



BANK OF MILLBROOK TRUST AND INVESTMENT SERVICES

REVIEW AND OUTLOOK

PUBLICATION 60

JULY 2023

Bull markets are born on pessimism, grow on skepticism, mature on optimism, and die on euphoria.

-Sir John Templeton

Our newsletter from April was leaning into some pessimism. The markets were grappling with the prospect of the banking industry’s instability, due to the lightening-fast failure of several large institutions. The debt ceiling negotiations were looming and of much concern in the current political environment. Being pessimistic seemed a logical response.

Since that time the S&P has climbed 10%. The regional bank’s quarterly earnings reports are not as dire as expected. The debt ceiling discussions in Washington came down to the wire, but approval to lift was agreed upon. Inflation has continued to modestly pull back; unemployment has not moved from a low of 3.6%, and the US economy is consistently moving along.

The question of what the second half of the year will bring could be framed in optimistic terms, or are we in a euphoric state?

We choose to be exceedingly cautious. The strength in the markets is primarily based on ten companies out of the 500 in the S&P. If any of those companies (such as Apple, Microsoft, Nvidia, Google, Meta) falter the rest of the market will follow. The markets seem to ignore the much higher interest rates which will be impactful in many areas of the economy. The yield curve inversion, defined as the 2-year treasury at a higher yield than the 10 year treasury, has been inverted for 10 months at this point. Historically this screams a pending recession.

Perhaps this time is different. And we might have a mild recession and a soft landing. We will see. Meanwhile we are pleased to be finding fixed income with yields over 5% and taking advantage of market volatility, when it comes, to purchase high quality equities.

Enjoy the summer, may it bring gatherings of friends and/or family.

With our best to you and yours,

TRUST AND INVESTMENT TEAM

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CPWA®

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AND TRUST OFFICER*

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BANK OF MILLBROOK
TRUST AND INVESTMENT SERVICES

44 FRONT STREET
MILLBROOK NY 12545

845-677-4266

BANKOFMILLBROOK.COM



ECONOMIC OUTLOOK

Summary

An economic surprise occurred in June, when the final revision for first-quarter GDP unexpectedly increased by 0.7%, to 2.0%. Combined with GDPNow forecasting 2.1% growth for the second quarter (as of early July) and the Fed's projection of only 1%, growth for the full year seems less and less likely. Since the Fed is attempting to curb growth in order to slow inflation, they have made it very clear that despite holding the overnight rate steady in June, at least two more rate increases are expected to occur before year's end.

Hikes are likely to continue because the economic data since mid-April has been very strong in aggregate and the Bloomberg Economic Surprise Index has shot up to its highest levels since late 2020. Still, we have yet to feel the full impact from the banking crisis that occurred earlier this year. It is expected as banks recapitalize, lending will be reduced, which should have a drag on economic activity.

Another potentially overlooked economic headwind could come from student debt. With approximately \$1.7 trillion in student debt outstanding, it is the largest type of debt in the U.S. aside from mortgages. For the past several years, 43.5 million people have been able to defer their average student loan payment of nearly \$400 per month, spending those funds on goods and services instead. That equates to roughly \$17.5 billion per month, or \$209 billion per year, that has been contributing toward higher inflation.

However, as part of the debt ceiling agreement, student loan interest and repayments will restart for the first time in three-

and-a-half years during the second half of 2023. Graduates from 2020 (and later) will need to start preparing for their first ever student loan payments and millions of others will resume where they left off pre-COVID. After providing a tailwind to the economy for several years, student debt will soon become a headwind, the strength of which could influence the Federal Reserve's decisions.

Positives

The final GDP revision for the first quarter increased by 0.7% to 2.0%

Durable goods orders in May smashed expectations (1.7% vs. -0.9% est.)

ISM services moved further into expansionary territory (53.9)

Negatives

Core PCE (the Fed's preferred measure of inflation) remains elevated at 4.6% year-over-year

ISM manufacturing remains in contractionary territory for the eighth consecutive month (46.0)

Pending home sales continue to disappoint at -20.8% year-over-year)



EQUITY OUTLOOK

Summary

The S&P 500 climbed 6.6% in June capping a strong first half of the year that saw the index gain 16.9%. The strong performance for the month was extremely broad across equity style, size and geography. The Russell 1000 Growth Index and Russell 1000 Value Index rose 6.8% and 6.6% respectively. The Russell Midcap Index jumped 8.3% while the small cap, Russell 2000 Index, added 8.1%. Returns in foreign markets were positive, but somewhat muted relative to domestic performance. The developed MSCI EAFE Index rose 4.6% and the MSCI Emerging Markets Index gained 3.8%.

Few market prognosticators expected such a strong first half of 2023. At the beginning of the year, many thought we would either be in a recession or at the least nearing a recession soon. Most indicators were definitely pointing in that direction at the time. In recent weeks, however, broad consensus has been shifting to a soft landing scenario. During a soft landing, the Federal Reserve's rate hikes slow the economy to the point of successfully stamping out inflation but avoid creating a hard, economic recession. Stock market performance seems to be reflecting that shift in consensus.

Equity markets may now need a soft landing to justify market gains and current valuation levels. Any signal that inflation may be headed in the wrong direction or that the Fed may need to stay aggressive should be met with a negative market reaction. These expectations will likely add a level of volatility to equity markets throughout the remaining summer months and headed into fall.

That being said, developments in recent weeks have been quite positive for equity investors. Companies will soon begin reporting quarterly earnings results once again with a lower bar. Assuming the path of inflation and Fed policy maintain the current trajectory, we would expect the markets to hold the current gains for the year and perhaps add to those gains in the second half of 2023.

Positives

Fed nearing the end of hiking cycle

Headline inflation continues to moderate

Resilient corporate earnings

Market breadth has widened recently

Negatives

China recovery has fallen flat

Some inflation components remain sticky

Strong labor markets frustrate Fed



FIXED INCOME OUTLOOK

Summary

For the first time in 15 months the Fed took a pass on raising the overnight rate at their mid-June Federal Reserve's Open Market Committee (FOMC) meeting. Whether it was a skip, a pause, or the end of the rate-hiking cycle remains a hot topic of discussion. The accompanying press statement and Summary of Economic Projections show most committee members believe additional rate hikes are warranted. In fact, only two of the 18 participants believed the rate will be at the current level at year's end. The majority expect at least two additional rate increases. The concept of skipping a meeting while still expecting additional hikes is perplexing to many forecasters and investors, especially following 10 consecutive hikes. In an effort to shed some insight, Chairman Powell reiterated that this month's skip had more to do with the pace of increases rather than the ultimate endpoint. Many investors and strategists question the need for more restrictive policy when the rate of inflation continues to fall and there are some signs the economy is slowing. By not hiking during the June meeting policymakers will be able to see more data before making additional policy decisions.

Another point made perfectly clear following the June FOMC meeting is that investors should not expect a rate cut this year. With the Fed's hawkish outlook for policy, the 2-year Treasury yield climbed another 50 basis points (bps) to end the month at 4.90%. Similarly, the 10-year yield has made back most of its spring decline, ending the month 20 bps higher at 3.84%. Credit spreads have been on a narrowing trend since mid-May and closed the month 15 bps tighter. The move tighter in spreads drove positive excess return for the investment-grade corporate bond index, generating +0.41% total return during the month of May.

We still believe the broad bond market indices will deliver mid-single-digit returns for the calendar year. If the incoming

economic and inflation data are enough to justify the two additional Fed rate increases, then the front end of the curve could move a bit higher as only one rate hike is expected. But as usual, longer-maturity bonds will be less sensitive as the impact of a higher overnight rate in the near-term will be offset with more economic disturbance in the long-term. We still favor a higher allocation to corporate bonds but the room for excess return is narrowing as spreads tighten. If spreads were to move in another 10 or 20 bps, we would recommend decreasing corporate exposure in favor of treasuries.

Positives

The Fed has now paused after hiking 10 straight meetings

U.S. investment-grade corporate bonds yield almost 5.5% in aggregate

Negatives

Significant issuance to rebuild government cash levels

Inflation statistics easing but at a slower pace. Fed may tighten policy two more times

Unknowns

Bank lending standards as commercial property loans need refinancing

Russia/Ukraine war and Putin leadership questions