

## February 27, 2023 – Investment Commentary

### Macro Matters

A cascade of upside inflation and growth surprises pushed the S&P 500 Index to its worst weekly loss since early December. The index declined approximately 35% of the rally that began in October but is positive 3.4% for the year to date. The declines last week were widespread, and growth stocks fell only modestly more than value shares. Stocks fell sharply following worrisome signs that inflation might have reversed course and accelerated again as the year began. On Friday, the Commerce Department reported that its core (less food and energy) personal consumption expenditures (PCE) price index increased 0.6% in January, above expectations of an increase of 0.4% and its biggest rise since August.

According to CME Group data, futures markets began pricing in a roughly 27% chance of a half-point (0.50%) hike in the federal funds target rate at the upcoming March policy meeting, with approximately a 38% chance that the so-called terminal rate would reach a target range of 5.50% to 5.75% or higher. Likewise, expectations that the Fed would begin cutting rates in the fall dwindled considerably.

Last week's data sparked a sell-off in US Treasuries, with the yield on the benchmark 10-year US Treasury note nearing 4.00% for the first time since mid-November. Municipal bonds performed even worse for much of the week, despite a lack of new issuance. Investment-grade corporate bonds traded lower after some prominent retailers reported earnings and some concerns about the health of the US consumer gained traction. Rates rose across the yield curve. The recession-watch 3M-10Y spread compressed 12bps and closed the week at -89, a level last seen in 2002, signaling a recession in the coming months. The 2Y-10Y spread widened 7bps and is now -88; recent levels have not been seen since the early 1980s. Rates were higher in other developed markets as well. The BTP-Bund spread widened 5bps to 1.90%. 5-year and 10-year breakeven inflation expectations were up slightly and now sit at 2.57% and 2.38%, respectively; the 10Y real yield rose 12bps to 1.57%.

Shares in Europe fell as better-than-expected economic data and corporate earnings raised the prospect that central banks might persist with interest rate increases. However, the German economy shrank more than expected in the fourth quarter, spurring fears of a recession. In local currency terms, the pan-European STOXX Europe 600 Index ended 1.4% lower. Chinese stocks advanced after three weeks of losses as hopes for stepped-up regulatory support offset concerns about elevated US tensions. The Shanghai Stock Exchange Index gained 1.34%.

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).

### Outlook and Portfolio Construction

Inflation is trending lower, but the fight isn't over yet. Asia has generally seen milder inflation. Japan, for the first time in over 20 years, is experiencing inflation and positive real interest rates. The market is having a healthy debate on how quickly inflation will fall and whether it will get to the US Federal Reserve's (Fed's) 2% target.

Interest rates are near peaking. Investors disagree on how long the Fed will hold rates at the higher level. The implications for fixed income and equity investors are that the Fed is unlikely to provide a "Fed put" if the market has a correction.

Time to consider increasing fixed income allocation in public and private strategies. We believe there are certain risk adjusted opportunities in private credit to generate “equity like” returns for “debt like”<sup>\*</sup> risk. The average S&P stock market return for the last 20 years was 8.9%. Fixed income is now providing income again. Rates are near a peak, and 2023 may be a year of positive returns for fixed income. There’s a quality bias when leaning into fixed income. We believe investment grade and municipals in this environment of continued economic and earnings uncertainty provide ballast and income. However, because yields are higher, it doesn’t imply risk is lower. The recent shift from yield-scarcity to abundance is intriguing but one that needs to be approached carefully with both public and private credit strategies. The reason is that higher rates make the operating environment more difficult, putting more pressure on profit margins and balance sheets in a slowing economic environment.

#### *Disclosures*

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#### *Investment Commentary Sources: Bloomberg and Morningstar*

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