July 2023
Market Commentary

First Affirmative FINANCIAL NETWORK
Invest for a Sustainable Future

The "Other 493" Play Catch Up

By Theresa Gusman
July 26, 2023

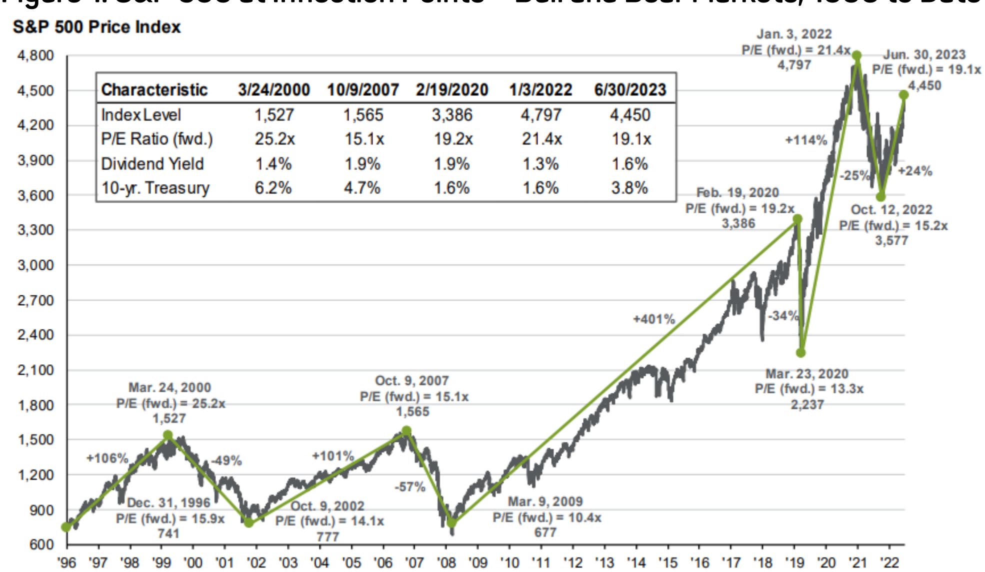
Overview

The S&P 500 increased 8.7% in the second quarter, boosting the first half rise to 16.9% (see Figure 1). 70% of the performance of the S&P 500, more than 95% of the performance of the more concentrated MSCI USA, and 70% of the performance of the MSCI ACWI, were driven by just seven Artificial Intelligence (AI)-driven stocks -- Alphabet, Amazon, Apple, Meta, Microsoft, NVIDIA, and Tesla. As a result of this market concentration, actively managed large blend funds underperformed their passive counterparts by a whopping 133 basis points in the year to date through June 30th, according to Morningstar Direct.

The S&P 500's narrow leadership in the first half camouflaged paltry returns from most of the index (see Figure 2). The low single digit gains posted by the "other 493" S&P 500 companies in the first half are more reflective of the current market environment – and in line with our expectations – than the 16.9% AI-fueled gain recorded by the S&P 500. Coming into 2023, most observers were convinced the US economy would dip into a recession. In fact, the Philadelphia Fed survey from January showed nearly 44% of respondents predicted a recession would happen in the next 12 months, the highest number in more than a decade. Inflation has moderated and recession has been averted to date. As a result, corporate earnings exceeded analysts' expectations in the first quarter, and according to FactSet, blended S&P 500 earnings reported to date have exceeded the projected 9.0% decline in the second quarter.

Further gains in July have put the market within striking distance of its January 2022 peak. However, with earnings estimates rising broadly, valuations of the "other 493" are not extended. The degree to which Information Technology valuations have been stretched relative to the market in the first half is shown in Figure 3. Whereas the Price/Earnings (P/E) ratio of the Information Technology sector is near its 10-year high, the valuations of nine of the ten sectors in the S&P 500 are at, marginally above, or marginally below their 10-year averages.

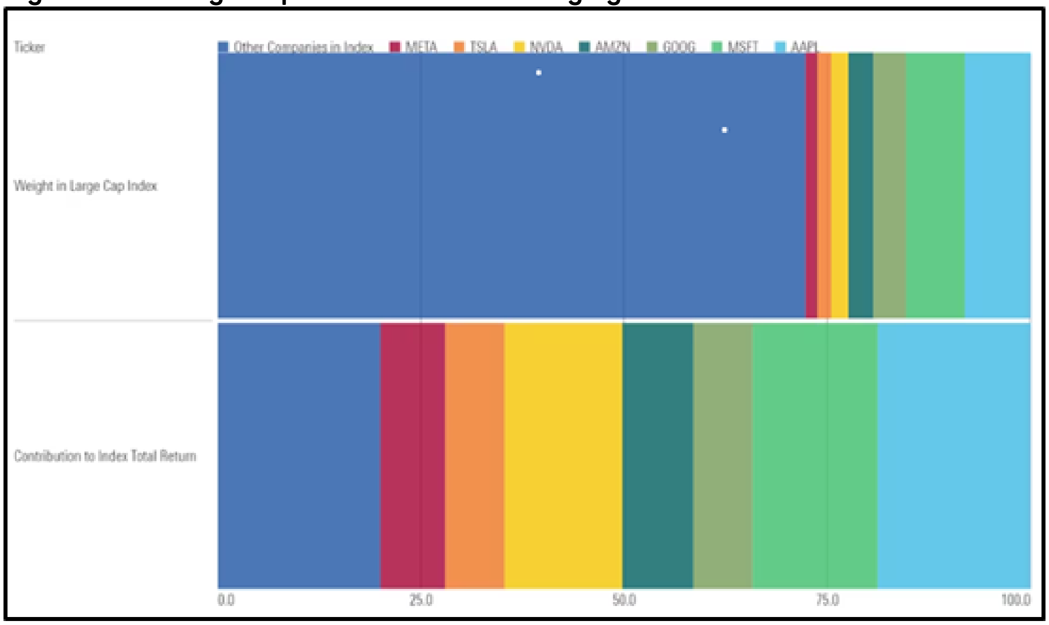
Figure 1. S&P 500 at Inflection Points – Bull and Bear Markets, 1996 to Date



Source: J.P. Morgan Asset Management Guide to the Markets – U.S. Data are as June 30, 2023

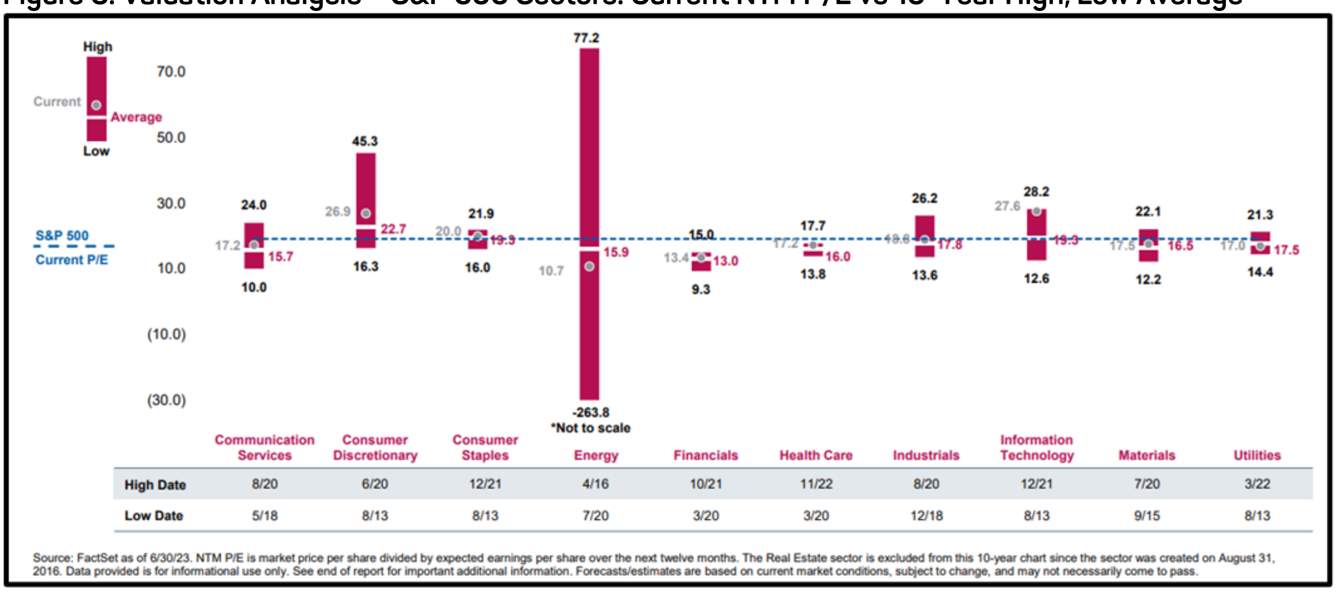
Market breadth expanded in recent weeks as the S&P 500 continued to advance. Against the backdrop of broadly reasonable valuations, moderating inflation, slow growth, possibly followed by a mild recession, and steady interest rates following a final 25 bps to a 22-year high in Fed Funds rate of 5.25%-5.5% in July increase, we look for continued modest equity gains and increased breadth in the second half.

Figure 2. US Large Cap – Return Contributing by Stock Year to Date



Source: J.P. Morningstar – Data as of Mid-June

Figure 3. Valuation Analysis – S&P 500 Sectors: Current NTM P/E vs 10-Year High, Low Average



Second Quarter Market Review and Outlook

The US outperformed all developed markets in the second quarter (see Figure 4). Within emerging markets, Latin America (+19.27%) and India (+13.10%) were the top performing markets and China (-9.75%) was the worst performer. US Large Growth stocks (+10.97%) significantly outperformed Large Value (+3.64%) in the second quarter, and large cap stocks broadly outperformed small although the variation by style was more pronounced.

Figure 4. Global Equity, Fixed Income, and Real Assets Performance (Percentage Change), 2Q 2023

		2Q2023	2023 YTD	Last 12 Months	Last 24 Months Annualized
	Global	0.90	14.10	16.50	-0.83
Equity	**US Equities**	2.98	16.18	18.96	1.00
	US Large Cap	3.12	16.65	19.29	1.81
	US Mid Cap	-0.48	8.82	13.74	-2.25
	US Small Cap	0.05	9.26	14.92	-4.57
	Non-US Equities	2.62	9.95	12.62	-4.62
	Non-US Developed Markets	3.20	12.03	18.64	-0.95
	Non-US Emerging Markets	0.96	5.12	1.12	-13.35
Fixed Income	**US Aggregate**	-4.44	2.62	-2.13	-5.22
	US Treasuries (Intermediate)	-1.54	1.40	-1.89	-5.16
	Municipals (Intermediate)	-0.47	2.14	3.36	-3.86
	Investment Grade Corporate	-5.24	3.50	1.62	-6.45
	US Corporate High Yield	-3.89	4.72	8.07	-3.11
	Bank Loan	2.84	5.69	10.34	2.45
	Emerging Markets	-3.39	3.66	6.53	-8.40
Real Assets	**Commodities**	-4.22	-7.59	-14.22	8.94
	Energy (Oil/Gas)			-15.08	25.92
	Energy Pipelines (MLPs)	5.17	9.19	29.28	15.66
	Precious Metals	-2.98	3.15	6.10	0.36
	Industrial Metals	-15.65	-7.97	-7.38	-5.19
	Agriculture	-1.88	4.64	4.02	6.72
	REITs (Real Estate)	-3.46	3.44	-3.95	-6.03

Corporate Profits – Exceeding Expectations

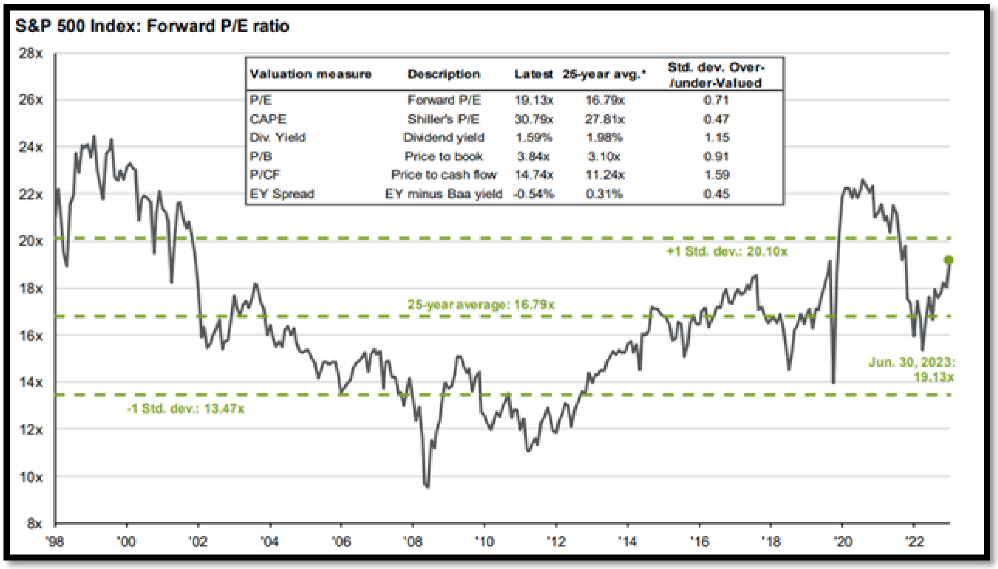
We remain convinced that corporate profits will be among the key drivers of market performance as we move through the second half. This has become even more likely as valuations – particularly tech valuations -- have moved higher year-to-date (see Figure 5).

We continue to monitor two factors closely:

- **Earnings estimates.** In the first half, earnings exceeded estimates as revenues increased faster than expected due to the combination of rising prices and resilient demand. If the US economy slips into recession or growth slows further, the earnings outlook will deteriorate. We again caution that analysts are notoriously bad at forecasting earnings declines, and once the earnings shortfalls begin, an acceleration the pace of deterioration is possible.

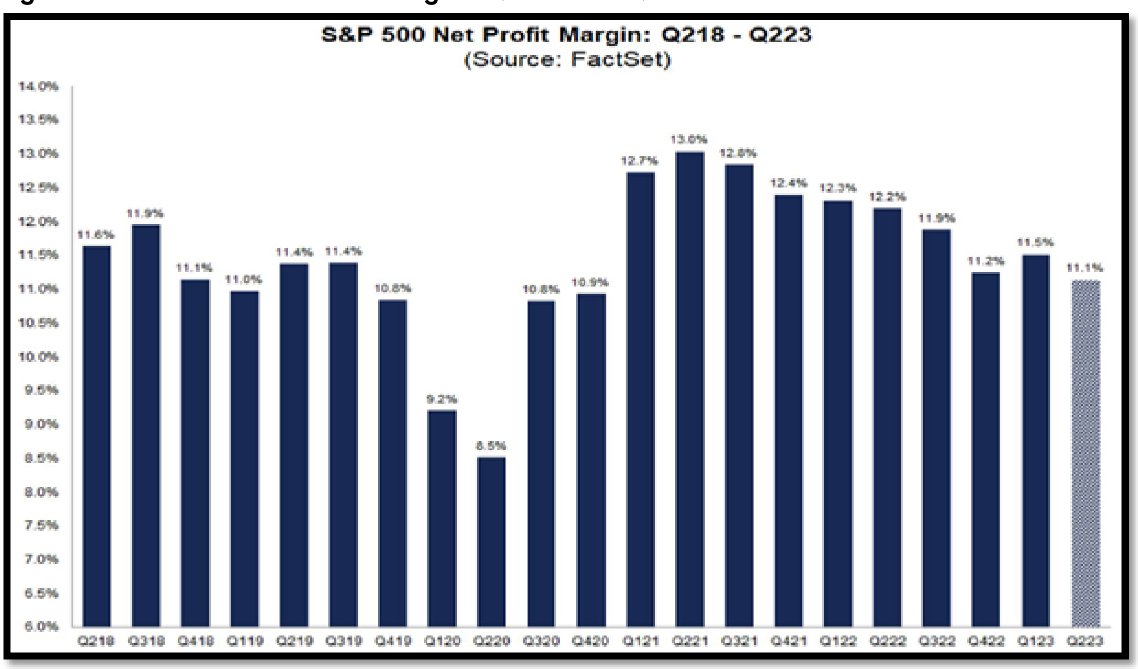
- **Profit margins.** As shown in Figure 6, profit margins contracted in the fourth quarter, rebounded slightly in the first quarter, and are set to fall marginally in the current period. As sales growth decelerates and turns negative in some sectors, margin contraction will accelerate, and operating profits could fall further. Pricing power should continue to differentiate winners and losers in 2023. Rising labor costs – particularly among airlines, freight carriers (i.e., UPS), and auto manufacturers, higher interest rates, and slowing nominal sales growth could bite into profits. On the flip side, a weaker dollar poses a tailwind for companies with overseas sales.

Figure 5. S&P 500 Valuation Measures, 1997 to Date



Source: J.P. Morgan Asset Management Guide to the Markets – U.S. Data are as June 30, 2023

Figure 6. S&P 500 Net Profit Margin 2Q 2018 – 2Q 2023

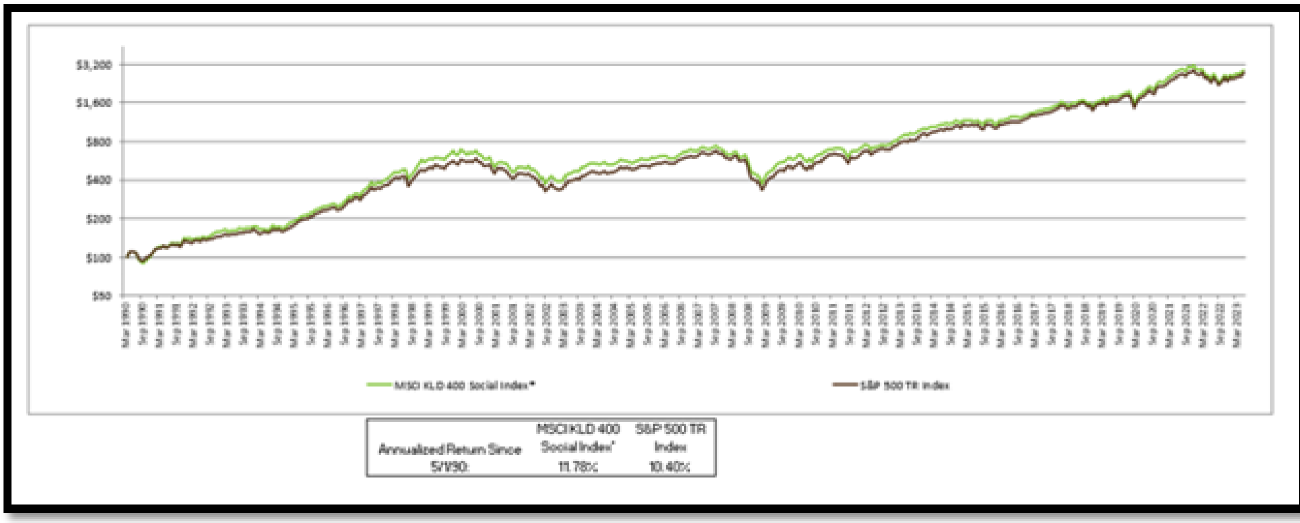


Achieving Long-Term Investment and Impact Objectives

The shift into sustainable, responsible, and impact (SRI) investments continues – albeit at a slower pace. Following years of excess performance and a rare period of underperformance in 2022, as shown in Figure 7, the MSCI KLD 400 index resumed its winning ways in the first quarter but lagged the tech-heavy S&P 500 in the second quarter. The sustained, consistent performance of this standard SRI/ESG benchmark over time supports our view that strategies incorporating environmental, social and governance (ESG) factors – with an eye toward making the world a better place – and mainstream financial returns can be achieved simultaneously.

As always, everything we do at First Affirmative is driven by our dedication to enabling advisors to deliver financial results to clients and belief in the power of capital to bring about lasting environmental and social change. Our innovative Values-Aligned Direct Index Solution (VADIS) and Sustainable Managed Mutual Fund and Multi-Manager Investment Solutions are built to enable clients to achieve their financial goals over the long term, along with their individual environmental, social, governance, ethical, and values-based objectives. Each portfolio is carefully constructed to be well diversified across assets, sectors, geographies, securities, and management styles –– and designed to weather periods of uncertainty and volatility.

Figure 8. MSCI KLD 400 vs S&P 500 Indices, June 30, 2023



Source: Morningstar. *Data prior to 9/1/2010 is that of the MSCI KLD 400 Social Index GR, while data since 9/1/2010 is that of the MSCI KLD 400 Social Index NR. Indexes are unmanaged groups of securities. Index performance does not include the impact of cash, fees, or transaction costs. Investors cannot invest directly in indexes but may purchase mutual funds or other investment products designed to track the performance of various indices.

First Affirmative Financial Network
5475 Mark Dabling Boulevard, Suite 108, Colorado Springs, Colorado 80918
719-478-7036 | www.firstaffirmative.com
Registered Investment Advisor (SEC File #801-56587)

Advisor Inquiries
phone: 719-478-7036
businessdevelopment@firstaffirmative.com

Business Development, Marketing, and Media Inquiries
phone: 719-478-7036
businessdevelopment@firstaffirmative.com

Service Inquiries
phone: 719-478-7036
service@firstaffirmative.com

General Inquiries
service@firstaffirmative.com