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Quantvest

Financial Outlook

First Quarter 2023

Summary

At a Glance

- Inflation looks to have peaked
- The FED's tightening campaign may be close to ending
- Lower bond yields have spurred gains in both bonds and equities
- But caution is warranted as inflation and bond yields may stay higher than the market currently expects

Point of View

Jan Erik Warneryd, Chief Investment Officer

The first quarter of 2023 proved to be a good one for financial assets. Both the S&P 500* (up 7.5%) and bonds (Bloomberg/ Barclays Aggregate Bond Index*+2.96%) did well as yields fell and the market started sensing an end to the Federal Reserve Bank (FED) tightening in the near future. In 2022, real rates on 10-year TIPS (Treasury Inflation Protected Securities) rose from -1% to +1.5% which caused losses for both equity and fixed income, and so far in 2023 the drop in real TIPS yields (see below) has led to positive returns for both asset classes.

* The Standard and Poor's 500 and the Barclays Aggregate bond index are both market indices and are not managed, cannot be purchased and do not reflect the deduction of any fees. The volatility and performance of an index and an investor will not be the same.

TIPS 2020-2023

Rates peaked and equities bottomed in the fall of 2022 as the market increased its expectation of a coming recession. While growth has surprised on the upside in recent quarters, both in the US and globally, there is still a broad market consensus that a recession is very likely later in 2023. The outlook has recently deteriorated further due to the regional bank crisis (the failures of Silicon Valley and Signature Banks). For this reason, the market now believes that the Federal Reserve are close to the end of the tightening campaign they started in 2022 and will soon embark on aggressive rate *cuts*. Current market expectations are that the FED funds rate will fall from about 5% in June 2023 to 2.8% by the end of 2024.

The circumstances under which the FED would cut rates as aggressively as the market expects would likely include a severe recession, but we believe that is an unlikely scenario. Our base case is that with the peak in inflation behind us, the FED is very close to ending the tightening campaign, but we do not expect a swift pivot to rate cuts. We may see one more rate hike before the summer but after that we expect the FED to keep rates unchanged for another quarter or two before evaluating whether rate cuts are needed. However, it seems clear that the FED were paying attention to the banking system's woes as they appear to have been preparing to hike by 50 basis points on March 22. In the event, the FED raised by 25 basis points as volatility and uncertainty gripped the market. The market has welcomed the FED's heightened awareness of potential stress in the financial sector as their message heretofore had been very hawkish. Market expectations of a "FED Pivot" after the summer are once again very high.

While the recent bank turbulence may be adding to uncertainty and recent indicators point to a weakening in the US economy, embedded expectations point to both inflation *and* rates falling rapidly in coming years. To accept current market pricing as correct, an investor would simultaneously have to believe the following:

- The economy will be weak enough to force the FED to cut rates starting in July or August
- Despite the FED currently saying inflation is too high, inflation will actually fall towards 2% in the next 2 years even as the FED pivot to rate cuts
- The US equity market will benefit from lower rates but not be hurt by the recession that forces rates and inflation lower
- The long end of the yield curve will continue to trade at yields of about 3.5% or lower as fixed income investors see the recent high inflation experience as a one-off event that doesn't warrant a forward-looking risk premium. The market essentially puts a near-zero percent probability on inflation much above 2% on average over the next 30 years

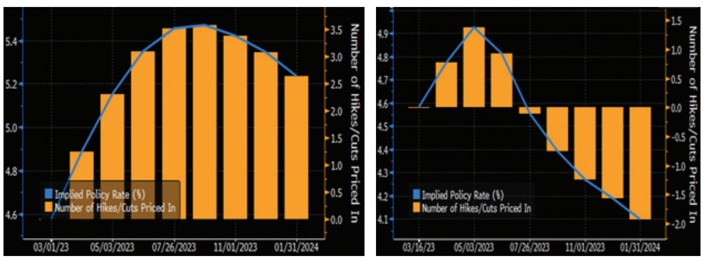
It seems reasonable that some, but not all, of the expectations listed above could turn out to be correct. For example, will the equity market not be negatively affected by a potential recession? Will inflation really reach 2% even if the FED start to cut rates in the summer of 2023? Maybe it would be reasonable for the long end of the Treasury market to require a risk premium just in case inflation flares up again at some point in the next 30 years? After all, the break-even 30-year inflation rate between nominal Treasuries and TIPS is currently at 2.2%.

A key question for the next few years is whether we will return to the post-Financial Crisis environment of Monetary and Fiscal stimulus, low rates and buoyant asset values or whether the future will look more like the 1980s and 90s. Let us remember that the fiscal spending and Quantitative Easing undertaken in the past decade-plus was justified partly by the argument that as long as inflation wasn't a problem the stimulus could continue indefinitely. There may be reasons to believe that some of the forces that weighed on inflation such as Globalization and well-anchored expectations may have less of a benign impact going forward. For example, it is plausible that geopolitical tensions will force reshoring of manufacturing away from China to the US and Mexico, resulting in higher prices which will, in combination with the inflation spike in recent years, increase inflation expectations. Such increased expectations would likely result in a higher realized inflation rate as workers and companies seek compensation, in effect causing an upward price spiral that self-perpetuates as expectations become entrenched. This would be a significant change from the environment investors have experienced in the last decade-and-a-half or so. Even the FED, according to forecasts by FOMC (Federal Open Market Committee) members, believe the long-term level of FED funds is only 2.5%. This implies a future 2% inflation rate plus a real rate of .5%, both of which are significantly lower than levels seen in the 1980s and 90s. It is possible that financial markets are ill-prepared for a shift back to a higher inflation environment, or at least one where inflation fears end up having more of an impact on asset prices. For this reason, we will remain cautious until the mismatch between realized and expected inflation has narrowed.

Bond Markets

Mark McDonnell, Senior Portfolio Manager

The first quarter of 2023 starting as most years do, with professional bond investors making modest adjustments, setting asset allocations and positions across the yield curve after refining forecasts of the economy and markets. That changed dramatically in March with the rapid collapse of four regional banks. Markets reacted violently with the 2-year note dropping over 100 basis points in three days. Markets both respond to new information and in many cases are used as the interpretive device by market participants to determine the severity of that new information. Sometimes those signals exaggerate the threat. The 2-year note was flashing a serious warning sign to the market. Therefore, it is important to understand why it reacted as it did. In the days immediately prior to the Silicon Valley Bank (SVB) debacle Jerome Powell was encouraged by the ability of the risk markets to absorb a rapid series of rate hikes and spoke in a way that led the market to expect a renewed aggression to the pace of tightening. In early February, the market priced in a few more tightenings with a peak Federal Funds Rate of under 5%. By early March the markets readjusted aggressively, with expectations of peak Fed Funds up at least 50 basis points. The market was very one sided. The rapid unprecedented drop in the 2-year yields was indeed a result of a change in Fed Funds expectations as illustrated in the two panels from Bloomberg pricing Fed Funds expectations a mere 2 weeks apart, but it was also a result of changes in positions. The unwinding of those positions created the appearance of a much larger financial crisis as rates plummeted. We would argue that the Regional Bank issue is serious, but not as serious as “the tape “made it look.



Source: Bloomberg

The problems with Silicon Valley Bank and the other three failed regional banks were and are serious. There can be further failures. However, we don’t believe this situation is anywhere similar to the Great Financial Crisis. It is important to understand why it happened. Liberty Street Economics of New York and the Federal Reserve bank identified the first factor. Banks were awash in deposits and felt no need to offer higher rates to attract any more. As the Fed raised rates, they failed to keep pace. Concurrent with that most banks that saw a rapid accumulation of deposits like it happened at SVB invested a good deal in low yielding treasuries and mortgages. It is important to note that the quantitative easing initiated in 2020 was so aggressive that it drove the yields and more importantly the durations of mortgage pools to very low levels. The aggressive hiking by the Fed as they played catch-up on inflation resulted in significant unrealized losses on their books. Normally while important it is far from life threatening for a regional bank. However, since they were paying very little on their deposits *and* accounts over the FDIC limit of $250,000, some were questioning why they were taking outsized risk on their cash relative to the larger money center banks. Those very large banks are called Global Systemically Important Banks (G-SIB). You probably know them as “too big to fail”. They have significantly greater reporting requirements and are rightfully perceived as having greater checks in place. Money started moving from regional banks to the money center banks. The Fed was quick to guarantee deposits above the FDIC limit and created a special borrowing facility for those regional banks. This went a long way to solve for the default risk, but bank confidence plays a large part in keeping those deposits at regional banks. Fortunately, the quick action by government officials bolstered confidence. Every Friday the Fed releases what is called the H.8 report and we can see flows from regional banks to the money center banks. Large at first, we see much more manageable flows in the last report.

Interest rates dropped precipitously. Equities fell and credit spreads widened. We were and are modestly underweight corporate bonds in our positioning, believing credit spreads reflected mid cycle compensation rather than the additional yield one should get with an economy showing some signs of its age. However, our development of the macro view vis a vis this banking crisis gave us the wherewithal to reduce the underweight in credit. We added a corporate bond to the portfolios. The following chart from Bloomberg will help to explain why we bought what we did.

Source: Bloomberg

Normally bonds issued by companies that produce consumer staples trade at an additional yield or spread *somewhat* comparable to senior debt of finance companies. In the panic caused in part by the dramatic overreaction in interest rates the spread on G-SIBs, those too big to fail banks, widened considerably. We were able to add one of those banks to the portfolios at a spread we believe compensates our clients for the credit risk at this point in the cycle.

STRATEGY

We continue to have a mild underweight in duration, finding little value in the long end of the Treasury market. As mentioned, we continue to have a small underweight in corporate debt. We took advantage of the widening in mortgage spreads to reduce virtually all of our underweight in mortgages. We believe most of the rise in rates is behind us in no small part due to the tightening in financial conditions brought on by the regional banking situation. We believe we are well positioned for an economy that is in the latter stages of the business cycle but still has some room to grow. We believe we will still see occasional mild shocks as quantitative easing is over and Central Banks across the globe continue to further withdraw liquidity, giving us the opportunity to again increase credit exposure on spread widening.

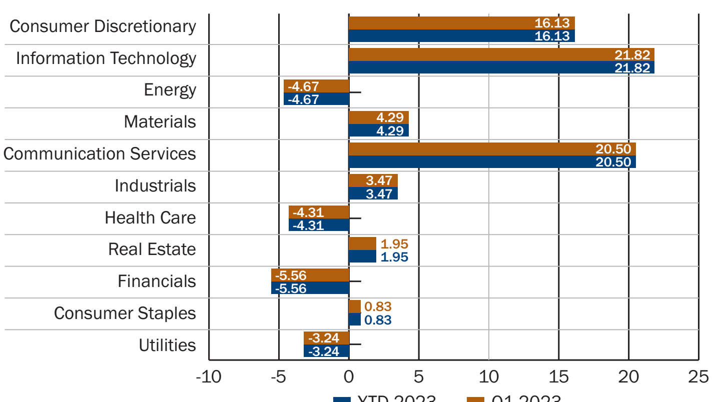
U.S. Equities

Jan Erik Warneryd, Chief Investment Officer

The first quarter of 2023 offered investors a roller-coaster ride. After a roaring almost 9% rise by early February, the S&P 500 gave up all YTD gains by mid-March due to concerns about banks, only to rally again into quarter end. The S&P 500 ended the first quarter up 7.5%, led by Information Technology and Communication Services (see below). Both sectors were up over 20%. Financials (banks) was the worst performing sector for the quarter, with a negative 5.56% return. Energy also put in a negative return, at -4.67%. The S&P 500 is now up about 15% from the end of Q3, a fairly remarkable turnaround in the face of negative market sentiment and widespread expectations of a recession later in 2023. The fact that the Fed and other institutions acted quickly to limit the fallout from the regional bank crisis doubtlessly reminded the market of other interventions in recent memory going back to the financial crisis of 2008-9 and, more recently, the COVID pandemic. The aggressive rate cuts priced in for later in 2023 suggest the market thinks the "Powell Put"* is alive and well.

* The Powell Put is the Idea that the Fed provides downside insurance for the stock market as a whole through policy intervention, i.e., interest rate cuts and quantitative easing.

S&P 500* Index
Total Return (%) by Sector / Quarter End March 2023

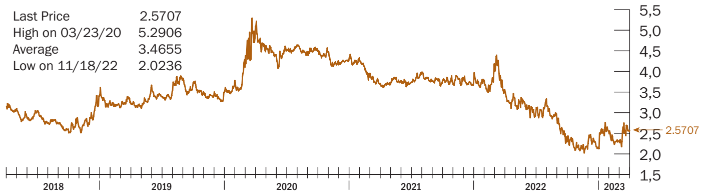


Source: S&P Global

* The Standard and Poor's 500 is a stock market index. Indices are not managed, cannot be purchased and do not reflect the deduction of any fees. The volatility and performance of an index and an investor will not be the same.

Just as the main driver of the negative equity market performance in 2022 appears to have been higher interest rates, specifically higher ***real*** rates, the drop in the 10-year Treasury Note yield from 3.88% at the end of last year to 3.47% by the end of Q1 2023 helps explain the market's recent overall positive performance. Looking more closely at sector performance, we note an unusually wide performance gap between over and underperformers. The dispersion between, for example Information Technology and Financials is over 25% for the quarter. Again, just as Technology and growth stocks in general underperformed in 2022 due to higher yields reducing the present value of future cash flows, lower yields so far in 2023 have favored these stocks. As mentioned above, arguably the driver of negative returns for equities and other "real" assets was the rise in real interest rates. In 2022, the real yield on 10-year TIPS (Treasury Inflation Protected Securities) rose from -1% to over 1.5% by the end of the year. So far in 2023, this yield has fallen to 1.14% (see Chart below).

SPX/TIPS



Source: Bloomberg

The fall in real yields has made the stock market more attractive relative to bonds as can be seen in the chart above which shows the spread between the CAPE (Cyclically Adjusted P/E) earnings yield on the S&P 500 index and the real yield on 10-year TIPS. This spread can be seen as a measure of the forward-looking risk premium, in real terms, that an Equity investor could earn by investing in Equities instead of Treasuries over the long term. The spread fell from about 4% at the beginning of 2022 to about 2.13% at the end of the year, but has since risen to about 2.57%.

U.S. Equities (cont'd)

Jan Erik Warneryd, Chief Investment Officer

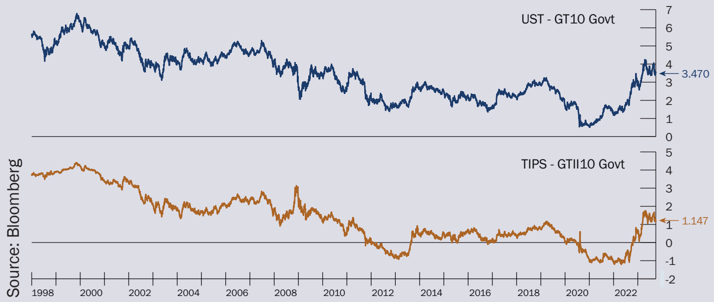
STRATEGY

Our base case for the US economic outlook is that we will avoid a recession, although our conviction level has been negatively impacted by the recent turbulence in the banking sector. However, since early March the market has lowered its expectations for the peak Fed funds from about 5.6% to 5% currently, followed by significant rate cuts starting in the summer. The market currently expects the Fed funds rate to fall to 3% by late 2024, which is a drop of almost 1% from just before the demise of Silicon Valley Bank. This revised rate outlook is clearly a positive for asset markets but it is mitigated by the as-yet-unknown fallout from the current uncertainty surrounding banks, including the potential drag from more restrictive bank lending. While we think the US banking system is sound, it is reasonable to expect credit availability to be negatively impacted by recent turmoil in the sector. Bank capital has clearly been impacted by declining values of holdings of otherwise credit-worthy bonds and Mortgage Backed Securities, but we do not think there is a threat to overall bank solvency, especially if the economy can avoid an outright recession.

Our relative optimism about the US economy stems from our expectation, shared by the market, that we are at or close to the peak in monetary tightening. Where we disagree with current market pricing is with the extent of rate cuts expected. Since we think a recession can be avoided, we don't think the FED will cut anywhere near as aggressively as the market implies. The conundrum in the market appears to be that while a recession is likely necessary for the FED to cut aggressively, that would of course impact earnings negatively. Be careful what you wish for! We think inflation has peaked and this will give the FED "cover" to end its current tightening campaign very soon but we also believe the economy will be strong enough to keep rates "higher for longer" than the market expects.

While the current tightening cycle has been aggressive, outright nominal and real yield levels are not particularly high as seen from a 25-year perspective (see below). The upper half of the chart shows nominal 10-Year Treasury Yields and the lower chart shows 10-Year (Real) TIPS yields.

10 Year Yields



We believe the Value factor will continue to provide good returns to investors, notwithstanding recent growth stock outperformance, as investor interest in such sectors as Health care, Autos and Telecoms returns in a rotation away from high-priced sectors favored essentially since the 2008-9 financial crisis. Although the Value factor performed well in 2022, it was almost entirely due to the outstanding performance of the Energy sector. We believe other Value sectors will join Energy and contribute to outperformance for the factor going forward.

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OPTIMUM QUANTVEST CORPORATION

We take a different approach to traditional US fixed income and equity investing by using a combination of macroeconomic and fundamentally based analysis. With a track record of over 30 years, we have assisted pensions, insurance companies, corporations, endowments, foundations and high-net worth individuals with their investment needs. Our approach to investing combines a macroeconomic perspective with an inherent value bias. We collaborate with our sister companies in Montréal and Paris to enhance our analysis of the markets. While our expertise is investment management, becoming a trusted partner and advisor defines our purpose.

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