ROBERTSON STEPHENS®

May 15, 2023 – Investment Commentary

Market Movements

Last week, stocks and bonds were down on the week. The S&P 500 outperformed MSCI EAFE (Non-US developed) and MSCI Emerging Market indices. Across U.S. Russell style & market cap indices, large-cap growth did the best, and the quality factor led more broadly. As for fixed income, the 10 year treasury yield rose 2 bp on the week to 3.46% and the 2/10 treasury yield spread inverted further to -52 bps, indicating a pending recession. The best performing parts of the bond market included municipals. Municipal credit remains strong, with historic levels of revenue collections and rainy day funds. Attractive spreads plus sound credit conditions offer an appealing entry point. We expect municipal defaults to remain low. High yield bond spreads were flat on the week at 471 bps but are still below their 20-year average of roughly 500 bps.

Approximately 90% of the S&P 500 reported Q1 EPS, which fell by 3% year on year in 1Q 2023 vs. 1Q 2022 actual earnings, versus consensus estimates for -7% growth at the start of reporting season. In sum, while the companies performed better than research expectations, the reality suggests we are at the beginning of a modest “earnings recession”.

Typically, companies revise their guidance downward in the second half of each calendar year and we believe the pressures of a tight labor market and higher interest expenses will continue to pressure profit margins. Risks to the profit outlook are skewed to the downside, given the uncertainty around banking sector stress (regulation, commercial real estate, economic slowdown). We are closely monitoring real yields that if they continue to rise will compress the S&P 500 forward P/E multiple from 18x to its long term average of 16x.

Inflation, Interest Rates, and Investments (The I’s Have it)

U.S. core CPI came in at +0.40% month-over-month (annualized 5%) and +5.5% year-over-year. Headline CPI came in at +0.40% month-over-month (annualized 5%) and +4.9% year-over-year. We believe the month-over-month trends are more relevant than year-over-year indicators of “sticky inflation” where the absence of any recent declines in CPI or PPI suggest the Fed will need to keep rates “higher for longer.” The bond market mostly took the recent inflation prints in stride, still placing an 85% probability of no hike in June and for them to hold until September and then the bond market is pricing in three 0.25% rate cuts into the fourth quarter. Treasury yields keep hitting formidable support in the 3.30% to 3.40% for the 10 year yield. In our view, treasury yields are probably tilted to the downside as the year goes on and the economy continues to decelerate. As a result, we continue to prefer intermediate higher quality investment grade corporate bonds, agency MBS, municipal bonds and selective private credit across fixed income.

We believe that while valuations are a very poor market timing tool over the short term, they do contain valuable information for longer-term return forecasts. Today’s high valuations may portend a period of average returns for most U.S. equities. On the flip side, with a potentially weakening dollar plus current valuations outside the U.S. attractive from a historical perspective there is attractive risk adjusted opportunity abroad. Finally, while we believe the debt ceiling will likely be resolved in the near term with a “kick the can solution,” we advise clients to ensure appropriate levels of liquidity are held in portfolios as a buffer against any market volatility.

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