

May 8, 2023 – Investment Commentary

2 Games of Chicken

Fed vs. Market. The Fed raised interest rates last week, but it looks like this may be the last consecutive rate increase of this cycle. They still see inflation as too high and labor markets as very strong, but they recognize that rate increases are leading to tightening demand in the most interest rate-sensitive sectors. They do not seem to think that they will be lowering rates soon, although the market has a different outlook. Last week, rates fell at the short end but rose at the long end. The recession-watch 3month-10year spread widened 14bps and closed the week at -180, its lowest level since 2002, signaling recession. The market expects 2-3 cuts from the Fed by year end. The peak rate for this cycle is expected to be 5.25%, with a target rate of 4.25%-4.75% by year end.

The Nasdaq Composite is up 20% from a Dec. 28 low. The gains were helped by the anticipated Fed's pause and cuts, so anything that interferes with that thesis such as sticky inflation -- could be a surprise to the market. Additionally, a Fed rate cut may be a reactive move by the Fed due to concerns about a hard landing scenario. The S&P 500 is trading toward the high end of its twelve-month trading range at 20x+ trailing earnings and over 18x+ forward earnings above its 20 year long term average while inflation is above 4% and earnings are still declining year on year.

This is the second quarter in a row with S&P500 year-over-year earnings declines and the third quarter in a row with lower quarterly earnings as the S&P500 quarterly earnings peaked in Q2 2022. The sell side research analyst is forecasting for the back half of 2023 positive earnings growth to resume after what could be three quarters of year-over-year declines. In the face of tightening bank credit standards, lagged and variable effects of a 500bps increase in Fed rates and potentially sticky inflation market P/E multiples do not provide any substantial margin of safety.

From a credit perspective, high yield ("junk") bond spreads rose last week to 471 bps but are still below their 20-year average of approximately 500bps suggesting a base case "soft landing" macro scenario. Finally, commodities are trading down in anticipation of an economic slowdown where oil prices are struggling to hold onto early April gains generated by the surprise OPEC+ announced supply cuts.

Debt Ceiling. The political standoff associated with the possibility of millions of people not receiving their checks from their social security, Medicare and other federal government checks will likely force a base case "kick the can" solution for a few quarters. However, the 2023 politics appear to be more challenging than years past, as evidenced by the challenges House Speaker McCarthy endured to win his leadership role. We anticipate this will cause more volatility combined with the cocktail of other matters described above. However, we find the disparity between the equity market and bond market volatility of interest where equity volatility (VIX index) is at its lowest level since before the Fed began its hiking initiative while bond volatility (MOVE index) is meaningfully higher than its long-term averages.

Portfolio Construction

We believe the valuation set up for stocks outside the U.S. are attractive with the added benefit of a potentially weakening dollar. We remain cautious with selective quality growth and value equity allocations and support high quality fixed income for ballast and income.

Disclosures

Investment Commentary Sources: Bloomberg

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