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MARKET SIGHT LINES

Keep Composure as Equity Market Volatility Increases in the Second Half: Three Positive Forces

By Michael O'Keeffe, *Chief Investment Officer*

As I engage with clients this time of year, I often get the question: "Where will the stock market end the year?" My answer for 2023: "We expect market higher volatility in the second half, and there is a strong possibility that the stock market will end the year lower from here." But I am also quick to suggest the long-term investor keep composure through any negative volatility, as getting such market calls right and timing the market are really hard. In fact, I am also sharing three positive forces supportive of the equity market: momentum, broadening participation, and improving earnings.

In this Sight|Lines, we share some thoughts on equity market volatility, composure, and three forces that could be positive for stocks going forward.

THE TAKEAWAY: WE SEE HIGHER VOLATILITY IN THE SECOND HALF, BUT STAY THE COURSE.

People analyzing the stock market spend a lot of time focused on volatility and market direction. Let's review where we are as we pass mid-year 2023. In summary:

- Stock market volatility has been muted in the first half of this year, and markets have posted better-than-expected results over that period, driven by the strong performance of Big Tech stocks.
- We expect stock market volatility to increase, with a strong possibility that the market will end the year lower from here given the continued economic uncertainty and possible government shutdown.
- The long-term investor benefits from keeping composure, remaining invested through this volatility, as we see three forces that are positive for stocks.
- After strong first-half performance, the S&P 500 often posts a positive return in the second half.
- As we approached the middle of the year, we observed a shift from a Big Tech-led market to a broader market, a positive for most investors.
- Analyst views on future earnings, a critical input to stock market levels, have been improving.

We believe long-term investors should stay the course through increasing market volatility.

IN-DEPTH: WE SEE HIGHER VOLATILITY AND A POSSIBLE LOWER MARKET FROM HERE, BUT THREE FORCES ARE SUPPORTIVE OF STOCKS. LONG-TERM INVESTORS ARE BEST SERVED KEEPING COMPOSURE AND STAYING THE COURSE.

Most investors know that making near-term market calls and timing the market are really hard. Even so, the media, market participants, and clients alike spend a lot of time focused on market volatility and its near-term direction. As we head into the second half of 2023, there are many forces at work affecting stocks. Going deeper:

- Stock market volatility has been muted in 2023, posting better-than-expected results:

- The VIX Index, a measure of S&P 500 Index volatility, averaged 16.4 in the second quarter, well below its 30-year average of 19.8.
- The S&P 500 Index earned a total return of 17% year to date through June.
- Big Tech stocks, comprising a big part of the index, drove these results. The NYSE FANG+ Index was up 74% over this period, while the S&P 500 Equal Weight Index was up just 7%.

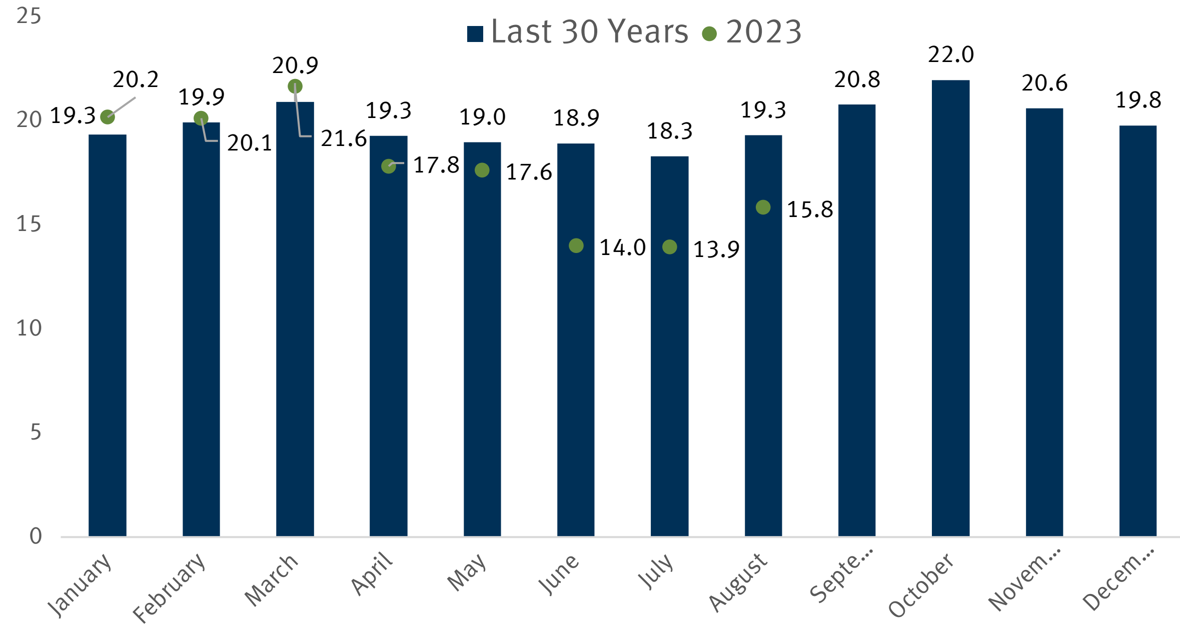
- Stock market volatility usually increases in the second half. Figure 1 shows the average VIX levels, by month, including the 2023 levels:
  - VIX has indeed been lower than normal so far this year.
  - The chart shows that VIX usually increases in the September-December period.
- While we see a strong possibility of a lower market from here, the long-term investor should keep composure and remain invested through volatility, as we see three positive forces that could cause markets to move higher.
- Figure 2 shows when the S&P 500 starts a year strong, momentum often carries through the second half:
  - Since the 1950s, there have been 26 years where the S&P 500 earned a return of 10% or more.
  - Of those years, all but three experienced a positive second half, illustrating momentum.
  - The average first half return for those years was 16%, not far from the first half 2023 result of 17%.
- As discussed above, Big Tech stocks drove the cap-weighted S&P 500 higher, but the market is broadening out, a positive sign for diversified investors:
  - The S&P 500 was up 8.9% year to date through May, while the S&P 500 Equal Weight Index fell 0.6% over that period.
  - Since then, the S&P 500 has returned 5.7%, while the S&P 500 Equal Weight is up 6.6%, with the energy and industrials sectors the best performing, up 13.0% and 10.6%, respectively.
- We'll go deeper on earnings in our next Sight|Lines, but here are some relevant details this week:
  - The number of companies reporting earnings above the mean estimate and the magnitude of the surprises suggest economic uncertainty has impacted companies less than feared.
  - Analyst views on future earnings are improving, with the 2024 S&P 500 earnings estimated to rise 11.7%, compared to 10.1% at the beginning of this year.

CONCLUSION

This time of year, clients often ask: "Where will the stock market end the year?" This year I've suggested that equity market volatility may well increase in the second half, and the market may move lower from here to end the year. But, the long-term investor should keep composure, as market timing is hard. Three positive forces – momentum, broadening participation, and improving earnings – may push the market higher from here.

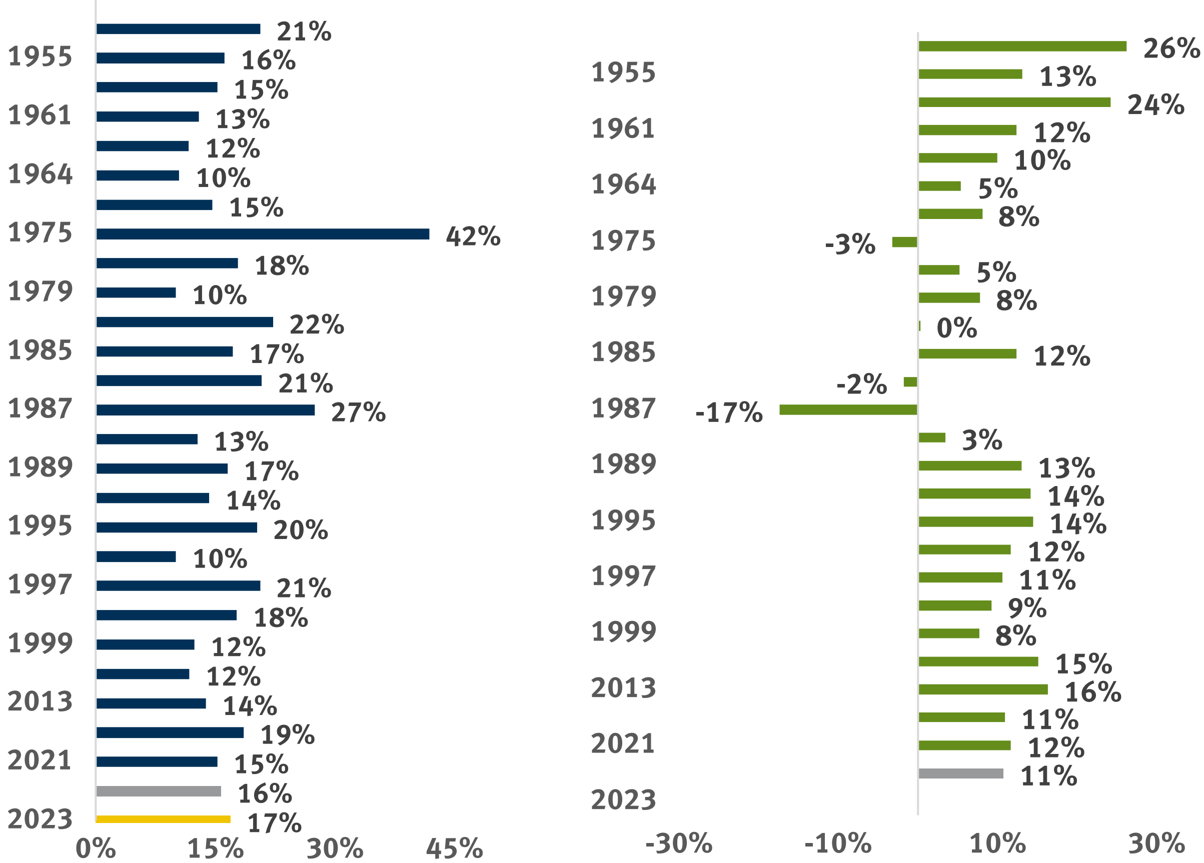
Michael P. O'Keeffe, CFA
Chief Investment Officer
michael.okeeffe@stifel.com
www.stifelinsights.com

Figure 1. Average Daily VIX Level - Last 30 Years



Source: Stifel CIO Office via Bloomberg, as of August 17, 2023

Figure 2. S&P 500 Years' With First Half Gains Greater Than 10% and Second Half Performance



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Asset allocation and diversification do not ensure a profit and may not protect against loss. There are special considerations associated with international investing, including the risk of currency fluctuations and political and economic events. Investing in emerging markets may involve greater risk and volatility than investing in more developed countries. Due to their narrow focus, sector-based investments typically exhibit greater volatility. Small company stocks are typically more volatile and carry additional risks, since smaller companies generally are not as well established as larger companies. Property values can fall due to environmental, economic, or other reasons, and changes in interest rates can negatively impact the performance of real estate companies. When investing in bonds, it is important to note that as interest rates rise, bond prices will fall. The Standard & Poor's 500 index is a capitalization-weighted index that is generally considered representative of the U.S. large capitalization market. The S&P 500 Equal Weight Index is the equal-weight version of the widely regarded Standard & Poor's 500 Index, which is generally considered representative of the U.S. large capitalization market. The index has the same constituents as the capitalization-weighted S&P 500, but each company in the index is allocated a fixed weight of 0.20% at each quarterly rebalancing. The Dow Jones Industrial Average (DJIA) is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange (NYSE) and the NASDAQ. The DJIA was invented by Charles Dow back in 1896. The MSCI EAFE index (Europe, Australasia, and the Far East) is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the U.S. and Canada. VIX is a trademarked ticker symbol for the Chicago Board Options Exchange Market Volatility Index, a popular measure of the implied volatility of S&P 500 index options.

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