

## June 5, 2023 – Investment Commentary

### Markets

Last week, the S&P 500 Index touched its highest intraday level since mid-August 2022. The technology-heavy Nasdaq Composite Index generated its sixth consecutive weekly gain and hit its highest level since mid-April 2022. In contrast with the past several weeks, however, the rally was broad-based, with strong gains in both value and growth stocks, and small-caps outperformed large cap stocks. As for fixed income, the 10 yr. Treasury yield fell 11 bps on the week to 3.69%, and the 2-year – 10-year treasury yield spread inverted further to -82 bps, indicating a pending recession.

During the month of May, equity gains focused on large-cap U.S. growth companies. However, the average stock was down for the month, as were international equities. The 10 largest stocks in the S&P500 rallied an average of +9.1% in May, while the other 490 stocks fell an average of -4.1%. The VIX Index (“fear gauge”), a measure of stock market volatility, continued to be subdued in May. After closing April at 15.78 – a 52-week low – the VIX ticked lower to start May before closing the month at 17.94 below the long-term average of ~20-22. The yield on the 10-year U.S. Treasury closed April at 3.44%, but it ended May higher at 3.64%. The yield had risen to over 3.8% in late May before declining rather sharply over the last few days of the month. Rising rates put bond returns under pressure in May. Although bonds declined for the month, most fixed income sectors remained positive year to date. The job market remained resilient as the unemployment rate dropped to 3.4%, matching the lowest level since 1969. However, manufacturing continued to contract, and while the service sector grew, the pace of growth slowed for the last two months.

### What Caught Our Attention: Mixed News

Data suggests the U.S. economy is certainly slowing down, but it does not tell us a severe recession is imminent. Having benefited during the pandemic, manufacturing sectors are weak while the services sectors are strong. The strong jobs market has helped the U.S. dollar strengthen and helped the equity market generate some broader participation amongst small and mid-cap stocks. Last Friday’s strong nonfarm payrolls report surprised on the upside, but the details in the report seemed to suggest that the labor market might be cooling. Employers added 339,000 jobs in May, well above consensus expectations for around 190,000. But the unemployment rate—estimated by surveys of households—also surprised by rising to 3.7% from 3.4%. Suggesting a more difficult job market for workers, the Labor Department reported that the number of people losing jobs or completing temporary jobs jumped significantly in May and reached its highest level since February 2022. The fixed income inverted yield curve(s) suggests a recession is pending. However, credit spreads for various asset classes are trading largely below or in line with longer term averages, which suggests investors are not concerned about an economic slowdown.

Headline inflation in the eurozone slowed to an annual 6.1% in May from 7.0% in April. The core rate—which excludes volatile food and fuel prices—came in at 5.3%, which was also an improvement from the prior month and below expectations.

New home sales by China’s top 100 developers rose 6.7% in May from a year earlier, down from gains of more than 29% in the previous two months. The latest data from the China Real Estate Information Corp. was further evidence of China’s slowing post-pandemic recovery even after the central and local governments rolled out an array of stimulus measures at the end of 2022 to support the country’s property sector.

### So what...

We believe monetary policy (the Fed) is going to continue to play a role in fighting sticky inflation with the debt ceiling issue temporarily behind us, but subsequently stimulating growth when we do eventually fall into a recession. This suggests higher for longer interest rates now while inflation is still the issue, but interest rates will need to drop when the unemployment rate meaningfully rises.

The S&P 500 is now only down approximately 9% from all-time highs, the MSCI All Country World Index is down approximately 10% from all-time highs, the VIX is near its lowest since before COVID, and high yield spreads are tight. The bond market is pricing in a skip from the Fed in June, followed by a hike in July, and then hold until one cut in November. Not that long ago, there were no rate hikes priced in, but three cuts to end the year. In sum, the markets are indecisive and highly dependent upon recent data. We do not believe recession risk is behind us. Even though the S&P 500 is moving higher, the market cap equal-weighted S&P 500 index is down year to date. Copper prices and most other commodities have fallen year to date. We believe this is a signal that cyclical stocks are likely to underperform defensives. We remain cautious as we anticipate a slowing economy, profit margin compression and valuation multiple pressure in certain sectors.

### Disclosures

*Investment Commentary Sources: Bloomberg*

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