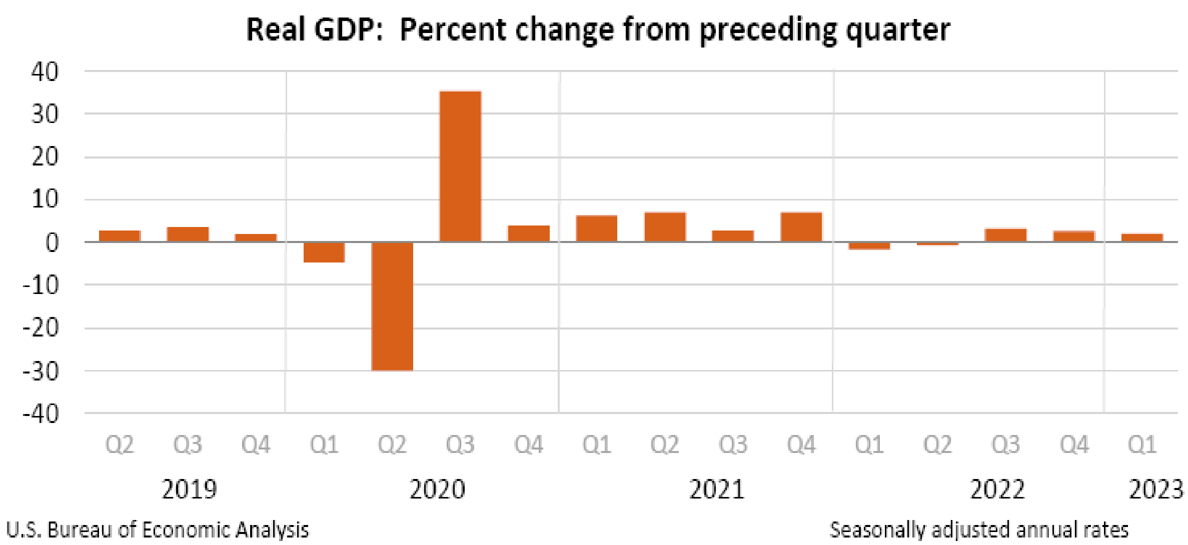
VICTORIA
Capital Management, Inc.

Financial Markets Perspective

July 2023

A Return to Normalcy

The economy and financial markets returned to some modicum of normalcy during the first six months of this year as the remnants of the pandemic continued to dissipate. Growth in the economy continued through the first half with a much better-than-expected 2% gain for the first quarter. The largest positive contributions to the real GDP growth rate in Q1 were consumer spending, government purchases, and net exports. There are still a few economists who are forecasting a recession, but most data points are indicating just a slowdown, not a recession. For example, housing starts are up 20% over the past year even though mortgage rates more than doubled to more than 7%!

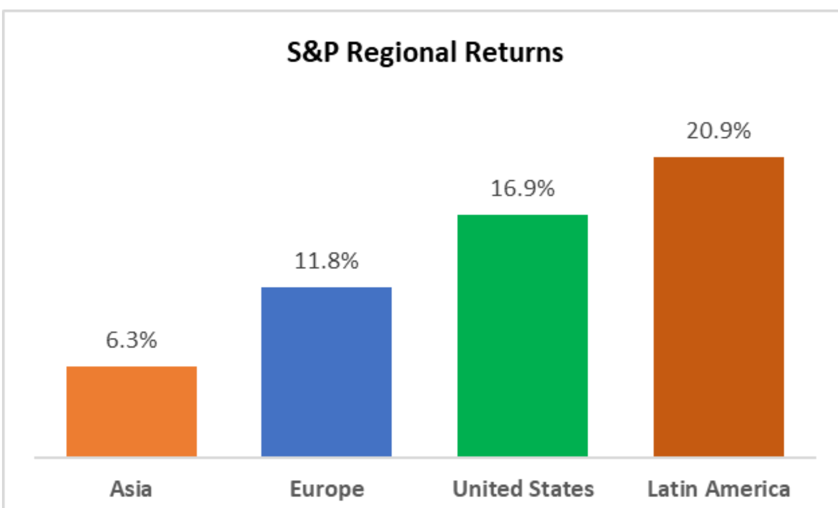


Monetary policy continues to impose higher interest rates on the economy with expectations that one or two more increases in the fed funds rate are in the cards for the balance of this year. The Fed is trying to get inflation down to its target of 2% and we are hopeful that we are getting there sooner rather than later. Yet continued increases in interest rates have not undermined the overall economy nor the technology sector that is booming nor the consumer who continues to exhibit a rising level of confidence. Corporate profits continue to do well and forecasts for further gains into 2024 are increasingly likely. The surge in awareness of artificial intelligence is adding further excitement to the potential applications of this technology across broad sectors of the economy. These advances will likely contribute to the ongoing positive influence on our lives as has the personal computer, the Internet, and the mobile phone.

Another factor contributing to a return to normalcy is the fact that there has been a decline in the rate of inflation so far this year. For all of 2022, the consumer price index rose by 6.5%. For 2023, that measure of inflation has fallen to an annual rate of increase of ~3%. Rather than reporting the monthly change in the CPI (Consumer Price Index), the data is reported on a trailing 12-month basis. So, even with the latest CPI data point for May reported as up at 0.1% (an annual increase of only 1.2%), the report emphasized that the trailing 12-month rate was 4%! Another measure of inflation, the Producer Price Index (PPI), declined by 0.3% in May suggesting that inflation, at least as measured by the 12-month moving average, will continue to fall.

Interest rates have remained stable over the past six months although a minor uptrend was underway earlier in the year as the Fed continued to push rates higher. Then, the banking crisis hit, and interest rates fell across the board. The Fed's bailout of the banking system by guaranteeing depositor accounts reversed the decline and short to medium-term interest rates rebounded to near where they were at the end of last year. The increase in interest rates since early 2022 has benefited savers who hold floating-rate short-term investments such as money market accounts and CDs. These retirees have basically had zero interest rates for the past decade so the recent rapid rise in rates has boosted their income– a welcome relief for many reliant on their retirement savings to try to maintain their standard of living.

The stock market has historically been a guide to the overall health of the economy and this time is no different. For the first six months of this year, domestic stocks, as measured by the S&P 500, gained nearly 17% while the NASDAQ Composite rose by a whopping 31%. The Dow Jones Industrial Average lagged, with a return of less than 3%. The leadership of mega and large-cap information technology stocks gave a huge lift to the overall markets. However, in June we began to see a strong rally in other sectors as the markets' gain expanded across stock categories. Bull markets are usually characterized by rallies in "blue chips" and only later in the advance come gains in mid and small-cap stocks as investors' confidence continues to broaden. This has been the case so far this year as the S&P MidCap 400 index gained nearly 9% and the S&P SmallCap 600 rose by 6%. This broadening of the gain in domestic equities indicates improvement in the economy going into next year. Also, strong advances in many foreign stock markets (shown below) indicate a healthy global economy.



Much of the strong impetus for the stock market advance this year has been the popularity of the interest in new applications of artificial intelligence (‘AI’). A leading chipmaker, Nvidia, reported record profits for the first quarter and indicated the trend would continue for the rest of the year as more companies needed their chips to build their AI capability. As with the emergence of the personal computer in the early 1980s, the availability of artificial intelligence has reached the average person in the street and use of this medium is bound to expand productivity.

Additional support for a return to normalcy is the fact that oil prices have stabilized even in the face of continued OPEC threats to reduce production. The U.S. dollar has remained constant keeping the cost of imports in a narrow range. The volatility of the stock market has also fallen to record lows, and the November election outcome has imposed constraints on spikes in government spending and taxing which should continue at least until 2025, if not beyond. There should be no more government spending explosions as we experienced in 2020 and 2021. Lastly, inflation has fallen back to reasonable levels and may fall further, increasing the chance of stable if not lower interest rates.

The war in Ukraine remains an outlier and we have no confidence that anyone can predict the outcome. However, we are observing the unusual effects that such events can have on the changing face of combat. In 1939, the Polish cavalry rode out to meet the German tanks. In 1944-1945, air superiority and massive aerial bombing raids eliminated the combat ability of the Germans and Japanese. In Ukraine, Russian missile attacks are being mitigated by anti-missile systems while the introduction of drones (pilotless guided airplanes) is affecting combat in both Ukraine and Russia. These events are setting the stage for the next combat event, one that is likely to be waged with thousands, if not hundreds of thousands of cheap drones carrying cameras and bombs to destabilize the enemy. The insertion of AI into this equation could make the difference between winning and losing.

As we enter the second half of this year, stability could mean a slight Fed-induced increase in interest rates and the digestion of the outsized stock market gains of the first half. Without government interference in the overall economy, we do not see a reason to be concerned about the impact of a forecasted recession or the likelihood of continued increases in inflation. One big “scene” is likely to be the upcoming 2024 election and the outcome of that election and its effect on the economy and financial markets. Stay Tuned!