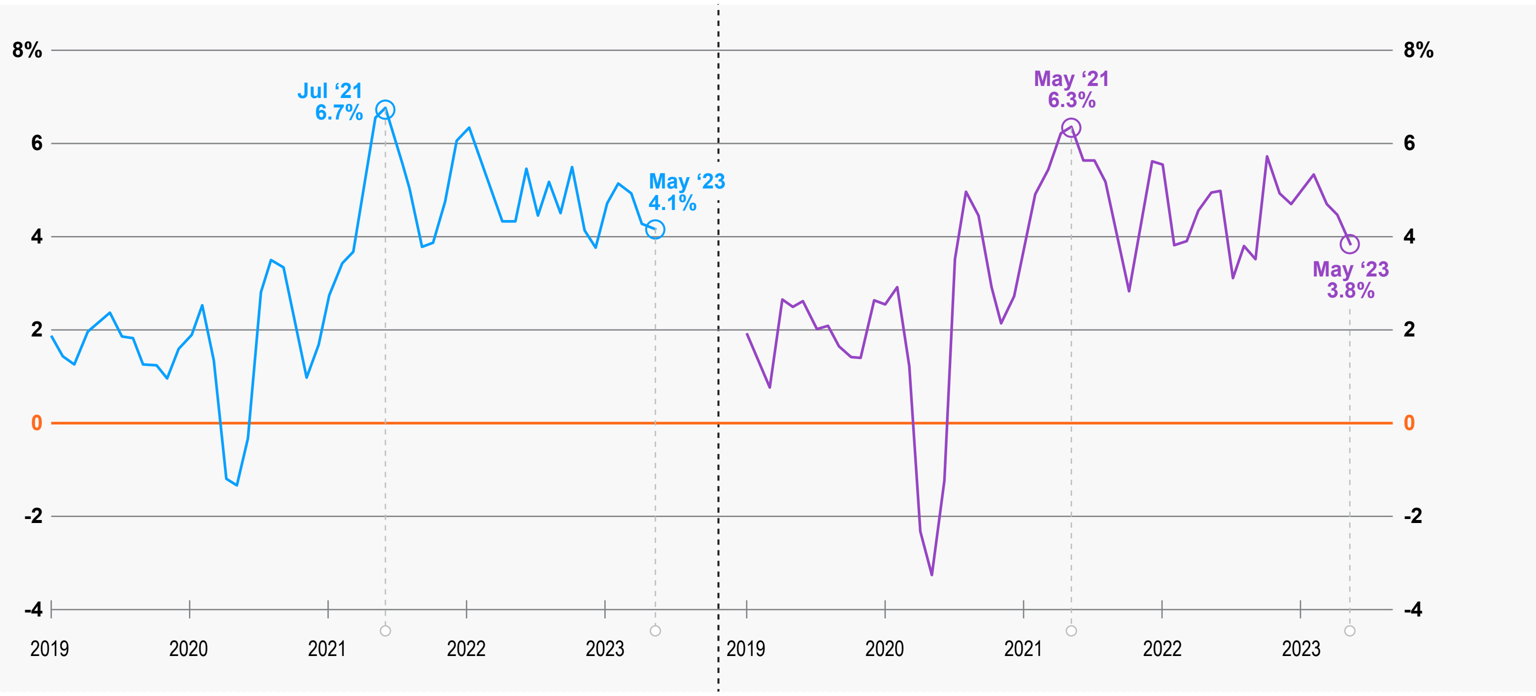
**|Figure 19|**

**Inflation progress has stalled**

PCE - Core (3-Month Change, Annualized)

PCE - Core Services ex Housing (3-Month Change, Annualized)




Source: Carson Investment Research, FRED, Bloomberg, 05/30/2023

Used car prices have also been declining for several months, contributing to lower inflation. We're starting to see this in the new car market as well, with semiconductor chip supply improving and boosting automobile production.

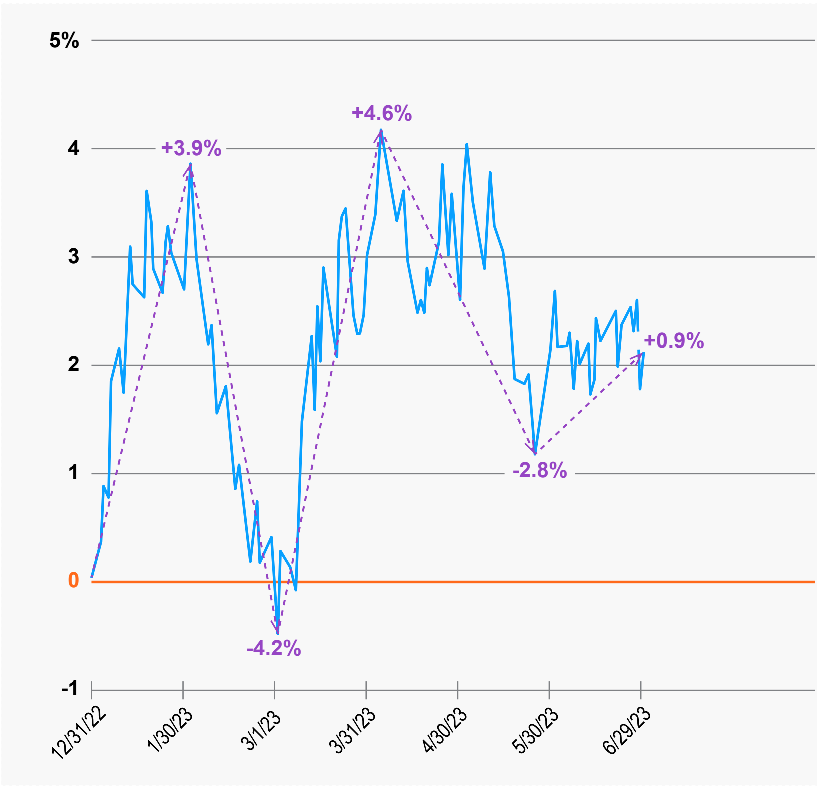
Housing inflation has been running hot, but this is due to methodological issues related to how the official rental price data are calculated. The good news is that official rental inflation looks to be turning lower now, with the deceleration in private rental data finally starting to show up.

The bad news is that the Federal Reserve's preferred measure of inflation – the personal consumption expenditures index excluding food and energy ("core" inflation) – has not seen much progress. Over the past three months (through May), it's been running at 4.1% on an annualized basis **|Figure 19|**. Fed officials have acknowledged the issues with official rental data, so they've carved out an inflation basket that excludes housing. The problem is even that measure is running just under 4%, well above the Fed's 2% inflation target.

**|Figure 20|**

**A roller-coaster ride for bonds in 2023**

Bloomberg Aggregate Bond Index Cumulative Return (From 12/31/2022 Through 6/9/2023)




Source: Carson Investment Research, Factsheet, 05/30/2023

All this to say, households are finally seeing real income gains as overall inflation finally heads lower. Yet, there's not been much progress from the Fed's perspective. We do believe even core services minus housing inflation will start to fall in the second half, but the Fed will want to see it to believe it.

Six months ago, we wrote that the main question related to policy going into 2023 will be, "How long will the Fed continue to keep interest rates high?" – as opposed to "how high" and "how fast," which were the predominant questions in 2022. This frame still applies, perhaps even more so.

The fact that inflation is no longer accelerating higher means we are close to the end of interest rate increases. Simply put, it's unlikely the Fed continues to ratchet up rates. However, persistently elevated core inflation means they are unlikely to cut rates any time soon – at least, not until they see decisive signs that core inflation is moving back to their target.

Pushing against all this in the first half of 2023 was the banking crisis, which helped fuel bond market volatility.

Interest rates fell (and bond prices rose) at the beginning of the year amid more pessimistic economic outlooks. That changed quickly, as it became clear that the economy was more resilient than most economists expected, confirming our outlook. This pushed yields higher and bond prices lower.

The regional banking crisis completely upended expectations. The prospect of credit tightening in the aftermath of the banking crisis led investors to price in three or four rate cuts by the end of 2023. Even the Fed said that potential credit tightening would be equivalent to rate hikes.

Fast-forward three months, and the economy has continued to show its resilience. We discussed earlier how the labor market has defied expectations month after month. As a result, bonds saw a sharp repricing recently, with investors no longer pricing in any rate cuts this year **|Figure 20|** on the previous page.

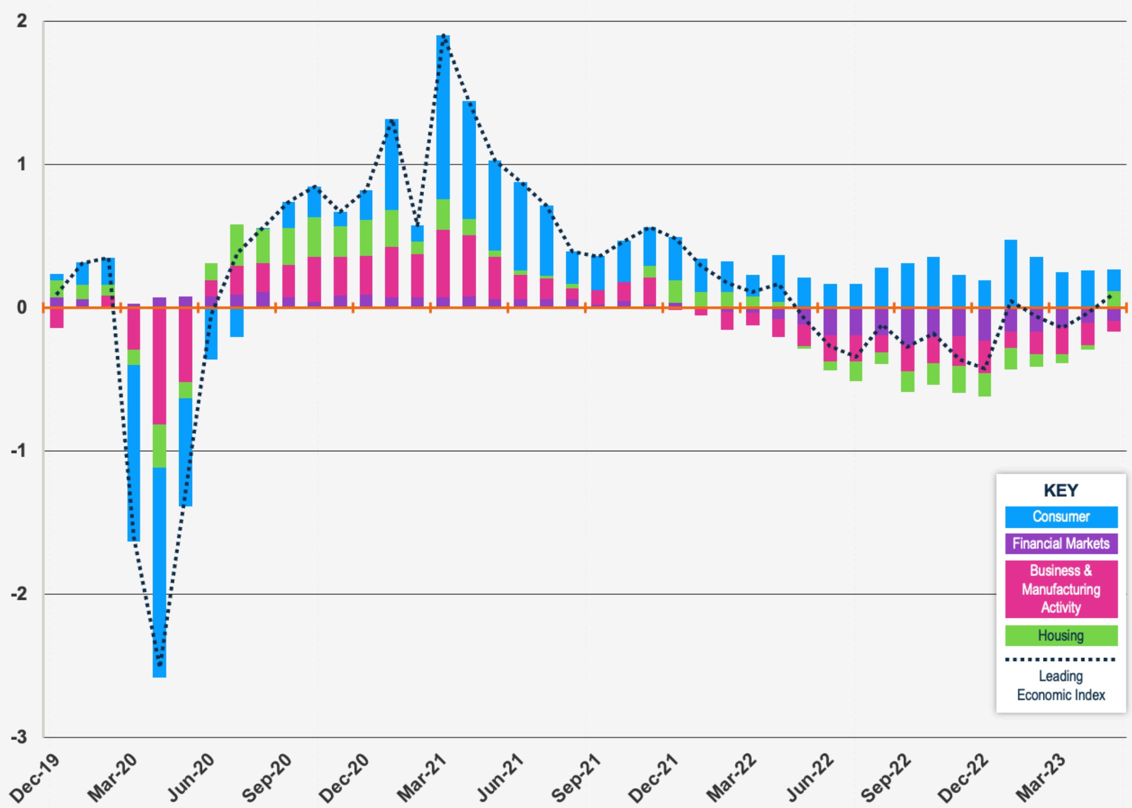
Our tactical house view remains underweight fixed income, especially long duration treasuries. Our base case is that the economy will be able to avoid a recession this year, and we believe the risk-reward ratio favors shorter-duration cash-like securities.

Our positive outlook on the economy also keeps us overweight commodities. However, we shifted some of this allocation towards gold, which we view as a portfolio hedging tool.

# The Bottom Line

- Headwinds of 2022 fading as economy normalizes
- Consumer strength has helped drive recovery

**|Figure 21|**
**Consumer in the driving seat, even as other sectors improve**
Leading Economic Index - USA: Contributions




Source: Carson Investment Research, 05/30/2023

Looking ahead, the headwinds from last year are fading as the economy normalizes. Breaking our leading economic index for the U.S. into underlying components captures how the economy has evolved since the pandemic hit three years ago. In a nutshell, the consumer has driven the recovery and carried the economy through last year. Even better, as we discussed earlier, consumer indicators have only gotten stronger over the first half of 2023 **|Figure 21|**.

The main risk of a recession last year was due to the Fed raising rates as fast as it did, which adversely impacted housing, financial markets and business activity. The good news, as we discussed earlier, is that these sectors are improving even as consumer strength continues. Additionally, the drag from financial conditions is beginning to ease as the Federal Reserve gets closer to the end of rate hikes and markets rally.

We see the potential for stocks to continue to outperform bonds and potentially make new all-time highs with more good news. Small caps and cyclical value should take the baton from technology and communications, as we see a broadening out of overall leadership. Bonds still make sense in a portfolio, but we remain underweight fixed income, as sticky rates and likely better performance from stocks will continue.

The path back to normal was never going to be easy, but we've made huge strides to getting there. There will be more growing pains, but after COVID and all the layers of fallout, we knew this path back to normal would be anything but normal.

The key to staying on financial track on the cusp of change is to avoid emotional reactions and regularly assess your long-term plan. No matter how stocks and other assets perform this year, you'll want to maintain an actively managed financial plan that caters to your specific financial goals, circumstances, risk-tolerance level and investing horizon.

As an investment research team, Carson Research monitors and assesses underlying factors that can affect market conditions as we deliver advice and provide portfolio management services. Our professional guidance delivers a longer-term outlook that can help you navigate an unpredictable market. That way, you have greater confidence in your plan as you work toward your financial goals and find the freedom to focus on what matters in your life.

Contact your professional advisor if you have any questions or concerns about your investing strategy for the year ahead. Meanwhile, we'll continue to keep you updated and informed about market movements and economic changes that can affect your investments.

In conclusion, we believe there's much to be optimistic about as we move into the second half of 2023 and look toward 2024. We look forward to working together on this journey!

[1] https://www.newyorkfed.org/microeconomics/hhdc

[2] https://fred.stlouisfed.org/series/A011RE1Q156NBEA

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