The Cobblestone Advisor

Investment Brief

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COBBLESTONE CAPITAL ADVISORS

Maintaining Proper Perspective

US and international equity markets continued their upward trajectory during the second quarter, as economic data has generally come in weak but above expectations for much of the year. The US economy in particular has proven more resilient than expected, leading to a marked improvement in investor sentiment. Against this backdrop, domestic large cap stocks led, up +8.7% during the second quarter and +16.9% during the first half of the year. International developed and emerging market equities have also performed well, delivering +11.3% and +4.9% during the six-month period, respectively.

While US bonds experienced a modest decline during the quarter (-0.8%), they remained in positive territory during the first half of the year (+2.1%). Consequently, balanced portfolios have generally delivered healthy returns to start the year.

To be sure, uncertainty surrounding the path ahead for US economic growth and the trajectory of financial markets continues to persist. Corporate earnings remain under pressure, and business spending continues to trend lower. Over the next several weeks, we will learn how companies fared over the last few months as they release second-quarter financial results. Earnings are expected to decline by -7.2% on a year-over-year basis, which would mark the third consecutive quarter of declining earnings and the largest decline since the US economy ground to a halt three years ago amid the depths of the pandemic. To the extent that earnings remain under pressure, businesses could opt to further curtail spending in the quarters ahead, leading to knock-on effects that reverberate throughout the economy.

While the risk of a US recession within the next 12 months remains high, predicting the timing, depth, and duration of a recession—as well as related movements across financial markets—is notoriously difficult. We consider the exercise a fool's errand. Instead of attempting to identify the specific characteristics that define near-term risks, we believe a more prudent approach is maintaining a longer-term perspective, one that is better aligned with an investor's financial goals and time horizon.

Despite the near-term risks, we see several positives supporting the economy and investor portfolios over the intermediate to longer term. One is the consumer, which remains healthy. Unemployment is at historically low levels, and consumers continue to spend. Nominal wages are now rising at a faster rate than inflation, improving purchasing power and sentiment. With inflation continuing to trend lower—the latest measure showed prices rising just 3.0% year-over-year in June—consumer sentiment and household balance sheets should benefit.

On the policy front, after an aggressive rate hike campaign levied by the Federal Reserve, policymakers now have ample room to ease should economic or market conditions deteriorate to worrisome levels. While additional rate hikes may be on the horizon, policy interest rates are already at the level they were heading into the Global Financial Crisis, giving the Fed the same amount of dry powder that it had heading into one of the worst economic crises in history.

With regard to market dynamics, following a calamitous year for fixed income markets in 2022, bonds are now delivering attractive yields. The last time bond

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Total Return (%), Ending 6/30/2023				Annualized		
	Qtr	YTD	1 Year	3 Years	5 Years	10 Years
S&P 500 Stock Index	8.7	16.9	19.6	14.6	12.3	12.8
Russell 2000 (Small-Cap Stocks)	5.2	8.1	12.3	10.8	4.2	8.2
MSCI World Ex. US (International Developed Stocks)	3.0	11.3	17.4	9.3	4.6	5.4
MSCI EM (Emerging Markets)	0.9	4.9	1.8	2.3	0.9	3.0
Bloomberg US Aggregate Bond Index	-0.8	2.1	-0.9	-4.0	0.8	1.5
Dow Jones US Select REIT	2.9	5.8	-0.7	9.1	3.3	5.7
Consumer Price Index (% Chg over Period)	1.1	2.8	3.0	5.8	3.9	2.7

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yields were at these levels (approx. 5.0%) was during the depths of the Global Financial Crisis (2008). Bonds went on to deliver a +5.3% annualized total return over the next five years.

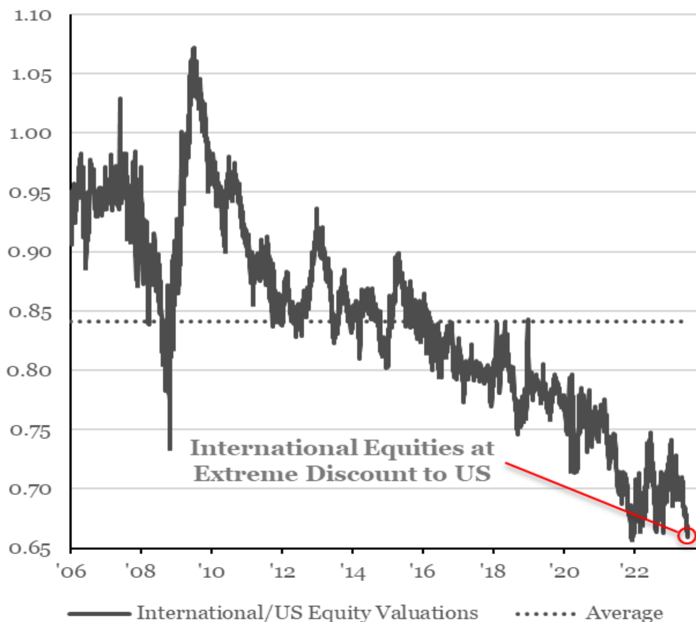
With higher starting yields, bonds are expected to provide a much stronger return tailwind to multi-asset portfolios than they have in recent years. It also better-positions the asset class to act as a ballast to investor portfolios in a recessionary, risk-off type of environment, when investors tend to seek the relative safety of the asset class, which pushes bond prices higher.

Within equities, to the extent that markets hit another rough patch in the months ahead, it is important to remember that historical periods of volatility and market dislocation have provided investors with ample opportunities. The current environment is no different, and pockets of opportunity already exist.

One area where we see opportunity is within international equities. International equities are currently priced at an extreme discount to US equities (left panel below), and we have a meaningful allocation to this part of the market.

Even within US equity markets, overvaluation is concentrated in the largest US stocks (right panel below). We have persistently maintained an underweight allocation to these securities across our portfolios, opting instead to focus on more attractive segments of the US equity market.

We would also note that we construct durable client portfolios to weather recessionary market environments. Building our portfolios in this fashion allows investors to navigate short-term volatility and achieve their long-term investment objectives. Keeping this in mind and maintaining a longer-term perspective can help investors stick with their investment plan in choppy markets, increasing their chances of achieving an optimal investment outcome.



Source: MSCI, S&P Dow Jones, JP Morgan, Bloomberg. Right panel depicts valuations of stocks within the S&P 500 Index.

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