

February 6, 2023 – Investment Commentary

Macro Matters

Global equity markets generated strong performance in January 2023. In the U.S., the S&P 500 returned 6.3%, while the NASDAQ had its best start to the year with a 10.7% return. There is growing divergence between the hawkish policy outlooks of central banks and the dovish outlook being priced in the markets. The policymakers insist they will “stay the course.” The markets assume they will “pause and cut.” Last week's macro headlines were dominated by central banks as the Fed, ECB and BoE all had their latest meetings. All three central banks hiked rates in line with expectations.

Perhaps of greater importance for markets is that all three central banks signaled that rate decisions beyond the March meetings are likely to become more data dependent, suggesting we are getting very close to peak rates, with the FED Chair, Powell, not pushing back on markets pricing in rate cuts this year.

The market reaction was positive. In Europe, all major equity indices ended last week higher (Euro Stoxx 50 +1.9%, UK FTSE 100 +1.8%, German DAX +2.2%), while the yield on the 5yr and 10yr bund fell by 6bps and 5bps, respectively, to 2.20% and 2.19%. US equities ended the week on a softer tone as a strong payrolls report, including higher than expected weekly hours and hourly earnings. That said, the S&P still ended the week +1.6% higher. The S&P 500 (US Large Cap) and NASDAQ trade above their 20-year averages based on forward P/E ratios, while the Russell 2000 (US Small Cap) trades below, as does the MSCI EAFE (Non-US Developed Market Equities) and MSCI EM (Emerging Market Equities).

During January, fixed income asset classes continued their positive performance since the lows in the fall of last year as rates fell across the curve and spreads compressed. Municipals returned +2.7%, and investment grade corporates returned +4.0% in January. High yield bond spreads fell to their lowest level since May 2022 and returned 3.8%.

During the month of January, rates fell across the curve, and rate volatility fell though it remained elevated. The recession-watch 3month-10year spread fell 65bps and closed the month at -118, the lowest level since 2002, signaling a recession in coming months. The 2year-10year spread fell 14bps and is now -70, levels not seen since the early 1980s. Last week, 10yr Treasury yields rose about 15bps following the employment report to end the week around 2bp higher at 3.52%. The dollar fell 1.4%, continuing to come off its 20-year high. The commodities complex was flat. Brent was down slightly to \$84/bbl. Both US and European natural gas prices fell due to warmer than expected weather.

While various economic data indicate a slowdown, one critical metric remains robust. The job market has stayed surprisingly resilient, complicating the Fed's inflation-fighting efforts. Despite moderating inflation rates, we believe the extended period of elevated inflation combined with restrictive monetary policy ultimately will likely trigger a recession consistent with the 3month-10year yield curve inversion. But the depth and duration of the downturn remain uncertain, largely due to the long and variable lag associated with monetary policy's economic consequences.

Portfolio Construction

Even though an imminent recession may be unsettling, it's important to remember that thoughtfully constructed portfolios are generally designed for changing economic scenarios. Cash is a positive return strategy these days, and we believe while cash is a positive return strategy these days, it isn't a profitable one over the long-run. Timing the market is particularly challenging and often unrewarding. If we look back in time, consecutive negative calendar years for equity markets are historically rare. Since 1950, negative calendar years for the S&P 500 Index have been followed by a positive calendar year performance 80% of the time, with an average return of 15%. In addition, the third year of the presidential cycle has historically been the most robust, with an average return of 16.8% for the S&P 500 Index since 1950 and a positive return ratio of nearly 90%. A negative financial year, especially one as significant as 2022, is bound to take a bite out of investor confidence.

Recessions are normal — and unavoidable — components of economic cycles. We believe emphasizing quality and discipline in your investment portfolio remains a prudent strategy regardless of the economic backdrop. Given our current expectations, we believe generally focusing on higher-quality securities may help portfolios weather a recession. Additionally, our fixed income view remains incrementally extending duration which may offer value, as interest rates typically fall heading into a recession. Our equity views focus on companies with higher profitability and healthy balance sheets that may offer more resilience in an economic downturn and increasingly tilt more overseas

given the valuation levels and positive catalysts including a weaker dollar and China reopening. Additionally, companies in more defensive sectors and dividend-paying stocks, tend to offer value as economic conditions weaken. Finally, technology companies with dependable, secular earnings growth tend to outperform during economic downturns.

Disclosures

Investment Commentary Sources: Bloomberg and Morningstar

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