

The AI Rally has Lost Steam. Will Markets Start Trading Based on Fundamentals?

Major Indices Decline in August

Amid inflation concerns and fears that the Federal Reserve will keep interest rates higher for longer than expected, all three major US stock market indices were down in August. Broad-based emerging market equities (-6.1%) were among the worst performers, followed by US small-caps (-4.2%) and international developed equities (-3.8%). Aside from high yield credits (+0.2%), bonds were mostly down as investment grade corporates fell 1.2%, Treasury Inflation Protected Notes declined 0.8%, and municipal bonds decreased 0.8%. Commodities produced mixed returns as crude oil gained 2.6% while silver, gold, and broad-based commodities were down (-1.3%, -1.3%, and -1.0%, respectively).

Exhibit 1: Trailing Returns as of August 31, 2023

	Index/ETF	1-Mo	YTD	1-Y	3-Y	5-Y
Equities	US Growth (IVW)	-0.66%	24.03%	13.24%	6.71%	11.53%
	US Large-Caps (SPY)	-1.63%	18.66%	15.85%	10.50%	11.06%
	US Value (IVE)	-2.79%	12.66%	17.04%	14.08%	9.35%
	US Mid-Caps (SPMD)	-2.97%	10.02%	10.59%	12.78%	6.37%
	International Developed Equities (IEFA)	-3.80%	10.66%	17.65%	5.94%	3.99%
	US Small-Caps (SPSM)	-4.24%	7.16%	5.40%	12.61%	4.53%
	Broad-based Emerging Markets (IEMG)	-6.07%	6.09%	3.66%	-0.20%	1.47%
US Fixed Income	High Yield Credit (HYG)	0.19%	5.85%	7.01%	0.81%	2.28%
	US Aggregate Bond Index (AGG)	-0.63%	1.60%	-1.07%	-4.41%	0.48%
	US Treasury 7-10 Year (IEF)	-0.73%	0.56%	-3.64%	-6.52%	0.11%
	Municipal Bonds (MUB)	-0.77%	1.49%	2.27%	-1.08%	1.59%
	Treasury Inflation Protected Notes (TIP)	-0.81%	1.26%	-3.74%	-1.67%	2.13%
	Investment Grade Corporate Bonds (LQD)	-1.23%	3.04%	0.95%	-5.11%	1.42%
Commodities	Crude Oil (USO)	2.58%	7.06%	2.67%	34.92%	-8.60%
	Broad-based Commodities (BCI)	-1.02%	-3.54%	-9.06%	14.41%	6.15%
	Gold (GLD)	-1.28%	6.12%	13.04%	-0.88%	9.66%
	Silver (SLV)	-1.32%	1.68%	35.07%	-5.14%	10.41%

Source: FactSet. Data as of August 31, 2023.



Fed May Need to Raise Rates Further

At this year's annual Jackson Hole symposium, Federal Reserve Chairman Jerome Powell expressed a hawkish stance. "Although inflation has moved down from its peak – a welcome development – it remains too high," he stated, as core annualized CPI and PCE for July remain at more than double the 2% target (4.7% and 4.2%, respectively). His statements suggested that the central bank may need to increase interest rates further given robust GDP growth and consumer spending readings, as well as a resurgence in housing market activity. "Additional evidence of persistently above-trend growth could put further progress on inflation at risk," Powell commented. He also acknowledged various indications that the strength of the labor market is cooling, but additional tightening may be warranted if such developments halt or reverse. Moreover, the Fed Chairman indicated policymakers will "proceed carefully" at upcoming meetings, and implied a patient approach to additional rate hikes so that officials have time to assess how recent tightening is affecting the economy.

Loosening in the Labor Market

The most recent Job Openings and Labor Turnover Survey (JOLTS) revealed that job openings in July were 8,827 thousand, notching their lowest reading in 28 months. Additionally, August ADP payroll data came in softer than expected, and the prior two months of nonfarm payroll data saw big downward revisions, all suggesting that the labor market is loosening. As tightening has lagged effects, are the Fed's interest rate hikes starting to take effect?

Exhibit 2: JOLTS Job Openings – United States

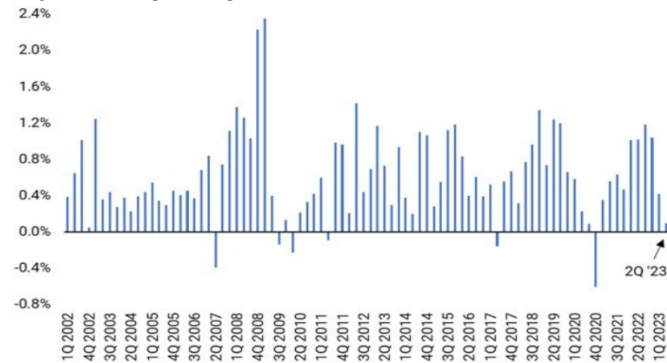


Source: FactSet, US Department of Labor, Astoria Portfolio Advisors. Data as of August 29, 2023.

Sell the News?

In terms of price action on the day after reporting earnings, the Q2 2023 earnings season has been one of the weakest observed over the past decade. Even for stocks that beat earnings estimates, price action was more muted compared to history. Are investors starting to question the disconnect between market fundamentals and the economic outlook?

Exhibit 3: Median S&P 500 Stock Price Reaction T+1 Day Post Reporting: EPS Beat

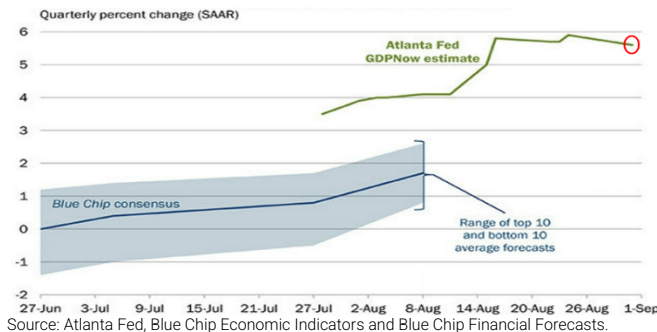


Source: Compustat, Morgan Stanley Research.

Long Dated Yields See Higher for Longer

Per the Atlanta Fed GDPNow model as of August 31st, GDP is expected to grow an annualized 5.6% in Q3 2023. Though this forecast is expected to come down as the quarter progresses, economic growth has been more resilient than many anticipated. As a likely result, the 10-year US Treasury yield surpassed 4.3% on August 21st, its highest level since 2007. Many believe this is a sign that bond markets are convinced rates will stay higher for longer to rein in the economy's strength.

Exhibit 4: Atlanta Fed GDPNow Model



Source: Atlanta Fed, Blue Chip Economic Indicators and Blue Chip Financial Forecasts.

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Exhibit 5: 10-Year US Treasury Yield



Source: FactSet, Astoria Portfolio Advisors. Data as of August 31, 2023.

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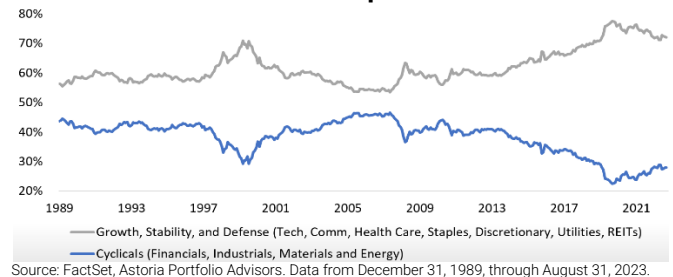
When looking at growth relative to value via their respective Russell 1000 indices, growth is outperforming value by historically elevated levels. As growth stocks have had an incredible AI-related run this year and their valuations have richened, does this suggest a turning point lies ahead where cheaper and fundamentally attractive stocks outperform? Furthermore, since 2019 to date, growth-like sectors have made up 70-80% of the S&P, exceeding the highs last seen around 2000. However, their share of the S&P has decreased from the highs in recent years, while the portion of cyclical sectors has increased. As we enter a new macroeconomic environment, likely characterized by not as stable inflation and higher volatility compared to the last decade, will this trend continue?

Exhibit 6: Russell 1000 Growth / Russell 1000 Value



Source: FactSet, Astoria Portfolio Advisors. Data from December 31, 1978, through August 31, 2023. Calculations use monthly price returns. December 31, 1978 = \$100. Past performance is not indicative of future results.

Exhibit 7: S&P 500 Index Composition



Source: FactSet, Astoria Portfolio Advisors. Data from December 31, 1989, through August 31, 2023.