

Will Second Half Performance Follow the First Half?

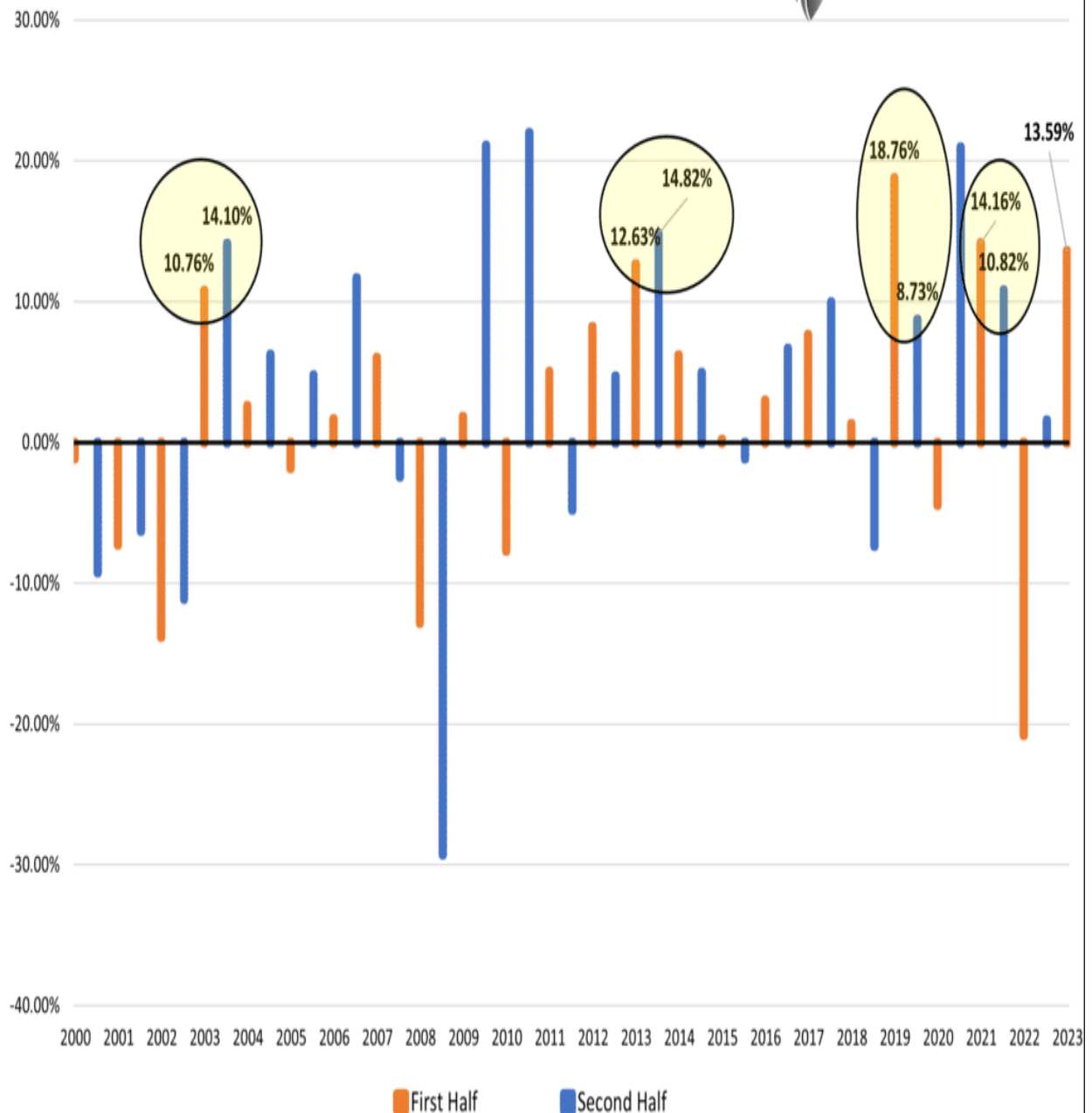
The S&P 500 rose 13% in the first quarter, the third-best first-half-of-the-year performance since 2000. While the performance was outstanding, the critical question for investors is what comes in the second half. The graph below compares the first half performance for each year to its second half. The circles highlight first half periods, like the recent six months, when the S&P 500 rose over 10%. Solely using history as our guide, we should expect a second half of solid returns. However, *past performance is no guarantee of future results*.

To play the devil's advocate for what the chart portends, consider the environments of the four prior 10%+ first halves and strong second halves. The first instance, 2003, followed the dotcom bust, where the S&P 500 fell by over 50%. Given the sharp drawdown and significant stimulus, a sustained bounce was not unreasonable. The double-digit gains in 2013 were supported by QE, a zero Fed Funds rate, and the ECB bailout of the "PIGS." 2019's performance was also aided by liquidity as the Fed was lowering rates and buying bonds. The strong first and second half in 2021, like in 2003, followed a significant drawdown and was further boosted by unprecedented fiscal and monetary stimulus. The environment in the second half of 2023 differs vastly from the four periods we discuss. History is on your side this coming second half, but the Fed isn't!

First Half vs. Second Half Gains



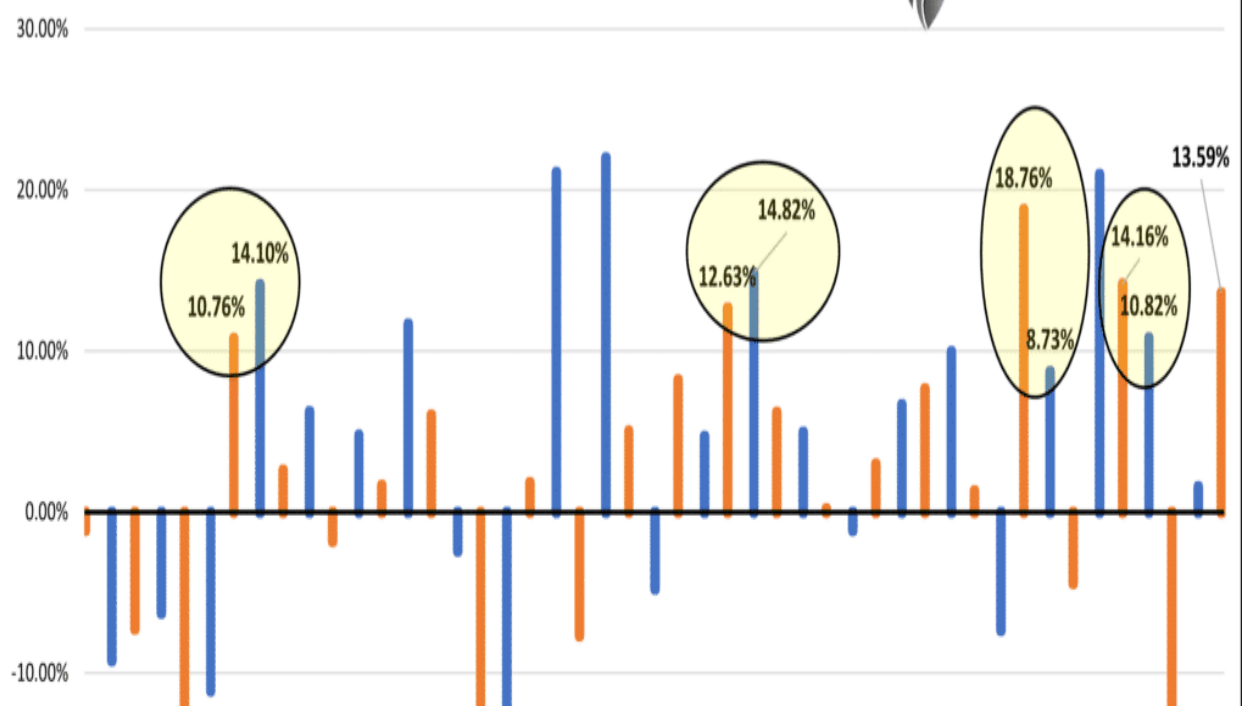
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First Half vs. Second Half Gains



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Time to Buy Small-Cap Stocks?

Using forward the price-to-earnings ratio, small-cap stocks are trading at their biggest discount relative to large-cap stocks in over 20 years. The only time the valuation gap was wider was on the eve of the dot com bubble bursting in early 2000. As we share in the second graph, from January 2000 through 2003, the S&P 600 small cap index rose almost 40% while the 100 largest S&P 500 companies fell approximately 30%.

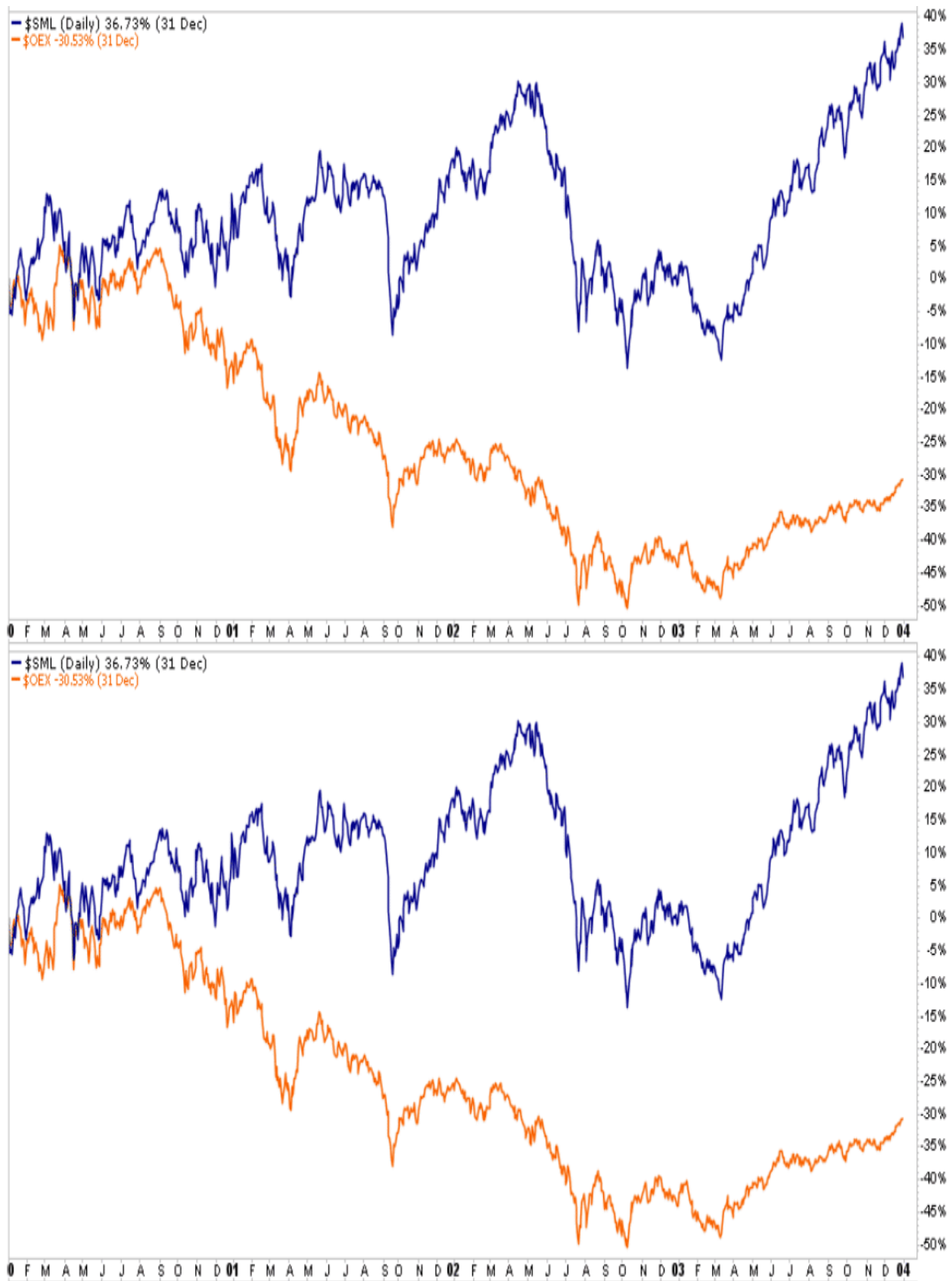
EXHIBIT 88: Small-Cap Stocks Remain Historically Cheap vs. Large-Cap Stocks, Trading at 20-Year Lows (-30% Below Long-Term Average)



Note: Valuation analysis excludes outliers and non-earners. Data as at April 30, 2023. Source: BofAML Global Research, FactSet.

EXHIBIT 88: Small-Cap Stocks Remain Historically Cheap vs. Large-Cap Stocks, Trading at 20-Year Lows (-30% Below Long-Term Average)

Relative Forward P/E: U.S. Small vs. Large-Cap

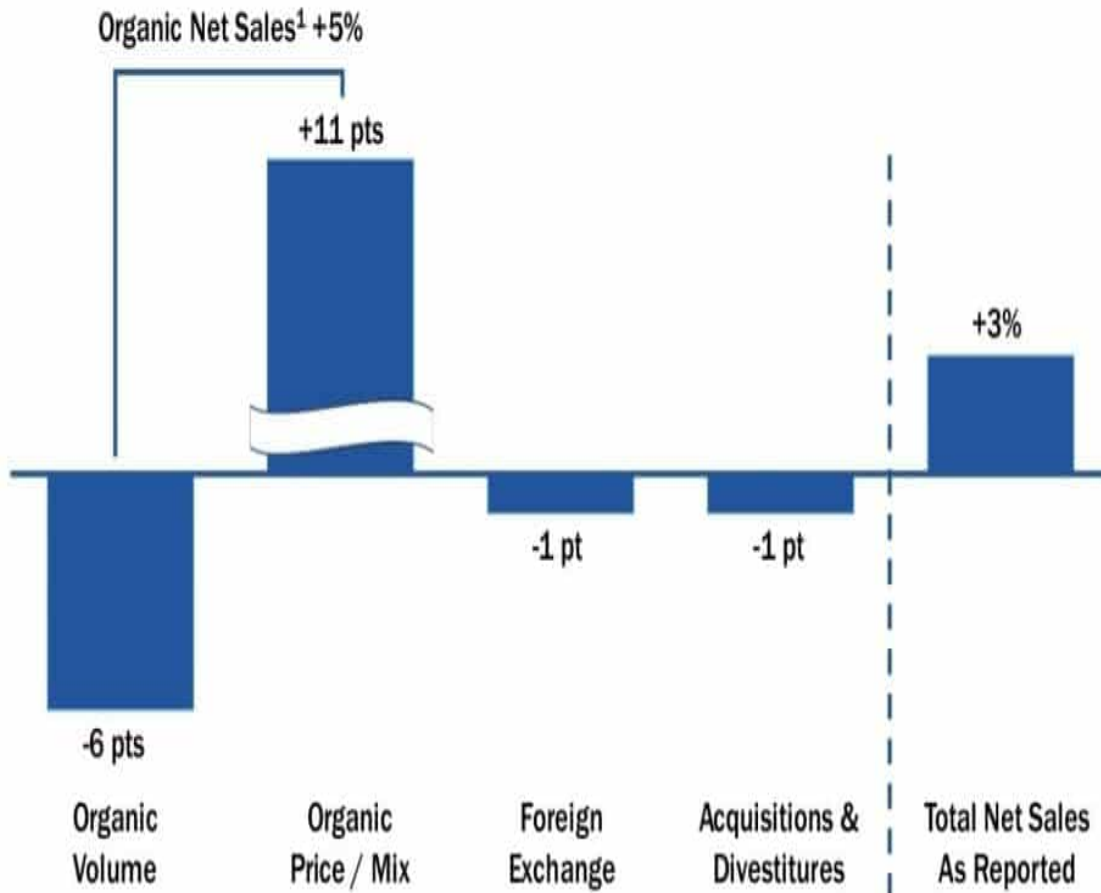


General Mills Warns About Its Consumers

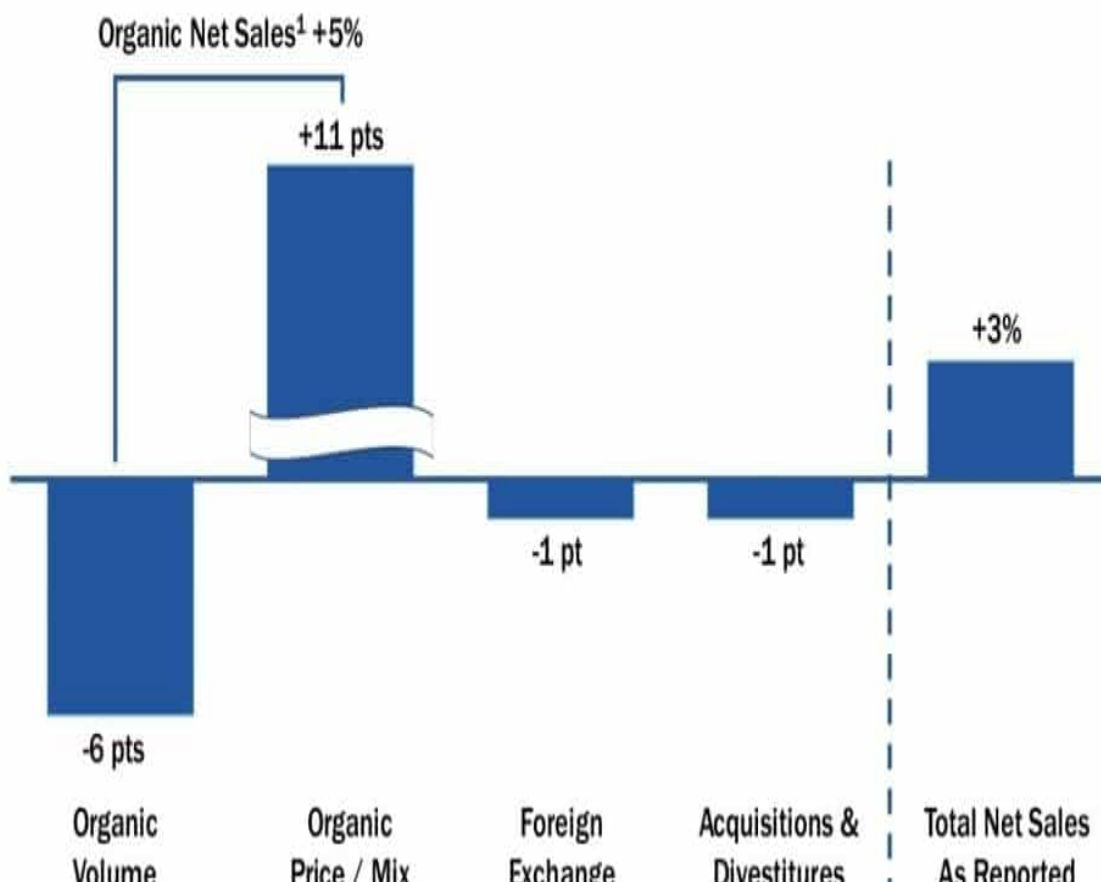
The following graph is from General Mills's recent earnings announcement. Net sales rose by 5% despite raising their prices by 11%. Consumers reacted to higher prices by buying less. As shown, sales, as measured in volume, fell by 6%. As we get a new batch of quarterly earnings reports from many companies in a few weeks, we will pay close attention to see if consumers are cutting back due to inflation, as shown below.



Components of Fourth Quarter Net Sales Growth



Components of Fourth Quarter Net Sales Growth



Bank Profitability and Lending Incentives

In yesterday's [Commentary](#), we wrote:

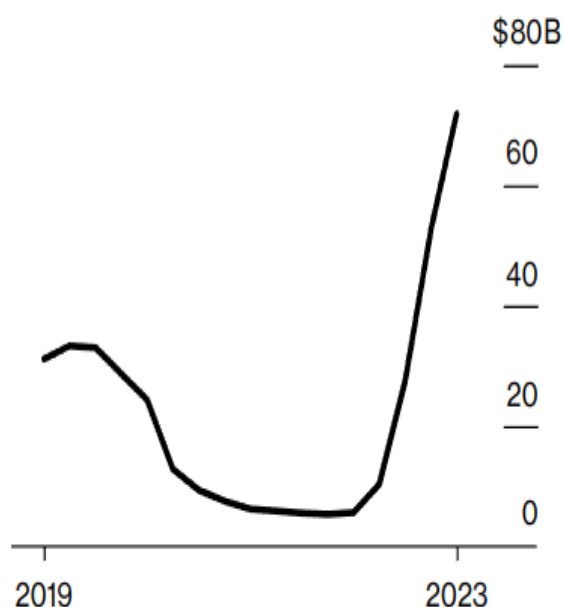
When the yield curve inverts, banks that often borrow at short-term rates and lend for longer terms long see the potential profitability for new loans decline. Such disincentives tighten lending standards.

More importantly, tightening lending standards negatively affects economic activity for an economy so dependent on borrowing. To help quantify the effect of the inverted yield curve on bank profitability, we created a proxy lending margin. The second graph below shows it is now at the lowest level in 25 years. We share additional evidence in the first set of graphs below, courtesy of Bloomberg. Interest expense for banks is now more than net income. Before the Fed rate hikes began, the banking sector had very little interest expense as interest rates were at or near zero percent. Simply, bank profit margins are waning. As seen in the third graph below, their lending standards are tightening quickly. More on yield curves, debt, and bank lending is found in our most recent article- [Treasury Yield Curves, Is This Inversion Different?](#)

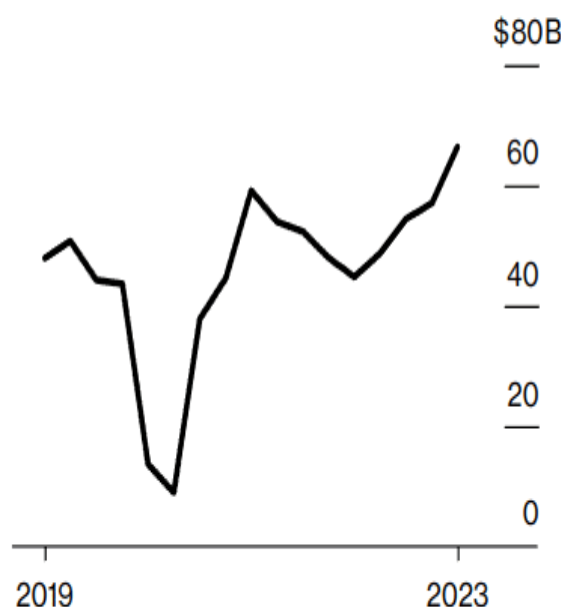
Banks Are Spending More on Interest Than They Have in Years

The industry spent \$72 billion on interest expense in the first quarter—more than their average quarterly profits

Interest expense



Net income

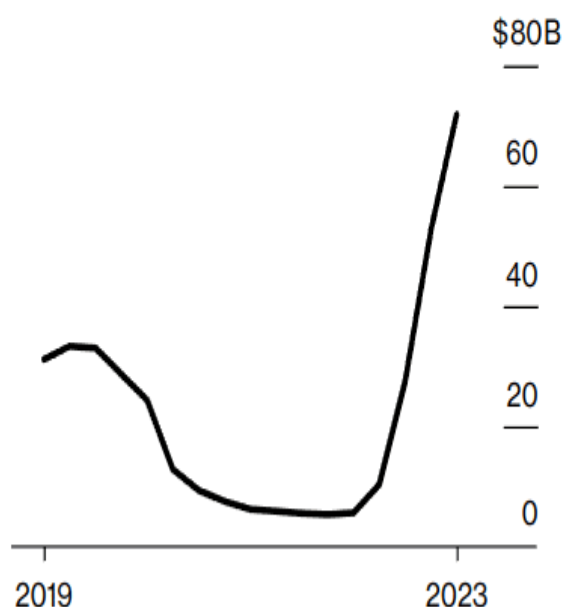


Source: Federal Financial Institutions Examination Council

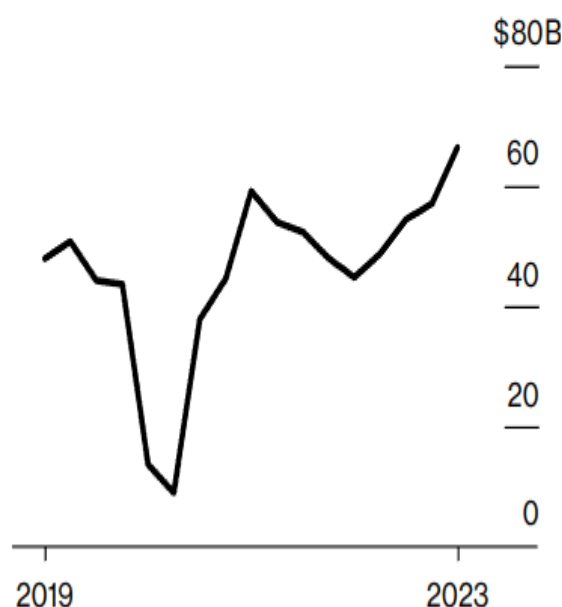
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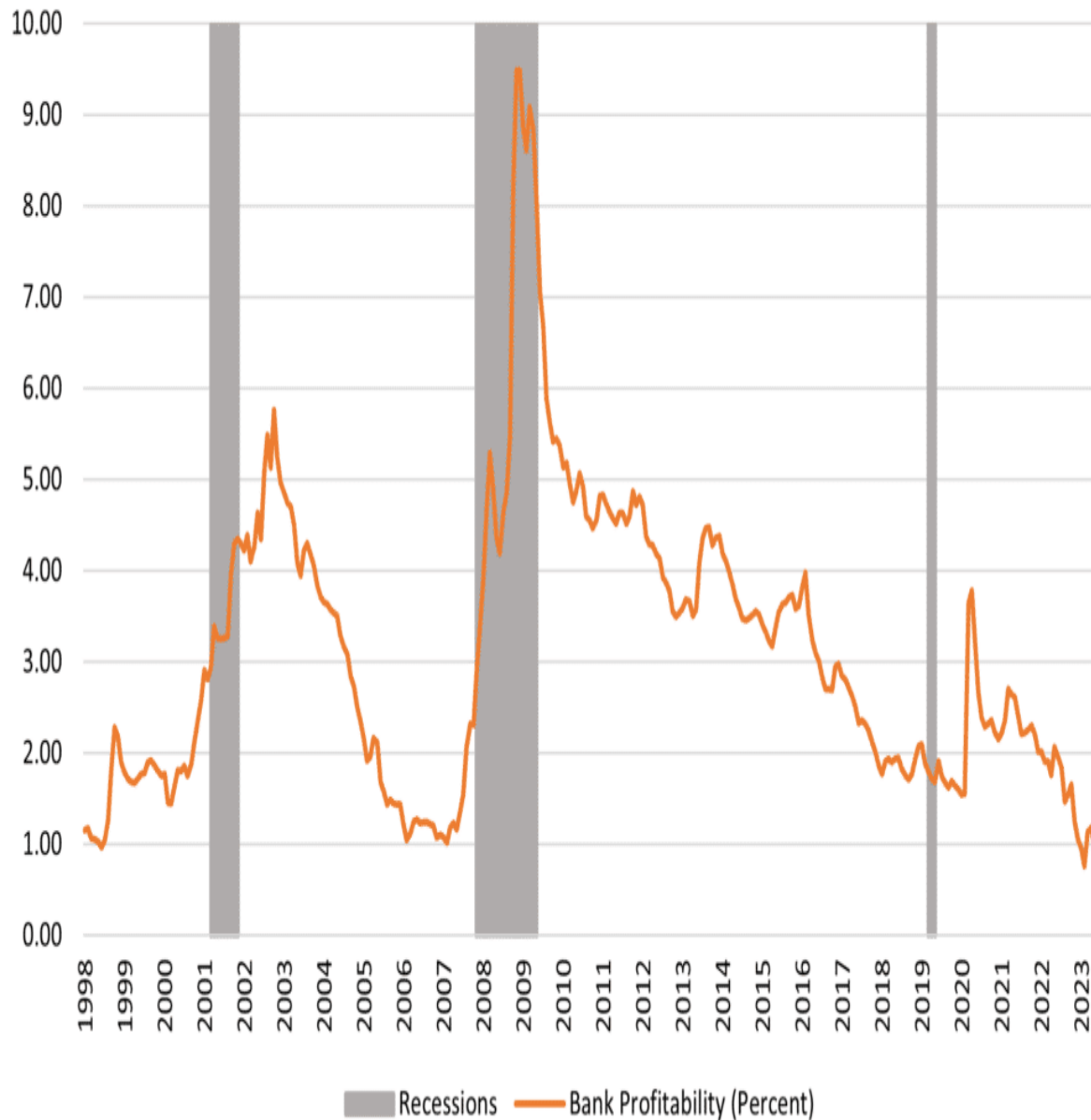
Net income



Lending Profitability



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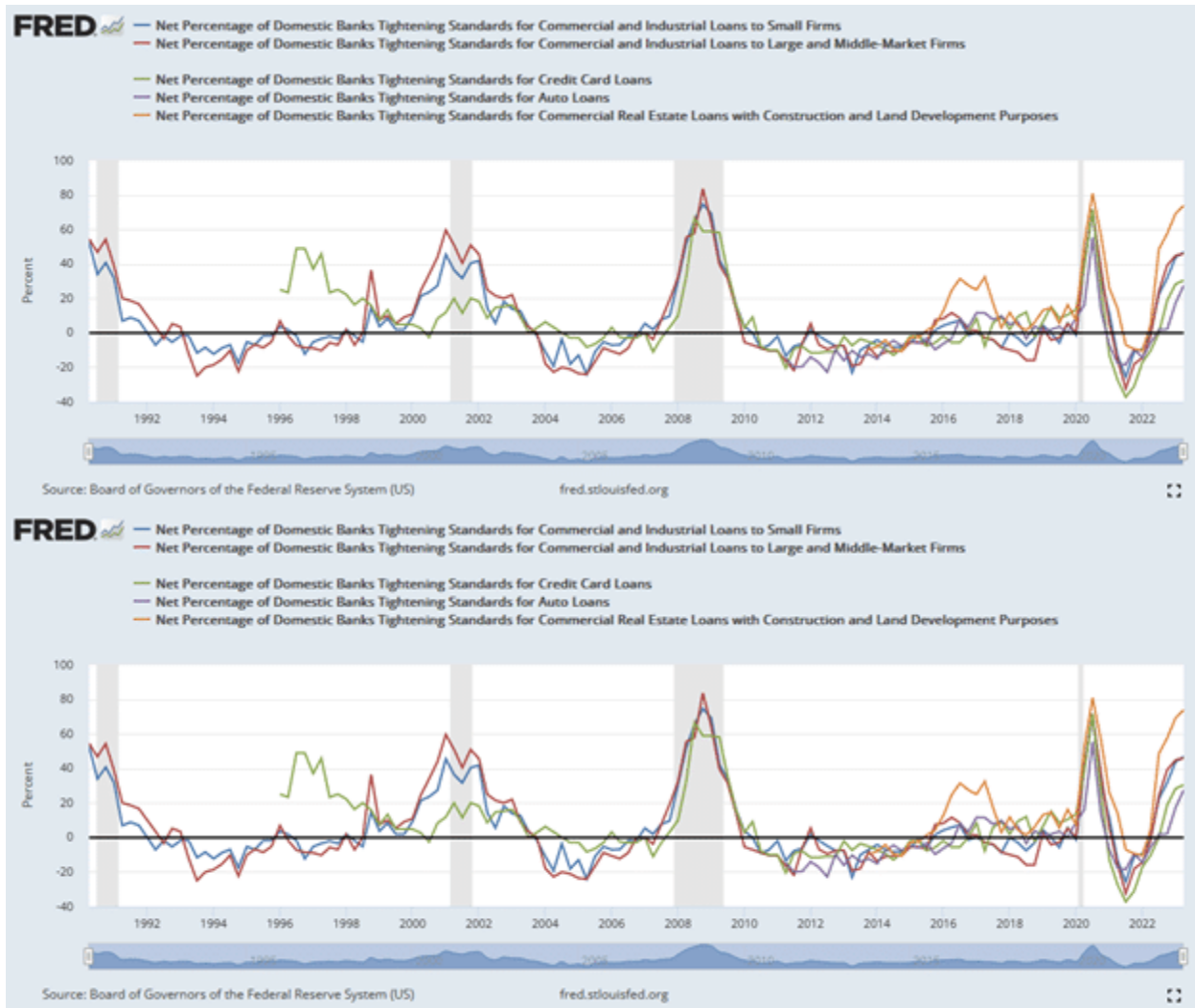


Lending Profitability



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