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

THE S&P 500 surged 8.7% in the second quarter of 2023, fueled by large technology stocks (Russell 1000 growth was up 14.4%). Growth outperformed value up and down the capitalization spectrum, although the economically-sensitive consumer discretionary space performed extremely well (up 16%) as concerns about a recession seemingly eased. This is also evident in the historically defensive areas of the markets that underperformed. The health care sector (+2.9%), consumer staples (-0.03%) and utilities (-2.5%) all trailed the broader indices.

Fixed income underperformed equites by a wide margin with few bright spots. High yield bonds couldn't keep up with even the worst broad equity index, but was at least positive, up 1.75%. The remaining fixed income indices—from U.S. credit (-0.3%) to U.S. Treasuries (-1.4%), no matter the duration—were all negative[i].

SIGNIFICANT DIVERGENCES AND DELUSIONS OF GRANDEUR

The financial industry and markets are currently experiencing a significant divergence between bank tightening standards[ii] and high yield spreads, which in our view holds crucial implications for the overall economic outlook and investors. Historically, a rise in lending standards (a Fed survey done quarterly) has been linked to economic activity declines and subsequent recessions. Moreover, when lending standards surge dramatically, default risk—as indicated by the high yield options-adjusted spread—also increases. These correlations have been reliable indicators of economic conditions in the past.

However, recently, an unprecedented divergence between bank tightening standards and high yield spreads has emerged. This suggests the market is not fully pricing in the underlying risks within the banking system and the probable economic outcomes. This discrepancy leaves us with two potential scenarios: either lending standards will converge with the bond market's estimation of default risk or default risk will rise dramatically.

The current market anticipates a Fed pivot that could drive a significant rise in risk assets. To gain insight into such a scenario, we examined past rallies on Fed pivots, like the ones in 2006 and 2018. Notably, these rallies occurred in an environment with easy banking conditions, unlike the present situation. Therefore, the assumption of a similar outcome this time probably won't hold. The current lending standards are not comparable to the conditions during previous Fed pivots, but the market appears to disregard these concerns, evident from the expansion in earnings multiples by 25% this year[iii].

Recent developments in the banking industry indicate that banks are unlikely to reduce their lending standards in the next six to nine months[iv]. The most recent survey by the Fed indicates that banks expect to continue tightening standards due to a weakening economy, declining collateral values in commercial real estate, deposit outflows and liquidity concerns. This forecast further solidifies the possibility of a recession.

LEADING ECONOMIC INDICATORS (LEI) CONCUR

The Leading Economic Indicators have been on a steady decline, marking 15 consecutive months of contraction[v]. This persistent decline is historically a strong indication of an impending recession. The average time from the LEI peak to the start of a recession is 13 months, and we are currently at 18 months since the index's peak in December 2021. Furthermore, in the eight times since 1960 that we've had economic activity decelerate this deeply (a decline of more than 5%), we've never avoided a recession.

Although investor sentiment remains optimistic, historical data and market trends highlight the potential risks ahead. The labor market may provide temporary stability, but the overall economic outlook appears uncertain. Considering the depth and duration of the LEI decline and the historical accuracy in predicting recessions, it is prudent for investors to exercise caution and consider the limited upside potential amidst current market conditions. Taking a conservative approach in risk management may prove to be wiser than overly optimistic strategies, given the mounting evidence of economic challenges on the horizon, although we'll dive deeper into the strategies below.

THE DIVERGENCE BETWEEN STOCKS AND BONDS

Current equity market sentiment is overwhelmingly bullish, with retail investors and professionals alike showing elevated optimism. The CNN Fear-Greed Index[vi] and the AAII retail bulls indicate a strong appetite for risk assets. The CNN Fear & Greed Index currently measures "Extreme Greed," while the AAII retail bulls surged by 10% last week, reaching its highest level in over two years[vii]. However, with an S&P 500 P/E at nearly 20-times earnings and T-bill yields at 5.5%, equities are not overly compelling from a risk-reward standpoint[viii].

We think bonds continue to present a more realistic view of the economy compared to the exuberant stock market. With the 10-Year Treasury rate surpassing 4% recently, taking on duration risk is also becoming a more attractive option. The last time rates reached these levels, the S&P 500 was considerably lower, perhaps indicating some relative value.

THE INTERMINGLING OF INFLATION, EMPLOYMENT AND CONSUMER SPENDING

The CPI inflation report for June fell short of expectations, showing a modest increase of +0.2% month-over-month, compared to the consensus forecast of +0.3%. Notably, the core index recorded its lowest monthly reading since February 2021. On an annual basis, the core CPI is currently at +4.8% year-over-year (compared to the consensus forecast of +5.0%), down from +5.3%, which is the lowest level since November 2021[ix].

When examining the underlying details, the rental components are playing a significant role in the disinflationary process (the same significant role they played in upside inflationary readings in 2021 and 2022), in line with expectations and their typical lags. The shelter category's pace of growth decelerated to +0.4% on a monthly basis, down from +0.6% in the previous period, resulting in a year-over-year trend of +7.8% compared to +8.0% previously observed in December 2022. As time progresses, this category is expected to further unwind as the lags continue to filter through the data, putting downward pressure on inflation.

Many have pointed to the employment picture as the saving grace for the economy, one that will keep it from recession. However, the seemingly positive 209,000 print on June payrolls was not bullish after diving into the numbers. When considering the downward revisions and accounting for the moderate upward skew in the BLS birth-death model (especially during a period when business bankruptcies are surging at the fastest rate in over a decade), along with the steep increase in multiple job holders (resulting in double counting), it becomes evident that employment actually contracted in June. Although the headline jobless rate declined to 3.6% from 3.7% in May, the broader U-6 measure, which accounts for all forms of labor market slack, rose to a 10-month high of 6.9% from 6.7%[x].

Whether it's the above "truth" about employment or just consumers being tapped out or not willing to slow down spending, a look at revolving consumer credit outstanding is even more concerning. Not only has the U.S. consumer spent all of the stimulus money from March 2021, credit-card debt has risen roughly 30% since the 2020 low to an all-time high (15% above the previous 2019 peak.[xi]). Delinquency rates are also rising, not surprising given the vast amount of debt taken on, coupled with the record 21% interest rate. It appears like the consumer is close to being tapped out, which is concerning given that consumer spending makes up two-thirds of U.S. GDP.

PUTTING IT ALL TOGETHER…

The divergence between bank tightening standards and high yield spreads is a critical factor to monitor in the current financial landscape. The historical correlations, along with the unprecedented discrepancy, imply potential risks and uncertainties for investors. As lending standards remain tight and banks anticipate further tightening, the possibility of a recession looms large.

It appears reasonable to assume that short-term rates have peaked after this substantial tightening cycle. While longer-term Treasury yields have had opportunities to break out, they have only managed to form double tops. This suggests that we are currently at peak growth, inflation and credit cycle. Based on the odds, a return to a normal yield curve is expected, led by a partial reversal in the Fed's aggressive tightening cycle. This would entail significant declines in short-term interest rates and more moderate declines in longer-term rates, still offering substantial total returns for bond investors in the coming year (or maybe a touch longer if the Fed waits for more certainty about the direction of the economy). As the curve normalizes, the entire curve is expected to move lower, making a barbell 2s-10s strategy an attractive option.

As for equities, we think it is important to note that the equity markets have never bottomed while the Fed was still in a tightening cycle. 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 are still not factoring in a recession. 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. As we said last quarter, we continue to believe that 2023 will be much more about trading tactical runs in the equity market than about buy and hold. Given the recent rally, it might be time for another technical trade, taking profits and risk off the table. The return to buy and hold is looking more like a 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.

The current market rally, driven by momentum and sentiment, lacks solid economic underpinnings. While market conditions appear strong, the high valuations and extreme sentiment make it a dangerous proposition to increase exposure at this point. Market positioning is reminiscent of previous times when reality set in after a period of heightened optimism. We believe the next major move in equities is down. Investors should position accordingly.

QUESTIONS AND COMMENTS

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Sources

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