Market Commentary - Q1 2023

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After ending 2022 as the worst year for stock markets since 2008, markets have rebounded resiliently in 2023, with the Dow Jones Industrial Average, S&P 500, and NASDAQ all posting positive returns in Q1 2023. This is in the face of macro uncertainties, high profile corporate layoffs, bank failures, and restrictive Fed policy that have dominated market sentiment. The recent crisis surrounding regional bank failures and new economic data have nonetheless prompted fresh concerns of a recession that could derail any optimistic market reaction in the near term. As a result, long-term yields have fallen dramatically, causing further inversion of the yield curve, as the bond market wrestles between the possibility of sustained above average inflation and a recessionary environment. Additionally, the recent regional bank failures could also be a blessing in disguise if contagion is contained, especially as it can result in less rate hikes by the Fed- which has been one of the primary driving forces for asset price weakness in the last 15 months. As one door closes, another opens- and in this commentary, we seek to evaluate the potential risks and opportunities that lie ahead.

Here We Tech Again

Declining Treasury yields led to a resurgence in tech stock performance in the first quarter- specifically, mega cap tech stocks as they performed extraordinarily well, with the top 6 mega-cap tech stocks returning an average of 42.39% in the first quarter. Collectively, those 6 stocks make up 23% of the S&P 500 but account for 56% of the S&P 500 gains so far in 2023. In fact, such performance is reminiscent of mega cap tech stock outperformances during periods of low interest rates prior to 2022. Investors seem to find elements of defensiveness within these mega cap stocks during periods of volatility, especially those within the Technology sector. The collapse of Silicon Valley Bank bifurcated the tech industry as banks have tightened their lending appetite for the industry. Access to abundant and cheap capital is vital for many tech businesses, and tighter and more expensive access to capital results in further compression of return potential as the capital required for growth becomes more limited. In contrast, this increases the attractiveness of well-capitalized, cash rich, profitable tech companies that have potential for continued above average growth, as this may indicate a resilient business model that can sustain a potential economic recession. These criteria are synonymous to the characteristics found in the mega-cap tech companies, which coincidentally have outperformed their less capitalized tech peers.

For investors, there are several differences between this year's tech outperformance and the prior era of low interest rates. Firstly, the 40-year downtrend in interest rates that existed prior is now reversing. A reprieve from higher rates this year due to recessionary concerns has facilitated an echo of the prior era, with tech stocks surging as interest rates wane. However, trading on the knee-jerk reaction of such reversion should come with cautionary signs as the sustainability of such outperformance comes into question.

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Drawing upon historical comparisons, we can gauge how things have played out in the past. For example, Nvidia is the best performing stock in the S&P 500 in 2023- returning a whopping 90% in the first 3 months. This is the stock's best quarterly performance since the fourth quarter of 2001 when it soared 144% in the midst of a recession and bear market that spanned three years. The following year in 2002, Nvidia would go on to crash 90% (from peak to trough) before finding its support in October 2002. Secondly, the resurgence of the mega-cap tech stocks has re-introduced tremendous stock market concentration risks, which could increase market volatility and an over-reliance on a handful of highly correlated stocks for return and risk contribution. For example, Apple and Microsoft alone account for 13.2% of the S&P 500 composition- the highest level since Bell System and IBM ruled the S&P 500 in 1978.

As these mega-cap tech companies have announced large number of layoffs to protect margins in the face of a growth slowdown, the positive reaction to their stock price thus far could prove pre-mature, potentially leading to larger pullbacks in the future should expectations fail to materialize.

The Economy is Slowing

Economic activity in the manufacturing sector contracted in March for the fifth consecutive month following a 28-month period of growth. The March 2023 ISM's Manufacturing PMI index recorded their weakest numbers since May 2020. Strikingly, all 10 sub-indexes of the PMI index were signaling contraction (numbers below 50), marking the first time this has happened since 2009.

Manufacturing at a Glance

INDEX	Mar Index	Feb Index	% Point Change	Direction	Rate of Change	Trend* (months)
Manufacturing PMI®	46.3	47.7	-1.4	Contracting	Faster	5
New Orders	44.3	47.0	-2.7	Contracting	Faster	7
Production	47.8	47.3	+0.5	Contracting	Slower	4
Employment	46.9	49.1	-2.2	Contracting	Faster	2
Supplier Deliveries	44.8	45.2	-0.4	Faster	Faster	6
Inventories	47.5	50.1	-2.6	Contracting	From Growing	1
Customers' Inventories	48.9	46.9	+2.0	Too Low	Slower	78
Prices	49.2	51.3	-2.1	Decreasing	From Increasing	1
Backlog of Orders	43.9	45.1	-1.2	Contracting	Faster	6
New Export Orders	47.6	49.9	-2.3	Contracting	Faster	8
Imports	47.9	49.9	-2.0	Contracting	Faster	5
Overall Economy				**Contracting**	**Faster**	**4**
Manufacturing Sector				**Contracting**	**Faster**	**5**

Source: Institute for Supply Management, March 2023

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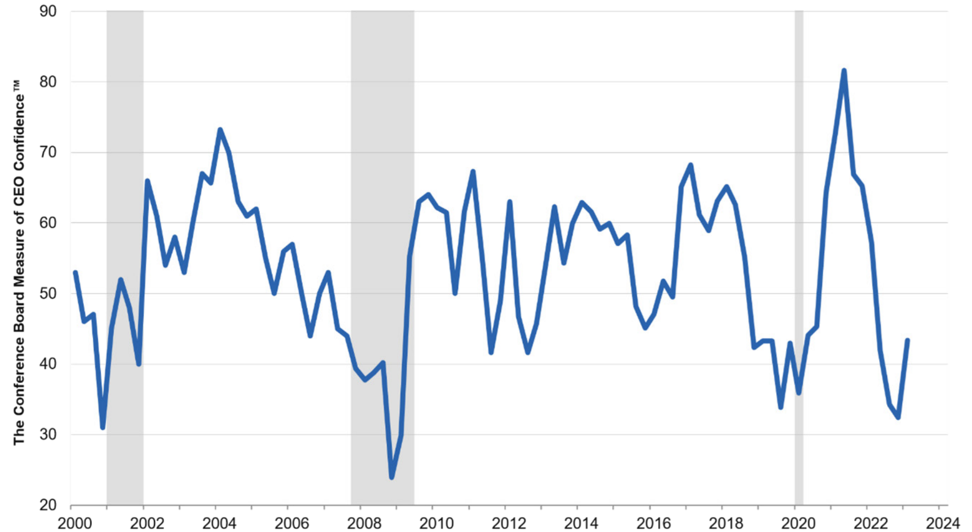
Contraction in the manufacturing data highlights the lower economic output businesses are expecting for the future, foreshadowing a high probability of an economic slowdown and potential recession. This is especially evident in the backlog of orders and new orders data.

Business CEOs continue to anticipate a recession, with 93% of CEOs expecting a recession over the next 12-18 months according to the Conference Board's CEO Survey. Despite that, CEO's have become a little more optimistic this year, with many anticipating that a recession will be brief and shallow.



Similar sentiment can be found within small business owners with whom many are moderately and somewhat concerned about the impact of a recession on their business. However, there are many factors that influence this sentiment and many are often at odds with one another. A bright spot among small business sentiment is that the majority of owners still plan to expand their workforce in the next 12 months as hiring continues to get easier as big company layoffs have presented opportunities for small businesses to fill critical roles.

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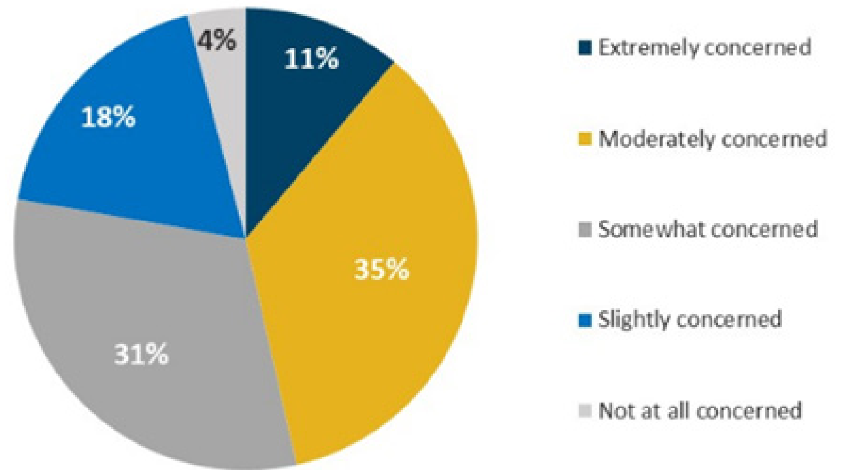

Source: March 2023 WSJ/Vistage Small Business CEO Confidence Index n = 655

Speaking of filling critical positions and the labor market, US jobs data were just released as of this writing. US employers added 236,000 jobs in March, providing an argument that the labor market is still too hot to get employment cost pressures and inflation under control. But upon deeper review, it is clear that prospects of the labor market are already cooling, and policymakers risks unnecessary economic harm if they ignore the signs.

Top-line employment numbers are heavily influenced to the upside by extreme and well-known structural worker shortages in private education, healthcare, and leisure and hospitality. Together, these 3 categories accounted for 72% of the private payroll increases in March. If we remove government and these three categories from the picture, the net increase from the remaining employment categories added just 52,000 jobs, well below the pre-pandemic average of 97,000 (between 2017 to 2019). Aggregate payrolls in goods-producing sectors have begun to decline, as well as those in the financial services and construction sector. Payroll growth in information (media, telecom, and data processing) have slowed significantly. If the Fed waits for payroll growth in healthcare and leisure to slow, it is likely going to overshoot its target rate.

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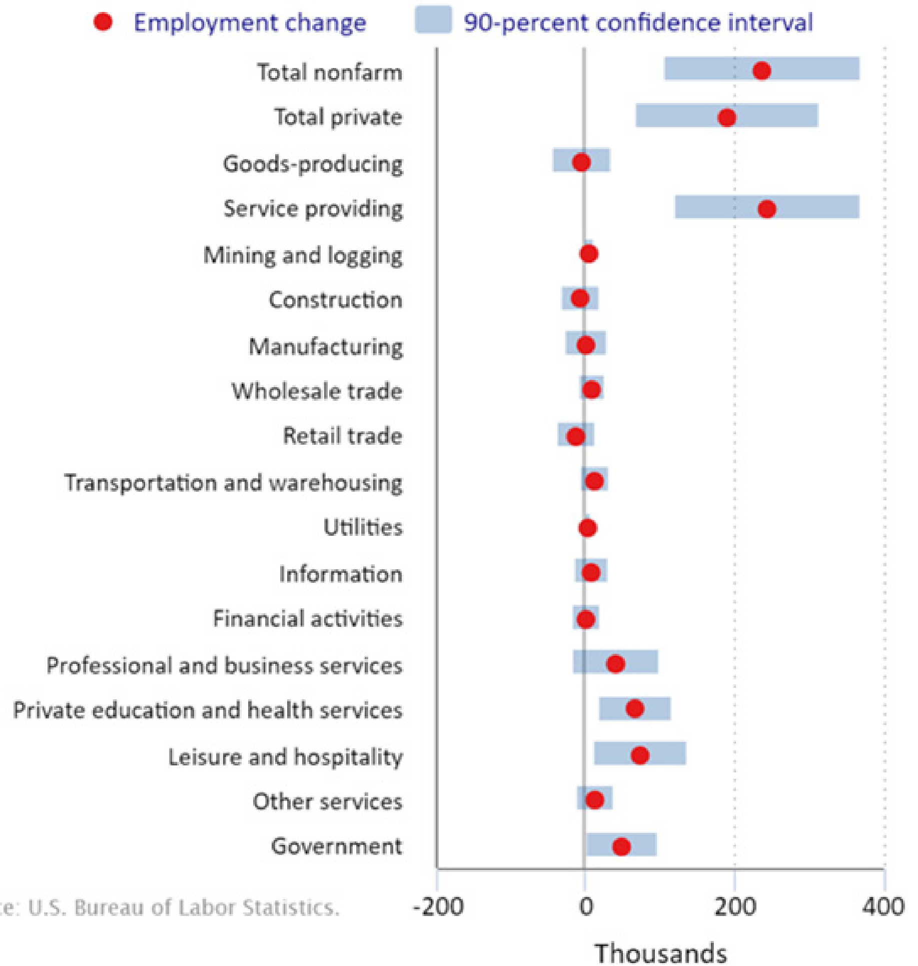

In areas like nursing, worker shortages are so pronounced that employers are likely going to keep adding workers regardless of how high interest rates go. Burnout, retirements, and an aging demographic have contributed to the supply and demand imbalances in the industry. Additionally, leisure industries' payrolls are still recovering after suffering from a plunge in immigration rates during the pandemic. Overall employment numbers are still below pre-pandemic levels. In some areas, companies would have to be put out of business for payroll growth to halt. If the Fed keeps pushing rates higher until headline payroll growth meets its definition of acceptable, it could render a harsher than necessary recession.

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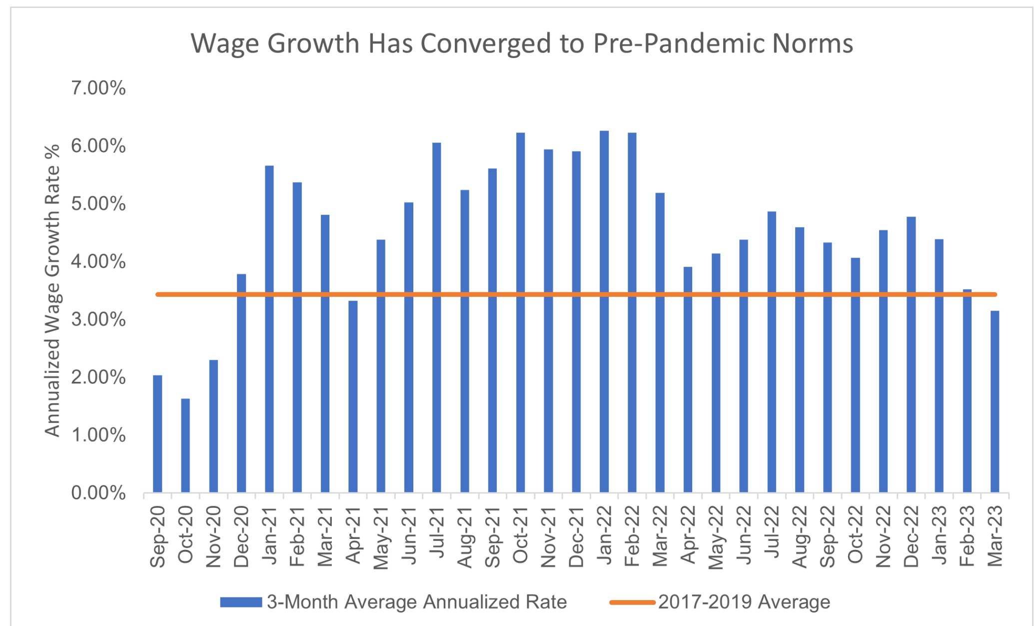
Wage inflation is also another indication that the labor market is under control per the Fed's inflation goals. Average hourly earnings are now rising at a three-month seasonally adjusted annualized rate of 3.2%, which is near pre-pandemic norms and close to the Fed's inflation goals. Assuming a 2% inflation goal with a 1.5% productivity growth rate, it would imply that anything under a 3.5% wage growth should be acceptable. Annualized wage growth is running at 3.2% today, below the average pre-pandemic pace.



Source: Bureau of Labor Statistics, Liberty One Investment Management, March 2023

Despite these numbers, 2-year Treasury yields jumped 13 basis points after the jobs data release. This knee-jerk reaction indicates the reliance on unemployment and payrolls headlines more than the underlying data. This more than likely cements another 25-basis point hike when the FOMC meets again in May. The Fed governors are already getting the labor market cooling that they are looking for, they just have to look beneath the surface.

Similar to the general consensus, economic data is pointing towards a recession or at the minimum, economic deceleration in the near term. Although recessions can have detrimental effects on the economy, their effects are typically not long-term in nature. Recessions are a natural element of any business cycle that ebbs and flows in a cyclical pattern. The beauty of recessions is that economic excess gets flushed out of the economic system as businesses become more disciplined and leaner. This increases productivity, encourages more efficient uses of capital, and it is a period where new innovative ideas and businesses are formed. For example, Bill Gates and Paul Allen started Microsoft during the height of the oil embargo recession of 1973 to 1975. Similarly, companies like Uber, Airbnb, Square, Groupon, and Venmo were all created and launched during the Great Financial Crisis between 2008 and 2009.

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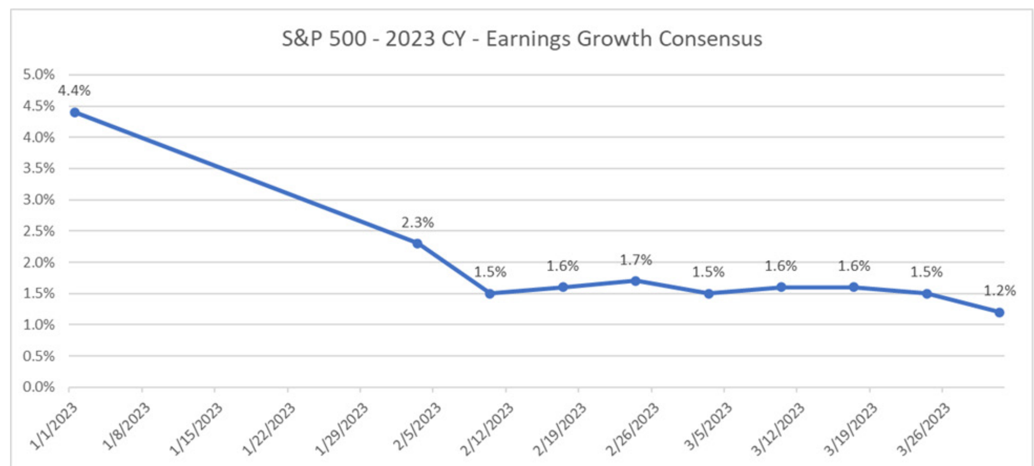
Recessions also usually coincide with market bottoms, which could be a great opportunity for investors. Tremendous opportunities can be found both in good and bad times, but attractive investment opportunities are more abundant during periods of economic weakness. There is a common saying on Wall Street that goes: “Money can be made in bull markets, but fortunes are made in bear markets”.

Earnings Revisions

2023 full year earnings outlook were cut by more than half during the first quarter’s earnings season. Coming into 2023, we surmised that 2023 earnings expectations appeared to be overly optimistic given the economic data trends and economic weakness that the Fed was seeking to induce to fight inflation. We think 2023 earnings expectations are more reasonable now but still believe that 2024 expectations could still be somewhat optimistic. Despite the decelerating trends in earnings growth, revisions have been minimal since the regional banking turmoil that began on March 10.



Source: Refinitiv, Liberty One Investment Management, March 2023

Stock markets appear to shrug off potential earnings’ cautionary signs, underpricing the risk of credit tightening implications on future economic growth. Instead, the prevailing sentiment foreshadows a stronger market with the expectation that a recession would broadly be contained. More importantly, the market is pricing a return of a supportive Fed, expecting rate cuts in the second half of 2023. Such expectations may or may not materialize as the Fed has maintained its hawkish stance, demonstrating no indications of a rate cut in 2023. Nonetheless, the Fed is extremely data dependent and could alter its stance should economic conditions deteriorate beyond expectations.

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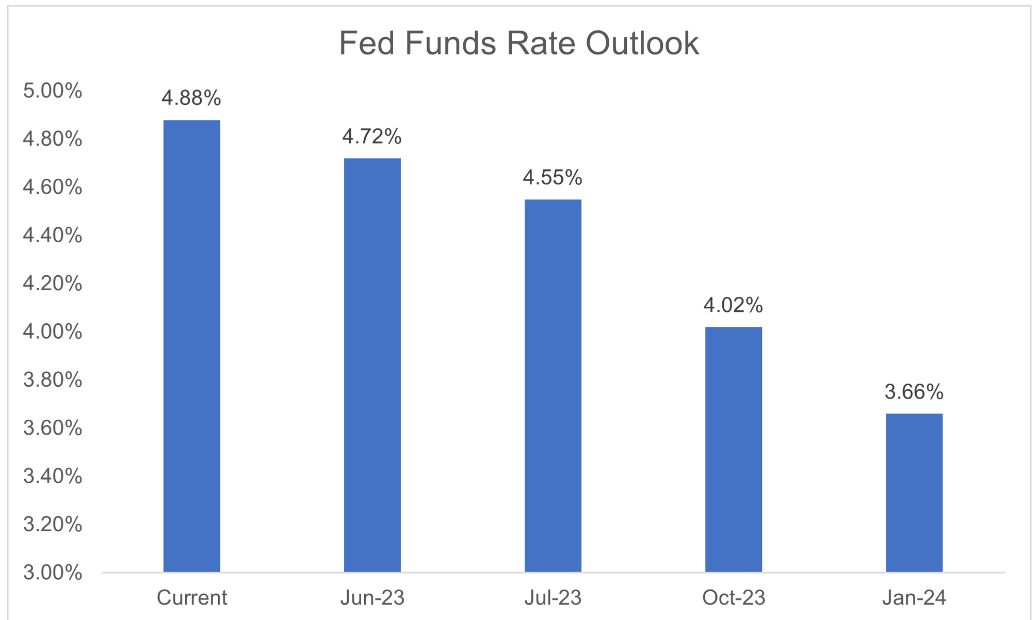

Source: Refinitiv, Liberty One Investment Management, March 2023

The Outlook

Weaker economic outlook is likely to be expected with signs of economic slowdown across most macro-level data. Bond markets appear to be pricing in slower economic growth with inflation likely to have peaked. With the recent tightening of lending standards, we also anticipate credit spreads to widen, with lowest quality bonds most susceptible to such repricing. Under such a scenario, bonds could be an attractive asset class, especially longer duration, and higher quality bonds. We shifted our bond allocation to reflect this perspective in the first quarter which has rewarded our investors nicely. Although current 10-year Treasury yields are at the low end of our neutral target range of 3.5% to 4.5%, we continue to anticipate some volatility in yields and will opportunistically adjust our fixed income weighting accordingly.

Additionally, stock markets' valuation multiples are now more in-line with historical averages. Most of the exuberance in market valuations diminished last year as the Fed embarked on its restrictive policy campaign. As a result, markets are relatively cheaper but are not necessarily cheap by historical standards. Until investor sentiment flips towards broad-based optimism again, the direction of the market is likely to be dictated by fundamentals in the near term which is skewed to the downside. Therefore, investors should expect market volatility to persist as market leadership continues to rotate among its constituents.

The recent fears of contagion within the regional banking turmoil appear to have been contained for the time being. The difference between the recent events and what happened during the Great Financial Crisis is that recent events are more of a liquidity issue while what happened in 2008 was more of a credit issue.

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The liquidity challenge can be resolved more easily because liquidity can be accessed by various Fed tools or by borrowing from other willing banks by posting assets as collateral, while credit challenges are much more difficult because they are tied to economic conditions, requiring time to cycle through. Either way, access to capital and confidence in the financial system are critical components to a healthy, well-functioning capital market.

On the bright side, although markets may be converging on the likelihood of a recession, they are also beginning to look through it. It may be too early to call for a market bottom right now, but we may not be too far away from one either. The yield curve may have to invert further or even fall, while equities may have to take another cycle down before it recovers- usually around the time monetary policy pivots and leading economic indicators trough. Market timing is always difficult, but time in the market has historically rewarded investors better than timing the market. Structuring a solid portfolio mix that gives investors confidence to remain invested in the market despite the uncertainties is critical to their long-term investment success.

For our longer-term outlook, we expect inflation to move back towards the 2% target fairly quickly as prospects of long-term economic growth are likely to be lower. This is primarily driven by our expectation of a public deleveraging cycle- especially after the significant debt burden we incurred to recover from the pandemic. About 70% of the public debt matures within the next 5 years, which would likely carry higher interest expenses when refinanced. However, lower growth can be offset by a strong consumer base and a millennial generation that is entering their family formation years (typically the strongest periods of consumption). Therefore, the bulk of future growth would most likely come from growth areas in personal consumption expenditure and productivity growth, instead of capital expansion and government consumption expenditures.

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