



## Economic and Investment Market Outlook - July 2023

# “What, me worry?”

I’m no anthropologist, but as far as I can tell, the earliest example of catchphrase usage among modern humans dates back to 1956, when MAD magazine introduced Alfred E. Neuman as its mascot. As a kid in the early 1980s, I was a subscriber and loyal fan of MAD magazine (the fold-ins were a particular favorite of mine), but I’ll admit that I never fully understood what Alfred E. Neuman was getting at with his famous catchphrase “What, me worry?”

But today, as an adult, I think I’m starting to understand. Alfred always seemed to display a beautifully naïve lack of concern about what was happening in the world around him, carelessly carrying on with whatever he was doing — even as things seemed to be in danger of collapsing all around him. But things would usually turn out just fine for Alfred, despite his near-complete lack of concern for things that should probably worry him a great deal. As I reminisce about MAD magazine today, “What, me worry?” strikes me as apt a catchphrase for markets as you’re likely to hear anywhere: The future path of economic growth is becoming less and less certain, geopolitical risks are intensifying and the Federal Reserve remains very much in tightening mode even as inflation appears to have peaked. And yet markets — equity markets in particular — are happily whistling their way higher.

Here are a few things U.S. equity markets blissfully ignored during the second quarter: toxic fall-out from a regional banking crisis that began in March; an aborted *coup d’état* in Russia that threatened to destabilize the world’s biggest military nuclear power from the inside; the prospect of two more rate increases by the Federal Reserve (to accompany the 5% the Fed had already handed us); softening corporate earnings; and a continued — albeit uneven —

weakening of the U.S. economy. Despite that, the S&P 500 Index added another 8.3%, besting the first quarter’s nearly as impressive 7.5% gain. Almost any way you measure it, U.S. markets were back in bull market territory as 2023 hit the mid-way point.

Once again, that advance was led primarily by a small handful of individual high-growth stocks that are led by an even narrower group that is now being referred to by some market watchers as “the Magnificent Seven” (Amazon, Apple, Alphabet, Meta Platforms, Microsoft, Nvidia, and Tesla). I get a little concerned when pundits hang a meme-worthy name like that on a group of recent market darlings, but this recycled version of last cycle’s FAANG (Facebook/Meta, Amazon, Apple, Netflix, Google) stocks did a pretty good job of powering U.S. stocks higher nonetheless — this time, on sudden optimism surrounding artificial intelligence as an investment. As a consequence, the performance gap between growth and value stocks continued to widen: So far in 2023, the Russell index of large-cap stocks has advanced 29% while its value-oriented counterpart gained a far more modest 5.1%.

It’s difficult to decide whether this is consistent with a recessionary view or not. On one hand, growth stocks tend to outperform when earnings growth becomes scarce (as it naturally does in a recession). On the other hand, the extreme optimism displayed by this small corner of the market during the second quarter felt somewhat out of sync with a world view that anything even approaching recession might be on the horizon. So if you’re looking to equity markets for clues on which direction the economy may be headed, you’ll have to make a few guesses.

The same goes for the bond market. After a truly disappointing performance in 2022, fixed-income markets staged a fairly robust recovery during the first quarter of 2023, only to retreat again in the second quarter as interest rates inched higher. Shorter-term rates once again rose faster than longer-term rates, causing the so-called “yield curve inversion” to deepen a little bit. An inverted curve is a classic sign that economic trouble lies ahead, so it appeared as if bond investors were a little more worried about the environment than their equity-focused counterparts seated across the trading floor. But not so fast: Credit spreads, which sometimes act as a proxy for how comfortable investors are that corporate borrowers will make good on the loans they’ve taken out, actually tightened a bit. Viewed through that lens, bond markets seemed almost as comfortable with the economy’s ability to sidestep recession as equity markets were.

### Outlook

Looking forward, one thing is clear: Market participants are sharply divided on where markets and the economy might go from here. On one hand, the extraordinary resilience of the U.S. labor market and the durability of consumers in the face of continued inflation and a dwindling in COVID-era stimulus make it easier to believe that Jerome Powell’s Federal Reserve has accomplished the near-impossible: corralling inflation through dramatically higher rates without tipping the economy into recession. Meanwhile, the regional banking crisis that suddenly sprang up at the end of last quarter appears to have been quickly and effectively ring-fenced by policymakers before it could do significant damage to the economy. On the other hand, it’s hard for some of us to imagine that the economy can survive what has arguably been the most aggressive rate-tightening campaign in Fed history without dipping into at least a mild recession.

Moreover, even if we have indeed sidestepped widespread damage from the regional bank fiasco, there is still likely to be significant fallout in the form of tighter credit conditions and enhanced regulation that could tighten financial conditions in a way that rising interest rates simply can’t. And in the background to all this are rising geopolitical tensions and mounting stress on the U.S. consumer as wage growth plateaus, price pressures remain entrenched, and bank accounts padded by pandemic assistance continue to deflate. Add to all this the likely resumption of student loan payments by millions of U.S. consumers this fall, and it’s not at all clear that the market’s optimism is justified — particularly as far as the resilience of U.S. consumers is concerned.

Regardless, we try hard to build all-weather portfolios capable of performing equally well when trends are favorable and when they turn sour. Whether it’s our slight bias toward value-oriented equities, the broad diversification we deliberately build into the underlying asset allocations, or our efforts to identify investment managers capable of outperforming even when their style is under duress (as occurred with U.S. value equity and short-term fixed income during the second quarter), these efforts paid off during 2022’s extremely difficult environment when the Lifetime series performed exceptionally well. If the back half of 2023 proves similarly challenging, we are hopeful that such efforts will again bear fruit.

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