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Chartwell Strategies Current Outlook

"Nothing in life is to be feared. It is only to be understood."

-Marie Sklodowski Curie
(Scientist, 1867 – 1934)

Summary

- *Led by the NASDAQ, the major indices rallied in the second quarter. Small-cap, Mid-cap, and value-oriented stocks participated as the rally broadened towards quarter-end.*

- *The performance of some indices, including the S&P 500, NASDAQ and Russell 1000 were distorted by the presence of 7 Mega Growth stocks whose large market capitalizations produced results with an upward bias.*

- *The performance of the Dow Jones Industrial and Transportation averages suggest that the equity markets have seen their lows and that the present rally has the potential to take the averages to new highs. These observations are supported by lower inflation numbers and a less hawkish Federal Reserve Board.*

Background

Buoyed by a slowing inflationary rate and a less hawkish Federal Reserve Board (the Fed), investors continued to take a positive attitude towards equity investments in 2023's second quarter; although the major indices experienced a wide range in their quarterly results, they all ended up in plus territory for the three-month period. Table 1 below summarizes the performance of the major indices for both the second quarter and the first half of 2023. Also shown is the performance of these indices over the past eighteen months (12/31/2021 to 06/30/2023), which represents the period when recessionary fears began to negatively affect the market's performance.

Peformance of Major Stock Market Indices
Percentage Change

INDEX	03.31.23-06.30.23	12.31.22-06.30.23	12.31.21-06.30.23
Dow Jones Industrial Average	3.97%	4.94%	-2.27%
Dow Jones Transportation Average	7.99%	16.84%	-17.62%
Standard & Poor's 500	8.74%	16.88%	-18.13%
NASDAQ	13.05%	32.32%	-10.70%
Russell 2000	5.19%	8.06%	-14.05%
Russell 2000 Value	3.16%	2.46%	-10.70%

Table 1. The equity markets have rebounded in the first half of 2023 after last year's sell-off.
Source: BLOOMBERG

Given the level of concern about the economy, international conflict and tensions, as well as ongoing domestic political discord, the performance of the major indices in the past quarter and first six months of this year is impressive. Cast against the broad pullback experienced in the stock market last year and the long consolidation of the major indices between June 2022 and March 2023, it appears that the equity markets have been discounting much of the anticipated weakness in corporate earnings caused by reduced sales, higher inflationary costs and interest rate expense, for this economic cycle.

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Much has been made of the fact that the NASDAQ had a stellar performance in the first half of this year, up 32.32%. Without a doubt, this year's NASDAQ performance has been spectacular. However, as shown in Table 1, for the eighteen-month period, ended June 30th, 2023, the NASDAQ Index was still 10.70% below 2021's year-end price. The S&P 500, the Russell 2000, and the Russell 2000 Value Indices were also down, 18.13%, 14.05%, and 10.70%, respectively, in the same time frame, while the Dow Jones Averages showed modest declines. These losses reflect the stock market's attempt to discount a potential recession in the face of a tightening monetary policy but expansionary fiscal policy.

The stated performance of the NASDAQ Index in the first half of this year is extraordinary, but misleading. There are 3,512 stocks listed in the Index. However, if it were not for seven "Mega Growth" stocks (Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia, and Tesla) in the Index, the six-month performance would drop from 32.32% to 9.04%!

A similar effect was realized in the S&P 500 Index, which also contains the seven stocks listed in the previous paragraph. In the first half of this year, the S&P 500 rose 16.88%, however, without the seven Mega Growth stocks, it drops to about 5%. In another and final example, Figure 1, illustrates the performance of the seven Mega Growth stocks plus that of Netflix against the performance of the NYSE, which contains over 2,000 individual components. As shown in Figure 1, the Mega Growth stocks (plus Netflix) gained about 60% in the first six months of this year, while the NYSE rose a meager 4.55% as of 06/07/23, the chart does not go to quarter end. Without the Mega Growth stocks, the Index would have declined about 10% in that period.

Performance of the New York Stock Exchange Composite (NYSE) Index
vs. its Most Popular Components as of 06.07.23

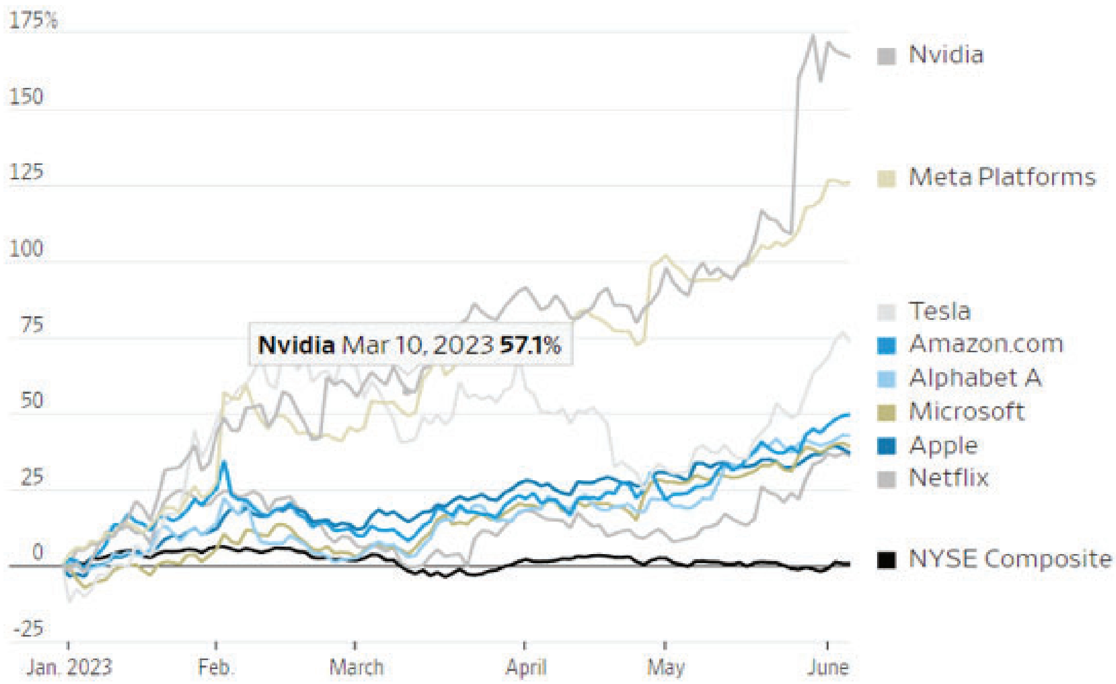

Figure 1. Without the exceptional performance of several stocks, the NYSE Composite would have been negative for the first half of 2023..
Source: Wall Street Journal 06.07.23

**Magnificent 7 Growth Stocks are Apple, Microsoft, Amazon, Nvidia, Alphabet, Tesla and Meta*

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This discussion is intended to provide some understanding of how distortions in market capitalization weighted indices can occur and to judge neither the virtues, or, risks associated with buying the seven Mega Growth stocks discussed. However, it is interesting to note that the price-to-earnings ratio (P/E)[1] of stocks in the S&P 500 is 20.5[2] as compared to P/E's ranging between 23.2 (Alphabet) and 81.5 (Amazon) for the Mega Growth stocks.

While the rebound in the NASDAQ captured the attention of most investors, more senior indices such as the Dow Jones Industrial and Transportation Averages reflected the ongoing challenges and progress being made by companies attempting to restore their operations to normal in the wake of the COVID plague shutdown, supply chain disruptions, labor shortages, inflationary cost increases, and higher interest rates. The performance of both the Dow Jones Industrial (DJIA) and Transportation (DJTA) Averages during this difficult period of adjustment is impressive and strengthens the case that further economic weakness is unlikely and that a deeper recession has been avoided.

Figure 2a shows the performance of the DJIA over a two-year period. The DJIA declined from 01/05/22 to 10/13/22 and after months of base building, has been able to break-out of this reversal pattern on 07/18/23. Charles Dow, creator of the Dow Theory, would be bullish since the Dow Jones Transportation Average, shown in Figure 2b, has acted in concert with the DJIA. The DJTA declined from 11/02/21 to 09/26/22 and then began the base building process before completing the turnaround pattern on 07/11/23.

Although economics is not a pure science and stock Index patterns are not invulnerable to global catastrophes, taken together, the action of the DJIA and DJTA is signaling higher stock prices in the near and intermediate term.

Performance of the Dow Jones Industrial & Transportation Averages Over the past Two Years

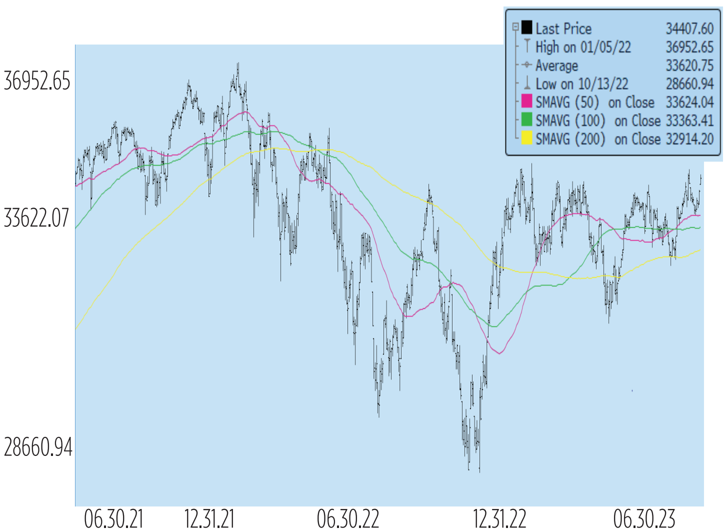

Figure 2a. Dow Jones Industrial Average (DJIA) 06.31.21-06.30.23
Source: Bloomberg

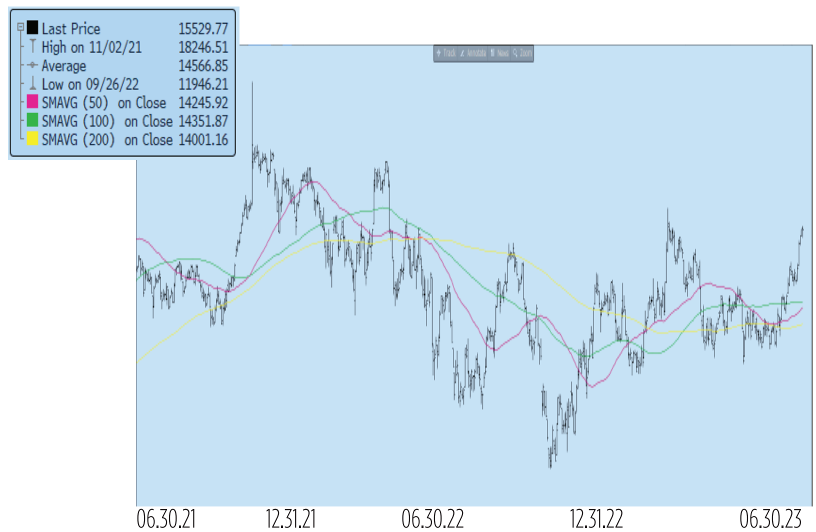

Figure 2b. Dow Jones Transportation Average (DJTA) 06.31.21-06.30.23
Source: Bloomberg

Figures 2a & 2b. After declining from previous highs, both Averages have completed reversal patterns and are now moving higher in unison.

[1] *P/E is the Price to Earnings Ratio and is used to determine the relative value of a company's shares. To calculate, it is the price the stock is selling at divided by the annual earnings.*
[2] *Market-cap-weighted P/E of the S&P500 as of 7/31/23*

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Our move to a more-defensive posture last quarter proved to not be “necessary” as the market took a positive view of the economy and inflation. While the Fed might still raise rates at least one more time (after the 25 basis point increase on 7/26), the consensus view has become that inflation is directionally improving and, hence, the Fed is close to being finished. This, along with continuing economic stability (that is, GDP growth around 2%) and reasonably good corporate earnings results, have provided a backdrop for improved consumer sentiment. Additionally, economists have lowered their predicted odds of a recession in the next year to just over 50%, with some, like Goldman Sachs, as low as 20% (WSJ, 7/17/23). The FOMC (Federal Open Market Committee) changed their view in July and no longer expects a recession. This shift has been favorable for stocks, but it has been large-cap, and technology-oriented equities that have dominated (large growth stocks were up 29% in the first half of 2023, while small value only rose 2.5%4). Only late in the quarter did the market broaden, and we started to see better returns from mid-cap and small-cap stocks as well as value outperforming growth. From a valuation perspective, these sub-groups, where most of our investments lie, have plenty of upside if this broadening continues, which we think could happen when the Fed either pauses or reverts back to cutting rates. If you wish to receive additional information about the IMAP program please contact Chartwell at (610) 296-1400 or info@chartwellip.com.

Definitions:

Dow Jones Industrial Average: The DJIA or “The Dow” is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange (NYSE) and the NASDAQ.

The Nasdaq Composite Index is the market capitalization-weighted index of more than 2,500 common equities listed on the Nasdaq stock exchange.

Russell 2000 Index: London Stock Exchange Group plc and its group undertakings (collectively, the “LSE Group”). ©LSE Group 2023. FTSE Russell is a trading name of certain of the LSE Group companies. Russell® is a trade mark of the relevant LSE Group companies and is used by any other LSE Group company under license. All rights in the FTSE Russell indexes or data vest in the relevant LSE Group company which owns the index or the data. Neither LSE Group nor its licensors accept any liability for any errors or omissions in the indexes or data and no party may rely on any indexes or data contained in this communication. No further distribution of data from the LSE Group is permitted without the relevant LSE Group company’s express written consent. The LSE Group does not promote, sponsor or endorse the content of this communication.

S&P 500® Index: (registered trademark of The McGraw-Hill Companies, Inc.) is an unmanaged index of 500 common stocks primarily traded on the New York Stock Exchange, weighted by market capitalization. Index performance includes the reinvestment of dividends and capital gains.

Investors cannot invest directly in an Index.

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