Adviser Outlook

It's summertime, and the living is easier for investors than it was this time last year. The potential for a knock-down, drag-out debt-ceiling debate has been delayed to 2025, allaying default concerns. Meanwhile, the proliferation of artificial intelligence with wide-ranging commercial applications has boosted U.S. stock market returns through midyear.

Will the markets spread their wings and take to the sky in the second half of 2023? That would be ideal, but there are no guarantees for investors. We're keeping our eyes on client portfolios and wealth plans to harness opportunities and mitigate risks in the markets.

OUR OUTLOOK

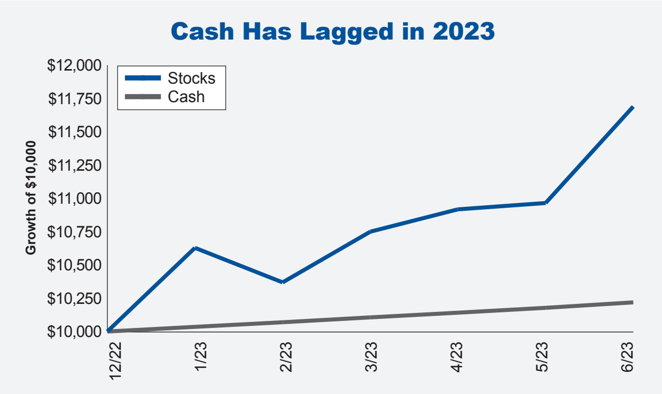
- ✔ **Indicators are mixed but they point to a recession. Low unemployment, stock market strength and, surprisingly, the housing market are all positives for the economy. In response, we expect the Federal Reserve to hike interest rates in July, but this will likely be the end of the tightening cycle.**
- ✔ **While the U.S. stock market has already risen 17% this year, this has been attributable to just a handful of stocks dubbed the Magnificent Seven.**
- ✔ **Cash yields may look enticing, but we favor bonds. Bond prices will benefit from a pause or reversal of Fed monetary policy, and locking in higher yields now, before rate cuts begin, will mean reliable income until maturity.**
- ✔ **Capital shortages driven by the credit crisis earlier this year have made private markets a more compelling complement to traditional investments for qualified investors.**
- ✔ **Valuations for small- and mid-cap stocks are at a steep discount to large-caps; these market segments typically outperform in the first year of a recovery, when their earnings are expected to bounce back.**

What We're Watching

The Federal Reserve spiritedly debated raising the fed funds rate at its June meeting. Policymakers kept interest rates static, but Chair Jerome Powell warned that further increases are likely if the conditions guiding their tightening policy persist. Markets have priced in at least one additional interest-rate uptick over the summer as a result.

Rate hikes create ripple effects throughout the economy—which is the point. Higher rates mean higher borrowing costs (think mortgages, auto loans and financing capital expenditures), which are intended to constrain growth and inflation. The Fed's actions have lowered inflation from the generational highs of last summer, but at 4% through May, it's above the central bank's long-run target of between 2% and 2.5%. However, the economy is showing signs of resilience: Consumer confidence is at a 17-month high and the job market shows few signs of slowing down.

This leaves policymakers with a mixed bag of data on which to base their decisions. Confident consumers tend to spend, which pumps more money into the economy, giving businesses the power to keep prices higher. These factors mean the Fed is walking a fine line between corralling inflation, supporting employment and not tilting the economy into a steep recession—hence the heightened scrutiny over every Fed action and its implications. Leading indicators are flashing recessionary signals, but strength in housing and the stock market muddy the picture.



Note: Chart shows hypothetical growth of $10,000 using returns of the S&P 500 index (Stocks) and the IA SBBI 30 Day TBill index (Cash) from 12/31/22 through 6/30/23. Sources: Morningstar Direct, Adviser.

The policy cycle has contributed to record-high assets in money market accounts—$5.4 trillion at the end of May, surpassing the prior record of $4.8 trillion during the pandemic era's stimulus programs. With money market yields around 4.75% after years parked near zero, it's understandable that sitting in cash may feel comfortable, especially after the stock market's 18% decline in 2022.

Unfortunately for those who chose cash over equities in 2023, the tables have turned. With the S&P 500 up 17% over the last six months, and up nearly 20% since this time last year, a sub-5% cash yield pales in comparison.

We acknowledge that stocks carry significantly more risk than cash—but there is a middle ground for those less comfortable with risk: Bonds. The same factors that have made cash yields appealing have been at play in the bond market. The key difference with bonds is that you can lock in those higher yields and the income they generate for years with the knowledge that you'll receive your principal at the maturity date (assuming you hold high-quality, investment-grade bonds).

Bond mutual fund and exchange-traded fund investors also benefit—while there is no maturity date for these investments, you have the opportunity to reinvest income as yields rise. When the Fed switches from tightening to loosening (i.e., from raising to lowering rates) and yields begin to fall, bond prices will rise. We believe the Fed is close to that turning point. Bonds may soon experience a returns tailwind, whereas cash accounts will begin to yield less and lack the potential to increase in value.

New Horizons

Apart from bonds, we see a range of opportunities for our clients over the coming months and years. The first is private market investments—a new offering from Adviser and Polaris.

Private market investments are made in companies or assets not traded on a public exchange or stock market. With over 10,000 private-equity-owned companies in the U.S. compared to less than 6,000 that are publicly traded, the investable market is significantly larger. We see three key benefits for investors: Access to thousands of privately owned companies in their earlier stages of growth, the ability to diversify your investments beyond public markets, and the potential for higher risk-adjusted returns. Give us a call to find out if private market investments are right for your portfolio.

In public markets, enthusiasm over artificial intelligence (AI) has driven a handful of tech stocks to dominate returns this year. We think we're still in the early stages of AI-fueled growth (and our portfolios have benefited, as our core models all have exposure to the so-called Magnificent Seven stocks—read more here: **adviserinvestments.com/mag7**). To date, most of the gains have come from companies creating AI-based products and the chips that they run on. Over the longer term, an increasing number of businesses and industries are set to adopt AI, creating efficiencies and raising their potential for profitability. Goldman Sachs estimates that this technology could boost annual productivity for S&P 500 companies by 1.5% over the next 10 years, which would flow through to higher earnings per share for investors.

The health care, education, financial services, retail and manufacturing industries all stand to benefit from the adoption of AI. We believe that jobs in these industries and others (like digital marketing) will transform as workers learn how to leverage AI. And as with any advance in technology, there will be both winners and losers.

ADVISER'S QUARTERLY WEBINAR

Listen to the replay of our *Third-Quarter Update: Building Wealth Through Economic Turning Points* at AdviserInvestments.com/webinar

Another facet of the stock market's concentration of returns has been an increasing valuation divide between the large-cap growth stocks that have risen the most and all the rest. Small- and mid-cap stocks are trading at a 20%–30% discount compared to the market leaders, creating the opportunity to invest at bargain prices. Likewise, the U.S. market overall has outperformed developed and emerging foreign markets. Maintaining portfolio exposure to these areas of the global markets creates growth potential and diversification when the pendulum swings to these under-loved segments. We saw this last year when value outperformed growth and developed foreign stocks outpaced the U.S.

Looking Ahead

As always, we encourage you to contact us for an initial conversation about your portfolio and wealth management needs. And while it may intrude on your summer fun, it's not too early to review your tax strategy. Our specialists can help you plan moves between now and year-end to create savings next tax season.

We've positioned client portfolios with their long-term goals at the fore while taking the range of possible near-term outcomes into account. Even if we do find ourselves in recession, it will not necessarily trigger wholesale changes to our investment strategy, as the timing and duration will be uncertain. Our mission is to make sure that client portfolios and financial plans are working in concert to help them live your best life. We hope you have a wonderful summer and hope to hear from you soon if we can do anything to help you achieve peace of mind about your financial goals.