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May 1, 2023 – Investment Commentary

Market Movements

The economy continues to look weak in many segments: the consumer and manufacturing is weakening, the banking industry is under stress, transport is experiencing a freight recession, and corporate IT spend is slowing and commodities are declining. The weakness is helping to slow inflation, but inflation still isn't low. McDonald's, for instance, still sees high single-digit inflation in 2023. The market widely expects the Fed to raise rates 25bps in May, and then has 1-3 cuts priced in by year end. The peak rate for this cycle is expected to be 5.25%, with a target rate of 4.5%-5.0% by year end. Last week, U.S. Treasury yields modestly decreased (price up; yield down) amid volatility ahead of the following week's Federal Reserve policy meeting. Concerns increased about the approaching debt ceiling date and negotiations for raising it. Investment grade fixed income sectors all had positive returns as rates fell. Municipals returned -0.1% and US IG returned 0.9%. High yield bonds returned 0.5% while bank loans were up 0.1%. Emerging market debt returned +0.4% as the US dollar fell. Credit spreads were slightly wider across fixed income although still largely consistent with long term averages.

The recession-watch 3month-10year spread widened 12bps and closed the week at -166, a level last seen in 2002, signaling recession in coming months. The 2year-10year spread contracted 3bps and is now -58. Rates fell modestly in other developed markets. The Italian sovereign BTP-German Bund spread was flat at 1.87% (below previously peaked stressed levels). The 5-year and 10-year breakeven inflation expectations fell slightly and now sit at 2.25% and 2.21% respectively.

US equities returned 0.9% for the week as better than expected earnings outweighed concerns of the path of interest rates, inflation and the economy. Growth and value returns were mixed by market cap. Sector performance for the S&P 500 was led by communication services (+3.8%) and information technology (+2.4%) while utilities (-0.9%) and industrials (-0.6%) were the worst performers. The non-US developed markets were flat. EM returned -0.3% gain, led by India (+2.9%) while China (-1.4%) lagged.

From a valuation perspective, the S&P 500 (US Large Cap) and NASDAQ trade above their 20-year averages based on forward P/E ratios, while the Russell Midcap (US Midcap) and Russell 2000 (US Small Cap) trade below, as do the MSCI EAFE (Non-US Developed Market Equities) and MSCI EM (Emerging Market Equities).

The dollar fell 0.2% while the commodities complex fell 1.5% driven by energy prices (-1.7%) and industrial metals (-1.8%) on the back of concerns about a global economic slowdown.

Volatility was flat for equities and bonds (VIX equity "fear gauge" is16 consistent with long term averages, while the MOVE bond volatility is 122 which is below the 180 peak in March2023 but well above the pre covid levels range of 50-60). Market sentiment fell slightly indicating that investors remain slightly bearish given the uncertain environment. The FRA-OIS spread (widely seen as a proxy for bank sector stress) rose 3bps to 30, off its March peak at 60.

Last Thursday, four stocks—Microsoft, Apple, Amazon.com, and Meta—accounted for nearly half of the S&P 500's strong gain (the biggest since January 6). Cyclical sectors generally performed poorly, however, as investors weighed several new signs of an economic slowdown, particularly in the manufacturing sector. Investors also seemed worried by a negative outlook for shipping volumes from United Parcel Service, which declined 10% Tuesday on the earning announcement news.

Shares in Europe fell as fears that interest rate increases might tip the economy into recession intensified. In local currency terms, the pan-European STOXX Europe 600 Index ended 0.5% lower. Major stock indexes were mixed to lower. China's Politburo, the country's top decision-making body, vowed to continue its "forceful" fiscal and monetary policy stance to support the economy as it faces obstacles in economic transformation and insufficient domestic demand,

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So now what…

The S&P500's appreciation has been driven by 10 stocks which account for approximately 90% of the year-to-date increase. The tailwind is supported in part by lower interest rates later in 2023 which should support expanding valuation multiples. We construct portfolios with a range of possible macro-economic outcomes. These scenarios include varying degrees of risks including stagflation, deteriorating earnings growth and the pending debt ceiling debate (we believe it will ultimately be resolved but create substantial volatility). As a result, we are supportive of growth equities and quality income opportunities in dividend growth stocks, investment grade bonds and private credit.