

## January 23, 2023 – Investment Commentary

After a strong start to the year, markets took a breath last week as recession fears continued to mount. Wednesday saw the biggest risk-off move so far in 2023, with equities slumping and sovereign bonds rallying after the latest US data magnified recession concerns and raised the prospect the Fed wouldn't be as aggressive with their rate hikes as expected. US PPI for December surprised to the downside, adding to hopes that inflation was durably on the way down. In addition, weaker than expected retail sales and industrial production added to the arguments in favor of the Fed easing up over the coming weeks.

On the back of the soft data, investors moved to price in a less aggressive pace of rate hikes over the months ahead. The terminal rate priced by the market dropped to as low as 4.84%, while the rate priced in for the end of the year dropped as low as 4.31%. Although both levels had moved higher by the end of the week to 4.90% and 4.42%, respectively.

The recession-watch 3month-10year spread widened 8bps and closed the week at -120, the lowest level since 2002, signaling recession in coming months. The 2-year-10-year spread tightened 4bps and is now -70; recent levels have not been seen since the early 1980s. Rates were modestly down in other developed markets as well. 5-year and 10-year breakeven inflation expectations were up slightly and now trading at 2.27% and 2.24%, respectively where the 10-year real yield fell 7bps to 1.24%.

Investment grade fixed income had slightly positive returns as rates were modestly lower and spreads compressed slightly, and municipals returned +0.6%. High-yield bonds returned -0.3% as spreads widened slightly, and emerging market debt rose 0.9% on a falling dollar and as tighter spreads.

Despite the ongoing volatility, US equities ended the week mixed, with the Nasdaq closing in positive territory (+1.3%) following a strong close to the week, while the S&P (-0.3%) was marginally lower. US 10yr Treasury yields fell to an intraweek low of 3.32% but ended the week just 2bps lower at 3.48%.

Moving to Europe, and with the Davos summit taking place, we heard from ECB President Lagarde on Thursday, who said that inflation was "way too high" and that the ECB would "stay the course until such time we have moved into restrictive territory for long enough so that we can return inflation to 2% in a timely manner." She even responded to talks of cuts in the future by saying that "I would advise market participants to revise their positions". Despite the broader risk-off move, the spread of Italian 10yr yields over German bunds did come down to 171bps, which is the tightest it's been in almost nine months.

## Portfolio Construction

We believe portfolio construction should incorporate deliberate allocations to value and growth in equities, as 2023 will be a year of transitions from peak inflation/interest rates and slowing growth. Value stocks tend to outperform during periods of elevated inflation and growth stocks could be at risk if inflation proves to be stickier than the market expects in its current base case. Within fixed income more broadly, rate volatility has moderated as the inflation outlook has cooled and market expectations grow that central banks are close to the end of their rate-hiking cycles. All-in fixed income yields remain appealing relative to other asset classes' opportunities. We maintain a preference for investment grade corporate bonds and high-quality municipals to help capture not only income benefits but also ballast in potential "risk off scenarios".

## Disclosures

*Investment Commentary Sources: Bloomberg and Morningstar*

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