INVESTMENT STRATEGY OUTLOOK

THE ECONOMY

Looking For Clarity? Then Look Elsewhere

May 2023

Things are seldom as they seem. With all apologies to Gilbert and Sullivan, there is perhaps no better way to summarize the economic data over the past few months. Okay, sure, we could apply that to most of the economic data since the onset of the pandemic, but rather than recapping the last three-plus years of often confusing and contradictory data there's more than enough from the past three months to occupy our space here. And, as if processing decidedly mixed messages from the economic data wasn't tricky enough, uncertainty over matters such as the debt ceiling, the banking system, and where the FOMC goes from here makes trying to plot the likely course of the economy, and in turn the markets, seem little more than a fool's errand.

The initial estimate from the Bureau of Economic Analysis shows real GDP grew at an annualized rate of 1.1 percent in Q1 2023, considerably below expectations. The biggest factor behind the surprisingly soft GDP growth print was a modest draw in business inventories which, thanks to the quirks of GDP accounting, took 2.26 percentage points off top-line real GDP growth. It is worth noting that the modest decline in business inventories in Q1 came after five consecutive quarters of robust inventory accumulation as firms scrambled to rebuild stocks which had been significantly run down by the combination of supply-side impairments and artificially boosted demand. With growth in both consumer and business spending clearly slowing in the early months of 2023, it could be that firms felt inventories were more or less right-sized.

While Q1 growth wasn't as sluggish as the headline growth print implies, neither was it as vigorous as implied by real private domestic demand – combined consumer and business spending. To be sure, we frequently note that we see real private domestic demand as a more meaningful indicator than top-line real GDP growth, in part reflecting how frequently swings in inventories distort measured real GDP growth, and the 2.9 percent annualized growth in real private domestic demand booked in Q1 is the fastest quarterly growth rate since Q2 2021. What we find concerning, however, is that much of this growth reflects the unusually strong growth reported in January in series ranging from consumer spending to core capital goods shipments, which was more than enough to offset what was generally weak February and March data. So, when looked at on a quarterly average basis, real private domestic demand looked healthy in Q1, but when looked at on a monthly basis, it seemed clear that Q1 ended on a much softer note than it began on, raising the question of just how much momentum the economy took into Q2.

At first glance, the April employment report would suggest a spring revival, with total nonfarm employment rising by a surprisingly strong 253,000 jobs and the unemployment rate falling to 3.4 percent, matching January as the cycle low. In keeping with our general theme of things seldom being what they seem, however, there is less to the April employment report than meets the eye. For starters, prior estimates of job growth in February and March were revised down by a net 149,000 jobs for the two-month period. Additionally, job growth has become less broadly based over the past three months, a trend which, should it persist, would be a worrying sign as to the staying power of this expansion. At the same time, the drop in the unemployment rate was primarily a function of a decline in the size of the labor force. Other labor market indicators show a further decline in job vacancies in March that left the level of vacancies lower than at any point since April 2021, and a further reduction in the rate at which workers are voluntarily quitting jobs. Along with a slowing trend rate of job growth, these are signs of a cooling labor market.

To that point, growth in average hourly earnings has clearly decelerated over the past several months, which some see as a sign of easing inflation pressures. We, however, see slowing growth in average hourly earnings as more a function of the mix of jobs added over the past four quarters, with lower-wage industry groups such as leisure and hospitality services, retail trade, and education and health services accounting for over fifty-five percent of all jobs added in the year ending with March 2022. This mix bias has weighed on average hourly earnings, thus holding down year-on-year growth.

Our argument is bolstered by the recent release of the Q1 Employment Cost Index (ECI), a measure of labor costs free of the mix bias that plagues the average hourly earnings metric. The ECI showed year-on-year wage growth of 5.0 percent in Q1, the fourth straight quarter of growth at or above five percent. It is worth noting that, like many private sector analysts (us included), the FOMC sees the ECI as the superior gauge of wage growth. To the extent FOMC members see a strong link between wage growth and inflation, there has not yet been nearly a strong enough deceleration in wage growth to inspire confidence that inflation will settle back at their 2.0 percent target rate any time soon.

The inflation data are sending their own mixed messages of late. Recall that in March, lower energy prices acted as a drag on headline inflation, a drag that reversed in the April data and which will reverse again in the May data. These swings aside, headline inflation is decelerating, but the same cannot be said for core inflation, which is proving to be frustratingly persistent. This is largely a reflection of core services price inflation not yet having eased. But, one implication of inventories being right sized, to the extent that is the case, is that firms will no longer feel compelled to offer sizable discounts in order to clear unwanted stocks (think back to the 2022 holiday shopping season), which in turn means that goods price disinflation will no longer act as a brake on overall inflation.

This could leave the FOMC in a most uncomfortable position. That core inflation has stubbornly refused to budge over the past few months would suggest that, even after having raised the Fed funds rate by twenty-five basis points at their early-May meeting, the FOMC is not yet finished raising the funds rate. Growing concerns over the potential economic fallout from stress in the banking system, however, raise the bar for further rate hikes higher than would otherwise be the case. The Federal Reserve's Q1 survey of commercial bank loan officers shows further tightening in lending standards and further softening in loan demand. In their policy statement issued following their May meeting, the FOMC noted that tighter credit conditions "are likely to weigh on economic activity, hiring, and inflation." In that sense, tighter credit conditions can serve as a substitute for additional funds rate hikes, but the two are anything but equivalent as, unlike central bank policy rates, credit crunches cannot be precisely managed, let alone contained.

This isn't to say a full-blown credit crunch is inevitable, but neither can one be ruled out at this point. The reality is that the outlook is no clearer to the FOMC than it is to the rest of us, and there are some potentially significant dark clouds looming over the economic landscape. This is a recipe for the considerable volatility seen in equity and fixed income markets over the past several months to be with us for some time to come.▲

Source: Bureau of Economic Analysis; Bureau of Labor Statistics; U.S. Census Bureau; Federal Reserve Board of Governors

STOCKS

Merit To Both Bull And Bear Arguments

The S&P 500 went virtually nowhere for the first three weeks in April but closed out the month with a 1.2% loss as economic data, earnings season, and debt ceiling worries gave both bulls and bears plenty to chew on. Those optimistic on the near-term path for stocks tend to point toward some mix of better than feared quarterly earnings releases, corporate credit remaining well-bid, and the prospect of a Fed pause as a reason to remain constructive on stocks. However, bears have an equally compelling laundry list of reasons to support their stance that a defensive posture remains justified. S&P 500 earnings estimates continue to be revised lower and may have additional downside, while the S&P 500 trades at a historically 'rich' 19X expected 2023 earnings and lending standards are expected to tighten further, thus limiting credit availability. All while monetary policy tightening over the prior year has yet to fully flow through the U.S. economy.

Bulls have ruled the day thus far in 2023, but gains have been driven largely by communication services and information technology behemoths such as Apple, Meta Platforms (Facebook), Microsoft, Netflix, and Nvidia, among others, all laggards in 2022. April was, for lack of a better term, rudderless, with the S&P 500 trading in a wide range while ultimately straying very little from where it started the month, which could embolden both bulls and bears to press their respective positions. Bulls cheer sideways markets that allow stocks to digest gains via time instead of through falling prices/profit-taking, while bears point toward the S&P 500's inability to break out to a new year-to-date high despite improved investor sentiment and earnings results as an indication that the market is running out of upside catalysts. Both the bull and bear narratives hold some merit, but April's relative calm is likely to give way to a more volatile and downbeat May due to the battle being waged over the debt ceiling.

Narrow market breadth has been a hallmark of the year-to-date rally, and leadership skewed toward defensive areas such as consumer staples, health care, and utilities during April, which leaves us less enthused about the near-term prospects for stocks. The small-cap Russell 2000 again lagged the S&P 500 and sector relationships serving as a gauge of sentiment and risk appetite such as consumer staples vs. consumer discretionary, are also throwing up caution flags. While these relationships don't dictate action or portfolio shifts, when taken together they paint a picture of a market with questionable character and one in which complacency shouldn't be allowed to creep in.

Economic Data, Positive Earnings Revisions Supportive Of Developed Markets Abroad – For Now. Eurozone equities continued to perform well during April as encouraging economic data (Leading Economic Indicators, Industrial Production, Exports) more than offset concerns surrounding elevated inflation in France, Germany, and the U.K. The MSCI EAFE index ended April higher by 2.9%, and 12.1% year-to-date, propelled by broad-based strength out of Europe

as France, Germany, Italy, Spain, and the U.K. have each posted year-to-date gains of 10.5% or more. Notably, while the consensus estimate for full-year 2023 S&P 500 earnings per share has fallen 6% since the end of October, the consensus estimate for 2023 EAFE earnings per share has risen 11.7% over the same time frame, a catalyst serving to improve investor sentiment. Positive economic momentum in the euro zone has led to strong relative performance out of the EAFE over the past two-plus quarters, but inflation remains elevated and with tighter monetary policy and energy insecurity concerns likely to weigh on economic growth and investor risk appetite in the back-half of this year. Investors should temper expectations surrounding euro area equities for the remainder of 2023 as many potential positives catalysts from an economic perspective are already priced in, and great expectations for euro area economic growth could prove unattainable.

China 'Changing The Narrative' Could Boost Emerging Markets. The MSCI Emerging Markets (EM) index fell 0.8% during April as China and Taiwan, which together constitute 45% of the MSCI EM index, each fell 3% or more. China held military drills in the South China Sea during the month, spurring speculation that China would invade and attempt to reunify Taiwan sooner rather than later. While geopolitical tensions tied to China/Taiwan have garnered headlines and weighed on investor sentiment and risk appetite for emerging markets, the more impactful story has been the uninspiring reopening of China's economy from stringent COVID lockdowns. China's rebound has left much to be desired, but we wouldn't underestimate the government's ability and resolve to stimulate economic growth over coming quarters. While the prospect of China moving on Taiwan cannot be discounted, we suspect tensions will ebb as China re-focuses its energy and efforts on driving economic growth. As China goes, so goes emerging markets and economic optimism could buoy broader EM sentiment near-term. Thus, we remain comfortable with a neutral allocation to emerging market stocks at present. ▲

BONDS

Debt Ceiling Debate Front And Center

April was a rollercoaster ride for short-term Treasury yields, evidenced by 1-month T-bills ending March with a 4.74% yield before bottoming out at 3.36% three weeks later and ending April at 4.35%. The extreme volatility in the 1-month yield during April is noteworthy, but even more stunning were the results from a 4-week T-bill auction the first week in May as investors, primarily money market funds, required a 5.84% high yield to take down $50B of issuance. This was 265-basis points above the closing yield for 4-week paper auctioned off just two weeks' prior. Investors now require a substantially higher yield for taking on what is perceived to be increased credit risk in short-term U.S. Treasuries given the "X-date" when the U.S. Treasury is expected to run out of funds, which is now believed to fall somewhere in the June/July timeframe.

Debt ceiling discussions are set to ramp up and take center stage in May after Treasury Secretary Janet Yellen stated that the U.S. Treasury could run out of cash as soon as June 1 if tax receipts fall short of expectations. In the wake of her remarks, questions have arisen surrounding the assumptions that went into this declaration. Secretary Yellen and Treasury likely floated the June 1 date with the belief that it was a conservative route to take as it conveyed a sense of urgency to the necessary parties to get their act together on raising the debt ceiling. If the U.S. government's fiscal situation has deteriorated at a rapid clip so far in May and corporate tax receipts don't accelerate meaningfully prior to the June 15 deadline for corporations to file, the June 1 "X-date" may be pulled forward.

Initial demands from the White House and House Republicans appear far apart and the impulse to get a deal done by June 1 may hinge upon the pace and size of corporate tax receipts that flow into Treasury's coffers this month. A delayed deal that stretches beyond Treasury's "X-date" is a possibility and could bring about a government shutdown and/or technical default in which no interest payments are missed. The debt ceiling debate will contribute to volatility in Treasury yields during May and the prospect of a downgrade of U.S. government debt by ratings agencies will be a possibility whether a deal or delayed deal materializes. If history repeats, or at least rhymes, a debt downgrade could prove profitable for holders of longer duration Treasuries which rallied when S&P downgraded U.S. government bonds from AAA to AA+ back in 2011. A duration profile in-line with the Bloomberg Aggregate Bond index remains preferable as near-term uncertainty surrounding the debt ceiling may shift capital into longer duration Treasuries and investment-grade corporate bonds, pulling yields lower and boosting total return.

Treasury Issuance To Rise Sharply, Corporate Issuance To Remain Restrained. Yields on long dated U.S. Treasury bonds could be pulled lower by debt ceiling discussions, but increased issuance may act as an offset. Earlier this month, Treasury guided 2Q borrowing substantially higher to $726B from the $277B announced in January, with the bulk of the issuance expected to be front-end loaded. The U.S. Treasury expects to issue $1.4T of bonds in from April through September, due primarily to a lower starting cash balance and tax receipts falling below Treasury's expectations. Too much supply is not a concern for investment-grade corporates as, according to Bloomberg, investment-grade issuance of $110B is expected during May, plus or minus $10B. Recent deals have traded poorly in the secondary market, and with uncertainty surrounding the debt ceiling and path forward for monetary policy set to persist throughout May, borrowers could delay offerings as they await a more constructive backdrop. Higher quality, long duration corporate paper should be a primary beneficiary as demand outstrips supply. ▲

ALTERNATIVES

Stability During Volatile Times

The HFRX Global Hedge Fund index marked time during April, rising just 0.3%, but despite minimal movement at the headline level there was some notable activity under the surface. On balance, both discretionary and systematic global macro/managed futures strategies fared well during the month, rebounding from a challenging first quarter. The HFRX Macro/CTA index rallied 1.3% during the month while the Systematic Diversified CTA index fared better with a 1.8% monthly gain. Year-to-date, both the Macro/CTA and Systematic Diversified CTA indices are lower by 1.1% and 4.0%, respectively, lagging the Global Hedge Fund index meaningfully. If sized appropriately, exposure to these types of strategies makes sense within the context of a broadly diversified portfolio as they perform best in trending markets, which tends to be the case when stocks or bonds are experiencing a drawdown.

Event driven strategies garnered attention during April as Microsoft's (MSFT) proposed acquisition of Activision Blizzard (ATVI) failed to garner antitrust approval from the European Commission charged with signing off on merger and acquisition (M&A) transactions across the pond. The MSFT/ATVI deal had been under the microscope since mid-2022, and the likelihood of the deal closing was viewed as a coin-flip for some time. Many tried and true merger arbitrage strategies carried minimal exposure to this deal and were less negatively impacted by it breaking, evidenced by the HFRX Event Driven: Merger Arb index ending the month flat. Conversely, riskier special situations strategies that engage in more speculative rumored M&A transactions were more exposed to the deal, leading to a 0.5% monthly drop in the HFRX Event Driven index. While we entered this year constructive on the outlook for merger arbitrage strategies, at this point, we must acknowledge the challenges that await merger arb strategies in the form of a combative regulatory/antitrust environment, not just in the U.S. but also abroad.

Given our outlook that traditional asset classes will likely continue to experience elevated volatility in the coming month(s), we continue to believe exposure to alternative strategies is warranted as a tool to mitigate volatility and limit portfolio drawdown. Hedged equity strategies, managed futures, long/short credit, merger arbitrage, and convertible arbitrage, among others, all hold appeal if sized appropriately. ▲

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