MORSE ASSET MANAGEMENT, INC.
23 Old Kings Highway South, Suite 200, Darien, CT 06820

July 18, 2023

2023 Q2 Investment Commentary

U.S. equity markets continued to rally through the second quarter on the back of a significant shift in sentiment and have established a new cyclical bull market. Pervasive bearishness has begun to capitulate as many of the forecasted risks that were priced into the market in the last year failed to materialize. Markets have climbed a wall of worry through a banking crisis, debt ceiling showdown, inverted yield curve, massive earnings reset and continued geopolitical strife. Inflation continues to abate. The job market and the consumer remain resilient. Economic expansion endures exceeding expectations of economists, businesses, and consumers. Corporate earnings have not been as bad as feared and breadth is broadening across capitalizations and sectors. Maintaining momentum will be more difficult in the back half of the year but if the current trends continue and earnings turn the corner equity markets should continue higher.

We entered a new cyclical bull market in June with the S&P 500 rising over 25% above the bear market lows in October of last year and has continued higher into July. In the 2022 bear market, the S&P 500 fell 25.4% over 9.3 months. This fits empirical studies for a bear market without an economic recession, which is shorter and less severe, and fits the typical market cycle (Chart 1). Over the past 60 years, there have been two bear markets for every recession. The pattern has been recession bear (2020), post-recession bull (2020-21), non-recession or echo bear (2022), and post-echo bull (2023) (Chart 2). The current cycle characteristics also fit within historical cases of a bear market within a longer more powerful secular bull market, rather than a secular bear like 2000-02 or 2008-09. While this is not a prediction the market will continue higher, it helps provide supportive historical context.

A narrow market, or poor breadth, had been a sticking point for bears who questioned performance in the first quarter. The magnificent seven (Apple, Amazon, Alphabet, Meta, Microsoft, Nvidia, and Tesla) and their sectors (Tech, Consumer Discretionary, Communications) continue to lead the market, but performance has broadened to validate the strength. While the above three Growth sectors were the only to post positive returns through the first five months of the year, all eleven sectors saw gains in June. Today, nearly 70% of the S&P 500 constituents trade above their 200 day moving averages, from only 40% at the end of May.

Inflation continued to moderate in June, with both headline and core inflation surprising to the downside. The Consumer Price Index eased to 2.97% year-on-year, which is 90% back to the Fed's target in just 12 months since June's peak. Excluding shelter, core inflation eased to 2.7% year-over-year, the slowest rate since March 2021. The June Producer Price Index (PPI) for final demand was 0.2% year-over-year, the smallest gain since August 2020.

Equity markets have given credence to the inflation trend, but the Fed and Bond market are still not convinced. The Federal Reserve will raise rates by 25 bps later this month after its June pause, bringing the funds rate to 5.25-5.50% and signaling another pause and hike. We continue to witness a tug-of-war between several critical macro forces: rapidly declining inflation, an inverted yield curve, and strong employment. The prospects for continued tightening with an inverted yield curve will keep skepticism elevated. The key question is thus whether the Fed will lower rates, un-inverting the curve, without seeing a significant rise in unemployment. If they do, we believe we will see a soft landing; So far so good.

The ISM Services PMI rebounded 3.6 points in June to 53.9, a four-month high and above the consensus of 51.3. The ISM Manufacturing Index fell more than expected in June to 46.0, the eighth consecutive reading below 50 indicating contraction. The ISM estimates that the latest PMI corresponds with 1.4% real GDP growth due to our largely service-oriented economy. The Atlanta Fed GDPNow estimate is currently for 2.4% GDP growth in the second quarter.

The job market remains strong. Consumer and Business survey sentiment continues to improve but remains neutral. Hard spending data is hanging on, led by Services. While job openings continue to decline, new additions and losses remain muted. Real incomes (wages growing faster than inflation) turned positive in June for the first time in two years. Consumer spending is more than 2/3 of GDP (GDP components Chart). As long as employment holds, expansion will continue.

For Q2 2023, according to Factset's July 14th *Earnings Insight*, the expected earnings decline for the S&P 500 is -7.1%. The decline is primarily due to continued margin pressures as revenue expectations remain positive. For Q3 2023 and Q4 2023, analysts are projecting earnings growth of 0.1% and 7.6%, respectively, ending the year positive. For 2024, analysts are projecting earnings growth of 12.4%. The year end bottom-up target price for the S&P 500 is now 4,847, up from 4,619 at the end of March.

As we have seen year to date, post peak inflation, valuation expansion (not earnings growth) typically drives the market higher as markets look forward to a recovery. We will now need to see earnings rise to support further upside. But the bar is low, and earnings surprises are trending up (EPS Surprise Chart). Analysts are starting to re-orient towards the realization that equity markets have been in an uptrend for the past 8 months. Estimate revisions are turning higher, and the conservative outlook is calling for a return to earnings growth in the second half.

Our playbook continues to focus on significant secular, cyclical, and structural trends. Innovation continues. Generative AI is one of the most important technology shifts in decades and is advancing at an unprecedented rate. We are favoring cyclicals over defensives, but we will continue balancing between high-quality growth at reasonable prices and businesses with stable free cashflow. Portfolio risk will be adjusted according to the prevailing market environment.

Markets are looking forward. Patience and conviction will continue to be rewarded.

Morse Asset Management Investment Team

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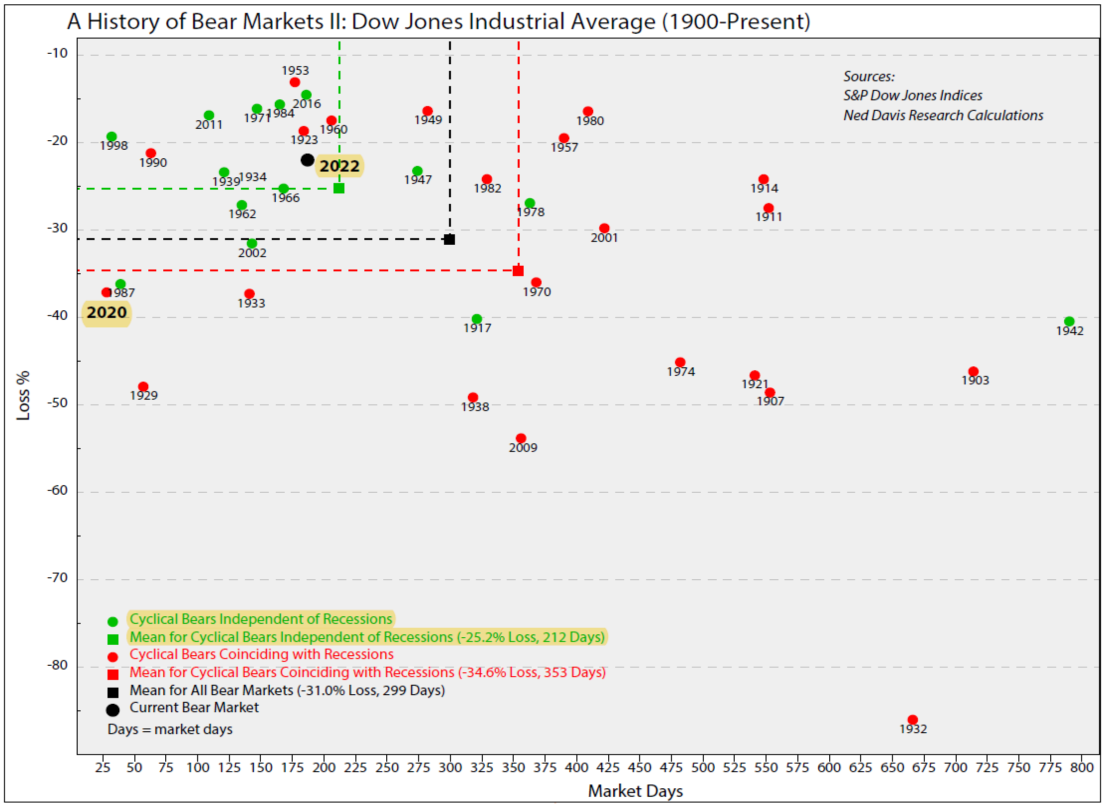

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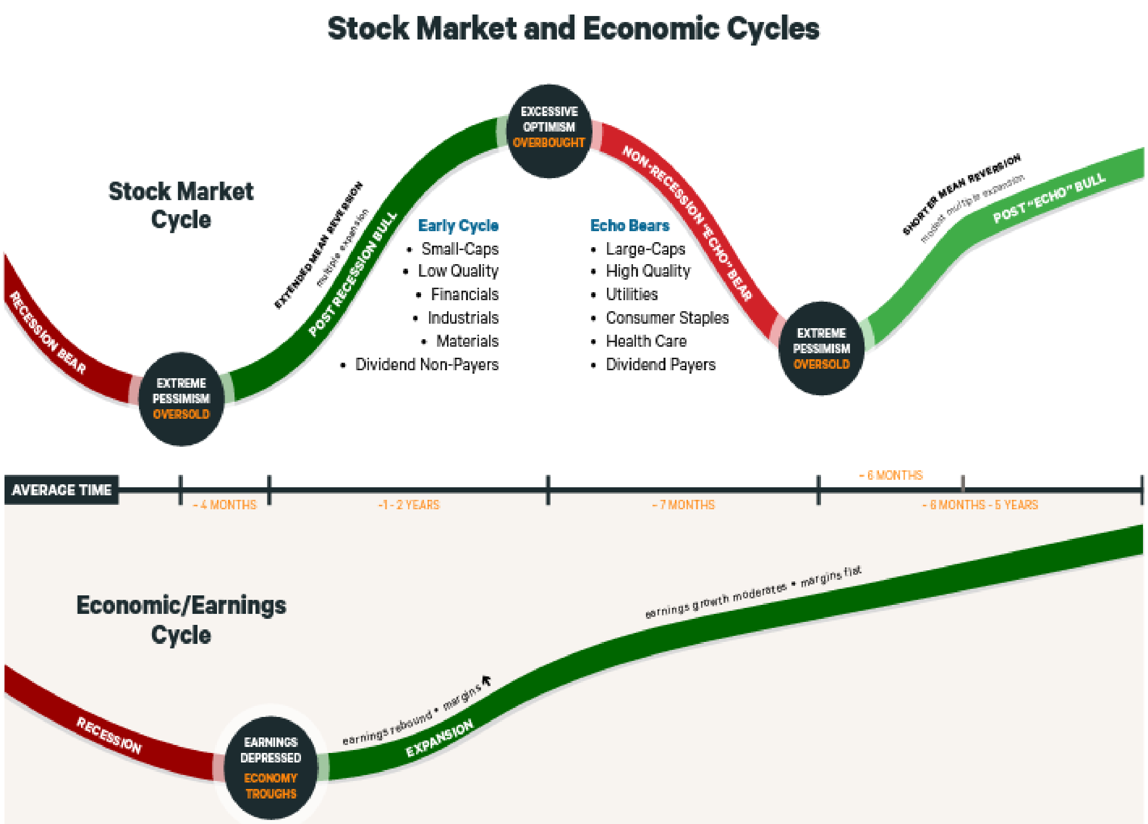

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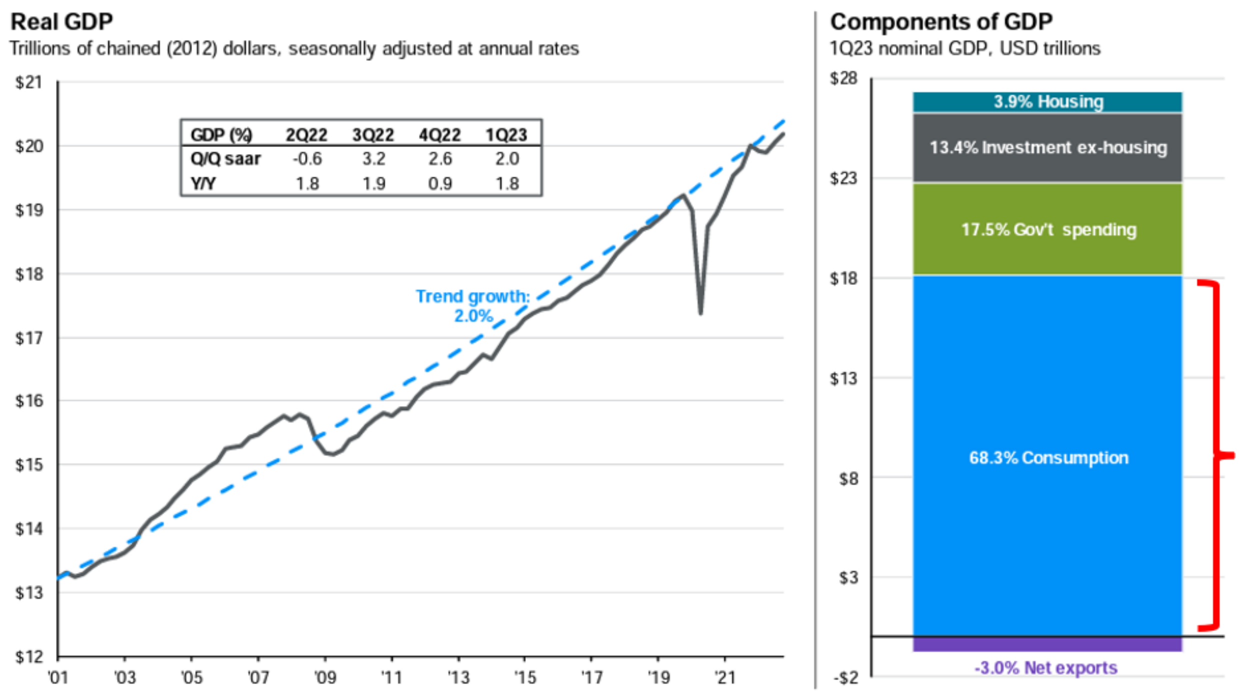
Economic growth and the composition of GDP



Source: BEA, FactSet, J.P. Morgan Asset Management. Values may not sum to 100% due to rounding. Trend growth is measured as the average annual growth rate from business cycle peak 1Q01 to business cycle peak 4Q19.
Guide to the Markets – U.S. Data are as of June 30, 2023.

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