James Investment Research, Inc.

Market Commentary

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JAMES
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Key Insights

- Shift in Federal Reserve interest rate tightening expectations.
    - Slowing inflation
    - Banking crisis and ensuing credit tightening
- Signs of a cooling economy: softening labor market and consumer spending.
- Earnings deterioration and strong gyrations in bond market.
- Rising odds of a recession may require a more defensive posture.

Monthly Recap

Year-to-date, both the stock and bond markets have posted decent returns, despite the pullback from late February through mid-March. This decline was partly due to the collapse of Silicon Valley Bank (SVB), which rattled markets as concerns grew about the potential contagion impact within the banking industry. Fortunately, the decline was short-lived, and the markets rebounded back to their year-to-date highs.

However, the event was significant as it shifted the market's view on future rate hikes. A couple of months ago, market expectations factored in several additional hikes, but the concerns surrounding regional banks quickly shifted the forecast to only a couple hikes before the expectation for a Federal Reserve (Fed) to pause.

After gaining 3.7% in March, the S&P 500 advanced 1.6%. Surprisingly, defensive sectors, such as healthcare, utilities, and consumer staples, led the rally and each posted strong gains for the month, advancing over 2%, each. In contrast, information technology, consumer discretionary, Industrials and Materials were the laggards and down on the month. Moreover, larger stocks outperformed small-cap stocks by a margin of 4.3%.

The aggregate bond market was up 0.6% in April. Corporate bonds outperformed their Treasury equivalent. Additionally, the belly of the Treasury curve (bonds with maturity between 5 and 10 years) outperformed. The banking crisis continue to pressure bond yields lower and prices higher, as investors sought safety until the dust settled.

In our recent quarterly outlook, we mentioned that the risk for a recession is elevated but may not materialize until the end of the year or early 2024. We have observed some deterioration in areas that have been resilient over the past several months, particularly in the labor market. There has been an uptick in unemployment claims, along with a decrease in temporary workers, indicating that the strength in the labor market is beginning to wane. Often, a decrease in temporary workers is a precursor to a decline in the overall labor market.

Furthermore, many of the regional Fed reports continue to surprise to the downside. We are observing declines in orders for the manufacturing sector, with some regions reporting some of the lowest levels in years and not painting a rosy picture. The housing market continues to remain weak as mortgage rates remain above 6%, keeping buyers on the sidelines.

The economy grew at 1.1% annual rate in the first quarter. Fortunately, consumer spending is still carrying the economy despite the headwinds of higher prices and a weakening labor market. The question is whether this will continue throughout 2023. We will continue to monitor the consumer and labor markets. Any weakness in spending or continued deterioration in the labor markets could be an ominous sign of a recession. Additionally, we have seen inflation pressure ease as home prices fall and input prices decline. The breakeven on the 2-year Treasury has fallen 0.5% since the start of April to 2.2%, which could lead the Fed to rethink rate hikes in the future. Investors could be closer to a rate pause in the months ahead.

Earnings Deterioration

Consensus earnings estimates for the ongoing first-quarter season were significantly lowered before the start of the reporting season. Projections for earnings per share (EPS) growth for Q1 2023 have been cut from 8.1% on 12/31/2022 to 1.4% just before the start of the reporting

season. As a result, the bar has been lowered, and this earnings season could perform better than initially feared.

However, management commentaries and guidance about the rest of 2023 are most important. Analysts incorporate this guidance into their estimates, which, in our view, remain too high for Q2-Q4 quarters. Consensus growth rates for Q2-Q4 remain above 10%, but downward revisions for Q2 appear likely. Unless the macro backdrop improves significantly, the same can be said for Q3 and Q4.

Higher inflation may have enabled many companies to exceed revenue growth targets. However, as inflation falls and wage growth catches up, companies' margins are narrowing from record highs. The S&P 500 margin has fallen from 13% in January 2022 to 10% currently. Moderating inflation is bad for revenue, and solid wage growth increases costs. Both are a recipe for falling profit margins and declining earnings.

Topic of the Month: The Bond Market

The global bond market is significantly larger than the stock market, with the Securities Industry and Financial Markets Association (SIFMA) reporting that as of 2022, the global stock market capitalization was approximately $101 trillion, while the global bond market was estimated to be around $123 trillion. It's worth noting that the U.S. equity and bond markets are the largest worldwide, accounting for 41.0% and 41.3% of the global market, respectively.

Compared to the stock market, the bond market receives less attention from most investors, who are drawn to the potential of significant long-term returns. However, investing in bonds is crucial for portfolio diversification, despite typically not offering as many opportunities for high returns. Bonds offer predictable income streams with fixed interest payments usually made twice a year. Moreover, they are considered a relatively safe investment option with less price volatility than stocks.

However, the diversification benefits that bonds have typically provided in the past disappeared last year, as both bonds and equities suffered steep losses. Higher yields are now back across the curve, and a more typical correlation between stocks and bonds is taking shape. This may signal a timely return for the time-tested 60/40 portfolio approach (60% in equity and 40% in bonds) after one of its worst years on record in 2022.

In general, higher returns in bonds can be achieved in the following ways: lending to borrowers who are considered less creditworthy than the U.S. government, which is known as credit risk, or lending for longer periods, which is referred to as term risk or interest-rate or duration risk.

Investors who lend for extended periods run the risk of their bond values decreasing if interest rates rise. Bond prices have an inverse relationship with interest rates, meaning that when interest rates rise, bond prices fall and vice versa. The longer the bond's term, the higher the likelihood of a decline in value. For instance, if an investor boughts a 10-year Treasury bond in November 2020 when the yield was 1%, and the current interest rate rises to 3.5%, the value of the 1% bond dropped by around 18%, resulting in a significant markdown if sold. However, if the bond is held until its maturity, the investor will receive the full value.

The recent example of the SVB bankruptcy may help explain these concepts. As there were limited profitable lending opportunities available because of rising interest rates, the bank invested most of its increased deposits in longer-term government securities to achieve higher yields. While these government bonds carry no credit risk, their values decline as interest rates rise. When some depositors sought higher-yielding money market options and withdrew their funds from the bank, the bank was prompted to sell some of these securities at a heavy loss.

Recession Fears vs. Sticky Inflation

The bond market is reckoning with two opposing forces that have major implications in its performance for the rest of the year. First, a rising recessionary risk later this year that results in a negative economic growth and a deflationary period, would see government bond yields plunge and prices rally as safe-haven bid materializes. It would also result in rising corporate bond spreads (the extra yield for taking the credit risk compared to an equivalent treasury bond) as the risk of default increases. This favors an "up in quality" move in portfolios.

The second driving force is related to how sticky inflation is. If inflation remains elevated above the Fed's 2% target, despite coming down, the Fed may find it challenging to cut short-term rates even if the economy experiences a significant slowdown. Inflation could remain sticky if the labor market continues to be robust, leading to wage growth. Moreover, more structural forces may be at work, such as rising hostile geopolitics affecting energy prices, de-globalization, and manufacturing onshoring, resulting in structurally higher consumer prices.

These factors indicate that inflation could be persistent, making it challenging for the Fed to address with traditional monetary policy tools. As a result, the bond market may need to grapple with these opposing forces, creating uncertainty in the bond market.

The risk of a recession is bullish for bonds due to the safe-haven bid, while sticky inflation is bearish for bonds as yields remain higher to compensate for inflation. This leaves us in the middle, with bond prices and yields likely to stay range-bound, in our view. The range is expected to be between 3.3% and the high yield of 4.2% observed last fall for the 10-year treasury bond, which serves as a proxy for the bond market. As of now, we are closer to the lower range. Therefore, it would not be surprising to see bond prices pull back in the next few weeks, particularly if upcoming economic growth and inflation reports exceed expectations.

Some Developments We Are Watching

Central Banks Policy Divergence

Central banks in developed economies, specifically the U.S., U.K., and Eurozone, have moved in tandem regarding monetary policy since the pandemic. However, inflation has remained stickier in the U.K. and Eurozone than in the U.S. In March, the U.K. Consumer Price Index was 10.1% higher than a year ago, while the U.S. inflation rate cooled to 5% on an annual basis last month.

The divergence in inflation paths may result in a continually more hawkish Bank of England (BoE) and European Central Bank (ECB) compared to the U.S. Federal Reserve. This is a bearish development for the U.S. dollar and has major implications for different asset classes. The higher yield differential U.S. bonds enjoyed last year will narrow as the Fed pauses and other central banks continue to catch up. This may lead to a waning foreign demand for U.S. bonds, keeping a floor on U.S. bond yields, and is one reason why we expect a range-bound market in the next few months.

Resilient U.S. Economy

The first quarter GDP is in the rear-view mirror; however, investors can identify where the momentum is in the economy. Mainly, consumer spending is carrying the economy forward. Consumers still have excess savings from pandemic stimulus, albeit dwindling, and are deleveraged compared to prior economic cycles. This spending momentum, especially in services, could carry on in the second quarter and may delay any potential recession until the end of the year or the beginning of 2024, resulting in choppy (range-bound) markets.

The outlook for bond prices and yields is uncertain, with opposing forces at play in the market. Bond investors will need to consider various factors, including inflation, economic growth, and geopolitical risks, to navigate the bond market successfully.

Conclusion

Given the signs of a cooling economy, including slowing inflation, a shift in Federal Reserve interest rate tightening expectations, and the banking crisis and ensuing credit tightening, investors may need to adopt a more defensive posture. Despite their current strength, the labor market and consumer spending are also showing signs of softening, and corporate earnings are also deteriorating. These factors increase the likelihood of a recession, emphasizing the need for a more cautious approach.

This includes focusing on investing in large companies, with strong revenues that can pass along higher costs and favoring defensive sectors, such as healthcare, utilities, and consumer staples. Additionally, we recommend sticking with high-quality bonds due to potential challenges posed by rising volatility resulting from the uncertainty surrounding the Federal Reserve's interest rate path and the recent banking crisis.

Sincerely, *The James Research Team*

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