First Quarter 2023
Market Commentary

April 19, 2023

Coming out the Gate Fast… Maybe Too Fast

Vacillations and surprises marked the first quarter's market activity. Perceived changes in tone from the Fed and its preferred interest rate path in response to shifting inflation, along with a banking crisis that may or may not have concluded, have somewhat paradoxically driven asset prices higher. Bond yields have made historically volatile moves, often whipsawing during the same week, while trying to decipher the correct response to the conundrum of rates and inflation. Equity markets generally proved highly resilient as well to any concerns as prices have moved higher in both U.S. and global equity markets.

The Fed is almost certain to be nearing the end of its hiking cycle. However, the impact of the last 12 months of higher rates is having an impact that is being felt in monetary conditions and industrial output, even if asset prices currently are acting as if there will not be a recession to follow this hiking cycle. As a result, equities were up 8-9% in 1Q (Figure 1), while bonds rallied modestly and gold continued to be well-bid in the chaos.

Overall, Nordwand continues to believe that the global economy is slowing, that aspects of credit and cash markets offer better risk-adjusted return prospects in the short-term than listed equities, and that the most prudent tactical response is to reduce risk sensibly during periods of strength, and to reallocate to lagging or more attractively-valued areas with proceeds.

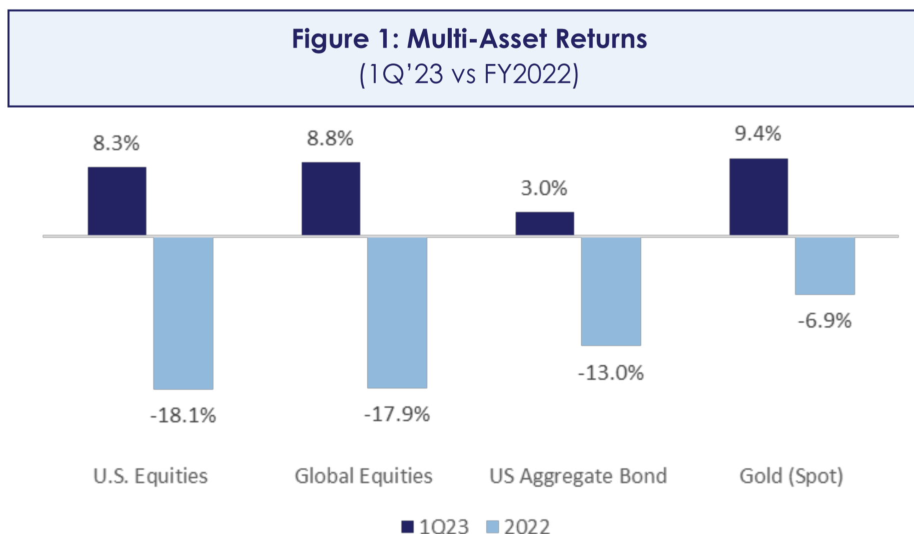


Figure 1: Multi-Asset Returns
(1Q'23 vs FY2022)

Source: Bloomberg, Nordwand Capital as of 3/31/2023.

Equities Start Strong. As we noted in Figure 1, equities have started the year strong. Growth and technology-linked equities, in particular, have begun the year on a torrid pace (Figures 2 & 3) as investors have bought the biggest laggards from last year while also moving to expect a quicker pace to Fed easing than seemed possible only 2 months ago.

Figure 2: U.S. Equity Sector Returns
(1Q'23 vs FY2022)

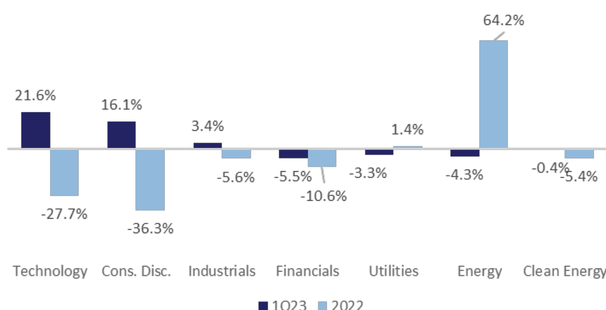
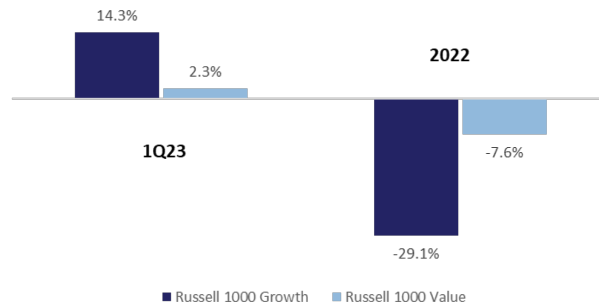


Figure 3: Growth vs. Value Equity Returns
(1Q'23 vs FY2022)



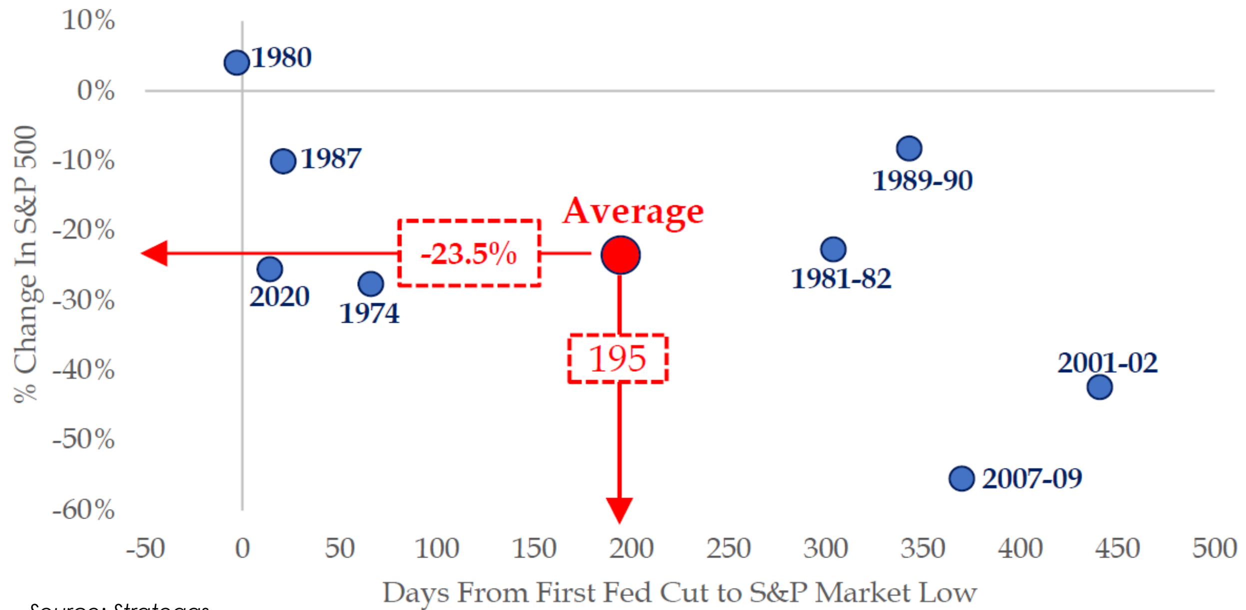
Source: Bloomberg, Nordwand Capital as of 3/31/2023.

In our mind, this calculus, and the pockets of outperformance we've seen to-date, come down to four factors: 1) a 15-year history of extremely accommodative monetary policies that has caused large swathes of market participants to put on their behavioral finance hat and assume this is the new normal; 2) the financial crisis that erupted in early March effectively tying the Fed's hands from further aggressive tightening maneuvers; 3) the reality that after 12 months of sustained hiking that much of the Fed's desired economic slowing is beginning to take root in the economy, obviating the need for more hiking; 4) the consequential preference for longer-tailed growth or consumer-oriented stories over those with defensive or value-based characteristics.

Digging into the fundamentals, earnings forecasts for 2023 are approximately flat versus 2022 (-1% per Bloomberg as of this writing), suggesting the impact of slowing global growth will impact bottom lines, although not that drastically. We expect there may be some continuing pressure on these forecasts as the year goes on, implying that equities are a bit more expensive than they appear at the moment. U.S. equities are ~1.0-1.5x more expensive on average on a price-to-earnings basis; global equities are more attractively valued.

In addition, it remains worth noting that equities historically bottom approximately 6 months *after* an interest rate cut by the Fed (Figure 4). We are possibly not quite finished the *hiking* process yet; the *easing* response may not begin until 2024, suggesting the equities market rally we witnessed in 1Q'23 is not yet the beginning of a longer bull market.

Figure 4: Trading Days and % Change From First Fed Rate Cut to S&P Market Low



Source: Strategas.

As a result of these factors, we think the return outlook for equities in the rest of 2023 is more nuanced and muted. We prefer global to U.S. equities given better valuation support, find prudence in reducing risk exposure during market rallies and tactically re-allocating to areas of strategic interest where secular growth and attractive valuations can both be found.

Yields: Oh the Places You'll Go! Bond yields have endured a roller-coaster ride to start 2023 the likes of which the market has never really seen before. The yield on the 2-Year US Treasury Note

Figure 5: 2-Year US Treasury Note Yield
(1Q'23)

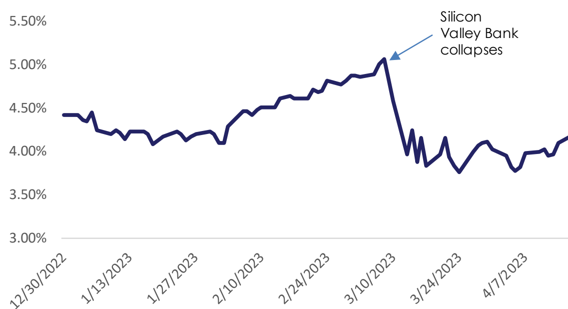
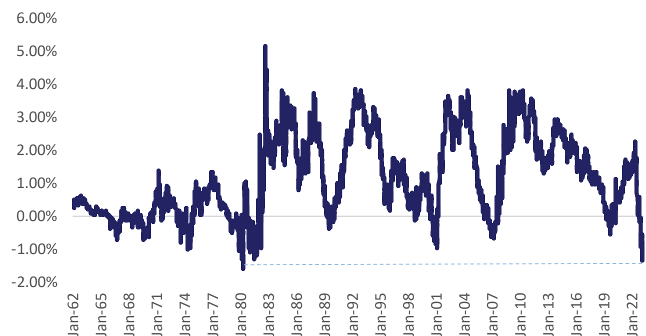


Figure 6: 10-Year Less 3-Month Treasury Yield
(1962-1Q'23)



Source: U.S. Treasury, Bloomberg, Nordwand Capital as of 3/31/2023.

rose steadily throughout February as public comments from Chair Powell and other Fed officials indicated that the market had been too sanguine about the Fed taking its foot off the gas re: continuing hikes. This reversed abruptly in early March when the collapse of Silicon Valley and Signature banks (Figure 5), followed soon thereafter by the collapse of Credit Suisse, caused investors to conclude that central bankers had limited appetite for further tightening. Indeed, investors are now expecting the Fed to cut rates a net 1-2 times from current levels by year end; the Fed does not share this view, and the ensuing battle for credibility will matter greatly in coming months, and is likely to add to volatility in markets over this time.

As to the shape of the curve itself, an inverted yield curve stands the traditional lending and credit creation model on its head, as banks typically borrow short and lend long. The 3-month vs 10-year Treasury curve inverted by about 128 basis points (bps) at March 31 (Figure 6), putting bank profitability at risk, and risk management – and its attendant costs – will have to be much better than what we saw at the collapsed banks in 1Q.

Clients may recall that we highlighted the degree of this yield curve inversion in our Year Ahead piece. The curve was inverted by about 55bps at year-end – effectively doubling during 1Q'23 – and has since continued to steepen, sitting at close to 150bps as of mid-April. With these conditions in mind, Treasury Secretary Yellen has recently commented that the banking sector may do some of the Fed's work for it, implying a reduction in lending and credit creation which in turn will augment the Fed's efforts and further slow the economy.

Against this backdrop, the opportunities we saw on the front end of the yield curve are slightly less apparent than they were in February, although we do still see value overall in the front half of the curve (3-Mo to 7-Yr). Furthermore, high yield bond spreads versus the 10-Year U.S. Treasury continue to be tight by historical standards and are currently sitting at just under their long-term average. This implies that the market is not concerned about credit defaults in riskier companies, and also suggests to us that investment grade, agency, and Treasury credit present better relative value on a risk-adjusted basis. Additionally, we continue to find private and direct lending interesting given the higher yield profiles amid what is generally secured debt; we expect to be revisiting this topic with clients in due course.

Summary

A strong start to the year in liquid asset markets has reduced the attractiveness of equities over the near-term, in our view, and highlighted the less risky and more reasonable rates of return on offer within various segments of the cash and fixed income markets. Corporate earnings are declining, albeit modestly, and lending standards that were already tightening are doing so more sharply following 1Q bank collapses. Both of these factors have tended to be strongly correlated to employment in the past. The state of the employment market has been perhaps the strongest argument that we will escape a recession following this extended bout of considerable inflation and subsequent monetary tightening. While that could turn out to be true, we see something more typical playing out over the coming months, and would remind clients once again of one of our favorite aphorisms by Sir John Templeton: "The four most expensive words in the English language are, 'this time it's different.'"

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