

April 24, 2023 – Investment Commentary

Bull vs. Bear

Last week, stocks performance was mixed, and bonds were down. The S&P 500 changed by less than 1% for the third straight week as bulls and bears struggled with current valuation multiples in the context of top-down macro and bottom-up fundamental challenges. The MSCI EAFE (non US developed) outperformed the S&P 500 and MSCI Emerging Markets indices. As for fixed income, the 10 year treasury yield rose 5 bps on the week to 3.57% and the 2/10 treasury yield spread inverted further to -60 bps. High yield bond spreads rose to 448 bps but are still below their 20-year average of roughly 500 bps, indicating little concern regarding an economic and earnings slowdown. The bond market is placing nearly 90% odds that Fed will raise rates again 0.25% to start May, then pause through November, where they cut 0.25%, and then again in December. As of last week, ~18% of the S&P 500 companies reported during Q1 earnings season, confirming the large banks benefited from the recent bank turmoil, however big tech and smaller banks will report over the next two weeks. The forward P/E on the S&P 500 last week was up on the week to 18.2x above long-term averages, where large cap growth forward P/E is 24x and both are above their long-term averages. These valuation multiples are consistent over time with positive mid-teens earnings growth expectations rather than consensus market expectations of flat year-over-year earnings growth.

European government bond yields edged higher as investors weighed the prospect of another interest rate hike from the European Central Bank (ECB) in May. Yields on 10-year German government debt climbed toward 2.5%, while yields on French sovereign bonds of the same maturity also ticked higher. In the UK, yields also rose on benchmark 10-year debt on strong inflation and wages data and expectations that rising rates will continue to tackle inflation. Generally speaking, the economic news coming from the Euro area and China has been stable to improving.

The US equity market bull case is predicated on a view of a soft landing, mild economic slowdown, easing banking sector stress and encouraging Q1 earning reports and guidance. The bear case focuses on the Fed's commitment to tackle inflation at the expense of growth, bank lending credit contraction, potential commercial real estate credit concerns, company margin compression and valuations with little margin of safety. Recession risks are signaled by various metrics, including an inverted yield curve, twelve consecutive falling months of the Leading Economic Indicator (LEI) and decreasing liquidity as measured by M2 money supply of approximately 5% year on year. If we look back in history, stock markets often bottom before the end of a recession but never before the beginning of a recession.

Portfolio Positioning

We maintain a defensive positioning favoring high-quality equities, fixed income and cash equivalents. We are underweight credit risk, and within equities, incorporate a balance of companies that are more attractively valued with both growth and defensive factors measured by low balance sheet leverage and lower exposure to economic risk.

Disclosures

Investment Commentary Sources: Bloomberg

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