2023: SEMI-ANNUAL MARKET UPDATE

SUMMARY

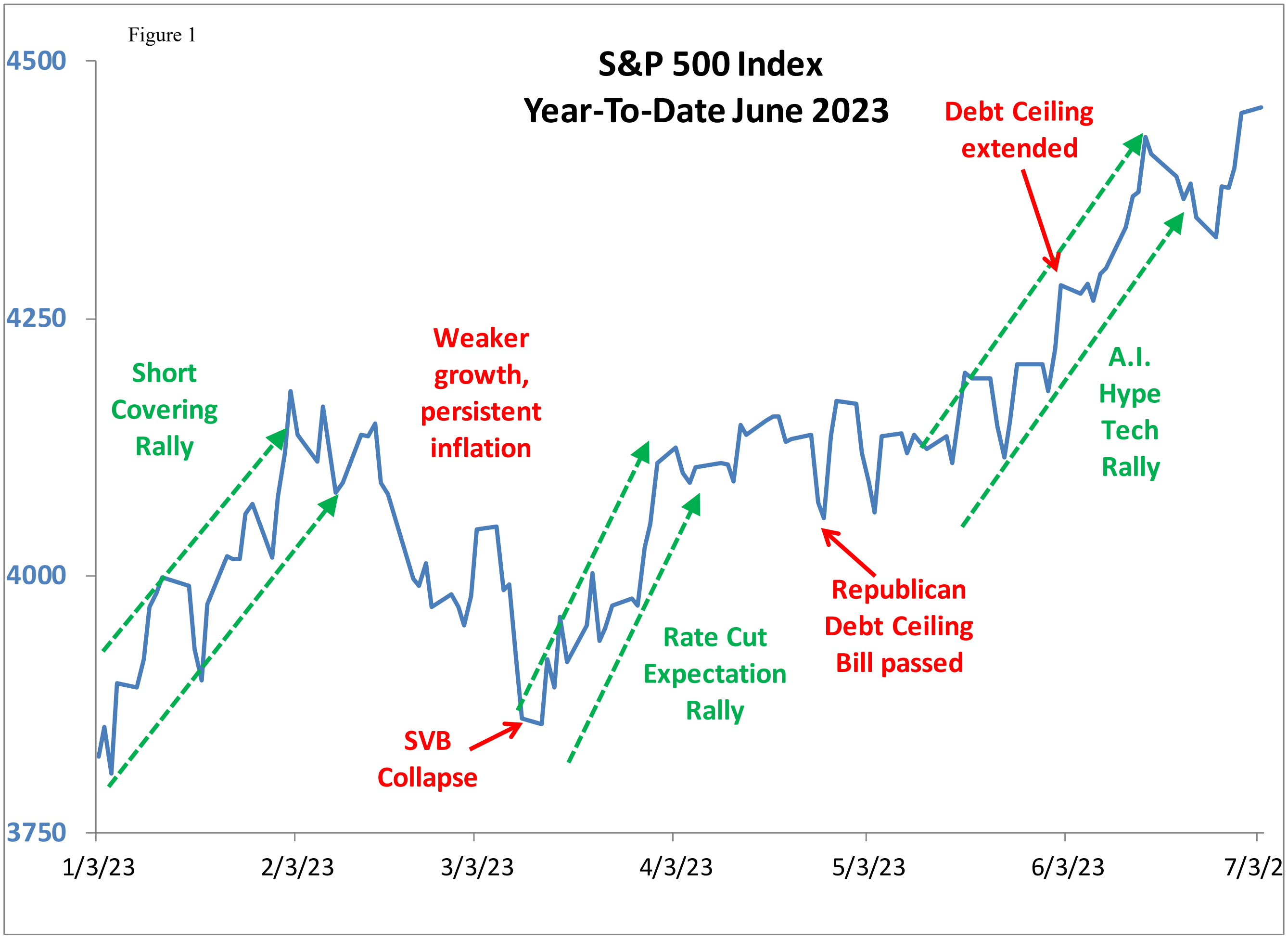
Global equity markets recovered in fits and starts from their previous year losses in the first half of 2023 as inflation slowly moderated and earnings fell less than expected (figure 1). Cracks began to appear in the financial system in March, as three banks failed. However, equity markets rallied on expectations of lower interest rates despite the Federal Reserve's stated intention to continue its hiking campaign to fight inflation.

In the first half of 2023, global equities rose +13.9% and U.S. fixed income +2.1% while broad commodities fell by -7.8% on sharp declines in energy prices. Volatility briefly spiked in March but fell during the period, and the U.S. Dollar ended flat against most foreign currencies.

THE INVINCIBLE U.S. STOCK MARKET

It is fair to say that investors started 2023 with a bearish bias on equities. After the drop in equity valuations in 2022, due to the sharp rise in interest rates, earnings were widely expected to decline as the U.S. economy slowed. Abandoning its draconian pandemic controls, China would however return to the fore as a leading growth engine for the world.

Figure 1



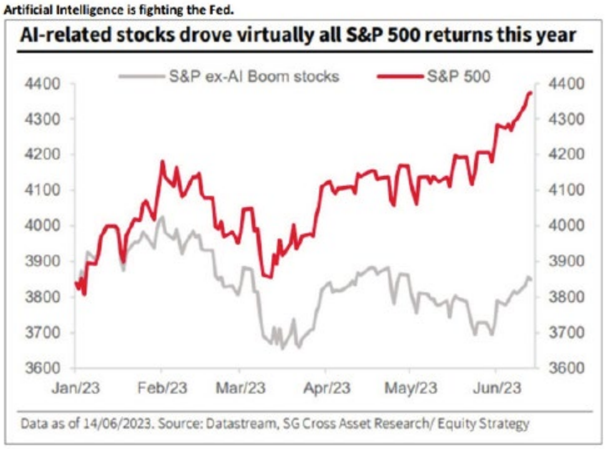
Instead, an unusual series of events all contributed to unexpected outperformance by U.S. equity markets. First, in January, a wave of short covering by hedge funds helped beaten down growth stocks recover. The market's positive momentum didn't last long, however, as economic indicators continued to point to a slowing economy.

Then in March, the collapse of Silicon Valley Bank, soon followed by Signature Bank and First Republic Bank, demonstrated the stress inflicted on the banking sector by rising interest rates and an inverted yield curve. An asset liability mismatch had become apparent across the banking industry as the cost of deposits had risen at the short end, while the value of "safe" long term treasuries had declined. Rising competition from money market funds and short dated treasuries caused a flight of bank deposits to these higher yielding assets, forcing banks to realize losses on their long-term holdings and leading to the collapse of three institutions with a narrow deposit base[1]. In a "bad news is good news" development, the market reacted by anticipating an end to rate hikes and indeed sharp cuts by year-end, which helped propel rate-sensitive large cap growth stocks once more. However, Fed officials remained steadfast in their commitment to inflation fighting, choosing instead to provide liquidity to the whole banking sector, and ultimately restoring stability.

By late May, another unexpected factor came to dominate equity markets, in the form of excitement surrounding widespread adoption of generative artificial intelligence, which can produce various types of content, including text, images or audio. Market participants concluded that the benefits of this technology would accrue to dominant players, now dubbed the "magnificent seven" since they already dominate equity market indices: Apple, Amazon, Alphabet, Meta, Microsoft, Nvidia and Tesla. The resulting rise in market valuations for these large components of the indices caused another surge in mega cap growth stocks.

In fact, the performance of the "magnificent seven" explains virtually all the returns of the U.S. stock market so far this year (figure 2), an impressive feat for equities that were among the most expensive in the benchmark, and an outcome that few anticipated.

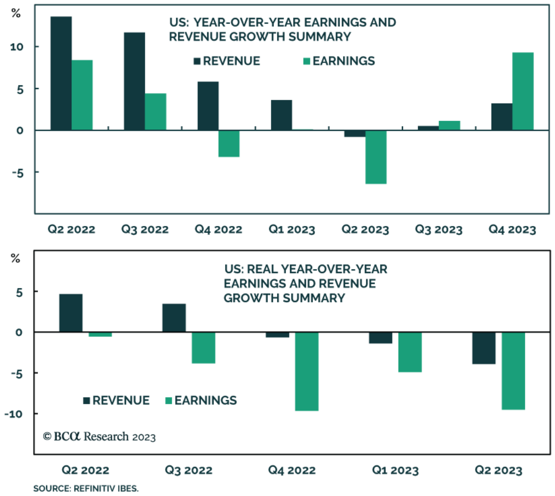
Figure 2



Source: Smead Capital, Societe Generale

By late June, the recovery broadened across most sectors. Underpinning the recovery were ebbing inflation measures and better than expected earnings. The first quarter of 2023 saw record negative earnings guidance from companies looking to set the bar as low as possible. This translated into a large positive earnings surprise for Q1-23, with earnings essentially flat with declining revenue (figure 3).

Figure 3



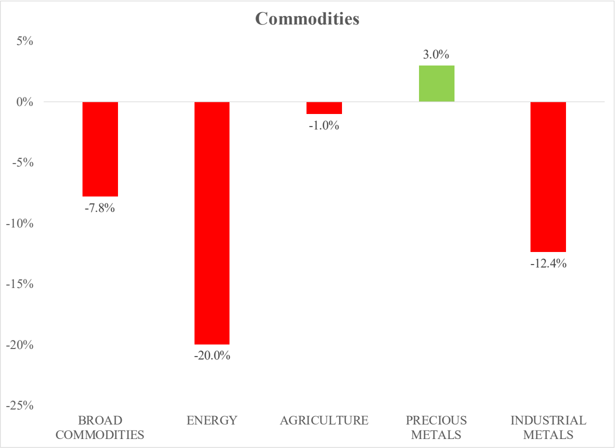
Source: BCA Research

[1] Silicon Valley Bank was the banker of choice for the venture capital industry, and networking led to herd behavior and a violent flight of deposits. First Republic Bank was similarly concentrated with high-net-worth clients whose deposits often exceeded FDIC insurance limits, causing similar asset flight.

The U.S. stock market thus ended the first half of 2023 up 16.9%, having successfully dismissed a hawkish Federal Reserve, recession fears and a banking crisis, and come up with a new rationale to justify high valuations. Invincible indeed.

The Chinese market, on the other hand, disappointed with lackluster activity measures. This led investors to adopt an increasingly bearish bias toward cyclical commodities, including energy and industrial metals (figure 4).

Figure 4

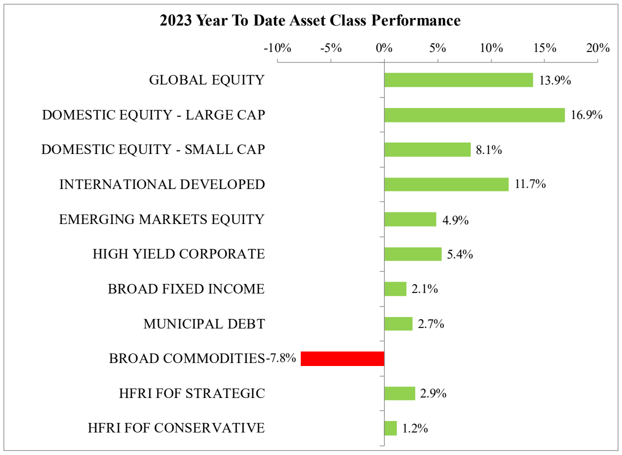


Source: Bloomberg

Reflecting growing market confidence, equity volatility as measured by the VIX index declined from 21.7 at the end of 2022 to 13.6 in June. The yield on the benchmark 10-year U.S. Treasury note peaked at 4.06% in February, dropping back to a low of 3.31% following the March banking crisis and settling at 3.84% by the end of June as the Fed renewed its commitment to fighting inflation. The U.S. Dollar was essentially flat during the period, depreciating by 0.6% vs. a basket of foreign currencies (DXY index). Gold rallied 5.2% through June, mainly in the wake of the banking crisis.

In a mirror image of 2022, all major asset classes gained for the first half, except for commodities. Defensive investments including fixed income and hedge funds lagged equities (figure 5).

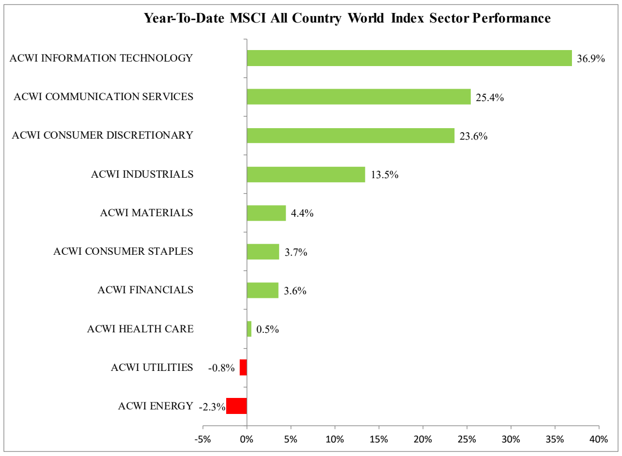
(Figure 5)



Source: Bloomberg

Year-to-date, most equity sectors are positive, led by sectors dominated by the “magnificent seven” stocks (Information Technology, Communication Services, Consumer Discretionary). Energy and Utilities lagged, due to the decline in commodity prices (figure 6).

(Figure 6)



Source: Bloomberg

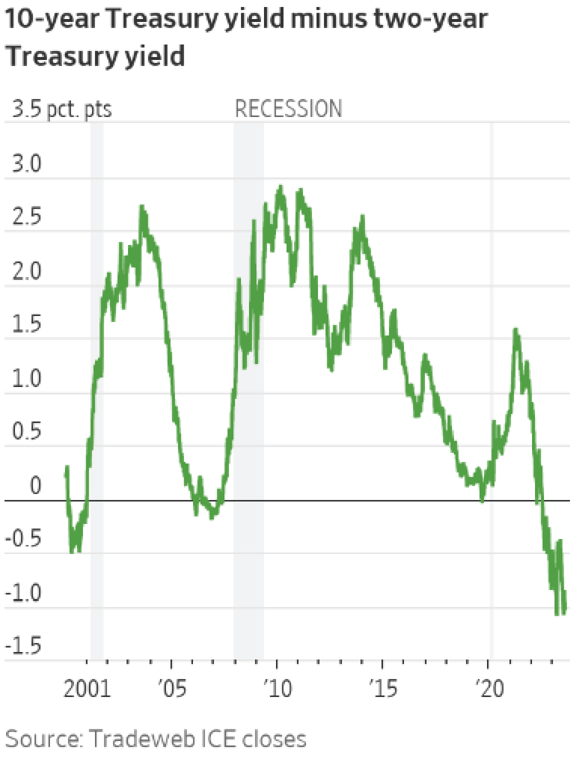
2023 was thought to be the year of the bond and most practitioners were defensively positioned in anticipation of a recession. Instead, ongoing economic resilience led investors to price a soft-landing scenario (decline in inflation with no recession), lifting the invincible stock market.

THE MARKET'S KRYPTONITE

Of course, even super-heroes are not invincible, and there is always a critical weakness introducing drama and uncertainty in what would otherwise be a foregone conclusion. Today, the market's kryptonite is the presence of inflation.

The sharp surge in inflation post-pandemic forced the Fed to aggressively hike interest rates, resulting in a yield curve inversion (where long-term interest rates are lower than short-term interest rates, see figure 7).

Figure 7



Source: Wall Street Journal

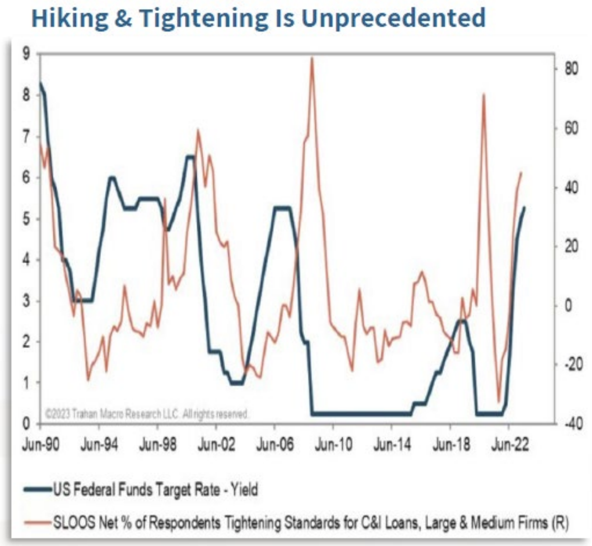
Historically, such a yield curve inversion has been a precursor to recession within six to 18 months. Generally, once recessionary conditions appear, banks adopt tighter lending standards, restricting the availability of credit to the economy. Eventually, a slowing economy allows the Fed to release the pressure by lowering interest rates.

This cycle is different.

First, pandemic stimulus checks swelled bank accounts during the era of low interest rates, prompting banks to invest in longer maturity, "safe" treasuries. As demonstrated in March, the rise in interest rates caused large losses on long-term bond portfolios, while prompting a flight of deposits to higher-yielding short-term assets. To protect themselves, banks reacted to the crisis by tightening lending standards before any recession materialized.

Second, the persistence of inflation prompted the Fed to maintain its hiking campaign despite the banking crisis, resulting in a unique situation of rising interest rates concurrent with tighter lending standards (figure 8).

Figure 8

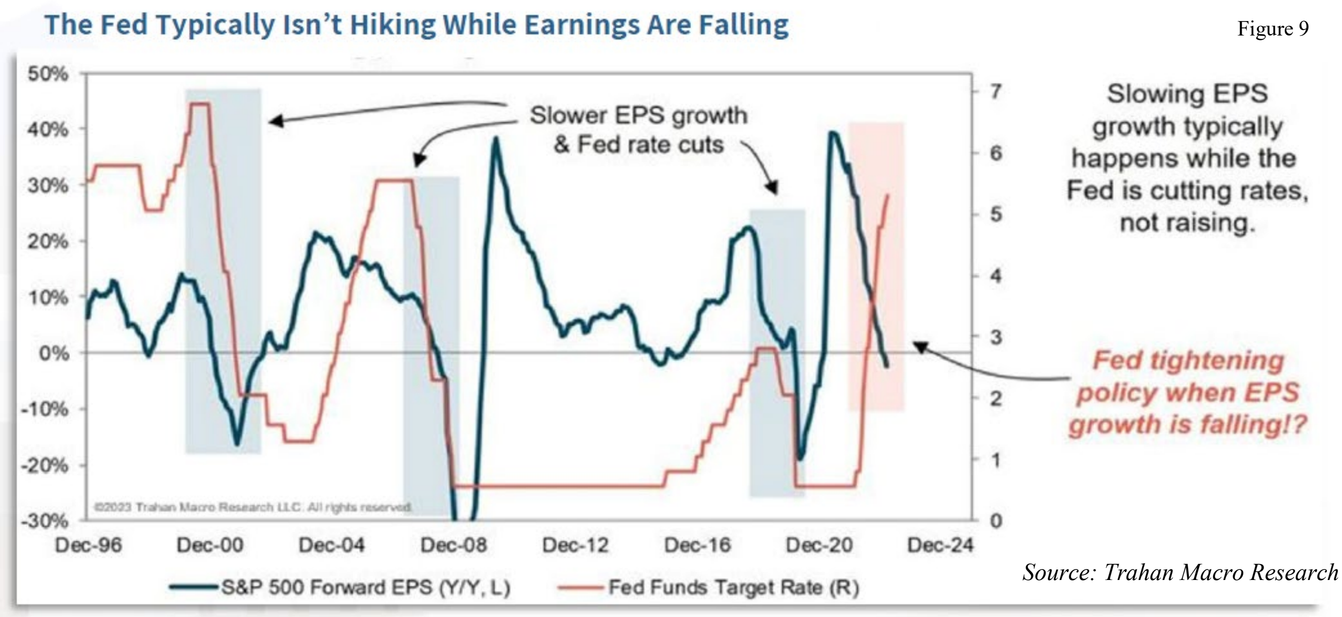


Source: Alpine Macro

Rate hikes despite tighter credit conditions and declining earnings (figure 9) will keep the U.S. economy on track for a recession.

Indeed, an inversion of the yield curve reflects a bearish signal by anticipating lower interest rates in the future (i.e. rate cuts in reaction to an economic contraction). Lower commodity prices similarly signal expectations for weak economic activity globally. Only equities reflect a positive outlook.

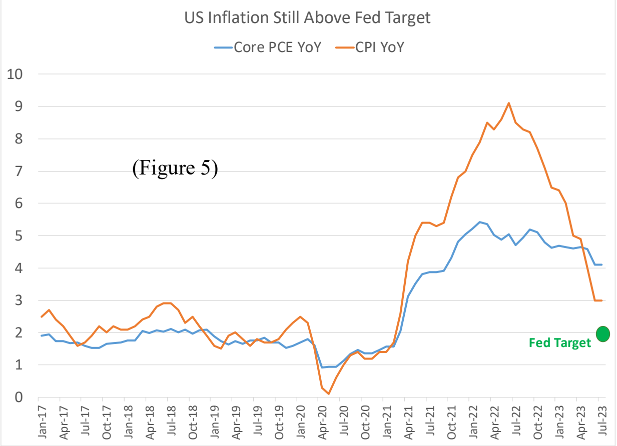
Figure 9



Source: Trahan Macro Research

Will the Fed respond to signs of recession with rate cuts? As shown in figure 10, while inflation is declining, it is still above the Fed's 2% target. Core inflation has also been falling more slowly than headline inflation, which includes energy prices, a trend that could easily reverse in our mind. In addition, a re-acceleration of the economy without a recession would fan the flames of inflation yet again, keeping rate hikes in play. Hence, we think that the Fed will be hesitant to cut rates too early and risk repeating the experience of the 1970's. Investors can hope for rate cuts but should prepare for the possibility of a recession with a delayed reaction from monetary authorities.

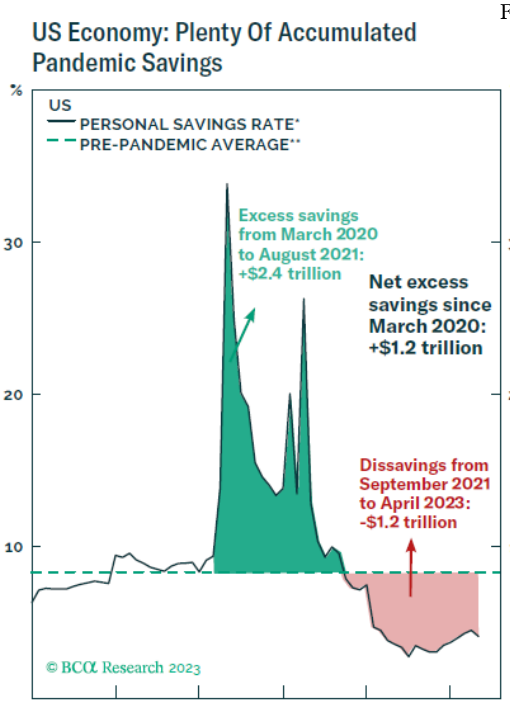
Figure 10



Source: Bloomberg

Why isn't the economy already in a recession? Consumers benefitted from a large transfer of wealth from the government during the pandemic and are in the process of spending accumulated savings (figure 11). This will delay but likely not ultimately prevent a recession.

Figure 11



* SHOWN AS A PERCENT OF DISPOSABLE INCOME.
** AVERAGE SAVINGS RATE FROM THE BEGINNING OF 2018 UNTIL THE START OF THE PANDEMIC.
NOTE: THE CALCULATION OF EXCESS SAVINGS ASSUMES A PRE-PANDEMIC BASELINE WITH 4% DISPOSABLE INCOME GROWTH AND 8.3% SAVINGS RATE.

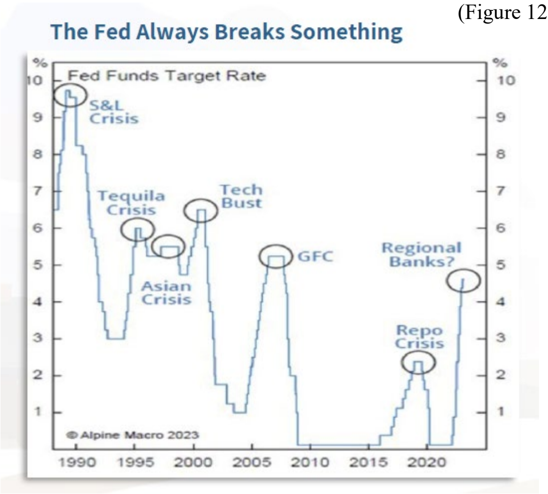
Source: BCA Research

LOOMING SUPERVILLAINS

The world of super-heroes is always under threat from supervillains. Current markets are no different with several issues looming over the horizon that will either fan inflation or constrain growth.

First, the banking crisis may not be over. As figure 12 demonstrates, sharp rises in interest rates usually result in major market stress.

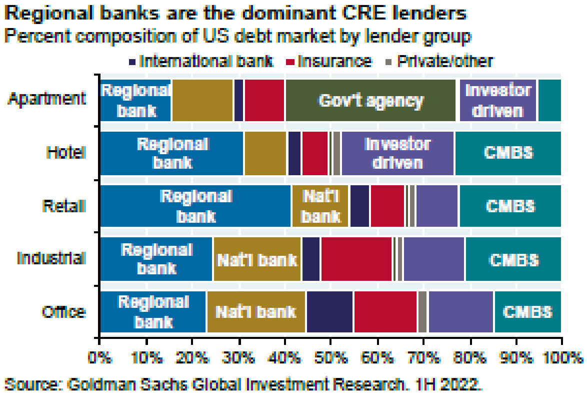
(Figure 12)



Source: Alpine Macro

In the 80's, increases in interest rates generated losses in commercial real estate loan portfolios that eventually led to the Savings & Loans (S&L) crisis. Current markets are reminiscent of this situation, as regional banks are a major holder of commercial real estate (CRE) loans (figure 13). With balance sheets already stressed by deposit flight, these institutions will need to contend with likely losses in CRE loans as rising interest rates make it impossible for many borrowers to refinance their debt.

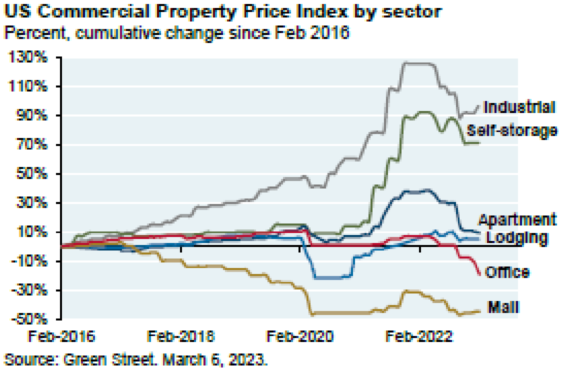
(Figure 13)



Source: JP Morgan Eye on the Market, Goldman Sachs

In addition, the valuations of real estate properties have declined as demand has waned across major sectors post-pandemic, notably in office and industrial properties (figure 14). Demand for office space has declined post-pandemic as work from home arrangements are now commonplace, and demand for industrial warehouses has slowed alongside the growth in online deliveries. U.S. regional banks hold over 20% of office and industrial property loans, making them particularly vulnerable in this category.

Figure 14

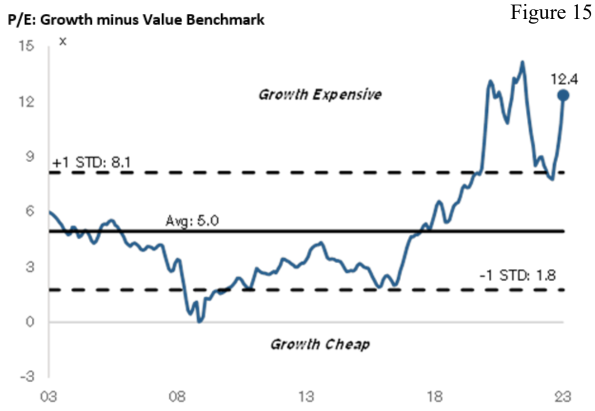


Source: JP Morgan Eye on the Market, Green Street

The threat of loan losses will continue to limit credit availability from banks in coming years, constraining economic growth.

Second, equity market valuations are on the rise again after falling during much of 2022. Hopes for rate cuts benefitted growth equities, while fear of recession led to a preference for high quality companies, leading investors to pile into a relatively few (magnificent seven) companies. As a result, equity market valuations are experiencing an "echo-bubble" in large cap growth (figure 15) that is reminiscent of the 2000 Tech bubble.

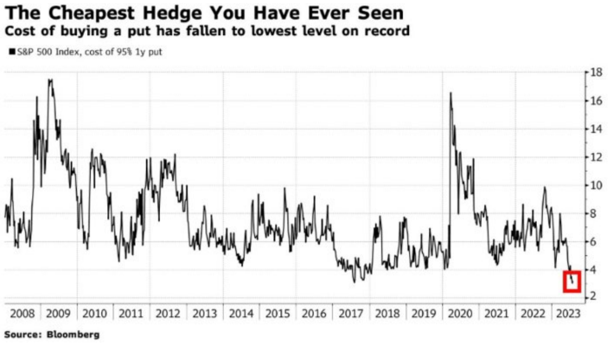
Figure 15



Source: Credit Suisse

In addition, the near-term resilience of the U.S. economy has led to remarkable complacence among investors as the cost of hedging downside risk reached new lows (figure 16).

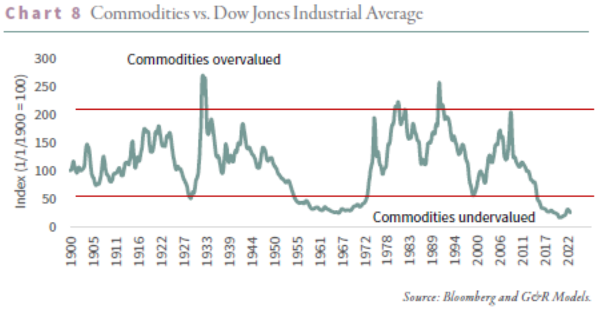
Figure 16



Source: Bloomberg

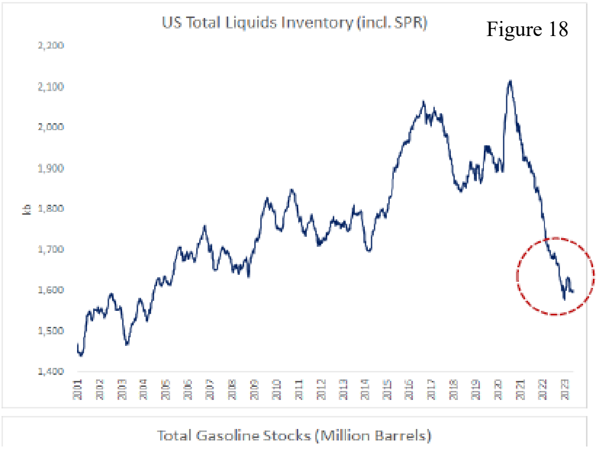
Third, investors continue to undervalue commodities despite signs of stretched supplies in physical markets. As shown in figure 17, commodity prices are at a historical low relative to the value of financial assets (U.S. equities).

Figure 17



Source: Goehring & Rozencwajg

In the past, high energy prices were resolved as new capital investments led to new discoveries and supply. This happened in the 1980's as oil discoveries in the North Sea offset OPEC and Iran embargoes. Similarly, high oil prices in the late 2000's were resolved as massive investment in U.S. shale oil resulted in oversupply. The recent increase in oil prices, on the other hand, was driven by tight supplies following lack of investment and as demand recovered post-pandemic. Prices then spiked in the wake of the Russian invasion of Ukraine. In response, the U.S. government engineered the largest release in history from the Strategic Petroleum Reserve (SPR). Figure 18 shows that total inventories (commercial inventories plus the SPR) are back to 2004 levels.

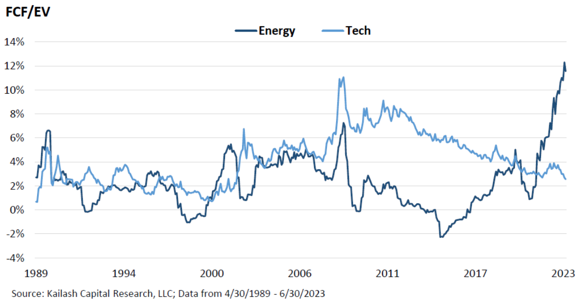


Source: Andurand Capital

While the market interpreted SPR releases as new market supplies, helping balance the market, this action really amounted to inventory draws and did not resolve the supply constraints. With total supplies at low levels and world oil demand reaching new highs, the risk of a renewed energy supply shock is elevated in our view. This would be an environment reminiscent of the 1970's.

Investors seem unworried about this risk, bidding up shares of technology stocks at the expense of energy. As a result, the valuation of energy shares (free cash flow/enterprise value) has rarely been more attractive while the attractiveness of technology shares continues to decline (figure 19). While valuations are not a catalyst signal, they are highly reliable in anticipating long-term returns.

Figure 19



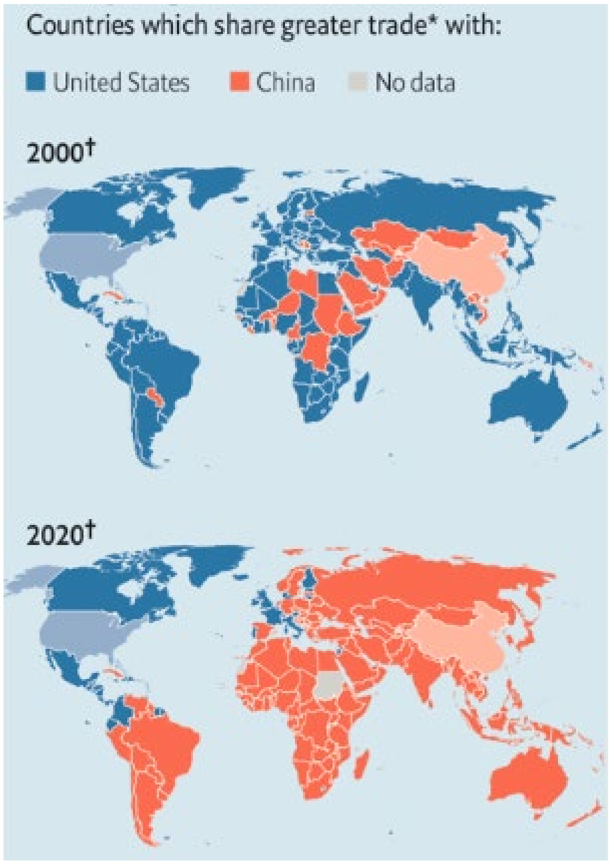
Source: Kailash Capital Research, LLC; Data from 4/30/1989 - 6/30/2023

Source: Kailash Concepts Research

Next, it seems likely that geopolitical tensions will continue. Russia and China seem to have made an alliance of convenience to help each other expand their respective sphere of influence over Ukraine and Taiwan, challenging the U.S. and its allies. Add Iran into the mix and a Eurasian block appears to be forming that could test the current U.S. dominated world order.

Consider the expansion of Chinese trade influence throughout the world, at the expense of American dominance between 2000 and 2020 (figure 20) and it is easy to understand why tensions have increased.

Figure 20



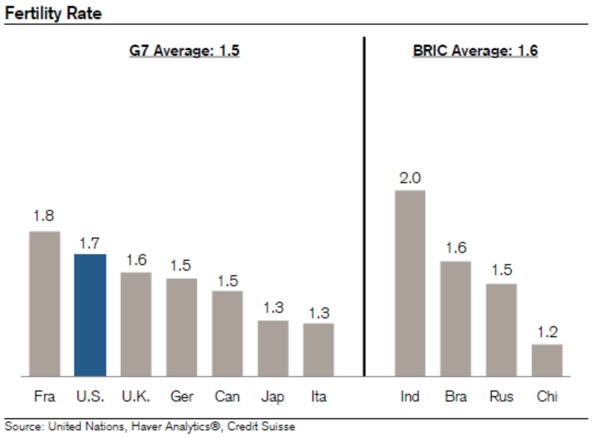
Source: The Economist

Mutual distrust is forcing a re-orientation of global supply chains, with "friend-shoring" replacing "off-shoring." This is a blow to globalization, a trend that contributed to low inflation for decades. Investment in new semi-conductor facilities in the U.S. under the CHIPS and Science Act is a symptom of the new inflationary trend resulting from geopolitical tensions.

Finally, the world population is aging, a slow-moving trend that will have huge implications in coming decades.

Figure 21 shows that fertility rates in all major countries are below 2.1 children per woman, the level considered necessary to maintain stable population levels. Even India, one of the younger countries is below replacement level at 2.0.

(Figure 21)

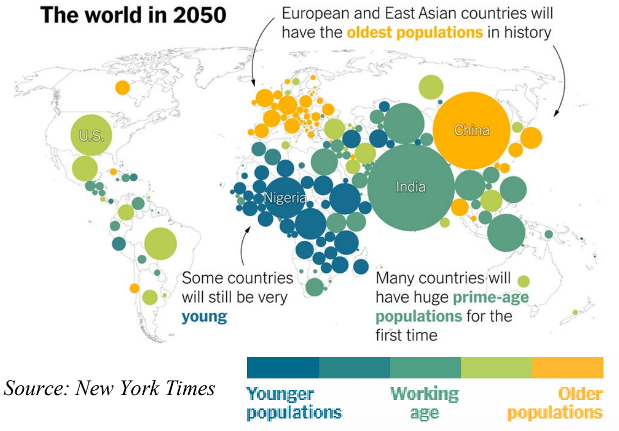


Source: United Nations, Haver Analytics®, Credit Suisse

Source: Credit Suisse

Declining birth rates and rising life expectancy mean a shrinking workforce relative to a rising pool of retirees. European and East Asian countries will age rapidly in coming years (figure 22), but the U.S. will experience the same trend.

(Figure 21)


The world in 2050
European and East Asian countries will have the oldest populations in history
U.S.
China
India
Nigeria
Some countries will still be very young
Many countries will have huge prime-age populations for the first time
Younger populations
Working age
Older populations

Source: New York Times

GDP growth is a function of the growth in the working age population and the growth in real output per worker (productivity). Therefore, a shrinking workforce is going to become a powerful headwind to growth in coming years, especially for countries seeking to limit immigration.

In addition, a shrinking workforce will tend to promote higher wages and inflation as employers compete for scarcer labor.

Following the end of the Cold War in 1991, and China's entry into the World Trade Organization in 2001, a massive number of new workers joined the world economy, a supply of new labor that helped support growth and lower inflation. Going forward, this trend will work in reverse as the world gets older and the working-age populations declines. Growth will become increasingly dependent on new technologies that will provide efficiencies and new capabilities to enhance productivity.

A NEW DAWN

Over the past 40 years, several secular trends contributed to lower inflation risk, including relative geopolitical stability following the end of the Cold War, abundant labor and natural resources, and ongoing globalization. The coming decades are likely to feature a reversal of most of these trends.

We believe that the central tendency of markets will err toward higher inflation and interest rate levels, and global growth will be more constrained than before. In particular, the recurrent risk of inflation will introduce more volatility in market outcomes.

Over the shorter term, the misallocation of capital that was promoted by a long period of abnormally low interest rates will need to resolve itself, creating stress in credit and equity markets.

This new financial era will increasingly reward highly diversified portfolios less dependent on a limited set of return drivers.

Owning long-duration assets such as equities and long bonds will become more challenging due to higher and more volatile interest rates. Hence, liquidity or the ability to rebalance portfolios will become more valuable, as will the need to develop access to and strong partnerships with exceptional managers of long-term illiquid assets.

On the other hand, shorter-duration strategies (i.e. favoring short-term cash flows over long-term appreciation) will become more attractive. As proof of this trend, witness the recent enthusiasm for private credit at the expense of large buyout funds.

In summary, the world is changing, and financial markets will need new heroes to face a more complex and increasingly volatile environment. We intend to find them for our clients.

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