Public

This Month in the Markets

January 2023

Equity Commentary

The Death of 60/40 Looks to Be Exaggerated

The equity market started the year surging, with the MSCI ACWI Net Total Return Index posting a gain of 7.2% in January. The MSCI World Value Net Total Return Index jumped 4.7% compared to the gain of 9.7% in the MSCI World Growth Net Total Return Index. The S&P 500 rose 6.3%, while the MSCI EAFE Net Total Return Index climbed 8.1%, and the MSCI Emerging Markets Net Index jumped 7.9%. The MSCI ACWI Consumer Discretionary Sector index was the top performer, posting a strong 14.1% gain driven by a rebound in some depressed retail shares. The MSCI ACWI Health Care Sector was the under-performer, with a loss of 0.4%.

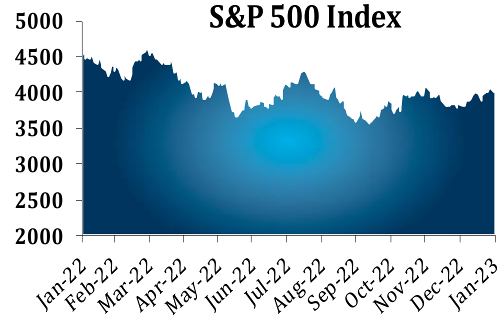
The correlation between stocks and bonds remained positive at the start of the year. Still, unlike last year, they moved together positively as long-term interest rates, and inflation expectations declined. Much has been written about the death of the 60/40 portfolio after it suffered its worst loss since 1937. January offered one of the best months for the portfolio after an energy crisis appears to be avoided in Europe, China's re-opening accelerated prospects for global growth, and employment reports remain strong. With rates at the highest levels they have been in over a decade and valuations in the equity market more attractive, we view the setup for the 60/40 portfolio to be more favorable than in recent years. The odds of a mild or no recession have become more common in the commentary. Still, we remain cautious, given some negative news flow from the housing market and the downshift we are beginning to see in consumption. We may have a case where the market has already discounted a lot of bad economic news, which could show up in the economic data over the next few months. Because the equity market tends to look forward six to twelve months, however, much of this has likely been factored in.

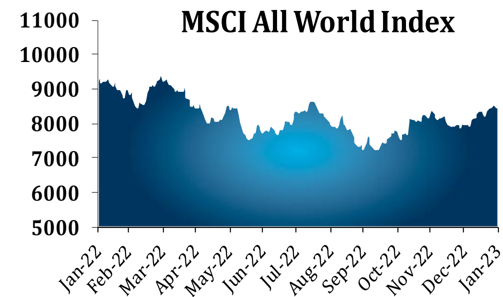
CVS Health Corp ("CVS") was the largest underperformer in the portfolio for the month, falling 4.7%, over concerns involving reports that federal health authorities are planning new standards for auditing billings for companies that offer private Medicare plans and the general weakness seen in the healthcare sector. The top performer in the month was Uber Technologies Inc. ("UBER"), up 25.1%, which rose on an analyst upgrade and the announcements surrounding right-sizing its labor force.

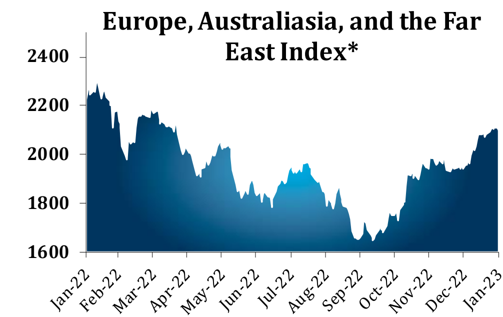
We sold Willis Towers Watson PLC as it approached our assessment of full value.

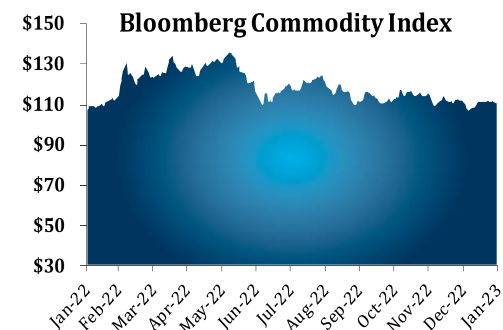
We had two purchases in January. Amazon.com Inc. ("AMZN") and Diageo PLC ("DEO"). Amazon underperformed the market by almost 16%since we sold the shares last May and now models with significant upside based on improving free cash flow estimates over the next three years. The company has 34% upside on our discounted cash flow model. The primary stock drivers are rising share in US eCommerce; large cash flow generation from AWS, which remains a share leader in the premium cloud segment; third-party ad commissions; long-term innovation trends; and an attractive valuation versus history.

At the month's end, we added Diageo shares. Diageo is a global beverage company with dominant brands, including Johnny Walker, Crown Royal, Captain Morgan, Tanqueray, Don Julio, and Guinness. Given their focus on premium spirits, many of which need to age for more than a decade, we believe the company has a relatively wide moat as it is very difficult for new competition to emerge in many categories. As a result, the company has been maintaining or growing market share in 75% of its brands and has grown sales with an 8% compound annual growth rate over the past five years. Since peaking about a year ago, shares of Diageo have sold off about 21%, pushing its valuation multiples to levels not seen since 2014-2015. While the market is focusing on risk, we took the opportunity to add a very high-quality business at what we feel is a very reasonable price.







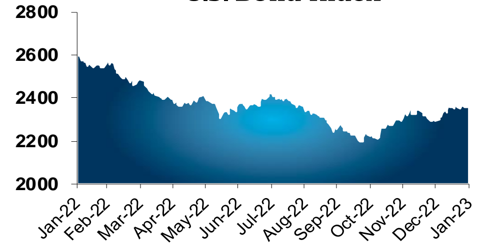


*MSCI EAFE Index

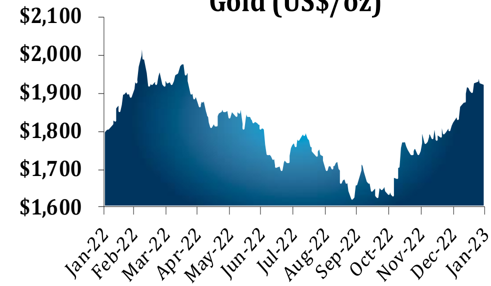
Fixed Income Commentary

A Blistering January

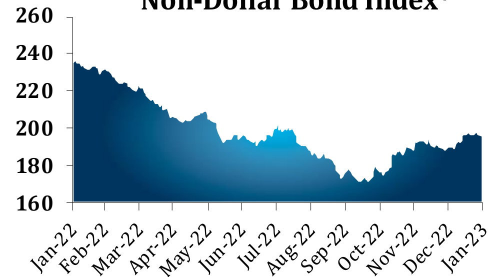
The year got off to a blazing start in January with gains across the board due to the rally in credit spreads and decline in treasury rates. The ICE BofA US (Investment Grade) Corporate Index rose 3.91%, closely followed by the 3.89% gain of the ICE BofA US High Yield Index. Credit spreads tightened across all rating cohorts, led by the CCC-rated and B-rated companies. This is notable as these higher risk companies were very much unloved last year. This dynamic reflects the overall "risk-on" tone of January. The re-opening of China, the world's second largest economy, and the improving economic data out of Europe helped propel this sentiment. In fact, credit spreads of the Bloomberg Asia USD High Yield Bond Index and the Bloomberg Pan-European High Yield (Euro) index declined more than their US counterparts. In addition, the dollar declined as proxied by the DXY index which fell 1.4%.



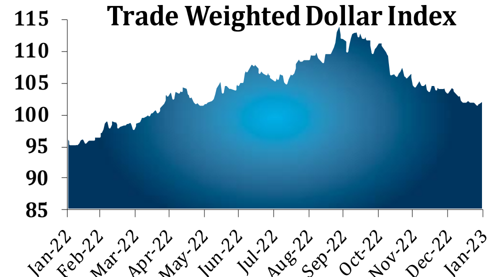
The ICE BofA All Maturity US Government Index rose 2.25% in January as rates declined across the treasury yield curve. The 2-year treasury yield fell 0.22% to 4.20%, while the 10-year treasury yield declined 0.37% to end the month at 3.50%. As a result, the yield curve further inverted. The 2Y-10Y portion of the yield curve inversion increasing another 0.15% to end the month 0.70% inverted. An even more dramatic inversion occurred in the 3-month to 10-year portion of the yield curve, which inverted a further 0.65% to end the month inverted by 1.18%. An inverted yield curve is a well-known leading indicator of a recession. As per Alpine Macro, excluding the 2022 COVID-19 induced recession, "the 10-2 spread inverted eight times for seven recessions; and the 10y-3m curve inverted six times, still missing one recession, in 1990." The 2Y-10Y portion of the curve has been inverted since July 2022, while the 3M-10Y portion of the curve only just inverted in November. This indication is in line with what we are seeing from other economic growth indicators. For example, the ISM Purchasing Managers Index New Orders component reading of 42.5 is well below the 50 expansion/contraction threshold.



On the other side of the coin, consumer balance sheets are healthy, buoyed by the impact of COVID-19 related handouts and the resilient labor market. While there are signs of the labor market softening (the wave of tech company lay-off announcements), it is doing so from a very tight level. The labor force participation rate is still well below the level that prevailed before COVID-19. The ratio of job openings to unemployed stands at 1.9x, indicating an unbalanced labor market. In addition, year-on-year (YoY) wage growth, while declining, remains elevated. The latest reading of the Bureau of Labor Statistics Employment Cost Wage for Private Industry Workers rose 5.1% YoY. Market expectations are for YoY inflation to fall sharply towards the Fed's 2% target over the next six months, using forward inflation swaps as a proxy for market YoY inflation expectations. This is due to large YoY base effects, given the elevated index values that prevailed in 2022, much improved supply chains, and a slowing economy.



These expectations for declining inflation and deteriorating leading economic growth data have driven the Fed pivot narrative. This narrative got a shot in the arm in the February 2nd FOMC press conference where Powell acknowledged many times that disinflation is underway and intimated the recent loosening in financial conditions was not of great concern to him. This was a decidedly different tone to his 2022 press conferences. The market took the news in stride, with rates falling across the curve and risk assets rallying strongly. The John Heywood quote springs to mind, "give him an inch and he'll take a mile…"



*Merrill Lynch Global Broad Market, Ex US Dollar Index

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