

July 3, 2023 – Investment Commentary

Market Movements

Last week, stocks were up and bonds down. The S&P 500 outperformed the MSCI EAFE (non-US developed) and MSCI Emerging Markets indices. The best performing sectors in the S&P 500 were REITS, energy, and materials. Across U.S. style & market cap indices, mid cap value did the best, and the smaller size factor led more broadly.

As for fixed income, the 10 year treasury yield rose 7 bps on the week to 3.81% and the 2/10 treasury yield spread inverted further to -106 bps. The best performing parts of the bond market were high yield, and bank loans. High yield bond spreads were down on the week, further compressing to 390 bps which is well below their 20-year average of roughly 500 bps.

3 of a Kind = Hawkish

1. U.S. initial jobless claims (unemployment insurance filings) declined,
2. Q1 GDP revised up and
3. U.S. Fed Chair Powell's statements are incrementally more hawkish.

Economic data last week was relatively positive, with the biggest improvement found in initial jobless claims falling back down 26k to 239k from 265k last month. The Investment Office continues to watch this data point closely as the labor market is the strongest pillar of the consumer led U.S. economy. The U.S. jobs report will be released Friday. On the third revision, nearly 3 months after the close of Q1, U.S. GDP was revised up from +1.3% to +2.0%, with consumer spending a significant driver. The massive fiscal stimulus boost of 2020/2021 helped support outsized GDP growth of more than 5%, that is now normalizing to approximately +2.0%. Over the last economic cycle of 2010-2019 real quarterly GDP averaged +2.2%.

Last week, Powell said he would not take two consecutive rate hikes off the table as a possibility. The bond market is now pricing in an 87% chance of a rate hike in July, and then a hold through March of 2024 when the market is suggesting the first cut. The U.S. dollar (DXY index) was on track to be up nearly +0.8% on the week before Friday's small improvement on PCE caused it to fall. The U.S. dollar is now down only -0.6% on a year-to-date basis after being up as much as +2.0% and down as much as -2.6%. While we see the U.S. dollar as not having as big of a move this year as last year, where at one point it was up +18.9% before ending the year +7.9%. The dollar's continued strength will be challenged as the U.S. Fed approaches its terminal rate and other countries continue to raise rates and exhibit resilient growth.

What Happened to Bonds

While "quality" was a key element for equities strength year to date, the fixed income markets had a different view on its importance. Over Q2, bank loans, emerging market debt (EMD), and high yield were the top performing parts of the bond market. Interesting because bank loans have one of the lowest durations across the bond market and EMD has the longest, but what they had in common is spread/credit risk that was looked at favorably in the quarter. During Q2 2023, within corporate bonds, AAA corporates were the worst performers down -1.0%, while the lowest quality CCC were +4.2%. High yield bonds spreads dropped nearly 65 bps on the quarter, with all of it really coming in June (with CCC "junk" spreads dropping the most implying "risk on"). Duration risk was more prevalent than credit risk over the quarter as the 10 yr. treasury yield rose 32 bps from 3.49% to 3.81%. Interestingly, the 10 year treasury yield is near where it started the year when it was 3.88%. The returns from the bond market year-to-date have been nearly completely driven from yield/income at +2.0%, we still have another half year of yield/income still to come. We will see where the 10 year yield ends the year, but for now we still believe in a choppy range bound environment before it eventually falls. In the meantime, the income/yield is likely to provide mid-single digit annual contribution to returns. Finally, the Investment Office is closely monitoring the potential macro liquidity risk associated with the Treasury replenishing its cash reserves (Treasury General Account – TGA) over the next 12 months where a principal concern is that the government will need to offer higher rates to entice investors like money market funds to purchase the new government debt, forcing banks to increase the amount they pay on deposits to avoid a deposit outflow.

Portfolio Considerations: Keep Volatility in Perspective

The Investment Office is focused on deliberate equity and bond allocations that emphasize quality. There are many interpretations of "quality," but for us it is companies with better balance sheets, higher return on equity (ROE)/profitability, and resilient earnings in the face of a slowing macro environment. As the quality factor has been in vogue, not surprisingly

U.S. large-cap stocks are of the best performers globally and technology stocks are leading all sector returns within the S&P500. We like the quality factor in a late cycle environment but recognize it has been a strong performer year to date. We continue to look to U.S. mid-caps as a compliment, given their cheaper valuations and quality growth opportunities.

Although volatility is an inevitable part of the investing journey, it's worth keeping it in perspective and not lose sight of your near term and long-term goals. As a result of spiraling inflation and interest-rate hikes by the Federal Reserve, volatility in the S&P 500 Index in 2022 was more than double the 10-year historical average from 2012-2021. Remarkably, 47% of trading days in 2022 had swings of + or - 1%—the highest level since 2009. We believe while investing in the stock market has its ups and downs, the longer an investor stays invested, the less significant those bumps in the road may appear. Historically, the longer an investor has held stocks (as represented by the S&P 500 Index), the greater the potential for an overall positive return.

- One-Year Holding Periods (Jan. 1, 1937–Dec. 31, 2022)- Stocks were up 76% of the time - 65 up periods, 21 down
- Five-Year Holding Periods (Jan. 1, 1937-Dec. 31, 2022). Stocks were up 90% of the time—74 up periods, 8 down
- Ten-Year Holding Periods (Jan. 1, 1937-Dec. 31, 2022). Stocks were up 97% of the time—75 up periods, 2 down

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