PARKSIDE INVESTMENTS

Phone: 312/778-7700
Web: parksideinv.com
Email: info@parksideinv.com

Market Review and Outlook 2Q23

Highlights

Equities continued to march higher during the second quarter, notching their third consecutive quarter of gains, as the S&P 500 Index recorded a second-quarter return of 8.7% (+16.9% YTD).

While stocks have technically entered a new bull market, a disproportionate amount of the S&P 500 Index gains have been driven by a small concentration of mega-cap technology stocks—potentially putting this market recovery on shaky legs.

The entire bull-market rally from the October 2022 bottom has been driven by valuation multiple expansion, as forward earnings estimates have declined slightly over the last eight months.

For the upturn in stocks to prove lasting, investors will likely need to see evidence of an earnings recovery, an end to Fed rate hikes, and broader equity market participation.

The benchmark U.S. Aggregate Bond Index posted a modest decline in the quarter—due to the increased prospect of additional rates in 2023—but it still generated a positive return for the first six months of the year.

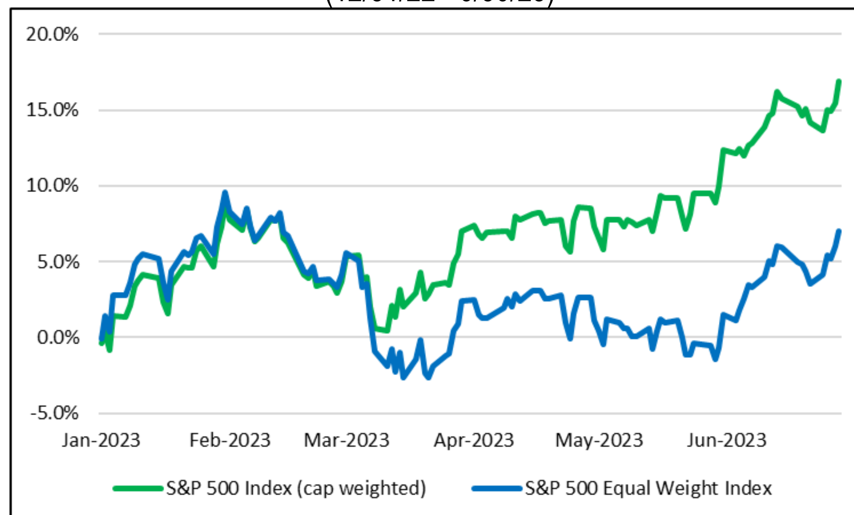
With the rate-hike cycle likely coming to an end by late 2023, bonds offer a compelling income stream and hedge to an economic downturn.

Market Review and Outlook

Global equities continued to march higher during the second quarter, notching their third consecutive quarter of gains, despite sustained monetary policy and macroeconomic concerns. Domestic equities led the field, as the S&P 500 Index recorded a second-quarter return of 8.7% (+16.9% YTD). International equity returns were more muted, but still positive. Persistent inflation in Europe capped the developed markets (EAFE) second-quarter gain at 3.0% (+11.7% YTD). Meanwhile, emerging markets (EM) posted a modest quarterly return of 0.9% (+4.9% YTD), as a slowdown in China (resulting in a new bear market for Chinese shares) dragged down otherwise strong equity performance across other developing countries.

With the S&P 500 Index closing the quarter up roughly 26% from the October 2022 bottom, stocks technically entered a new bull market in June. Under the surface, however, the equity market looks less robust than the capitalization-weighted index suggests. The bulk of the index's year-to-date gain is attributed to the outsized returns of a concentrated group of tech stocks. Seven of the largest tech and growth companies in the U.S.—Alphabet, Amazon, Apple, Meta, Microsoft, Tesla and Nvidia—now account for 28% of the S&P 500's market capitalization (up from about 22% at the start of the year). The average return for these seven mega-cap tech stocks was 82% during the first half of 2023, while the average year-to-date return for the rest of the S&P 500 was just 7.7%. This led to a significant divergence in the returns between the benchmark S&P 500 Index and the S&P 500 Equal Weight Index.

Total Return of S&P 500 Index vs. S&P 500 Equal Weight Index
(12/31/22 - 6/30/23)



Source: FactSet

Investors piled into the large technology names, seemingly believing their prime positioning in the secular growth opportunity of artificial intelligence (AI) will supersede any near-term threats posed by further interest rate hikes and slower economic expansion. The disproportionate influence of a few outperforming stocks leaves the stock market vulnerable to a quick unwind, however, if the current hype around AI dissipates and the tech sector suddenly stumbles. As was the case with the much larger dot-com bubble, or the more recent mini-bubbles in 3-D printing, clean technology, cryptocurrencies, cannabis stocks, meme stocks and SPACs, investor euphoria ultimately gives way to underlying fundamentals. AI could prove to be a once-in-a-lifetime and game-changing application, but even if that turns out to be the case, it seems premature for the market to coronate the winners of this nascent technological advancement with such fervor. In other words, the AI-driven outperformance of large tech stocks relative to the rest of the market seems unsustainable.

That said, as the S&P 500 Index continues its upward trajectory, there has been a palpable shift from bearish to bullish sentiment in the market overall. Whether or not this rally proves to be a fleeting bear market bounce or the start of a new sustainable bull market, however, remains open to debate. Bulls argue equities will continue to move higher in the second half of 2023, supported by gains in the stocks that lagged the market during the first half of the year. The bears argue that the equity laggards tend to be more cyclical/interest-rate sensitive and therefore conclude the latest market upturn will prove to be an unstainable head fake rally—pointing to the early-2000s for examples where equities experienced several bear market rallies of nearly 20% or more, only to be followed by further price declines.

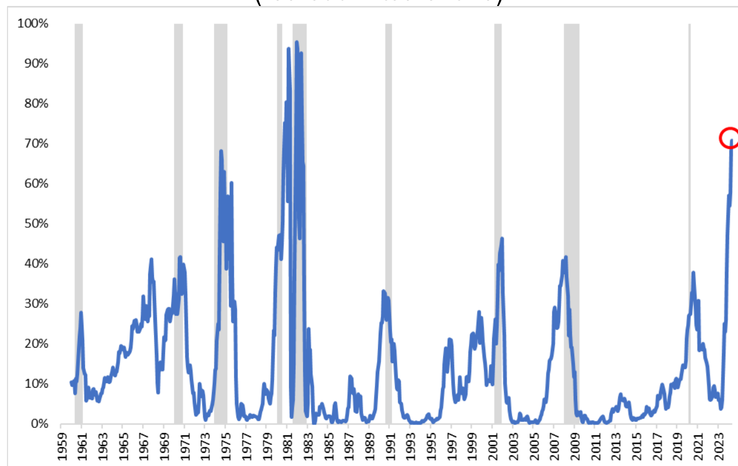
S&P 500 Index rallies amid the 2000-2002 bear market
(12/29/99 – 3/31/03)

Source: FactSet, Hussman Strategic Advisors

While the market is increasingly buying into the bullish argument (for now), the fact that the latest 20%-plus rally in the S&P 500 Index has been defined by extreme narrowness and broad cyclical underperformance raises legitimate concerns about its durability—particularly if the economy enters a recession.

Thus far, the "looming" recession forecasters have been tracking since the middle of last year has proven elusive. The near-term macro backdrop still appears supportive given sustained labor strength and continued GDP expansion. The risk of an economic downturn over the coming year remains elevated though. After a year-and-a-half of the most aggressive monetary policy tightening in four decades (with the federal funds rate rising from 0% in March 2022 to 5% today), historical precedent and common sense suggest that higher interest rates will eventually weigh on the economy. In fact, numerous predictive economic signals are flashing concerning warning signs. The New York Federal Reserve's yield-curve model, for example, puts the likelihood of a U.S. recession within the next year at 71%—the highest level since August 1982.

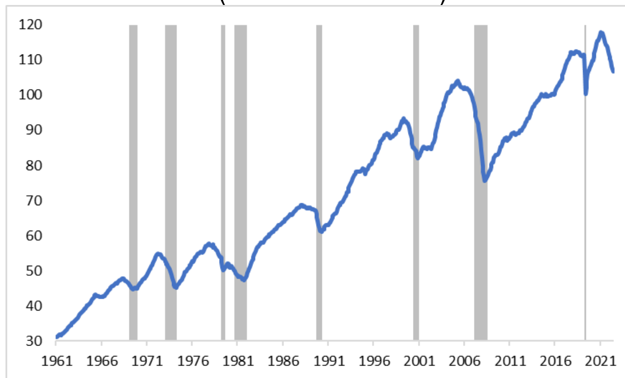
Yield-curve-derived probability of U.S. recession in 12 months
(1/31/60 – 5/31/2023)



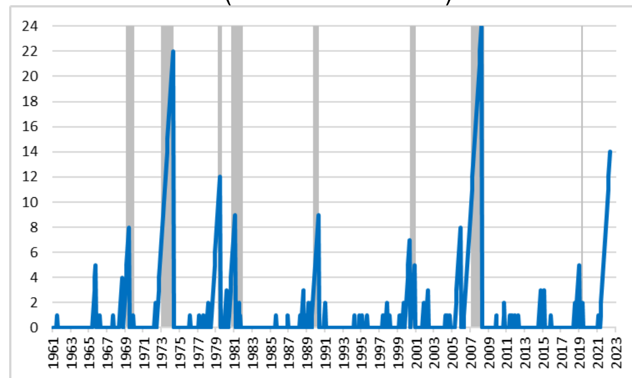
Source: Federal Reserve Bank of New York

Similarly, the Leading Economic Index (LEI)—which provides an early indication of significant turning points in the business cycle—is also flagging danger ahead. When leading economic indicators enter a persistent downward trend, recession typically starts 11 months later, on average. The LEI has now declined for 14 consecutive months, making it the third longest decline on record behind the recessions that started in 1973 and 2007. Thus, the economy still looks increasingly susceptible to a downturn.

Leading Economic Index (2016 = 100)
(12/31/61 - 5/31/23)



Number of consecutive months of LEI declines
(12/31/61 - 5/31/23)

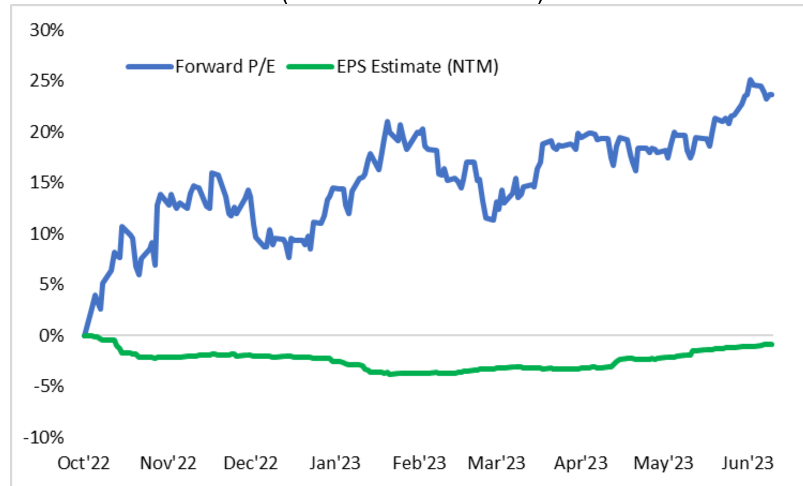


Source: Conference Board, FactSet

Over the last eight months, equities have steadily climbed the “wall of worry” that arose from the rising economic risk reflected in these recessionary barometers—which may end up being less predictive/timely amid an economic backdrop still warped by the unprecedented fiscal and monetary stimulus injected into the system during the COVID pandemic. Thus, a near-term selloff in equities is far from certain—particularly if recession is avoided. For the current upturn in stocks to become a confirmed bull market though, three developments will likely have to transpire: 1.) an earnings recovery, 2.) an end to the rate-hike cycle, and 3.) broader equity market participation.

Forward EPS estimates have declined slightly while forward P/E multiples have expanded nearly 24% since S&P 500's October 2022 low. In other words, the entire bull market rally from last year’s low has been driven by valuation multiple expansion. With the S&P 500 now trading at 19x forward earnings, valuation multiple expansion has likely peaked, so corporate earnings growth will need to reaccelerate to support current equity prices.

S&P 500 Index change in forward P/E multiple and EPS estimates
(10/14/22 – 6/30/2023)

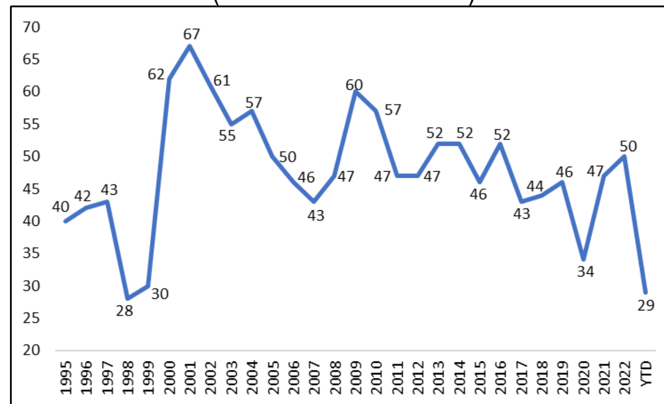


Source: FactSet

The bulk of the rate-hike cycle is likely complete, in our view, but interest rates could still move higher in the second half of 2023. The Federal Reserve declined to raise short-term rates at its June meeting for the first time in more than a year, as policy makers felt it prudent take additional time to assess the impact from its previous 10 consecutive interest increases. With inflation still well above the Fed's long-term target of 2% though, the Fed Chairman made it clear the door is still open to future rate hikes. The FOMC member "dot plots" indicate two more hikes are still expected over the remaining four meetings this year. The future-year dot plots do imply the Fed will start cutting rates in 2024 (by a full percentage point), however, if this year's outlook holds.

The third and final stipulation for this bull market to endure—broader market participation—will be highly dependent on the first two conditions (earnings expansion and ending rate hikes). The first six months of 2023 represented one of the narrowest markets in 25 years, with only 29% of S&P 500 stocks outperforming the index's composite return.

Percent of S&P 500 stocks outperforming the index
(12/31/95 – 6/30/2023)



Source: Jeffries, FactSet

A sustainable bull-market recovery will likely necessitate a much larger swath of companies participating in the equity rally. Encouragingly, the market's breadth broadened somewhat in June (from extreme narrowness earlier in the quarter), as each sector in the S&P 500 Index posted a positive monthly return in June and 62% of the index constituents ended the first half of the year with a positive return.

Given the still-elevated monetary and macroeconomic uncertainties, it's probably prudent to be measured about taking risk in the market after the strong upturn in equity prices. Wall Street's fear gauge—measured by the CBOE Volatility Index (or VIX)—has sunk to depths not seen since before the start of the Covid-19 pandemic, which may indicate investors have become too complacent after this recent market rally. It's plausible that stocks are in the early stages of a new bull market with further room to run, but there are enough guideposts and historical precedents to suggest that a recession by late-2023/early-2024 is still possible (if not probable). An actual economic downturn, even if mild, would likely cause investors to rethink their renewed bullish sentiment. We continue to believe the market could remain in a relatively wide (but capped) trading band over the near to medium term, with temporary spikes in volatility until monetary and economic risks moderate. Over the longer term, however, we expect a sustainable multi-year bull market to re-emerge.

Core Portfolio

During the second quarter, we purchased shares of Union Pacific and The Health Care Select Sector SPDR® Fund.

Union Pacific is the largest public railroad in North America, with a route map covering most of the central and western United States (west of Chicago and New Orleans). As one of the most efficient modes of transportation to move freight, railroads play a pivotal role in the U.S. supply chain and therefore offer a compelling means to invest in the country's long-term economic expansion. While cyclical, the railroad operators tend to hold up better than other transportation firms during economic downturns, as they are larger and better capitalized than trucking companies and are less sensitive to fluctuating fuel costs. Union Pacific has long had a reputation among investors as the best-run U.S. railroad, as it consistently generates above-average operating margins and returns on invested capital (ROICs) relative to its competitors. This is attributed, in part, to the company's desirable long-haul network (which benefits from less railcar switching vs. a complicated spiderweb network in the densely populated East) and a more lucrative freight mix than its peers. As the premier operator in a critical (and concentrated) industry, we believe Union Pacific is poised to deliver attractive long-term shareholder returns.

The Health Care Select Sector SPDR® Fund is an exchange-traded fund that owns a diversified portfolio of 65 public-equity holdings in the pharmaceuticals; health care equipment and supplies; health care providers and services; biotechnology; life sciences tools and services; and health care technology industries. We like the healthcare space, as it is a rapidly growing and innovative industry that tends to perform well throughout the economic cycle. By investing in a broad collection of healthcare names through this fund's structure, we can effectively and efficiently participate in the secular growth of the industry overall.

We sold our holdings in Truist Financial Corp. and Penn Entertainment during the quarter.

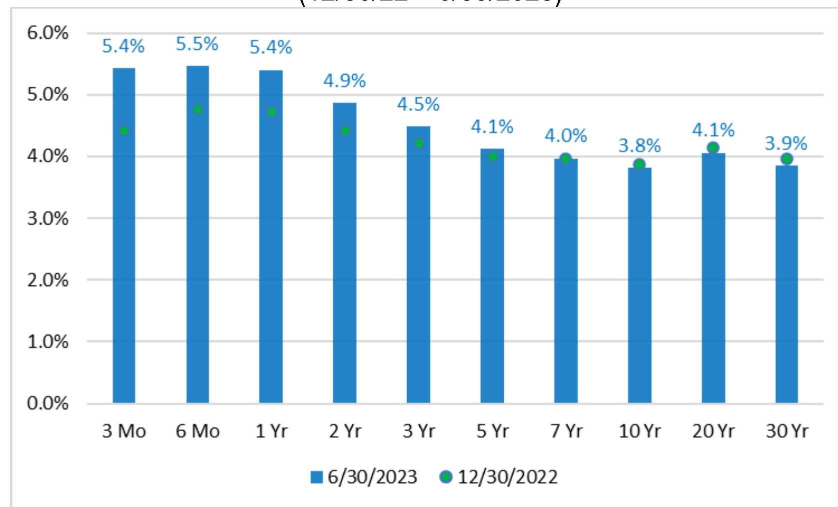
Truist is a regional bank with a presence primarily in the Southeastern United States. We viewed the company's top-three (or higher) market share ranking for bank deposits in high-growth states like Florida, Georgia, Virginia, North Carolina and South Carolina—where population growth is meaningfully higher than the U.S. overall—as a compelling way to invest in the geographic/demographic shift taking place in the country. However, the recent turmoil in the banking sector could have a lasting impact on the deposit/profit growth of regional banks versus the better capitalized "big four" banks. As a result, we sold our position in Truist and reallocated the capital to equity positions where we had more confidence in the upside growth potential.

Penn Entertainment operates land-based casinos across 20 states and 12 brands (such as Hollywood Casino and Ameristar). Additionally, Penn's media assets, theScore and Barstool, provide access to sports betting/iGaming technology and clientele, helping it form a leading digital position. We believe casinos and sports gambling continue to offer significant growth opportunities, but we're now less clear on Penn's profit growth trajectory given the intensively competitive U.S. gaming market. We decided to exit our position in the stock, as Penn's elevated debt load and lack of near-term positive catalysts made it less attractive relative to other positions in the portfolio.

Fixed Income

The prospect for additional Fed interest rate hikes put modest downward pressure on fixed income markets during the second quarter. Short-term Treasury yields pushed higher (and prices declined) in the quarter, as shorter duration bonds tend to be the most susceptible to interest-rate policy changes. Meanwhile, yields for Treasury securities maturing in more than five years ended the quarter nearly unchanged from the beginning of the year, reflecting easing inflation pressures and a tempered outlook for economic growth.

Short-term yields continue to rise while longer-term yields remain nearly unchanged
(12/30/22 – 6/30/2023)



Source: U.S. Department of Treasury

The benchmark U.S. Aggregate Bond Index posted a modest second quarter loss of -0.8%, but its year-to-date total return remains positive (+2.1%)—a welcome contrast to the benchmark's rare double-digit decline during 2022. With higher starting yields, bonds' coupon payments have been a key driver of their positive YTD returns—offsetting the lingering price pressure at the front end of the rate curve.

While as many as two more Fed hikes remain on the table in 2023, we believe that prevailing bond yields have now largely priced in these interest rate increases. We also hold the view that the federal funds rate will be at (or near) its peak for this cycle by year end. Against that backdrop, we think bonds offer a compelling investment case. We will continue to emphasize shorter-term maturities (due to the high current yield), but will retain some exposure to bonds in the 5- to 10-year maturity range—as longer duration bonds may provide solid capital appreciation if the economy slows down and yields compress.

Final Thoughts

During the first half of 2023, equity markets exhibited much more strength than most had anticipated. Given the resiliency of the U.S. economy thus far, the continued rally in stocks seems warranted. Equities may have trouble extending their gains in the second half of the year, however, as valuation multiples are stretched and economic conditions remain fragile.

Market sentiment may also prove a bit over extended. Whether from the alluring prospects of artificial intelligence, anticipation of a soft economic landing, or suspended belief about the Fed's resolve to squash inflation, investors may be setting themselves up for a letdown if any (or possibly all) of those suppositions prove incorrect. As a result, we would not be surprised to see volatility re-emerge in the back half of the year and for stocks to encounter temporary pockets of turbulence.

While volatility can be unnerving, it also creates opportunities. With the benefit of our long-term investment strategy, we can take advantage of volatility by proactively buying into transient market corrections, focusing on the broader bull market that we expect to gain traction over time.

As always, we appreciate your continued trust and confidence. Please reach out to us if you have questions or concerns.

One final note: We will be closing our underutilized Chicago office space as of July 31 and consolidating our desks to Parkside's Deerfield address. Our phones, e-mails, and personnel will not change. Please don't mail any items to Chicago and, if you want to meet in our office, we'll see you in Deerfield!

Have a great summer!

Parkside Investments, LLC

Please contact your Parkside representative at 312/778-7700 if there are any changes to your financial situation or objectives, or if you wish to modify any restrictions on your account.

Parkside Investments, LLC maintains a business continuity plan and periodically reviews the plan for disaster preparedness. In an emergency, news updates will be posted to our website *www.parksideinv.com* ***until the critical situation has been resolved. You may also contact us through our individual phone lines and e-mails or by our main phone 312/778-7700 and e-mail address*** *info@parksideinv.com*. ***Your calls and e-mails will automatically forward to other devices away from our offices.***

Disclosures: *The information contained in this message is intended to provide general information only and should not be construed as an offer of specifically tailored individualized advice or results. Clients or prospective clients should not assume that their performance will equal or exceed historical market results and/or averages. The securities identified and described do not represent all of the securities purchased, sold, or recommended for client accounts. The reader should not assume that an investment in the securities identified was or will be profitable. With any investment, there is the possibility of loss as well as gain. Past performance is not indicative of any specific investment or future results.*

Benchmark performance shown for various market indices is shown with interest and dividends reinvested and gross of all fees and expenses. An investor's individual performance would include interest and dividends reinvested, but would be net of all fees and expenses incurred from transactions and management of their portfolio. No one can invest directly in a benchmark.

Views regarding the economy, securities markets or other specialized areas, like all predictors of future events, cannot be guaranteed to be accurate and may result in economic loss to the investor. All statements other than statements of historical fact are forward-looking statements (including words such as "believe," "estimate," "anticipate," "may," "will," "should," and "expect"). Although we believe that the expectations reflected in such forward-looking statements are reasonable, we can give no assurance that such expectations will prove to be correct. Various factors could cause actual results or performance to differ materially from those discussed in such forward-looking statements.