

May 30, 2023 – Investment Commentary

Market Observations

Last week, stocks were mixed, and bonds were down on the week. The S&P 500 outperformed MSCI Emerging Markets and MSCI EAFE non-US developed indices. The best performing sectors in the S&P 500 were technology, communications, and consumer discretionary. Across U.S. style & market cap indices, large-cap growth did the best, and the quality factor led more broadly. Once the debt ceiling negotiations are settled, investors can revisit focusing on recession risks, margin compression and possibly more Fed tightening. The markets put the odds of a 25bps interest rate increase at 63.1% for the Federal Reserve's June 14 Meeting. That is up from 28.1% on May 23 in part due to the anticipated debt ceiling resolution. Stocks will close out the month today. The Dow is on track for its worst month since February, while the S&P500 and Nasdaq are both on pace to rise for the third-straight month.

As for fixed income, the 10-year treasury yield rose 11 bps on the week to 3.80% and the 2 year – 10 year treasury yield spread inverted meaningfully to -76 bps, indicating a pending recession. Last week, the best performing parts of the bond market included high yield. High yield bond spreads were down on the week to 446 bps, well below their 20-year average of roughly 500 bps. Although high yield spreads at 446 bps are above levels in February of 400bps and 300bps in 2021, HY is still relatively expensive to long-term history, especially with the threat of a pending economic slowdown. The high-quality bond market today measured by the U.S. Aggregate Bond index is now yielding 4.8%, mortgage back securities (MBS) 4.9%, and investment grade corporates are yielding 5.5%. High yield does beat the high-quality bond market with a yield today of 8.9%, but we would not chase credit risk at this point in the economic cycle.

We continue to believe the lagged impact of Fed tightening, and continued relative credit availability tightness, will be the biggest macroeconomic drivers from here.

What Caught Our Attention

Artificial intelligence (A.I.) continues to be a meaningful market driver, Germany fell into a technical recession, and a debt ceiling deal is likely to be achieved before June 5th "X" date. Of the S&P 500 ~10% return year-to-date, tech is now making up 80% of the gain. Valuations appear broadly elevated vs. history in the absence of meaningful top line organic growth. However, many large cap tech companies demonstrate quality characteristics of low financial leverage (net cash), high returns on equity, and resilient earnings. We continue to prefer the quality factor for a late cycle environment and that leads us to maintain exposure to certain U.S. large cap equity exposures.

German Q1 GDP came in at -0.30% after -0.54% in the prior quarter. This fits the old customary two negative quarters of GDP definition of a recession. The MSCI Germany equity index is still outperforming the S&P 500 year-to-date up +15% in USD. As for the Eurozone overall, the May preliminary PMIs suggest economic activity is still fine, but slowing. The MSCI Europe equity index is still outperforming the S&P 500 year to date, even with a massive sector drag of being significantly underweight technology. The way Europe is outperforming is that their stocks in the health care, financials, and industrials sectors are outperforming their U.S. counterparts.

Details of a debt ceiling agreement are still to come on certain parts of the deal, but several key points: cap government spending over the next 2 years, claw back certain unused COVID funds, reduce IRS funding, restart student loan payments, limit the ability to raise taxes, and certain energy permitting reform. Initial indications are that the deal will cut government spending by 0.2% of U.S. GDP or about \$50 billion. In a big picture perspective, the "deal" does not do much in terms of the broader economy but does remove a macroeconomic tail risk of a self-inflicted default for now.

Bull vs Bear

The bullish narrative focuses on soft-landing expectations supported by a still strong labor market, better earnings/guidance trends from first quarter reports, easing regional banking stress, housing market stability and overly depressed sentiment positioning.

The bearish narrative revolves around Fed pivot (cut) skepticism, sticky inflation, lagged and unknown variable effects of aggressive Fed tightening, inverted yield curve recession signals, declining money supply, tightening lending standards, concentrated market performance, market liquidity concerns and geopolitical tensions.

We remain cautious with intentional high-quality holdings in both equities and fixed income and deliberate allocations to alternative managers who are well positioned to benefit from market volatility, security mispricing, and capture durable income.

Disclosures

Investment Commentary Sources: Bloomberg

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