This Month in the Markets

February 2023

Equity Commentary

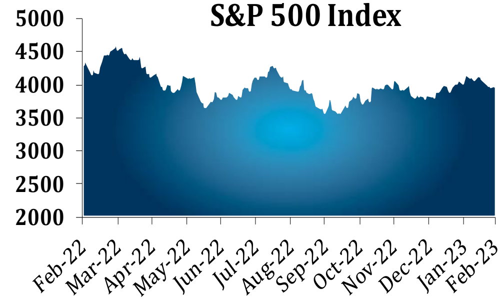
Good News Can be Bad News

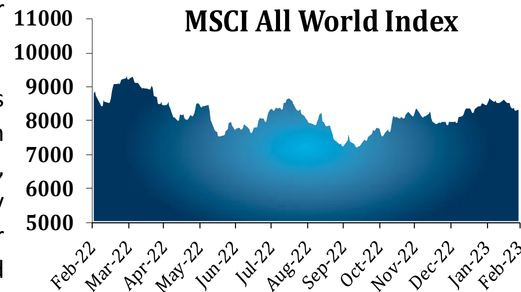
The equity market gave back some gains in February as the MSCI ACWI Net Total Return Index fell 2.9%. The MSCI World Value Net Total Return Index fell 2.9% compared to the drop of 1.9% in the MSCI World Growth Net Total Return Index. The S&P 500 slid 2.4%, while the MSCI EAFE Net Total Return Index fell 2.1%, and the MSCI Emerging Markets Net Index was lower by 6.5%. The MSCI ACWI Information Technology Sector index was the top performer, posting a small loss of 0.4%, driven by a rebound in some depressed technology shares. The MSCI ACWI Materials Sector was the under-performer, with a loss of 5.8%. The economic data was stronger than expected during the month, but commodity prices moderated after a strong performance during the prior four months.

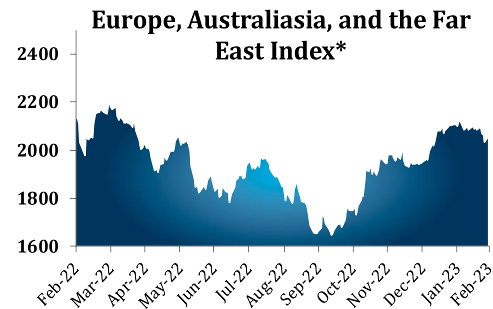
While January saw a shift in sentiment towards lower inflation, investors reversed course in February. Initially, the market was focused on a more certain recession, which would lower inflation pressure, but a shift in economic data, especially strong job numbers, has shifted attention once again to potentially persistent higher interest rates. It would be rational to believe that stronger economic data would be good for equity prices, but this needs to be coupled with a view on inflation and rates. Higher inflation and, thus, elevated rates for a longer period of time, will increase the discount rate and potentially put pressure on margins, thus lending a negative slant to future valuations. While the market was likely overly discounting rate reductions at the back end of the year, recent data suggests that inflation may be more persistent, and higher rates may extend through 2023. Good news can be bad news.

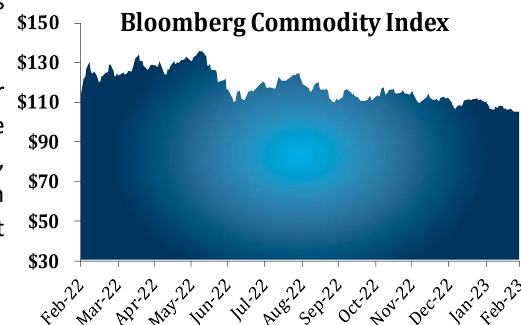
Fourth-quarter earnings reports also impacted the stock market. While fundamental results were on average better than expected, corporate executives were cautious about their 2023 outlooks. As a result, analysts were forced to lower their forecasts for many companies, especially in the consumer discretionary, technology, real estate, and financial sectors. Some of the pessimism was offset by multinationals whose executives were optimistic about the fast reopening of the Chinese economy after the "zero-covid policy" was ended.

Devon Energy Corp ("DVN") was the largest underperformer in the portfolio for the month, falling 14.7%, as crude and natural gas prices sold off during the month. The top performer in the month was Palo Alto Networks Inc. ("PANW"), up 18.7%, which rose after reporting a very strong quarter that included an outlook for rising cash flow margins and operating profitability. It also beat expectations in terms of revenue and billings.









*MSCI EAFE Index

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Fixed Income Commentary

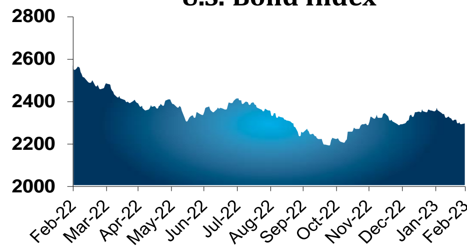
Rates React to Resilience

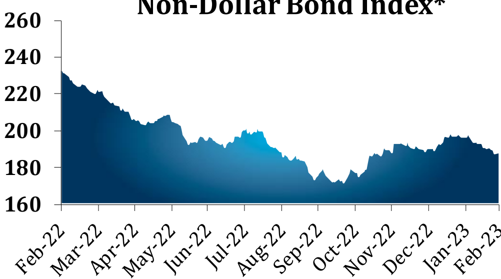
February was characterized by a series of strong economic data releases, which caused a significant shift in the US treasury yield curve, with the 2 year/10 year spread inverting the most in four decades. Unfortunately, this inversion has been an accurate recession indicator. It began with the February 3rd nonfarm payrolls report which came in very strong showing 517,000 jobs created in January versus expectations of 189,000. Despite a large seasonal adjustment which pushed the reported figure higher, it was a large job gains figure at a time when the labor market is already tight. On the same day, the ISM Services Purchasing Managers Index (PMI) was reported, which came in at 55.2 (vs 49.6 the prior month), well above the 50.5 consensus expectation. As a reminder a reading below 50 is considered an indicator of contracting economic growth. The Service PMI's are a closely watched data point by investors. Services sector spending compromises the majority consumer spending and comprises about two thirds of U.S. GDP. While these were only two data points, the strength of the US economy was unexpected by market participants. In the weeks that followed, we also got higher than consensus expectations readings from several closely watched data points, including the consumer price index (02/14), retail sales data (02/15), producer price index (02/16), and personal consumption expenditure (02/24). These data releases suggested the U.S. economy has been more resilient than expected, and inflation more persistent.

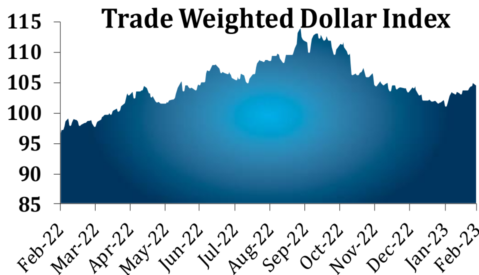
As a result, we saw interest rates move higher across the curve in February. The 10-year treasury rose 0.41% and ended the month at 3.92%. Meanwhile, the 2-year treasury yield rose 0.63% to 4.82%. As such the 2-year to 10-year spread on the yield curve further inverted to 0.90%. We also saw a large move in the Fed Fund futures curve which indicates market expectations for the fed funds rate at given points in time in the future. At the beginning of February, this curve showed the fed funds rate peaking at 4.90% in mid-2022, followed by almost two 0.25% rate cuts by year-end. It was also showing and expectation for six(!) 0.25% cuts in 2024. At February-end, the peak fed funds rate expectation had risen to 5.36%, and suggestive of only a 50% or so chance of a single 0.25% rate cut by year end 2023. What is interesting is that there are six 0.25% rate cuts priced in for 2024. This suggests the Fed pivot is still very much expected, it is just expected to occur from a higher terminal fed funds rate. We would expect the very inverted yield curve to flatten if over the course of the year the market prices out some or all of these rate cuts. This is far from a given, but worth noting.

Inflation is clearly trending down from its peak, but the path and settling point are very much unknown. The latest so called "super core PCE (Personal Consumption Expenditure)," which excludes shelter, food, and energy, rose 4.6% year-on-year in January, still over double the Fed's 2% inflation target. In addition, wage growth while declining YoY remains elevated. Meanwhile the labor market is tight. The participation rate has not recovered to pre-COVID levels, mostly because +55-year-olds have not returned to the workforce. The ratio of job openings to the number of unemployed stands at 1.9x, well above the pre-COVID range. It should be noted that the rise of working from home/abroad has likely distorted the job openings figure (through multiple postings of the same job). On the other hand, we have seen job cuts have risen sharply as per the Challenger Job Cut Announcements index, as well as some highly publicized tech company job cuts.

In the March 22nd Federal Open Market Committee meeting we will get an updated summary of economic projections and an updated DOT plot. In addition, we will receive an updated view from Chair Powell on his views of the labor market, inflation, and the Fed's current thinking around them. While volatility should persist, we believe that the bond market offers attractive value at current interest rates.







*Merrill Lynch Global Broad Market, Ex US Dollar Index

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