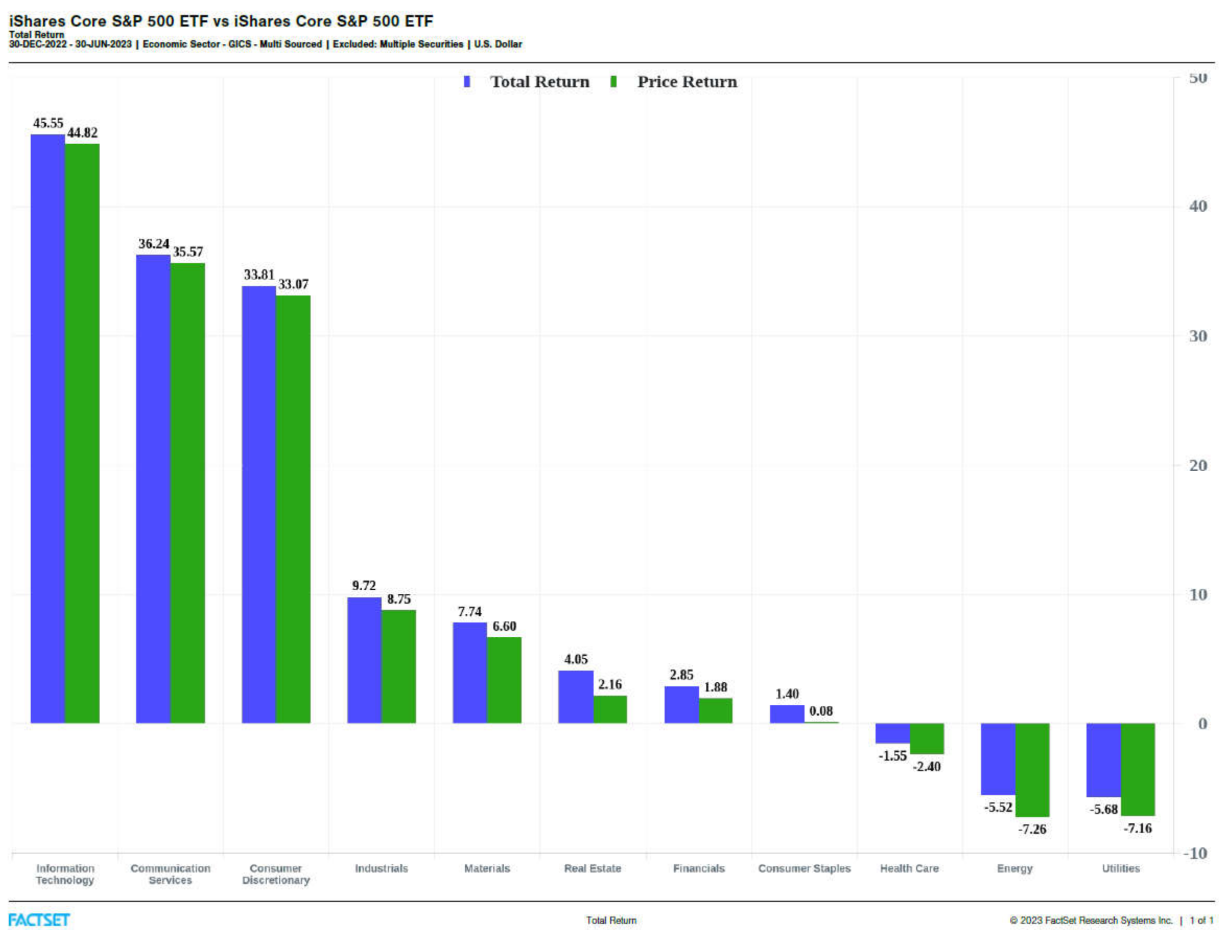
Chemung Canal Trust Company and Capital Bank, a division of Chemung Canal Trust Company

2023 Third Quarter Investment Outlook

By any standard, the first half of 2023 was a "consensus killer." Most economic data continued to exceed forecasts, particularly jobs and spending. Stocks rallied, with the Standard & Poor's 500 Index posting its third best first half performance in the last 25 years. The NASDAQ's 32% rise represented its best first half since 1983, following its worst ever first half in 2022. It was also the narrowest market in history, as just 25% of stocks managed to outperform the benchmark.

Last year's laggards became 2023's big winners, with the technology, communication and consumer discretionary sectors posting significant gains. Meanwhile, the more defensive health care and utilities



sectors, which held up the best in 2022's down market, actually declined in the first half as the market rose. The energy sector, which rose more than 60% during last year's market decline, is also down so far this year.

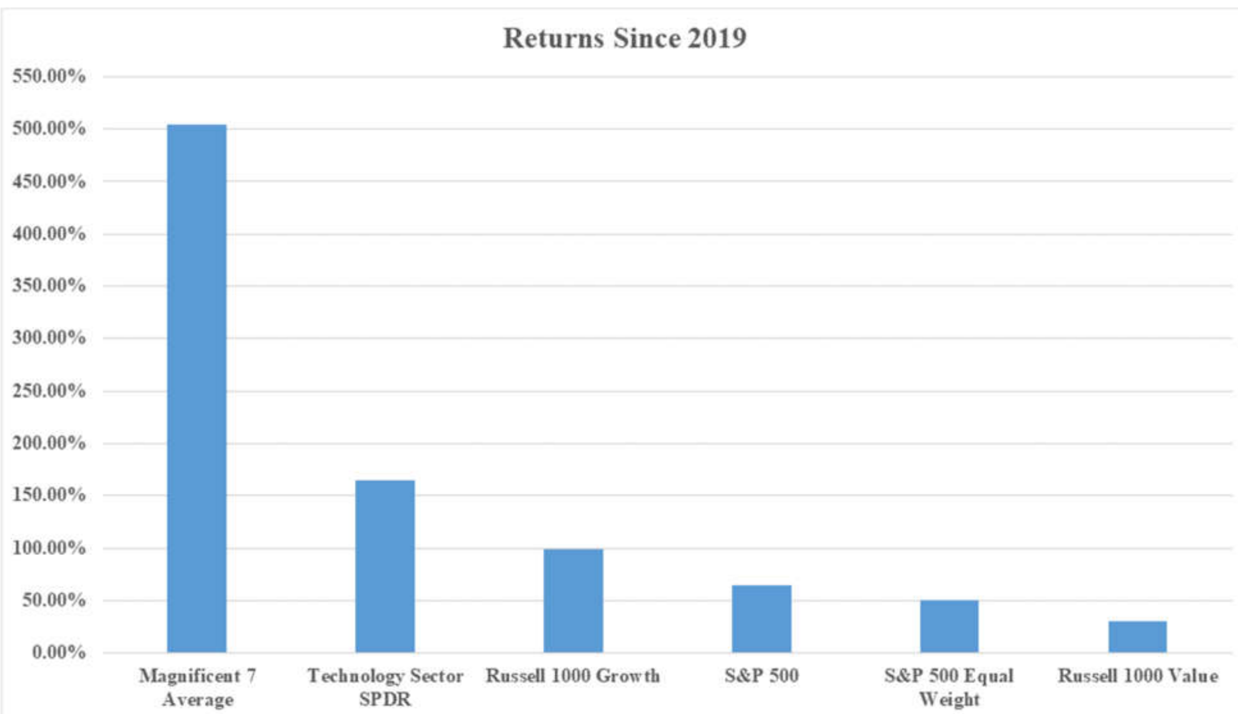
The staggering outperformance of the economically sensitive sectors (including industrials and materials) relative to the more defensive areas does not evidence a stock market that is discounting a recession any time soon. Indeed, the current risk-on nature of the market is just one of the many contradictions that are plaguing pundits and analysts this year.

<u>This Isn't Your Father's S&P 500</u>

The Standard & Poor's 500 Index is by far the most important, most followed, and most widely owned stock market index in the U.S. – or the world for that matter. But it has become so "top heavy" that it's becoming more representative of the fortunes of a few mega cap stocks at the top of the index, than it is of the market as a whole.

We have written repeatedly in past *Outlooks* of a small group of high growth, high P/E stocks whose stunning outperformance relative to the market has caused them to become significantly overweight in the index. The group became known as the FAANG stocks, an acronym coined by business commentator Jim Cramer from the initials of the five charter members – Facebook, Amazon, Apple, Netflix and Google. Facebook eventually changed its name to Meta and Google became Alphabet. Netflix imploded and was expelled from the group, but Microsoft, Nvidia and Tesla have been added. The acronym is no longer in use, but Bank of America analyst Michael Hartnett referred to the group as the "Magnificent 7" in a May research note and the appellation is gaining favor on Wall Street.

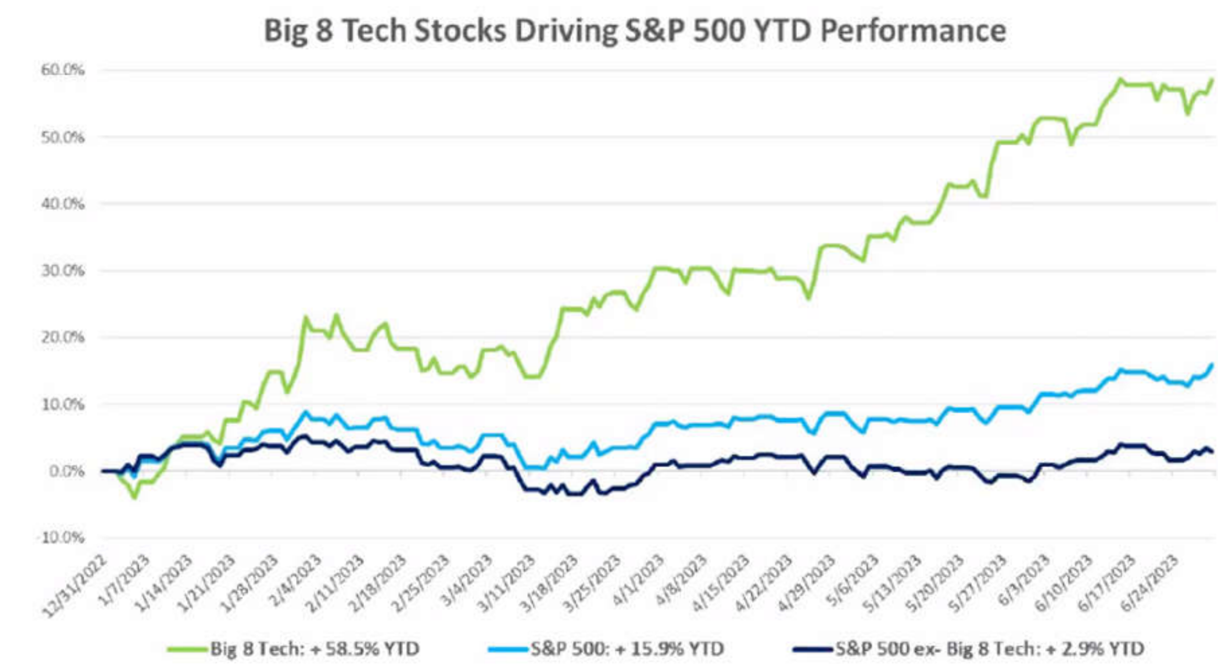
From the start of 2019, the stock prices of the Magnificent 7 have risen by an average of more than 500%, while the index itself is up "only" 80%. The worst performer has been Amazon, which has nearly doubled over that time, while Nvidia and Tesla have risen by 1,355% and 1,470%, respectively.



Apple, alone, by virtue of its $3-trillion market capitalization, is now worth more than the combined value of all 2,000 stocks in the Russell 2000 small cap index, and accounts for almost 8% of the S&P 500. Apple's market cap is now greater than the entire Gross Domestic Product of the U.K., France, Canada, Italy, Australia, South Korea, Mexico, or Spain – or virtually every developed economy on earth except the United States, Japan and Germany. More to the point, Apple's weighting in the S&P 500 is now greater than the weights of the bottom 200 companies in the index, combined. The weightings of Apple and Microsoft, the next largest company, are larger than the combined weights of the bottom 300 companies in the index. And the weightings of the Magnificent 7 carry approximately as much weight in the S&P 500 index as the bottom 400 companies!

If you're an investor in index funds, it is important to understand that your portfolio has become increasingly concentrated over the last 5 years, and particularly over the last 6 months. More than 30% of your money is invested in just 10 stocks – the Magnificent 7 (Alphabet has 2 share classes, so the 7 companies account for 8 issues) – plus Berkshire Hathaway and UnitedHealth Group. But while these 10 largest companies account for almost one-third of the market's value, they contribute barely 20% of the market's earnings. At this point would you rather own the Magnificent 7, or actively look for opportunities from among the other 493?

The market's rise in the first half of the year can be almost entirely attributed to the performance of this small group of stocks. While the S&P 500 rose almost 16% through June 30th, the Magnificent 7 (or the Big 8 Tech stocks, as they're called by Federated Hermes who provided the chart, below) rose by a weighted average of 59%. The rest of the market rose by less than 3%, which is not much of a recovery from the market's dismal performance in 2022.



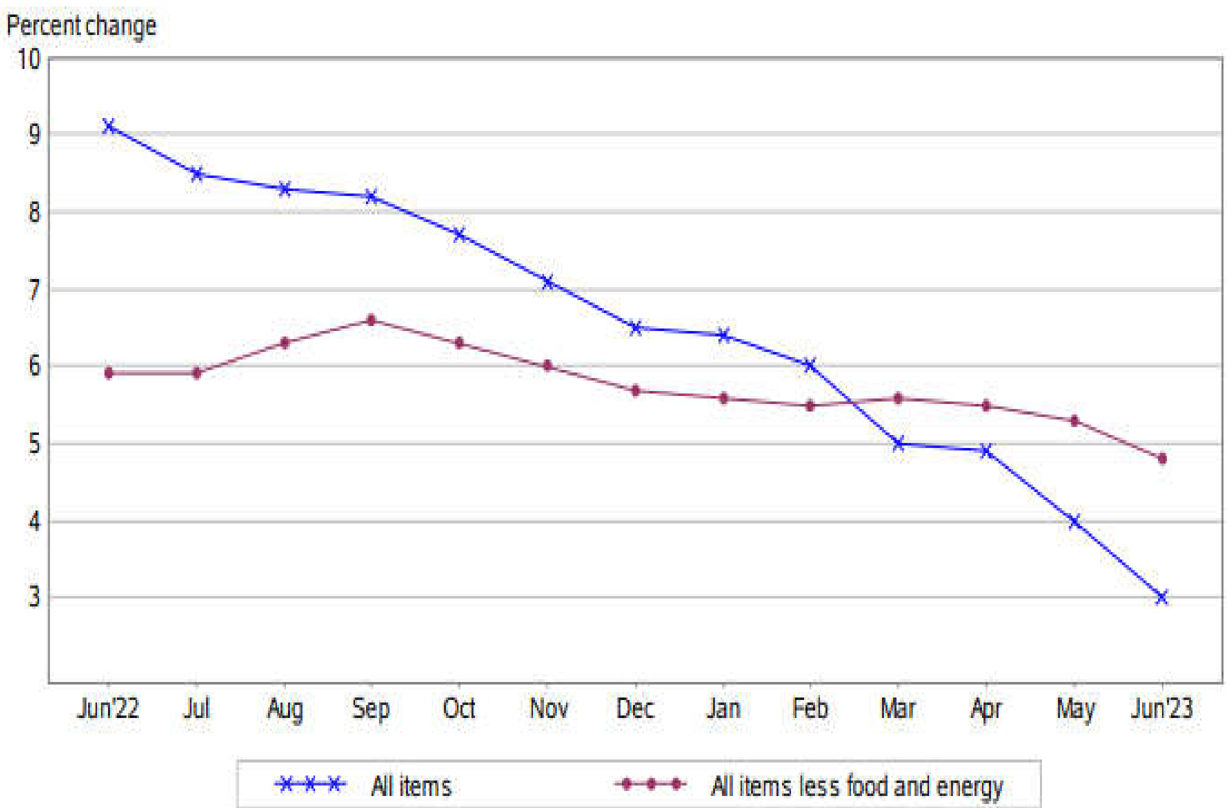
Note: Performance displays price return, not total return.
Source: Federated Hermes, Bloomberg as of June 30, 2023.

Not to belabor the point, but the total return of the S&P 500 in the first half – including dividends – was 16.9%. By comparison, the total return of the Invesco S&P 500 Equal Weighted Index Fund was just 6.9%.

The huge gains realized by these stocks were driven in no small measure by the market's sudden and unexpected obsession with Artificial Intelligence (AI). Each of these companies is working on – or deemed to be a beneficiary of AI, a technology whose uses, benefits and risks have not even begun to be understood. Still, Nvidia (+195%), Tesla (+112%) and Meta (+138%) accounted for more than 43% of the S&P 500's return through the first half of the year, and the Magnificent 7, as a whole, accounted for more than 90% of the market's rise. Even the *worst* performer in the group, Alphabet (+36%), rose by more than twice the rate of the index.

The Fed vs. Inflation, The Good Guys Are Winning (But It Ain't Over Yet)

Headline inflation continued to decelerate in June, following 500 basis points of Fed rate increases and more than a year of quantitative tightening. The Consumer Price Index (CPI, all items) fell to just 3%



above last year's level, which coincidentally represented the peak inflation reading of 9.1%. It should be noted that continued easing of global supply chain disruptions are helping, as well.

The 3% reported on a year-over-year basis was the smallest increase since the period ending March 2021, and was aided in no small part by a 16.7% decrease in energy prices over the last year. Core inflation, which excludes the more volatile food and energy prices, rose 4.8% over the last 12 months, remaining on a downward trajectory but still well above the Fed's 2% target.

Americans are far more optimistic as inflation has slowed, the labor market has remained strong and incomes are rising. The U.S. Index of Consumer Sentiment provided by the University of Michigan has risen for two straight months to its highest level since September 2021 (chart, below).

Such optimism, however, should be tempered by an understanding of how annual inflation rates are calculated. In the most basic terms, an annual inflation rate is measured as the price of a basket of goods today compared to the price of that same basket of goods one year ago. There are two moving parts, both impacting the ultimate rate of inflation. As the denominator (price of a basket of goods one year ago) of the inflation rate moves upward, an equal increase in current monthly prices will yield a lower annual inflation rate, although there has been no true improvement in inflation. The opposite effect also holds true if the rate of price increases a year ago was inordinately slow. This mathematical distortion in the inflation rate is referred to as the "base effect." This phenomena is most prevalent during periods when those "base" prices have changed rapidly, just as we saw in 2021 and 2022, and the latter now being the new base comparison. The peak in the inflation rate reached 9.1% last June. This means that the base comparison basket will now be moving upward at a less rapid pace. This has the potential to artificially put *upward* pressure on the inflation rate. While there's no intention to discredit the merit of measuring annual inflation rates, we would suggest looking to trends in monthly inflation data as a more useful metric to gauge any true improvement or deterioration in inflation.

The 2023 Recession and Al Capone's Vault

So far, the most widely predicted – and prepared for – recession in history is turning into the biggest non-event since Al Capone's vault at the Lexington Hotel in Chicago was opened on live TV in April 1986. The walled-off subterranean room at the hotel once owned by the mobster was discovered while the hotel was being renovated, and Geraldo Rivera managed to secure two hours of air time for the event. The hype was so great that he even had medical examiners and IRS agents present in the event that bodies or riches were unearthed. Alas, thirty million hyper-ventilating viewers – and an apologetic Geraldo - uncovered only debris and empty whiskey bottles in the vault, thus creating the "no news" news format that sadly still exists today.

Almost universally, analysts have been warning of a recession that would begin in mid-2023. The only questions really were whether it would be shallow or deep, brief or extended, and how high would the Fed have to drive interest rates in the meantime. As the jobs and unemployment numbers continued to surprise on the upside, recession forecasts began to be pushed further and further into the future, until the consensus now is that it is a 2024 event, maybe even a mid-2024 event. For more than a few analysts, it's even become a 2025 event.

Pushing out of the timing of a likely(?) recession to 2024 does give rise to an obvious contradiction, however. Consensus corporate earnings estimates for 2024 remain almost 12% above 2023's level, even as the consensus grows that 2024 will be a year of recession, not recovery. And this is only one of the many contradictory circumstances that investors are dealing with as they navigate this fluid and confusing economic environment.

Is It Different This Time, or Just Longer

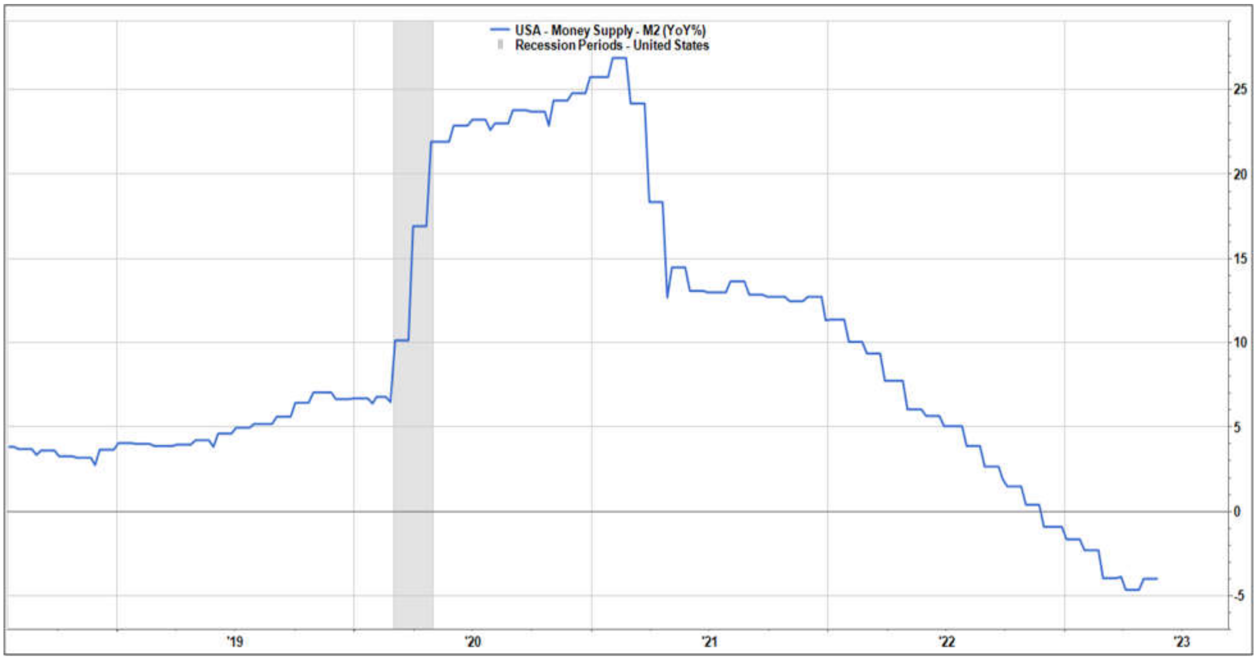
We have been cautious in our outlook and have maintained a defensive posture for more than a year, starting when the Fed raised rates for the first time in March 2022, and becoming even more cautious during the June-July period when the yield curve inverted. The main story hasn't changed, but there is a bias in any forward-looking discipline that we must be wary of, called "anchoring and adjustment" bias. It refers to the tendency to remain anchored to a previous forecast, and not incorporate the possible effect of new information.

All of the leading indicators of a recession that have been put in evidence over the last 6-12 months are still in place, yet some Wall Street forecasters and many economic models have begun lowering their recession probabilities in favor of a soft landing scenario. The easy thing would be to dismiss such thinking as wishful, or simply a manifestation of FOMO – the Fear of Missing Out – in response to a market that has defied the consensus. "This time is different" has been the imprudent course more often than not, but today's economy and government's role in it are very different than they were a half-century ago, so somewhere along the line some things must have changed. The point is that for every argument in support of remaining cautious based on what has always happened before, we have to at least acknowledge that there is a reasonable counter argument that this time may, indeed, be different.

If you're old enough to remember the Al Capone vault fiasco, then you'll probably remember also that the CBS newsmagazine *60 Minutes* used to have a closing segment called "Point/Counter-Point, wherein a liberal and conservative pundit would argue the issues of the day. That seems to be a useful format to weigh the evidence that bulls and bears on the economy and the markets are using in support of their positions.

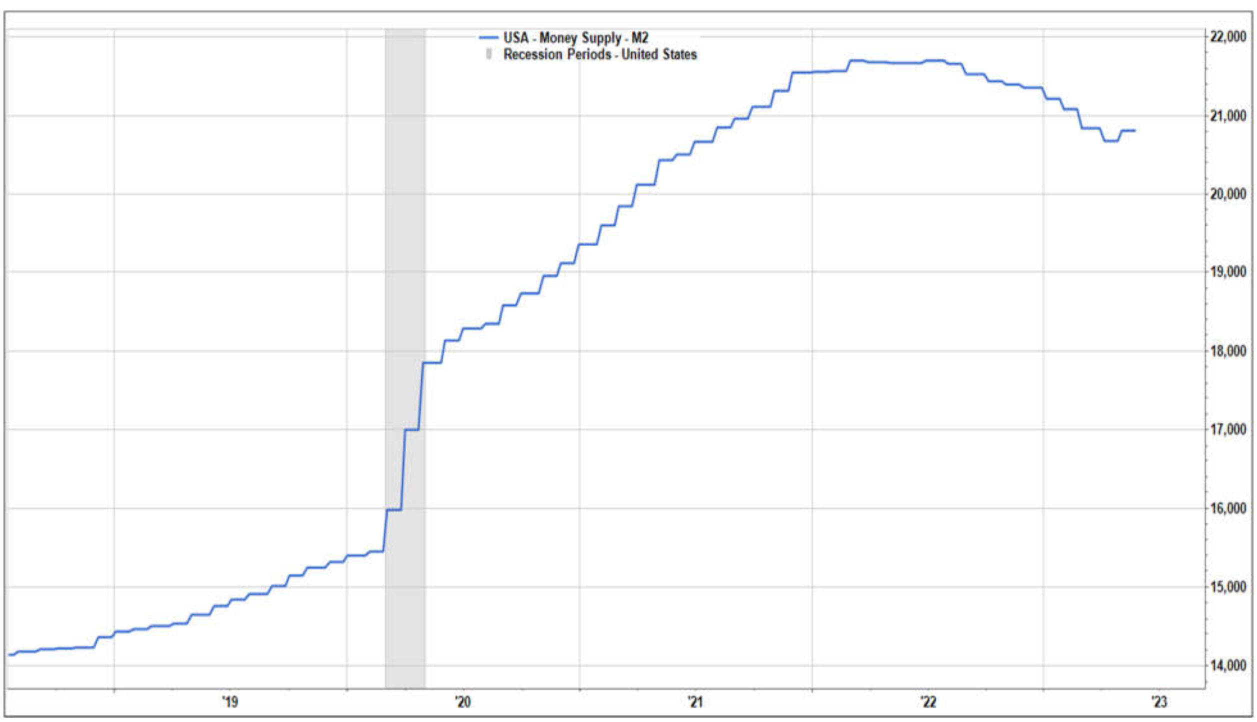
Point:

Real growth in M2, the broad measure of money supply that includes currency as well as checking and savings deposits, has been slowing since the April 2021 peak, as Americans spend down their excess savings that built up as a result of government stimulus funds. More ominous is the fact that M2 has actually been contracting in real terms since the 4th quarter of 2022, and that has historically been associated with recessions.



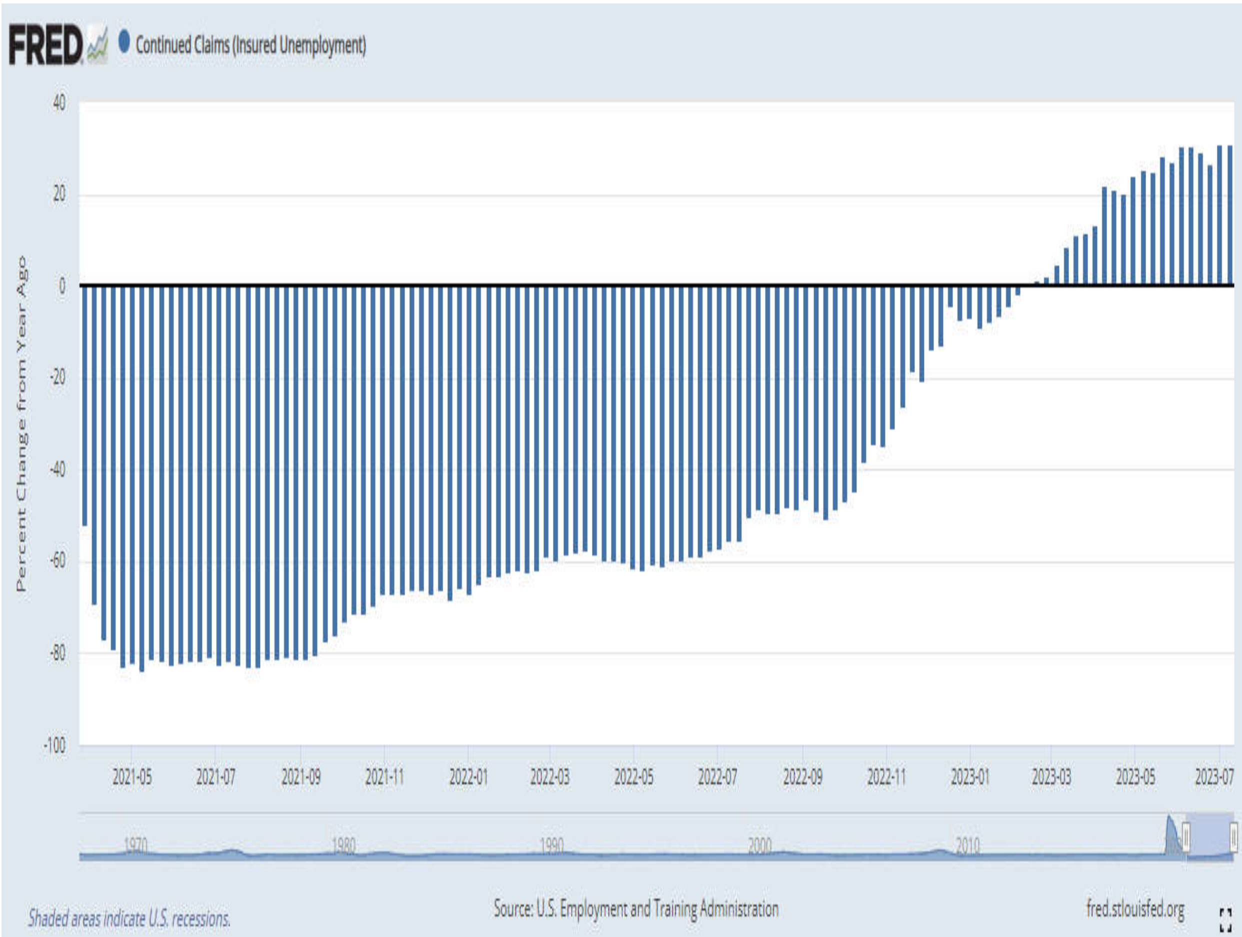
Counterpoint:

The decline in the growth of M2 began from a historically high base, and Americans still have considerably more in their bank accounts than they did before the pandemic – 35% more, in fact. Furthermore, strong (though slowing) jobs growth, rising incomes, and trillions of dollars in fiscal stimulus yet to be appropriated can keep fueling the economy for the foreseeable future – despite rising prices and a sharp increase in borrowing costs.



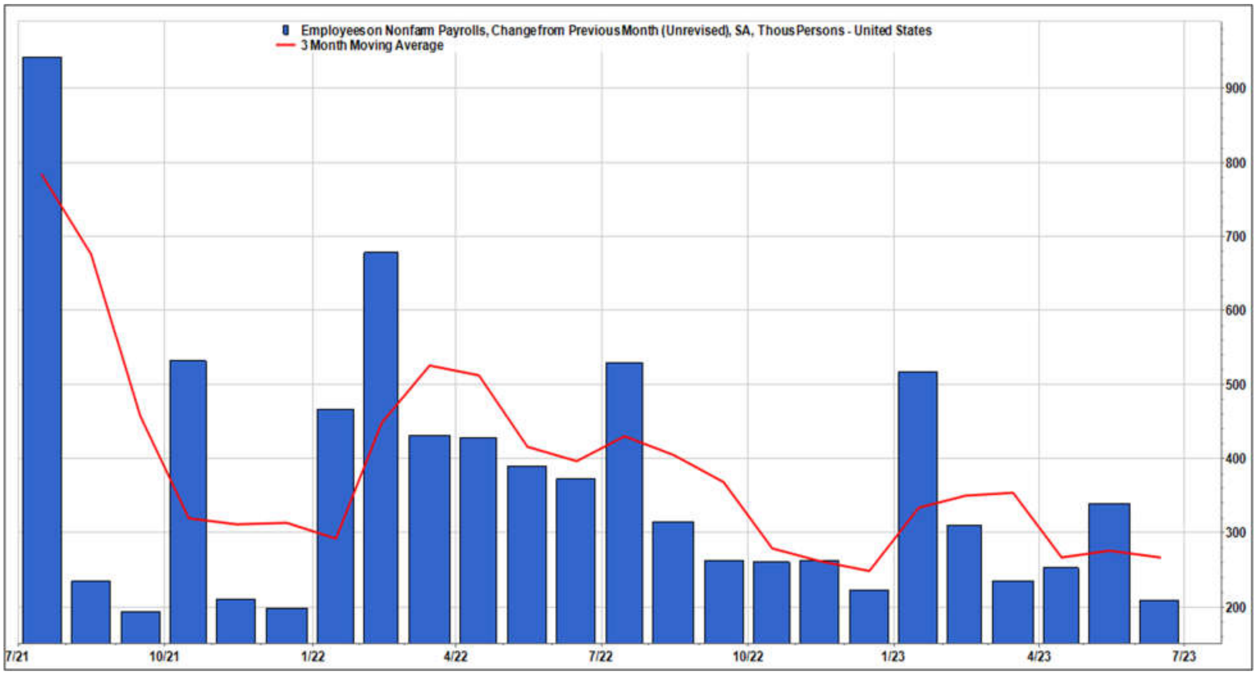
Point:

Continuing jobless claims continue to rise, with the most recent reading showing that continuing claims are 30% above the levels of June 2022. Historically, a year-over-year rise of even 10% has never occurred outside of a recession. Furthermore, monthly jobs gains are slowing and the June report of 209,000 jobs was significantly below the consensus estimate of 240,000.



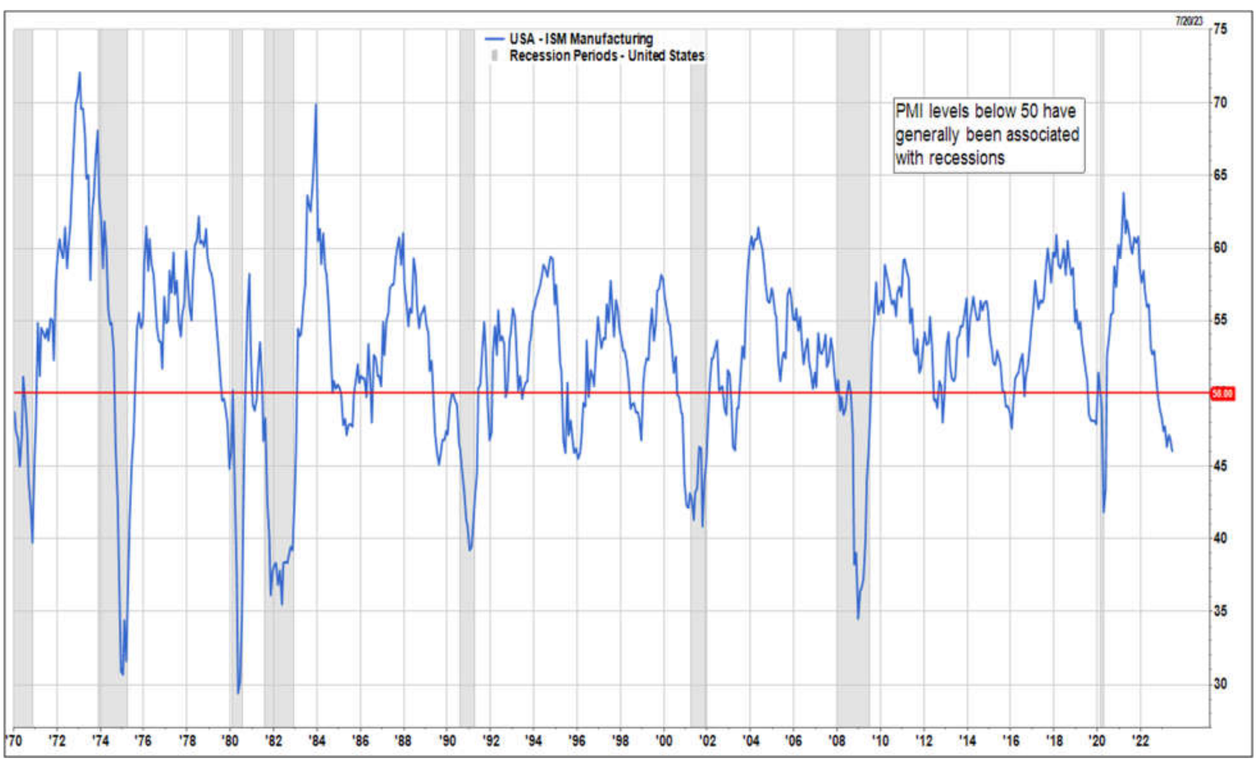
Counterpoint:

Monthly jobs reports are volatile and always subject to revision in subsequent monthly reports. The economy has created a monthly average of 243,000 new jobs over the last 10 years, if you exclude the distortions caused by the COVID recession which resulted in the loss of 20-million jobs in just one month. Even with the below-consensus June report, the three-month moving average has remained steady for the last two months, and the current reading of 267,000 new jobs is measurably above the 10-year average. The June report also showed that the unemployment rate fell back to a near-record low of 3.6%. It’s hard to imagine the unemployment rate rising when there are still 1.6 open jobs for every unemployed worker.



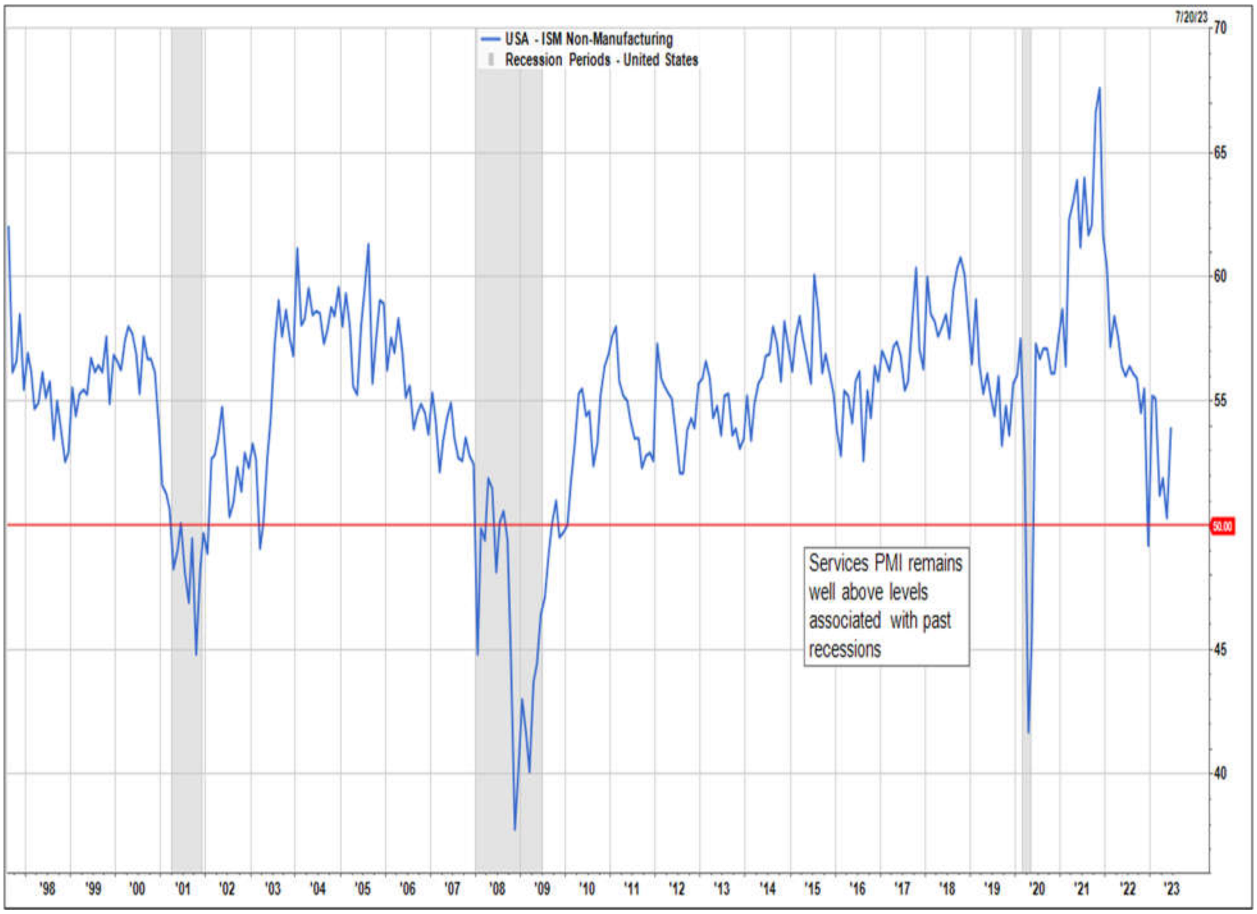
Point:

Manufacturing PMI, which fell below 50 in the 4th quarter of 2022, has remained below that level throughout 2023 and has fallen in each of the last two months. This is indicative of a sector that is, and has been, contracting.



Counterpoint:

Industrial production, while important, accounts for less than 18% of U.S. GDP, compared with more than 22% in 2000, and employs just over 19% of the workforce. Service industries, on the other hand, account for 75% of GDP and employ 79% of the workforce. Fed rate increases impact the services sector more indirectly and with a much longer lag time than manufacturing. Services PMI data remains well above recessionary levels, and may be showing signs of bottoming.



Point:

The S&P 500's rise in the first half and declining earnings have again driven valuations back to historically high levels. The market's forward P/E of more than 19 times earnings is now back above its median over the last 7+ years, and above the peak levels of the pre-COVID period when interest rates were lower, earnings were rising, inflation was non-existent and recession indicators were totally absent.

In fact, there is almost no measure by which the market is not overvalued relative to its long term averages. The S&P's current dividend yield of 1.6% is 20% below its average for the last 25 years, and its price/book and price/cash flow levels are above their long term averages by 24% and 31%, respectively.

Counterpoint:

If the Magnificent 7 have contributed an outsized percentage of the market's returns this year, it also accounts for an outsized percentage of the market's current, high valuations.

The S&P 500 forward P/E currently rests at 19.7 times forward earnings estimates, about 11% above its median since 2016. By the end of the second quarter, the combined weights of the Magnificent 7 stocks accounted for 27.7% of the S&P 500 index, and the entirety of the market's premium multiple over its recent levels can be attributed to outsized impact of the outperformance of this small group of very large

companies. This can be confirmed by looking at the current valuation of the NASDAQ 100, where the Magnificent 7's concentration is even greater – 55.7%, or more than twice their concentration in the S&P 500. At 28.6 times forward earnings, the NASDAQ Composite's multiple is almost 27% above its median P/E, or more than twice the premium that currently exists in the broader S&P 500.

If you remove the effect of the over-weightings of the Magnificent 7, an equal weighted S&P currently trades at a far more modest multiple of 15.7 times earnings, which is *below* the valuation level it has shown in recent years. If you think of it as a market of stocks rather than a stock market, there are favorable valuations that exist among the "Less than Magnificent 493."

Point:

Don't Fight the Fed.

"Earnings don't move the overall market, it's the Federal Reserve. Most people in the market are looking for earnings and conventional measures. It's liquidity that moves markets."

Stanley Druckenmiller, Philanthropist and former hedge fund manager

Counterpoint:

Don't Fight the Tape.

"Far more money has been lost by investors in preparing for corrections, or anticipating corrections, than has been lost in the corrections themselves."

Peter Lynch, Former manager of the Fidelity Magellan Fund

Where We Stand

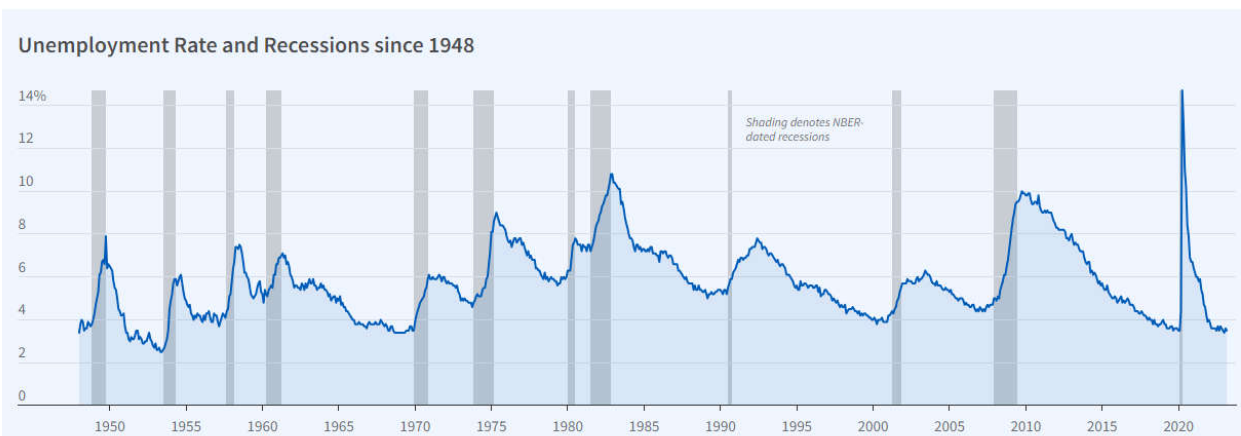
Peter Lynch is inarguably one of the most respected and successful investors of our time, but the money he speaks of that has been "lost" waiting for corrections was never real money at all, and was thus never lost. He was obviously referring to lost opportunities, money you could have had and don't. But in the stock market, opportunities are like busses – there will be another one coming by any time now.

Investors react far differently to losing money they could have had, than they do to losing money they already have. Our focus has been on capital preservation for the long term, not on maximizing returns in the short term in the face of a Federal Reserve that is committed to driving down the inflation rate to its 2% target, notwithstanding the level of unemployment that is required to get down to the target rate. If you don't preserve capital today, you won't be able to seize opportunities in the future.

For now, it remains our view that a recession in the U.S. either later this year or the first half of 2024 is still the most likely outcome, although our confidence level in that outcome is lower than it used to be.

Yes, the current labor market remains strong, but this is actually a "good news is bad news story" if recent Fed pronouncements have any credibility at all. Record low unemployment and more unfilled jobs than unemployed workers are impediments in the Fed's efforts to fight inflation, and the Fed has been clear that increasing levels of unemployment will be necessary if it is to bring inflation down to its 2% target. In other words, a recession will be painful, but the current rate of inflation – even if it is considerably below what it was a year ago - is unacceptable.

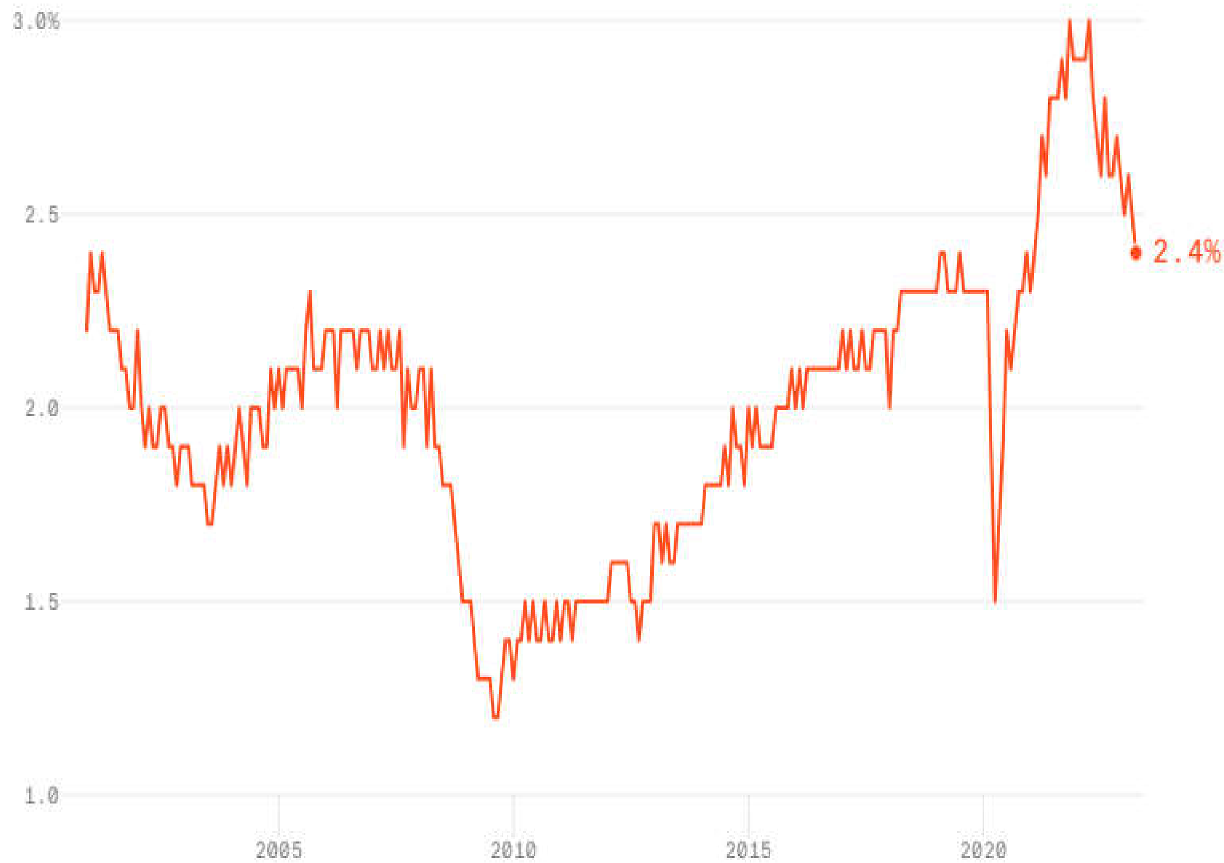
Regardless, the unemployment rate is a coincident indicator that has no predictive value. There is not a single instance of the unemployment rate rising in advance of a recession.



On the other hand, leading indicators of future trends in the labor market indicate that the downtrend in unemployment has likely ended, suggesting that it is set to rise. In addition to the rise in continuing jobless claims cited earlier, the private sector quits rate has begun to fall from the heights reached in the post-COVID period. The quits rate represents the percentage of workers who voluntarily quit their jobs for better opportunities, and a rising quits rate is an indicator of an improving jobs market. In times of economic uncertainty, however, the quits rate declines as employees grow less certain of finding employment elsewhere. Our expectation is that unemployment is set to rise from here, and an increase in the unemployment rate of 0.5% has generally indicated that the economy has entered a recession.

U.S. quits rate

Number of quits as a share of total employment; Monthly; December 2000 to April 2023

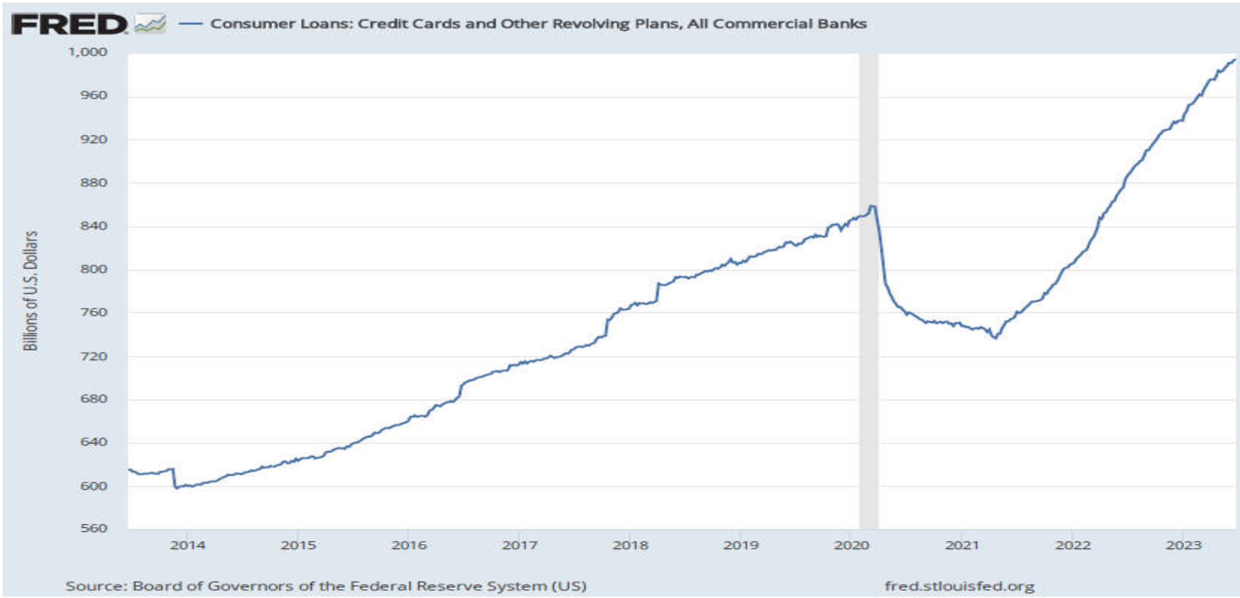


Data: U.S. Labor Department; Chart: Axios Visuals

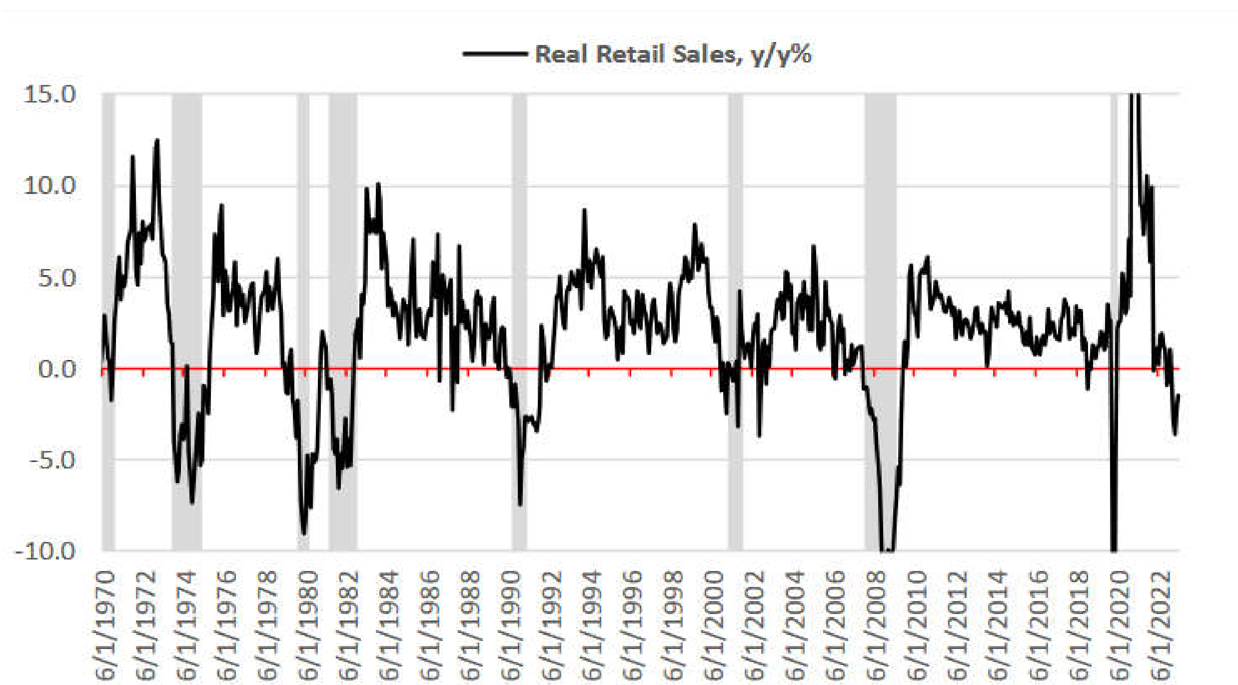
At the core of the debate over the economic outlook has been the sustainability of consumer spending, and how long the consumer can keep the economy growing. It's true that consumers' checking and savings account balances are well above pre-pandemic levels, but we think that the rate of change of the money supply is more instructive, and it is declining in real terms. Regardless of the actual amount of money consumers have to spend, human nature suggests that at some point, consumers will grow concerned that it is less than they used to have, and spending will drop. If unemployment begins to rise from here, which we think is likely *and the Fed has said is necessary*, incomes will drop and either spending must decline or those account balances must be spent down.

There are signs that spending may be beginning to slow.

Revolving credit and credit card balances have soared dramatically over the last two years, and is now more than 33% above where it was less than two years ago. So a meaningful portion of our excess savings that currently resides in those account balances has already been spent.



Retail sales missed consensus expectations in June, and real retail sales have declined year-over-year for the last 5 months, something not seen outside of a recession since at least 1970.



Source: Federal Reserve; Bloomberg

The rejection rate for U.S. credit applicants climbed to 21.8% in June, according to a Federal Reserve survey published earlier this month, the highest level in the last 5 years. The rejection rate stood at 17.3%

in February, the month before the Silicon Valley Bank failure, and banks are continuing to tighten credit conditions at the same time as borrowing costs are rising.

Even if none of this is compelling, there is still the fact that *a soft landing or no landing scenario has literally never happened after the yield curve has inverted and real money growth has declined.* On average, recessions have occurred 12-14 months after inversion, with the longest lag from inversion to recession being 24 months. We are only 12 months into the post-inversion period, still well within the recession window.

The collapse in the money supply in this cycle is now deeper than the declines that preceded each of the last 9 recessions. The yield curve remains inverted, and the inversion has, in fact, deepened as the Fed has continued its series of rate hikes and long term rates have held steady. Federal Reserve monetary policy remains restrictive, and may become more so, if only modestly. Inflation is slowing, but not fast enough to allow the Fed to reverse course.

The Fed uses the Personal Consumption Expenditures (PCE) as its inflation measure rather than the CPI, and while the PCE has fallen in lockstep with the CPI, it remains at 3.8% through May, far above the Fed's 2% target. The latest "Core" PCE reading, excluding food and energy, was even higher at 4.6%. The Fed is clearly not done, and committed to its "higher for longer" policy to avoid any breakout in long term inflation expectations.

As for the stock market, momentum is a real force and prices could well continue to rise even as the recession clock is ticking. Rallies such as the one we are experiencing are not uncommon. The S&P 500 is up about 19% since last July, similar to the rallies seen after the 1989 and 2006 inversions when the S&P 500 rose 24% and 23%, respectively. In both instances, however, those gains were more than wiped out in the subsequent recessions.

So, as to the question of whether this time is different or just longer – if longer goes on long enough, that becomes a distinction without a difference.

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