

July 10, 2023 – Investment Commentary

Market Conundrum

Last week, stocks and bonds were down. The MSCI Emerging Markets index outperformed the MSCI EAFE and S&P 500. Across U.S. style & market cap indices, mid cap value did the best, and the smaller size factor led more broadly. Last year while the S&P 500 lost over -18%. Even with the strong AI gains this year, the S&P 500 index needs to gain about 6% to break even from what it lost last year. Year to date U.S. equity returns were driven nearly 100% by higher valuation multiples and less by earnings growth. Some investors may argue the higher valuations are anticipating the end of the Fed's rate hiking cycle, even though the bond market doesn't seem to agree, given recent rise in yields.

As for fixed income, the 10 year treasury yield rose 24 bps on the week to 4.05% and the 2 year – 10 year Treasury yield spread steepened to -89 bps. The best performing parts of the bond market were municipals. High yield bond spreads were up on the week to 397 bps well below their 20-year average of roughly 500 bps.

What has been a conundrum for markets is that equities continue to rally on any sign of disinflationary readings with longer duration growth/quality doing the best, but the bond market has another take, suggesting inflation is not falling fast enough causing treasury yields to rise (price down/yield up). Eventually, we will see which wins out, but in time our view is that treasury yields will likely fall based on disinflationary pressures and decelerating global growth. We continue to believe the economic environment is likely to feel the lagged effects of tightening in the months to come. Over the course of the last week, the 30-year mortgage rate hit 7.22% a new high level in 2023 and close to the 2022 high of 7.37%. While the housing market is still showing resilience, eventually the toll of higher interest rates is likely to help moderate housing prices combined with increased unemployment causing further disinflation (lower inflation). We believe higher quality bonds and defensive equity sectors would be beneficiaries if the global economy decelerates further.

What We Are Noticing

Global manufacturing slowdown in June. Global business surveys showing a slowdown seemed to impact markets differently this past week. European equities were lower on Eurozone economic weakness, materials were one of the worst performing S&P 500 sectors and defensives did better.

The US labor market looks resilient. Key employment/economic reports were released last week, and interest rates rose to peak levels on the back of labor market strength reported by the private sector ADP that seems in conflict with the Fed's lower inflation target. 30-Year Treasury yields rose Friday near the 4% area for the fourth time this year, indicating inflation may not be as tame as expected. The 2-year US Treasury yield reached an intraday peak of 5.11% - the highest level since 2008. However, the government's payroll figures pointed below expectations sending the 2-year yield toward 4.9%.

The market expects the Fed to raise rates another 25bps on July 26th and possibly again on September 20th as they attempt to reduce the inflation. If rates keep rising above the 4% threshold, stocks and bonds could get hurt. If rates decline as they have four times already this year, stocks and bonds could set up for another leg higher. The market looks ahead and could be seeing an end to the Fed's rate-raising campaign, which could be good for growth stocks. The Fed raised rates consistently last year, and the market believes they are near the end. The CPI data to be released Wednesday will be the last material economic data before the Fed's next meeting July 25th.

The Fed decreased its balance sheet by another \$42 billion last week, fighting inflation by draining liquidity. The Fed expanded its balance sheet to over \$9 trillion on 4/18/22 by printing money to fight COVID. The more the Fed reduces liquidity and bank credit contracts the harder it is for the economy and earnings to grow.

Earnings season begins this coming week with big U.S. banks reporting. The Investment Office will be focused on several themes including but not limited to the impact on rising interest rates on deposit outflows, residual impact on the regional bank crisis and how big banks may continue to benefit, consumer metrics (credit card balances, delinquencies), commercial real estate developments and potential regulatory restrictions. We believe the key near term driver for the stock market will come more from company guidance than recent performance compared with weaker analyst earnings expectations.

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