ADP STRATEGIC PLAN SERVICES, LLC

Market Commentary & Outlook

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Market Commentary

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U.S. equities finish 1st half of 2023 strong: Most major equity indices saw solid gains during the first six months of 2023. The S&P 500 Index rallied 6.47% for the month of June while the tech-heavy Nasdaq finished up 6.5% for the month. Through the first half of the year both indices posted significant increases with the S&P 500 up 16.69%, and the Nasdaq up 32.32%.

U.S. fixed income rebounds: Coming off its worst performance since 1926, the Barclays U.S. Aggregate Bond Index has risen 2.09% year to date.

Foreign equities benefit as well: Both developed and emerging market equities posted positive performance for the first six months of 2023. Led by the MSCI EAFE Index's gain of 12.16%, the MSCI EM Index also climbed 5.02% during this period.

AI & tech continue to lead: While the S&P 500 Index saw gains of greater than 15% for the first half of the year, most of these gains were attributable to just a handful of companies with connections to Artificial Intelligence (AI). NVIDIA, Meta, and Tesla all saw their stock prices more than double during the first six months of 2023. To further illustrate the lopsided gains in the index, the S&P 500 Equal Weight Index reported a more modest advance of about 6% through the first half of the year.

Inflation cools, still above Fed target: While inflation remains higher than the Fed's stated target of 2%, the year-over-year increases in the Consumer Price Index (CPI) have come down significantly. Even though the most recent year-over-year increase in overall CPI for June reported at 3%, the core-CPI Index (which removes the impact of food and energy price changes) increased at 4.8%. Both measures exceeded the Fed's inflation target. At the same time, the higher-than-average inflation is having an impact on company earnings.

Fed action: The markets finally saw a pause in the federal funds rate hikes, with the Federal Open Market Committee (FOMC) announcing on June 12th that they were leaving rates unchanged to see how the economy responds to earlier increases. However, the minutes from their meeting that were released on July 5th made it clear that the Fed anticipates more rate hikes, albeit at a slower pace. Over the coming weeks investors will be focusing on inflation, unemployment, and wage data to gauge the prospect for future federal funds rate increases.

Earnings: Company earnings have been resilient, and profits have generally exceeded analyst expectations (albeit expectations that had been lowered earlier in the year given concerns about a recession). Corporate earnings guidance remains cautious, and investors will surely be watching for any indications of a coming U.S. recession.

Geopolitical risks remain: The conflict in Ukraine persists, and in late June we saw a short-lived rebellion in Russia against the Putin regime. Uncertainty about military and other actions that Russia may take in its war with Ukraine are destabilizing and represent risks that may have major market impacts. Ongoing economic and geopolitical tensions between China and the U.S. also weigh on global market sentiment.

Historically, markets continue higher: The S&P 500 Index's advance of more than 15% through the first six months of the year typically portends strong full-year results. When the market ahead by 10% or more in the first half of a year, it moves higher by an average of 8% in the second half and moves higher 82% of the time.[1] While this is encouraging, continued volatility in the markets during the next six months is likely.

History of Federal Reserve & Their Role in the Economy

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In 1913, the passage of the Federal Reserve Act led to the formation of the U.S. Federal Reserve System ("the Fed"). This legislation was primarily a response to a severe panic and bank run that occurred in 1907, in which large numbers of savers withdrew their money at the same time.. Therefore, the original purpose of the Fed was to enhance the stability of and public confidence in the U.S. banking system. With the passage of time, the responsibilities of the Fed have expanded beyond overseeing banks to supporting a healthy economy. The Fed has been tasked with monitoring and controlling the money supply via twelve Regional Federal Reserve Banks across the United States.[2] Additional laws were passed by Congress in 1933 and 1935 that established the Federal Open Market Committee (FOMC) that is responsible for setting national monetary policies.

The Chair of the Federal Reserve Board of Governors is nominated by the U.S. President and confirmed by the U.S. Senate to a four-year term. Current Federal Reserve Board Chair Jerome Powell also acts as the Chairman of the FOMC. Mr. Powell is in his second term as Federal Reserve Board Chair, he was reappointed to a second four-year term on May 23, 2022.[3] The FOMC meets eight times a year to decide the federal funds rate; this interest rate serves as a benchmark for U.S. interest rates. For example, the prime rate of interest as well as interest rates on mortgages and other loans are directly or indirectly linked to the federal funds rate.[4]

The Fed and the FOMC have become more well-known based on their high-profile role in supporting the U.S. economy and limiting the damage of the 2008 Great Financial Crisis. During that time, the Fed lowered interest rates and kept them low for an extended period while offering credit to banks, financial institutions, and other large enterprises. In 2020, during the pandemic, the Fed again took significant steps to sustain the U.S. economy by lowering interest rates and expanding access to credit to many financial institutions and businesses.

Unlike in 2008, when the U.S. economy suffered persistent job losses followed by a period of slow economic growth, during the COVID-19 pandemic lower interest rates together with economic stimulus payments, enhanced unemployment compensation, expanded child tax credits, and fiscal support for businesses via Paycheck Protection Program loans helped the economy bounce back relatively quickly. The prompt revival of the U.S. economy combined with a sharp rise in demand for goods and services resulted in higher prices, and these higher prices were exacerbated by supply chain disruptions and higher wage costs. **When prices increase for the goods and services we buy, we call this inflation. By the end of 2021, the perception that the rise in prices that had taken place (in 2020 and 2021) would be short-lived was no longer the consensus view among Fed policymakers.**

The Fed seeks to achieve the highest level of employment consistent with stable prices. After primarily focusing their attention on sustaining households and businesses during the pandemic by lowering interest rates and setting the conditions for broad access to credit, the FOMC started raising interest rates in March 2022. **The FOMC raises the federal funds rate to make borrowing more expensive with the goal of slowing economic activity. By raising borrowing costs, the Fed intends to reduce access to credit which should ultimately reduce the demand for goods and services and, consequently, restore price stability (i.e., lower inflation).**

When demand outpaces supply, prices tend to rise, and rising prices diminish the buying power of our money. Inflation is a primary concern for the Fed because rising prices undermine the ability of households to earn enough income to meet their basic needs, especially those with lower incomes. **In an effort to bring rising prices back to the Fed's target, the FOMC has now raised the federal funds rate by 5.25% from March 2022 through July 2023. This 5.25% increase includes the 0.25% federal funds rate hike approved by the FOMC on July 26, 2023.**

The Fed's stated goal is an average inflation rate that does not exceed 2%; since 2021, inflation has exceeded the Fed's target. For the twelve months ended in June 2023, the overall CPI number reported a 3.0% inflation rate while the core CPI rate that removes the more volatile food and energy sectors reported a 4.8% inflation rate.[5] While both figures demonstrate that ***the rate*** of price increases has declined, **prices are still increasing at a faster pace than the Fed's 2% target. For this reason, despite having raised interest rates by 5.25% during the last 17 months, the Fed intends to keep interest rates high until there is clear evidence that average price increases have returned to a rate of 2%.**

The Last Word

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As we finish our fiscal year and begin another, ADP Strategic Plan Services, LLC (SPS) continues its watch on the Fed's actions to control inflation and create a "soft landing" for the economy. Higher short term interest rates, a sluggish recovery in China, and continued conflict in Ukraine dampen the market sentiment, while the promise of artificial intelligence, strong corporate profits and continued consumer spending bring lift. More than ever, it is important that we continue our focus, not on short term volatility, but on long term results, time tested processes and low investment expense to help your participants succeed with their retirement goals. While portfolio changes have been infrequent, a great deal of effort continues to be applied to due diligence on the funds in your plan to vet the fund managers' processes and understand what drives their results.

This fiscal year marks the sixth anniversary of SPS, and we are grateful for the trust of more than 58,000 plan sponsors with over $16 billion in plan assets. We look forward to continuing to serve you and your plan's participants.

1 Source: Wall Street Journal: Here's How Stocks Historically End the Year After a First-Half Rally (wsj.com)

2 Source: https://portal.ct.gov/DOB/Consumer/Consumer-Education/ABCs-of-Banking---Banks-and-their-Regulators

3 Source: https://www.federalreserve.gov/aboutthefed/bios/board/powell.htm

4 Source: https://fred.stlouisfed.org/series/FEDFUNDS

5 Source: https://www.bls.gov/news.release/cpi.nr0.htm

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S&P 500 Index: The index measures the performance of 500 widely held stocks in US equity market. Standard and Poor's chooses member companies for the index based on market size, liquidity and industry group representation. Included are the stocks of industrial, financial, utility, and transportation companies. Since mid 1989, this composition has been more flexible and the number of issues in each sector has varied. It is market capitalization-weighted.

NASDAQ Index: The index measures the performance of all domestic and international based common type stocks listed on the NASDAQ Stock Market. It includes common stocks, ordinary shares, ADRs, shares of beneficial interest or limited partnership interests and tracking stocks. The index is market capitalization-weighted.

Russell 2000 Index : Measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000 Index is a subset of the Russell 3000 Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2,000 of the smallest securities based on a combination of their market cap and current index membership.

VIX Index: VIX is the ticker symbol and the popular name for the Chicago Board Options Exchange's CBOE Volatility Index, a popular measure of the stock market's expectation of volatility based on S&P 500 index options.

Consumer Price Index (CPI): a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services.

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