

## July 31, 2023 – Investment Commentary

### Market Movements

Last week, stocks were up and bonds were down. The MSCI Emerging Markets index outperformed the MSCI EAFE and S&P 500 indices. Mega caps led gains in the equities market, driving the S&P 500 Index up 1% and marking its third consecutive weekly advance. The large-cap equity index is now within 2% of its all-time high from 2022. One of the big drivers in market activity last week was the Federal Reserve's decision to reignite their rate hike cycle, implementing a 25-basis point rate hike and bringing rates to their highest levels in 22 years. While the Fed remains data-dependent, investors are anticipating a 50% probability of one last rate hike. Two-Year Treasury Yields, which are highly sensitive to changes in monetary policy, dropped five basis points to 4.87%. Fed Chair Jerome Powell said his staff had ditched the recession forecast it put in place in March, when banking turmoil had raised fears about a potential credit crunch. In the second quarter, U.S. GDP gained momentum, indicating a resilient economy. Additionally, the easing of the Personal Consumption Expenditure Deflator Index, the Fed's preferred measure of inflation, to 3% adds to the positive outlook. International equities gained as the European Central Bank raised interest rates by another quarter-point, and President Christine Lagarde expressed an "open mind" on future actions. The Bank of Japan's discussions on letting its 10-Year Yield rise beyond its 0.5% cap affected markets, leading to fluctuations in rates and stock performances.

Last week, the 10 year treasury yield rose 12 bps on the week to 3.97% and the 2 year – 10 year treasury yield spread remained deeply inverted at -92 bps. As of 7/26/2023, this spread has been inverted for an unprecedented 264 trade days, representing the most pronounced and prolonged inversion since 1980. The best performing parts of the fixed income market included high yield bonds. High yield bond spreads were down on the week to 371 bps, well below their 20-year average of roughly 500 bps indicating a strong belief in the "soft landing" scenario.

### What Caught Our Attention

China pledged stimulus, other central banks tighten, "goldilocks" U.S. economic data, earnings season and guidance seeing decent results.

The week began with news that Chinese leaders promised to step up support for the economy, signaling more "counter-cyclical policy." While light on details, the report raised expectations that policymakers in China will keep cutting interest rates and loosen property policies. Chinese equities rallied nearly ~7% last week on the headlines, helping emerging market stocks outpace other global equity markets.

In an opposite move, central banks in the U.S., Japan, and Europe all tightened monetary policy last week. The Fed and the ECB raised rates by 25 bps, as expected, offering little forward guidance regarding their next meetings in September. Meanwhile, the Bank of Japan surprised markets by loosening yield curve control (a policy designed to keep rates near zero to stimulate the economy). Central bankers globally are now contending with a tough combination of still-elevated inflation and slowing growth. In our view, the U.S. economy is in the strongest position to weather higher rates in the near term given the resilience of the labor market and clearer signs of disinflation.

The U.S. economic data last week contributed to that narrative. June core PCE inflation came in at +0.2% month-over-month, down from May and up +4.1% year-over-year (the softest reading since September 2021). July's consumer confidence report printed at its highest headline level since mid-2021 with respondents increasingly optimistic about the labor market. Meanwhile, Q2 GDP came in at a 2.4%, ahead of the 1.5% consensus, in part reflecting robust consumer spending. Durable goods also beat. One of the few misses last

week was in the June new home sales report (although the trend remains strong).

Finally, Q2 earnings season rolled on last week, with just over half of S&P 500 companies now having reported. Reported earnings growth now stands at -1.1% year-over-year.

### Portfolio Considerations

Even with the persistently inverted yield curve, the expected recession has yet to materialize. While historical patterns can offer valuable insights, they are not definitive predictions of the future but part of a mosaic of investment considerations. The current market behavior does not align with the expectation of a yield curve forecasted recession, as the S&P 500 Index has returned 21% since the yield curve inverted over a year ago. It's crucial to recognize that market dynamics can deviate from historical norms, and cautious interpretation is needed while navigating through the unique landscape of unwinding massive monetary and fiscal catalysts.

As a result, we deliberately construct quality portfolio in anticipation of a dynamic shift amongst three key scenarios including “soft landing”, stagflation and recession. After all, the longer the Fed maintains elevated rates, financial conditions are tight and the lagged effects begin to impact economic activity, the greater the risk of a Fed mistake with the economy being pushed into a recession. However, the “soft landing scenario” is supported by one of the strongest labor markets since the 1960s, with the unemployment rate resting at 3.6%. The growing credibility of the “soft landing” scenario further fuels market optimism, providing additional tailwinds for the ongoing rally driven largely by valuation multiples expanding and credit spreads tightening. Finally, the credibility of a benign outcome ignores the Fed and bond market poor track record of misreading the inflationary outcome as “transitory” over the past two years. The tight labor market with wage pressure impacting service sector inflation will challenge the current Fed target of 2% inflation.

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