

February 21, 2023 – Investment Commentary

Macro Matters

Last week, the major US indexes ended mixed as investors considered inflation trends might be taking an unfavorable turn. The combination of solid growth and stronger inflation puts the Fed in a very tricky position which may cause a reality shock for the market if the Fed keeps raising rates or keeps interest rates higher for longer (and potentially takes off the chances of cutting rates in 2023). Fears that the Federal Reserve would need to raise short-term interest rates more than previously expected caused U.S. Treasury yields to increase and fostered a rise in the U.S. dollar, sparking a decline in oil prices and energy stocks. (Oil is priced in U.S. dollars on international markets, resulting in pressure on demand when the dollar appreciates.) Bonds generated negative returns for the week as economic data seemingly confirmed recent hawkish comments from Fed officials that there was more work to do to tame inflation. As of the close of trading Friday, futures markets, as tracked by CME Group, began to price in an 18.1% probability that the Fed would hike rates by a half point (0.50%) at its March policy meeting, almost double the chance priced in the week before. The Fed slowed its rate increase increment to a quarter point (0.25%) at its meeting early in the month.

The yield on the benchmark 10-year Treasury note rose to a three-month high on Friday morning before decreasing slightly to end the week. (Bond prices and yields move in opposite directions.) Municipal bonds declined across most maturities amid rising Treasury yields and an increase in new supply issuance. Investment-grade corporate bonds tracked U.S. equities lower later in the week as economic sentiment weakened.

Shares in Europe rebounded as better-than-expected corporate results helped markets shrug off fears about additional interest rate hikes. In local currency terms, the pan-European STOXX Europe 600 Index ended the week 1.40% higher. France's CAC 40, which reached a record level earlier in the week, climbed 3.06%. Italy's FTSE MIB Index advanced 1.77%, and Germany's DAX Index added 1.14%. The U.K.'s FTSE 100 gained 1.55%, hitting an all-time high. European government bond yields headed toward recent multiyear highs due in part to hawkish comments from European Central Bank (ECB) policymakers.

Chinese equities fell for a third consecutive week as concerns over escalating geopolitical tensions with the U.S. hampered prospects of faster economic growth. The Shanghai Stock Exchange Index pulled back 1.12%. In Hong Kong, the benchmark Hang Seng Index declined by 2.22%. In recent months, Chinese authorities have rolled out several support measures for the struggling housing sector as it focuses on restoring economic growth in China. Economists now predict that the government will announce additional policies during or after the highly anticipated annual Parliament meeting, which starts in early March. Meanwhile, the People's Bank of China (PBOC) injected further liquidity into China's fiscal system via its one-year medium-term lending facility. The PBOC issued a statement pledging to offer precise measures to strengthen financial support for key areas and weak links in the economy, including steady loan growth, targeted housing credit policies to individual cities, and providing financial services to meet housing demand.

Outlook and Portfolio Construction

Some investors have become so optimistic that they have pivoted from debating about a "soft landing" to now a "no landing" scenario. In other words, the year-to-date recent stock market rally is foreshadowing that the economy will not only avoid a recession but keep growing. The bullish narrative includes the Fed pivoting later this year and cutting rates. However, we maintain a more sober view of the near term, where we monitor a mosaic of information, including the most inverted yield curve in decades, rising real yields, weakening corporate fundamentals, and a Fed committed to weakening the economy to tackle inflation.

In sum, we believe inflation will prove stickier with rates being "higher for longer" than many investors believe. Inflationary tailwinds include but are not limited to geopolitical concerns, energy/supply chain security initiatives and a tight labor market. In addition, we see deteriorating fundamentals and weakening outlooks shared by companies such as Walmart and Home Depot. With 80% of S&P500 companies reporting, it appears the Q4 earnings will be down year on year ~3% (~7% excluding energy).

Earnings beats vs. expectations are at a ten year low by some measures. US equities are trading near last summer's highs and above long-term average multiples despite weakening earnings. In essence, we believe markets are overpricing recent good news that we are past peak inflation and are complacent of risks.

Which asset classes have performed best when inflation is high (CPI above 3%) but falling? Value stocks have historically outperformed growth stocks, international stocks have outperformed US stocks, and small-cap stocks have outperformed large-cap stocks. We believe a quality portfolio focus with intentional equity holdings and suitable fixed income exposures is foundational to helping achieve long-term goals while staying invested in the short-term.

Disclosures

Investment Commentary Sources: Bloomberg and Morningstar

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