BERNSTEIN

Artificial Reality

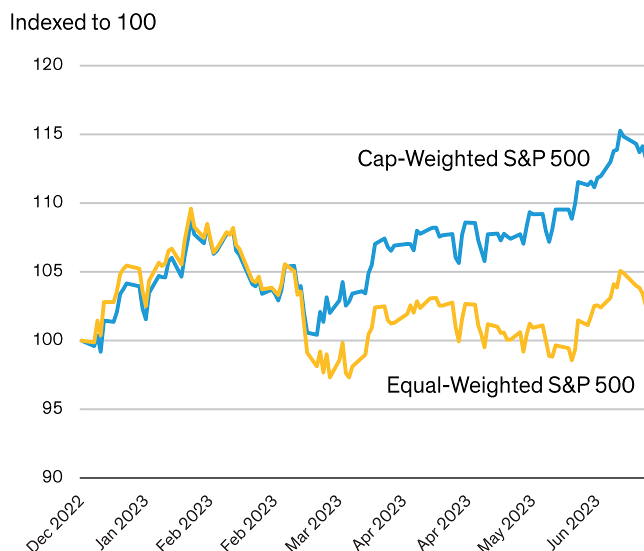
Have you ever been out for a meal and the server asks, "Have you dined with us before?" When this happens, I cheerily respond, "No, but I have eaten in a restaurant before." I am a foodie. My brother is a chef. I'm not poking fun at the restaurant industry (okay, well, maybe the pretentious ones). Instead, I'm raising the age-old expression, "This time is different." It's almost never different; it only feels that way in the moment. The letter this quarter will focus on how unfolding events, unintelligible as they may seem today, usually have a basis in history. I hope you enjoy.

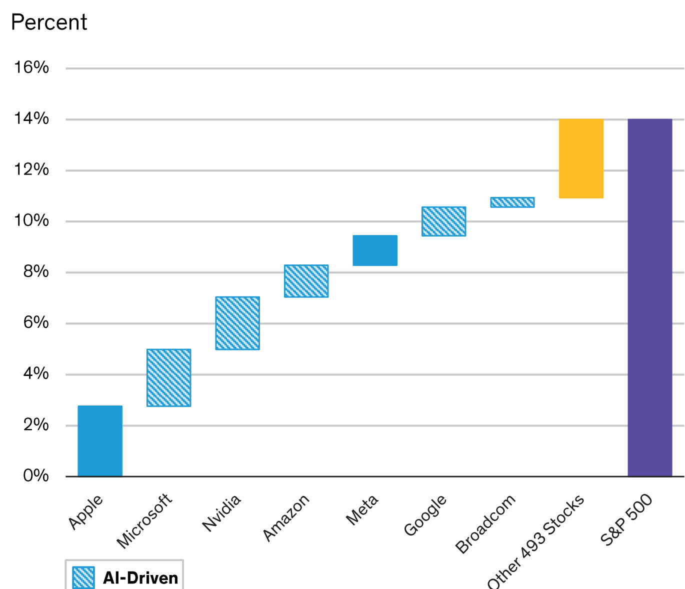
The markets entered the second quarter filled with trepidation as the economy grappled with a series of significant bank failures. Three months later, the S&P 500 has entered a bull market as investors look through those bank stresses, the debt ceiling debate, and an earnings recession and imagine an imminent end to the Fed's rate hike cycle along with a relatively soft landing for the economy. Some might ask, "What reality are we living in?"

All Hail Your New Robot Overlords

While topline returns are turning heads, the quarter's most interesting story unfolded below the surface. Through June 28, capitalization-weighted returns for the S&P 500—the measure we typically report—came in at 14.0% YTD. But since the largest stocks in the index accounted for the bulk of that performance, we'd highlight that equal-weighted returns (i.e., the average return from stocks) trickled in at only 4.2%. In fact, the top seven contributors accounted for 11 percentage points of the cap-weighted index's results (**Display**).

S&P 500 Performance YTD Has Been Dominated by Seven Tech Stocks





Past performance does not guarantee future results.
Source: Bloomberg and Bernstein analysis

While periods of concentration have occurred in the past, today's levels leave them in the dust. That reliance on the largest companies, rather than a broad rally from smaller-cap stocks, marks one of the two notable differences between this and past bull markets.

The other key difference is that historically, strong rallies that trip the 20% threshold for a technical bull market like this one tend to come early in an economic cycle. The median one-year market return following that achievement in the past has been 19%, with positive one-year returns in all 9 cases since 1960. Yet today, we still seem to be late in the cycle, with unemployment likely having troughed, rates near their peak, and signs of wear beginning to show in consumers' pocketbooks. That said, the tricky part about a late-cycle economy is that it can extend for years or end sharply, making it extremely hard to predict.

Another interesting component of today's market is that inflation is no longer the most important topic. If this were a boxing match, inflation would be staggering on its last legs. Meanwhile the market has returned to its usual obsession—growth in economic activity and corporate profits.

This quarter's market rally can be summed up in two words: artificial intelligence. The release of ChatGPT set off a frenzy for all things AI, propelling tech giants higher and leading the market's advance. We see real promise from AI in a range of areas, though we think the companies that will truly benefit are vastly outnumbered by those merely latching onto the latest corporate craze. Ultimately, like all new technology, advancements in AI should lead to greater efficiencies. Companies around the world will be forced to adopt it, lest their competitors gain an advantage at their expense. But far fewer will generate meaningful revenues, profits, or returns on capital from it.

A Straight or Curvy Road Ahead?

Beyond US equities, global stocks also delivered solid performance during the quarter, up 11.8% through June 28. In addition, high-quality municipal bonds returned 1.6% and the US investment grade bond market generated 2.6% (**Display**).

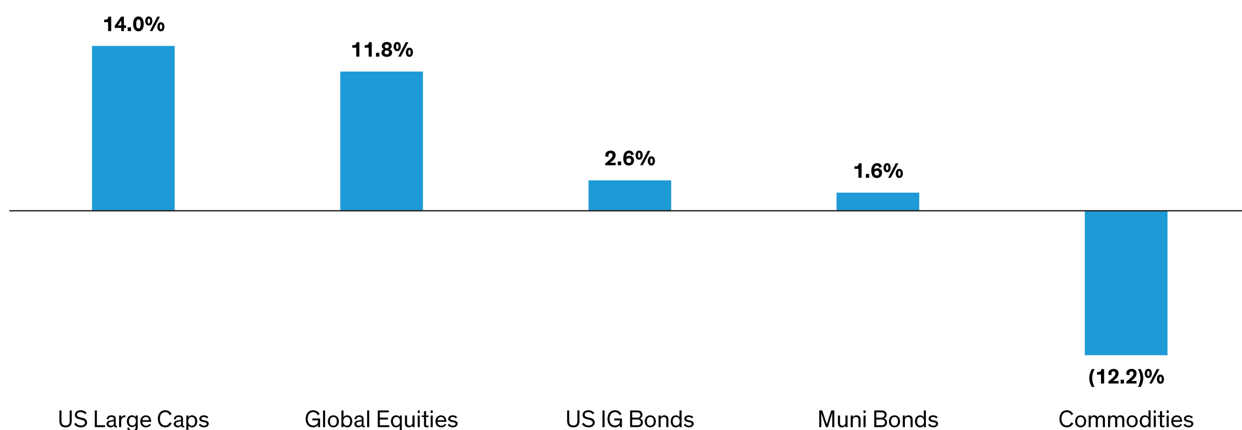
As we cast our eyes to the back half of 2023 and beyond, several questions linger. The economy has remained strong, but the Fed's monetary policy still aims to tighten financial conditions and weaken the labor market to bring inflation to heel. How much will this policy stance impact the economy? Can the current strength be sustained? Or will it result in a moderate downturn or even an outright contraction? While we continue to expect a mild contraction, we recognize the other real possibilities that could overtake our base case.

So far, the US economy has remained surprisingly durable thanks to a strong labor market and a hungry appetite from consumers. Likewise, the markets have seized on that resilience and dismissed potential shocks.

The markets currently appear to be pricing in a fairly optimistic scenario—either a moderate enough slowdown to count as a "soft landing" or an extremely short contraction followed by a sharp rebound.

YEAR-TO-DATE PERFORMANCE BY ASSET CLASS

Percent



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Source: Bloomberg and Bernstein analysis

To be fair, that's not completely unwarranted. The strength of the economy to date has nudged investors' views in that direction, and it could very well play out that way. Similarly, the markets' resilience could signal less vulnerability to negative events that may emerge in coming quarters.

While the latest market move has us somewhat cautious about public stocks broadly, they remain the engine of capital appreciation over the long term. They may have periods of ups and downs, and other asset classes may generate even higher risk-adjusted returns in the near term, but for those investing for the long run, stocks still are likely to deliver the highest total returns. Their potential outperformance becomes even likelier when you consider the risk of future inflation and the ability of companies to raise prices, as we saw last year.

Inside of public equities, a few themes are worth considering in the medium term. For instance, healthcare strikes us as particularly attractive as the industry continues to normalize and procedure volumes rebound post-COVID. What's more, we expect the sector's revenues to be sturdier in the face of an economic slowdown or outright recession.

What about fixed income? With the Fed and other developed market central banks nearing what we expect to be peak rates, we've finally turned positive on duration (interest rate risk) again. Despite mouth-watering yields on Treasuries maturing in the next two years, we'd be inclined to invest in longer-dated bonds that will benefit directly from the end of the Fed hiking cycle. In addition, credit remains appealing across the board—from municipal bonds and taxable bonds to investment grade and high yield. With stronger fundamentals than we're accustomed to at this phase in the cycle , the incremental yield from owning credit is compelling.

Some of the most interesting opportunities we're seeing come from less liquid asset classes. Today's strong demand for liquidity means that those who are willing to accept less are in a prime position to benefit. Whether in private real estate debt, private credit, or secondaries, the backdrop for deploying capital appears relatively attractive and could become even more so were an economic downturn to emerge.

What to Do from Here?

As the saying goes, "There's always something to do" in investing. However, there are times when the to-do list is shorter. This appears to be one of those times.

We remain focused on ensuring clients' cash levels are aligned with their immediate, liquid needs—and that cash is positioned to take advantage of today's yield environment safely. We're also alert to other planning opportunities to reduce the tax consequences in portfolios.

Staying in cash has felt comforting, despite missing out on strong stock and bond performance. But that comfort now comes with a ticking clock. When the Fed is done and ultimately cuts rates, returns on cash will fall while longer-dated bonds will benefit. The question for investors with large cash positions is whether they'd mind investing at those lower rates in the future rather than locking in current rates today. If you do mind, talk to your Bernstein Advisor.

Our portfolio managers continue to actively balance risk in their strategies, and we remain vigilant in structuring allocations across asset classes. As always, we thank you for your trust and for giving us the opportunity to be responsible stewards of your wealth.

And finally, during the quarter, my partner in leading the investment platform, Beata Kirr, decided to further her passion for impact investing and pursue a new opportunity. All of us at Bernstein wish Beata amazing success in her new venture.

Since she did not get a chance to make a formal farewell, I asked her to do so in this space:

After 16 incredible years at Bernstein, overseeing tremendous growth and evolution in our investing platform and working with so many of our special clients, I made the difficult decision to focus my career 100% on impact investing. I had a rare opportunity to join a newly formed fund as a member of their investment team and their Chief Impact Officer. I wish all the terrific Bernstein clients I met along my journey the best."

—Beata

Alex Chaloff
Chief Investment Officer

Alex Chaloff is the Chief Investment Officer and Head of Investment and Wealth Strategies at Bernstein. In this role, he leads a national team of strategists across investments and wealth planning—including asset allocation advice, investment platform oversight, model portfolio construction, new product development, manager research, tax planning and solutions, and estate planning research—while remaining continuously focused on moving our clients forward with strong after-tax risk-adjusted returns. Alex has spent his Bernstein career refining our investment platform, listening to clients, and conducting deep research into investment and wealth planning topics that are critical to achieving clients' goals.

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