First Quarter 2023
American Portfolios Quarterly Market Commentary
by Chief Investment Officer Clifford T. Walsh, CFA®

THE RESILIENCE OF the equity markets in the first quarter of 2023 was impressive. Despite the Fed raising rates another 50 bps and signs mounting that a recession is brewing, the S&P 500 gained 7.5%, fueled by strength in Communication Services (+21.2%), Technology (+21.6%) and, surprisingly, Consumer Discretionary (+16.1%). Growth outperformed value by a significant margin, as did large cap over small and mid. A slump in energy (-4.4%) and financial shares (-5.5%) was hardly shocking, given the pullback in oil and the regional banking industry issues that cascaded through the system, but a shift toward defensive positioning and lower rates surprisingly did not help Health Care (-4.3%) or Utilities (-3.3%). A recovery in the bond market helped support valuations with the U.S. Aggregate Bond index gaining nearly 3%, even outperforming a variety of equity market subsectors[i].

THE FED AND INFLATION

The rate hike cycle is just about complete. Whether or not the Fed hikes 25 bps or 50 bps in May, it is clear to us that one of the most aggressive tightening cycles since the early 1980s is all but done. The swaps market is factoring another 25 bp rate hike in June, while the interest rate futures market has the Fed holding steady at 500-525 bps[ii]—with expectations leaning heavily toward 25 bps in May to get to that rate.

We care little about what the Fed does, should it be a hike of 25 bps, 50 bps or nothing at all, as we believe it will likely mean little difference to the financial markets with the heavy lifting already complete. We believe inflation has peaked and the yield curve will not react to near-term Fed hikes except at the very short end. We ultimately expect the Fed to pause the rate hike cycle in June or July, and perhaps pivot to rate cuts in the second half of the year.

U.S. inflation is set to fall sharply in 2023, with many of the factors that drove inflation higher now reversing. Prices for goods are already falling and supply chain improvements support additional declines from here. Services inflation (excluding housing) will decline as pent-up demand from the pandemic has faded and wage growth normalizes in a cooling labor market. What's more, with the massive surge in new multi-family housing starts expected for 2023[iii], the significant and slow-moving rent and equivalent rent components of CPI will roll over later in the year.

The Fed's biggest concern—not including regional bank balance sheets—is seemingly that the labor market will buoy inflation, but even its unemployment projections have been rising, most recently expecting a percentage point increase in the unemployment rate (we think it will be higher). The lagged effect of recent Fed tightening should be enough to weaken the labor market. In fact, we're already seeing it, as the work week is contracting, temp agency jobs shrinking and initial jobless claims continue to rise. As such, we think the focus should shift away from the Fed, inflation and employment to focus on the banking sector itself.

THE CREDIT CYCLE WILL NOW TAKE LEAD IN ECONOMIC AND FINANCIAL MARKET IMPORTANCE

While it is true the failed Silicon Valley Bank and Signature Bank were outliers in terms of the mismatches between their highly run-prone deposit base and, in the case of Signature, riskier exposures (cryptocurrency), reports from the aftermath estimate up to 200 banks have worse balance sheets with greater mismatches and bond losses.

Given this, coupled with the scare likely given to many other banks (a good portion of which are seeing deposits leave), many banks are likely focused on shoring up their balance sheets; as such, lending standards are extremely likely to rise throughout 2023, which was already occurring in a significant way prior to the aforementioned bank failures[iv]. This has nothing to do with interest rates. The cost of borrowing is different than the availability of credit. If banks want to reduce risk, they don't lend or their terms become more restrictive, which also reduces demand for the loans. In 2008, we saw rates plummet, but lending standards rose dramatically[v]. Regional banks have supplied 20% of the credit to the economy over the past decade, so changes on the margin here are likely to have a widespread and negative economic impact.

While the Fed has successfully prevented contagion, it can't control the credit contraction that is under way, which is both deflationary and recessionary. U.S. commercial bank assets experienced a $60 billion contraction in the first week of April, down for three consecutive weeks and in six of the past seven. Since February, assets have contracted $90 billion (-2.2% year over year)[vi]. Not to mention, bankruptcy filings for small- and mid-sized businesses have surpassed the June 2020 peak, signaling a much more challenging economic backdrop than what seems to be factored into the financial markets at this point, but no doubt not overlooked by the banking community.

The Fed's Senior Loan Survey is a reliable recession indicator with a rise in lending standards predating the downturns in 1990, 2001, 2008-09 and 2020[vii]. The latest survey results for the first quarter signal a similar outcome, and that is even before the response to the bank failures. What's more, the tightening in lending conditions has been broadly based across corporate, consumer and commercial/residential real estate. The money supply contraction won't help, either. In February, the M2 money supply (cash, bills, bank deposits, coins and money market funds in circulation) dropped 2.2% year over year, the downward momentum increasing from a -1.7% rate in January[viii]. This represented the third straight month of a money supply contraction. December was the first time the money supply dipped into the red since the Fed began publishing data in 1960.

These issues, coupled with an already consistent downturn in the broad-tracking Leading Economic Indicators Index (discussed below), is why we believe a recession is inevitable and the interest rate cycle is set to pause and then reverse later this year. The unfortunate part is this does not seem to be factored into the financial markets as the High Yield Options Adjusted Spread—a measure of anticipated corporate default rates—remains muted, but historically is highly correlated to a significant rise in lending standards[ix].

THE LEADING ECONOMIC INDICATORS CONTINUE TO SIGNAL RECESSION

The Conference Board's Leading Economic Indicators Index is down more than 6% year over year[x]. Any time we've had economic activity decelerate this deeply, we've never avoided a recession—eight out of eight times. While the rate of month-over-month declines in the LEI have moderated in recent months, the index still points to risk of recession in the U.S. economy. Meanwhile, the coincident indicators appear to be flattening out, showing only 0.1% growth in February, while the lagging indicators showed 0.2% growth. The trend is growing clear—economic activity is slowing.

THIS ALL ADDS UP TO A DETERIORATION IN CORPORATE EARNINGS

One of the major issues we've cited as reason for avoiding market risk recently has been earnings expectations that were simply too high, not reflecting the negative impact of a Fed hell-bent on squashing inflation with higher interest rates. The good news is we continue to see progress as earnings expectations continue to tick down, and we expect more as this earnings season continues. The bad news is there are still significant cuts likely to be made. Earnings expectations do not factor in a recession at this point (our base case), and certainly not an acceleration in tighter lending standards for consumers and corporations alike. We are watching this closely, but it appears more likely that earnings contract by a double-digit rate this year rather than grow 4-5% or 7% annually through 2024[xi], as currently forecast.

WHAT HAPPENED TO THE DEBT CEILING DEBATE?

While it has been quiet on the debt ceiling front, we think it is going to emerge as a significant issue in the coming months. While the odds of a debt default are low, we do expect a negative fiscal policy shock … just one more headwind for the economy. We think the financial markets are too focused on inflation and the Fed's interest rate cycle, but will shift to this issue soon enough. It will be interesting to see how it all plays out. The ceiling will be lifted, as it always is, so the question really is whether hardcore Republicans will hold their ground—the fiscal conservatives want spending cuts, while Democrats want tax increases. Looking at history, previous debt ceiling debacles were bullish for Treasuries and gold, while bearish for stocks and the U.S. dollar. This is in line with our existing views at the present time.

PUTTING IT ALL TOGETHER…

So, what does a recession mean for the financial markets at this point? It means the bear market is not over and the low is not in for broad equity prices. Remember, last year was about the Fed's froth and the impact of higher interest rates on the market multiple, not a recession or earnings contraction. The equity markets have never bottomed while the Fed was still in a tightening cycle.

The good news is now, finally, there is an alternative. To paraphrase Seinfeld's Frank Costanza, "Bonds are back, baby!"[xii] With the massive rate hikes already stifling inflation through economic demand destruction, long-duration bonds should rally (it's already begun), helping to ease the downdraft in equities due to relative valuation support. Albeit, it will not stop the downdraft, not with the likelihood of an earnings contraction coming and multiples close to 19, but it will soften the blow. If you're not willing to take the duration risk, you can get a risk-free rate of 4.5-5% at the front end of the yield curve to wait things out for a year or more, if so desired. You can even get an A-BBB corporate bond with a yield higher than the S&P's earnings yield and 3-times its dividend yield[xiii]. As such, we recommend balance throughout the Treasury curve with a shade toward longer duration, and overweight in total for fixed income over equities.

It is simply too early to go overweight equities while the yield curve is still inverted, and earnings expectations and the HY Options Adjusted Spread still not factoring in a recession. That being said, there's a light at the end of the tunnel. We expect the Fed to pause in the middle of the year and perhaps begin to cut rates as soon as the third quarter. The equity markets will surely rally on the pause and the pivot. However, these turning points in Fed policy have historically not signaled the end to bear markets and these opportunities tend to be more tactical than buy and hold. The equity markets typically make their bear market bottoms in the last third of the recession and closer to the last rate cut, not the first, as the economic deterioration and earnings contractions overpower the positive sentiment from lower rates.

Once we see more reasonable earnings expectations and equity prices, we will look to take on more risk. We continue to believe 2023 will be much more about trading tactical runs in the equity market than about buy and hold. That might be a late 2023 or even early 2024 story.

The alternative asset class should offer some interesting opportunities as well. With declining interest rates likely on the horizon, U.S. dollar strength should fade, perhaps providing renewed interest in gold and related equities—and perhaps emerging market stocks, too, although not alternatives. Hedged or long/short equity strategies can also benefit from a downdraft in equities, or at least soften the blow.

As much as everyone hopes for a better 2023 for risk assets, and it certainly has been so far, we see last year as only part one. The pain of part two has yet to come. Patience, discipline and an understanding of history are required. With that, we will get through 2023, perhaps bruised, but not down for the count. We will then likely be positioned for a multi-year equity bull run.

QUESTIONS AND COMMENTS

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Sources

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