

June 12, 2023 – Investment Commentary

Market Moves

Last week, stocks were up and bonds down. The MSCI Emerging Markets index outperformed the MSCI EAFE (Non-US Developed) and S&P 500. The best-performing sectors in the S&P 500 were consumer discretionary, utilities, and energy. Across U.S. style & market cap indices, small-cap value did the best, and the value factor led more broadly.

As for fixed income, the 10 yr. Treasury yield rose five bps on the week to 3.74%, and the 2-year – 10-year treasury yield spread inverted further to -88 bps, indicating an economic slowdown. However, the recession-watch 3month-10year spread compressed 18bps and closed the week at -152, signaling recession. Last week, the high-yield market returned +0.3%. High-yield bond spreads were down on the week to 416 bps, well below their 20-year average of roughly 500 bps, indicating little concern about the consequences of any potential economic slowdown.

Fasten Your Seatbelts – Macro Cross Currents (Mixed Signals)

This will be an active week in the world of macro-economic data. It could also be another bumpy ride in the financial markets.

Fed Meeting. Scheduled for June 14th, the Fed is expected to pause rate increases during its June FOMC Meeting after ten consecutive hikes. However, the Fed may also communicate that it is not done hiking rates. The market now expects the year-end Fed Funds rate to be at current levels, with equal probabilities of ending 25bps higher or lower. The peak rate for this cycle is expected to be 5.5%, with a target rate of 5.0%-5.25% by year-end. It's worth remembering that while "holding" is not "hiking," the consequence is still a tightening of financial conditions, especially in the context of a shrinking balance (quantitative tightening QT) and decreasing bank lending activity.

ECB Meeting. The European Central Bank council meetings on June 15th, with another 25bps rate hike expected. The ECB seems committed to hiking rates; however, the variable effects of past hikes are beginning to slow the European economy.

U.S. CPI, PPI, and Retail Sales. June 13th, the Consumer Price Index (CPI) is expected to decrease to 4.2% year-over-year in May. It is important to note that this expected decline is the result of base effects (year-over-year comparisons) rather than a decline in incoming inflation (sticky month-over-month comparisons) and should not necessarily be extrapolated into the future. In other words, it is easier to drop inflation from its peak of 9% last year to ~ 4.5% this year, but the journey to the Fed's 2% target by year-end may prove more difficult. June 14th, the Producer Price Index (PPI) is expected to decrease to 1.5% year-over-year in May. June 15th retail sales are expected to decrease to 0.0% month-over-month change in May. Several key recession indicators have improved in recent weeks, suggesting that the risk of a near-term recession has decreased. Initial Jobless Claims—which typically rise significantly preceding a recession—remain well below historical levels, although the data is typically volatile. Yield curve futures imply an inverted curve through April 2025, a full 12 months later than just five weeks ago. On average, the yield curve un-inverts at a recession's onset. All else equal, a decrease in economic tail risk supports higher stock multiples.

Are there Green Shoots?

The S&P 500 recently increased 20% from its lows achieved in October 2022.

Historically speaking, crossing that threshold is not predictive of a continuing bull market. While the S&P 500 is up ~13% so far in 2023, the equal-weight index, which assigns each company the same index weight of 0.2%,

has increased by 3%. The equal-weight index has yet to recover to its levels before the collapse of Silicon Valley Bank.

There are two ways of looking at it. The bull case approach says the broader market can start making substantial gains where mid and small-cap stocks and European equities are trading well below long-term valuation averages and relative to the large-cap index. James Gorman, the outbound CEO of Morgan Stanley, said at a conference sponsored by the bank on Monday that they are seeing more "green shoots" in the investment banking business now that there is starting to be a clearer picture on the Fed. Finally, the U.S. IPO market declined dramatically in 2022.

However, there have been a few recent IPOs suggesting the capital market's "risk on" posture is gaining momentum.

On the other hand, the concentration of several strong stocks demonstrates a lack of conviction when it comes to the majority of the market and leaves it exposed if tech sentiment changes based on elevated near-term valuations and weakening fundamentals.

The next few days of inflation data, followed by the Federal Reserve's latest rate decision and commentary, will provide more near-term tests for the long-term growth objective of equity markets.

Disclosures

Investment Commentary Sources: Bloomberg

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