

## February 13, 2023 – Investment Commentary

### Macro Matters

Last week was a softer one for European and U.S. stocks as sentiment soured following last week's jobs report and some further concerns around inflation, particularly as investors looked to U.S. CPI data next week. This week has seen several hawkish remarks from U.S. officials that followed the hot labor market reading the previous week. This led to the market recalibrating views on the Fed's peak rate to around 5.2% from under 5% earlier this month. Government bond yields saw a notable sell-off with 10yr Treasury, Bund and Gilt yields rising by more than 20bps, 15bps and 35bps, respectively. Brent crude oil jumped by more than 2% after media reported that Russia plans to slash output by 500,000 barrels a day next month in response to Western-imposed price caps on its oil exports. Brent gained 2.5% at \$86.60 a barrel after the reports carried by Reuters and Bloomberg. WTI rose 2.8% to \$80.25 a barrel.

The latest U.S. inflation report on Valentine's Day was generally in line with expectations, although the 6.4% annual change in the Consumer Price Index and 5.6% change in the core CPI (ex-food and energy) were higher than some had anticipated. The report suggests that inflation should continue to climb down from its peak, but perhaps not as quickly as some may have hoped.

The S&P 500 is off to a good start in 2023—up more than 7 percent as of Feb. 13. Investors are anticipating the following announcement “Ladies and gentlemen, the Fed welcomes you to the next bull market. The local time is February 2023.” However, investors forget that the final installment always is “For your safety and the safety of those around you, please remain seated with your seat belt fastened and keep the aisle(s) clear until we are parked at the gate.” In other words, there may be some volatility along the way. We believe the foundational elements for a smooth landing without the need for seatbelts and clearing the aisle are premature when considering the Fed and earnings trends.

### Fundamental Earnings

After pricing in perfection only a week prior, the market faced a reality check last week in the form of a higher terminal rate and falling earnings. The cost of capital is rising again, albeit modestly, and the E in the forward P/E is coming down. Following the strong payroll report, the market seems to be listening more carefully to what the Fed has been saying for months. It is unlikely to pause and cut like the market had been signaling. The terminal rate is now up to 5.18%.

Meanwhile, earnings are losing altitude. With ~70% of S&P500 companies reporting Q4 earnings, 70% are beating estimates by an average of 1.5%. That's a below-average result based on historical results. The consensus earnings estimate for 2023 has now fallen to -1.7%. Based on the historical trend of declining estimates during each calendar year, aggregate earnings may fall 5% to 10% this year and likely more if there is a meaningful recession. The S&P500 at 4100 and a P/E multiple of 18x is above the long-term valuation trend and challenged to remain stable in the face of slowing earnings growth, “sticky inflation,” and higher for longer rates.

### Portfolio Construction

While the yields on credit-oriented sectors may appear attractive, the slowing economic environment and potential for wider credit spreads require prudence and thoughtful diversification. We believe establishing separately managed accounts, where available, and partnering with active managers in both high quality municipals and corporate credit and asset-backed securities may help achieve the goals of ballast and income in a portfolio.

Within equities, we believe allocations should include quality developed and emerging market non-U.S. stocks. We believe international equities can benefit from a weaker U.S. dollar as U.S. short-term rates peak, attractive relative valuations compared to their U.S. markets, and meaningful export exposure to China's economy reopening. Within U.S. equities, we maintain our emphasis on high-quality value and growth companies with characteristics that offer the potential for resilient, positive cash flows and dividends at reasonable multiples.

## Disclosures

*Investment Commentary Sources: Bloomberg and Morningstar*

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