WESTEND Advisors

A VICTORY CAPITAL® INVESTMENT FRANCHISE

Economic and Market Commentary

Q1 2023

The Cracks Have Started to Show

The Fed continues to tighten, even as bank turmoil highlights the economic stresses of elevated interest rates. We still see risks in economically sensitive areas of the market as the impacts of aggressive monetary policy work through the broader economy.

SUMMARY

- Recent turmoil in the banking industry is consistent with late-cycle economic conditions and does not change our broad outlook.
- We still see continued risk of slowing economic activity tied, in part, to the Fed's aggressive monetary tightening.
- Despite slowing growth, we see both relative and absolute return opportunities ahead in select U.S. equity sectors and fixed income.

Q1 2023 REVIEW

The start of 2023 may mostly be remembered for the two largest U.S. bank failures since the Great Financial Crisis, yet stocks still finished the first quarter (Q1) in positive territory. After 2022's sharp decline, the S&P 500 returned 7.5% in Q1 as fears over financial system contagion have been largely quelled to date by regulatory backstops.

In the U.S., stocks and bonds rallied in January as continued easing of inflation and longer-term interest rates fueled hopes for a pause or pivot in Fed monetary policy. Some areas of the market that fell the most in 2022 led the way up in early 2023, including mid-phase sectors like Information Technology and Communication Services. Momentum faded in February, as some inflation data exceeded expectations, raising questions over whether the Fed would continue slowing its rate hikes. The bank failures in March exacerbated volatility, particularly for Financials and other more economically sensitive sectors, though a pullback in interest rates helped cushion the impact on other sectors like Utilities and Consumer Staples. Stocks then rebounded into quarter end as fears of bank contagion eased.

International equity markets also rallied in January, led by emerging markets (EM), but trailed off as the quarter progressed. Overall, EM underperformed and developed markets outperformed the U.S. in Q1.

Bonds in the U.S. followed a similar pattern to equities in Q1 until stresses in the banking system drove an apparent flight to safety, pushing yields down in March, with the yield on the 10-year Treasury dropping about half a percentage point to end the quarter at 3.47%. Corporate bonds generally underperformed as credit spreads widened in Q1. The Treasury yield curve also flattened late in Q1 after the deepest 2-year to 10-year inversion since the early 1980s. Sharp reversals of yield curve inversions are common preceding recessions.

OUTLOOK

Despite headline-grabbing events in the banking industry, little has changed in our outlook over the past quarter. We did not specifically predict bank failures, but they are consistent with the late-cycle conditions we have been seeing and positioning for in recent quarters. While economic data is still mixed, we see continued risk of slowing economic activity tied, in part, to the Fed's aggressive monetary tightening. In our view, the elevated stress in the financial system is partly a consequence of aggressive monetary policy, but also part of the transmission mechanism through which Fed tightening affects the broader economy. Tighter financial conditions exacerbate the late-cycle challenges to growth and could pull forward the timing of a recession. As such, we see earnings for economically sensitive sectors at significant risk. Still, we see both relative and absolute return opportunities ahead in select U.S. equity sectors and fixed income.

Late-Cycle Progression

Banking turmoil and tighter financial conditions exacerbate late-cycle challenges to growth.

U.S. Economy and Equities: We continue to see cracks developing in the economic backdrop, beyond recent banking industry turmoil. While U.S. economic data has been mixed and Q1 GDP might come in above trend, even seemingly healthy headline employment data is showing signs of weakness under the surface. Broad measures of U.S. economic activity like the Chicago Fed National Activity Index weakened in recent quarters. The Leading Economic Index has also deteriorated over the last year as the Fed tightened monetary policy and interest rate-sensitive parts of the economy faced headwinds.

For banks, the Fed's interest rate hikes were initially a positive, in our view, but they also eroded the market value of long-term securities banks held as capital. While this may not be a problem when securities are not marked to market, high withdrawals at some banks with concentrated depositor bases forced sales of such securities at a loss.

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For now, regulatory backstops seem to have contained the risk of financial system contagion. We do not know if there will be other significant bank failures this cycle, but we believe the market and regulatory uncertainty banks now face will exacerbate pressures on profitability. We were already seeing a significant tightening of lending standards, which can slow lending growth, especially when combined with elevated interest rates and slowing economic activity. Now, we also expect bank net interest margins to be squeezed by increased cost of capital, as banks likely need to pay higher interest rates to maintain their deposit base, where they are competing against higher yields from money markets, Treasury securities, and other banks.

We have been avoiding the U.S. Financials sector since mid-2022, along with other highly cyclical sectors, given our outlook for a late-cycle economic slowdown. Recent events in the Banking industry affirm our near-term conviction in avoiding these sectors, as deceleration in many areas of the economy could be compounded by reduced access to borrowing and increased cost of capital.

The Other Financial Contagion
Bank turmoil could lead to even tighter lending standards, reducing access to needed capital for cyclical sectors like Industrials, Materials, and Real Estate.

Consumers have been a key driver of continued economic growth in the U.S., but robust income growth has not kept pace with inflation. Our analysis indicates 43% of consumer spending growth in 2022 was fueled by a decline in the savings rate, which is now well below long-term averages. The above-trend savings accumulated from lower spending and direct stimulus payments during the pandemic is now falling rapidly, and we do not see consumers reducing savings rates again in 2023. Meanwhile, despite continued strength in headline jobs data and near record low unemployment (typically lagging indicators), payroll growth has decelerated sharply among sub-industries that have historically provided leading signals for the overall job market, including temp workers, credit intermediation, and warehousing & storage. Anecdotally, there also have been notable layoff announcements in tech-related industries that expanded payrolls during the pandemic. All this suggests we could see a material deceleration in consumer spending this year. Amid this backdrop, we believe the full effects of the Fed's aggressive monetary tightening have yet to be felt.

The continued economic slowdown we expect, however, does not necessarily mean the broad stock market must decline a lot from current levels. While significant market downside is certainly possible and volatility is likely, in our view, the broad market could simply bounce around near current levels even as earnings deteriorate. In 2022, the S&P 500 declined more than 25% from its initial high to October lows, as contracting valuations priced in higher interest rates and increased economic risks. Going forward, with continued economic weakness and an eventual easing of monetary policy, we expect longer-term interest rates could begin to decline. This could support higher equity valuations and help offset the price impact of lower expected earnings.

Whether or not the broad market declines materially from current levels, we believe economic and market conditions are poised to reward late-phase sectors of the market that tend to have relatively stable earnings growth and which, in some cases, tend to benefit from declining interest rates, such as Consumer Staples and Utilities. We are emphasizing those U.S. sectors along with Health Care across our strategies. In contrast, we expect early-phase, economically sensitive sectors like Financials, Industrials, and Energy to underperform, and we are avoiding those sectors in U.S. allocations across our portfolios.

International: Foreign economies currently face many of the same economic headwinds as the U.S., but with some key differences that generally reduce our international outlook. Emerging markets, in particular, tend to be very economically sensitive. This is partly because many emerging economies are very reliant on exports or commodities, which can be significantly impacted by a global economic slowdown. As such we are underweighting EM in our global strategies.

Within developed markets, we believe Europe has faced greater risks from inflation than the U.S. over the past year tied, in part, to the region's dependence on Russian energy. While a moderate winter and favorable prior-year comparisons may contribute to easing inflation readings, we believe Europe still faces significant risks from monetary and fiscal tightening, and it has less savings cushion to support consumers than the U.S. Further, Europe's sector composition leaves it particularly sensitive, in our view, to a global economic downturn, as roughly half of European equity market capitalization is from early-phase, economically sensitive sectors like Financials, Industrials, and Energy. Thus, we continue to underweight Europe in global portfolios.

Among international equities, we still see developed Asia as a relative bright spot. Economic output in Japan, the largest developed economy in Asia, remains below potential, and stimulative monetary and fiscal policies remain in place. We see these factors supporting relative resilience for Japan amid a continued global slowdown.

Fixed Income: We currently see a favorable return opportunity and limited near-term risk for fixed income in balanced portfolios. After the sharp interest rate rise and worst bond returns in over four decades in 2022, we believe upside risks to longer-term interest rates is limited. The elevated yield on fixed income compared to recent history, combined with potential appreciation as interest rates fall, presents an unusually compelling return potential for bonds, in our view. Thus, we are overweight fixed income in balanced strategies, with an emphasis on longer-term securities that should benefit the most from falling interest rates as economic activity and inflation slow. We have also increased Treasury exposure over the past year, which we believe could benefit amid a flight to perceived safe assets.

CONCLUSION

We believe our portfolios are well positioned for the ongoing late-cycle economic challenges we see becoming increasingly evident. As always, we will continue to evaluate incoming data, and we stand ready to increase the expected economic sensitivity of our strategies when we see appropriate potential for economic and market recovery.

WestEnd Advisors Investment Team | April 3, 2023

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