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SUMMARY:

Stocks were higher last week (S&P 500 +1.6%), lead once again by the tech-heavy NASDAQ (+3.0%). YTD NASDAQ is +20.9%, S&P 500 +9.7% and DJIA +0.8%. The S&P 500 broke above 4200 for the first time since last August. The news backdrop featured seemingly positive progress on the debt ceiling negotiations. Best sectors were technology (+4.2%) and communication services (+3.1%); worst sectors were utilities (-4.4%) and real estate (-2.4%).

KEY TAKEAWAYS:

1. Although bumps are likely, stocks were generally higher on news that <u>both Democrats and Republicans want to get a deal done</u> on the debt ceiling issue.
2. <u>We see a debt ceiling deal containing two steps:</u> the first would be a temporary increase in the debt ceiling coupled with an agreement containing key items. The second step would fill in the details. Once that second step is completed, the debt ceiling would be raised past the Presidential election.
3. <u>Recent Fedspeak has been more hawkish</u> pushing the probability of another 25bp rate hike in June above 40%. (We continue to think the Fed will take a pause at their June meeting.)
4. <u>A continued softening of labor market conditions poses a risk to consumer spending.</u> While excess savings accumulated during the pandemic, rising real disposable income and increased borrowing have provided a near-term tailwind for consumption, the cyclical outlook is concerning.
5. The Leading Economic Indicator six-month rate of change <u>has never been this negative without a recession to follow.</u> (This is the ninth occurrence since 1960.)
6. <u>As much as $1¾ billion of commercial real estate debt sits on bank balance sheets</u>, with much of it maturing over the next 18 months, creating potential problems.
7. <u>The backup in interest rates has dried up funding markets</u> such that the number of new bankruptcies are up more than 40% y/y, the greatest increase since 2009.
8. Global equities are up 18% since the mid-October low. However, <u>internal equity dynamics indicate that the rally is running out of steam</u>. (The pace of gains has slowed considerably and breadth has deteriorated significantly.)
9. The stock market is up 8% YTD however, <u>backing out the top ten tech stocks results in a decline of 0.5%.</u>
10. <u>Apple is worth more than the Russell 2000 and JP Morgan is worth more than all publicly traded regional banks.</u>

EQUITY MARKETS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
DJIA	0.50%	1.69%
S&P 500	1.71%	9.91%
NASDAQ	3.08%	21.37%
RUSSELL 2000	2.57%	1.91%
RUSSELL 1000 GROWTH	2.52%	19.18%
RUSSELL 1000 VALUE	0.81%	0.53%

S&P EQUITY SECTORS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
COMMUNICATION SERVICES	3.06%	31.39%
CONSUMER DISCRETIONARY	2.64%	18.40%
CONSUMER STAPLES	-1.63%	2.38%
ENERGY	1.44%	-7.93%
FINANCIALS	2.19%	-4.27%
HEALTHCARE	-0.65%	-2.98%
INDUSTRIALS	1.30%	2.01%
INFORMATION TECHNOLOGY	4.25%	28.02%
MATERIALS	0.67%	1.67%
REAL ESTATE	-2.37%	-1.28%
UTILITIES	-4.27%	-5.57%

INTERNATIONAL EQUITY MARKETS (INDEX NET RETURN)	LAST WEEK	YEAR-TO-DATE
MSCI ACWI	1.09%	9.19%
MSCI ACWI EX U.S.	-0.11%	8.06%
MSCI EAFE	-0.37%	10.54%
MSCI EM	0.57%	3.01%

Risk/Reward Not Favorable

Investors have tried to front-run the end of the policy and economic cycles with little success. This decade has been unique in economic history on many fronts, including the unprecedented massive policy response to the pandemic, the resiliency of the global economic expansion despite some sizeable shocks and considerable pessimism about the future, and sticky inflation. Consequently, recession bets have not paid off and we expect the increasingly aggressive bets on lower policy rates in the U.S. and elsewhere to also be dashed later this year. We expect that investors will delay the recession call but not abandon it, and maintain a generally bond-bullish bias until it is clear that a return to the 2% inflation world of the 2010s is not occurring. This, in turn, implies more of the same for global financial markets: a lot of churning in bond and equity markets, but no clear break-outs/downs in the coming months. While the timing of renewed bearish trends seems to be beyond the next few months, we remain cautiously positioned on a cyclical basis believing that a breakout is more likely on the downside than the upside.

While somewhat oversold, we are positioned for a lower U.S. dollar in the coming year, and favor international markets. While global investors have somewhat warmed up to the euro area, relative performance has only improved slightly since late 2022. There are still plenty of headwinds for the euro area, especially with the war on its eastern border still raging. The U.S. economy, having been far stronger and recovered much sooner than the euro area once the initial pandemic wave crested, is now in a payback period for those areas which boomed, although the U.S. service sector still has decent momentum. The payback areas are witnessing layoffs (new unemployment insurance claims have modestly increased), which is cooling overall payroll gains.

FIXED INCOME MARKETS (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
BLOOMBERG U.S. AGGREGATE BOND	-1.12%	2.14%
BLOOMBERG U.S. CORP HIGH YIELD	-0.45%	3.68%
BLOOMBERG U.S. GOV/ CREDIT	-1.17%	2.27%
BLOOMBERG U.S. T-BILL 1-3 MONTH	0.08%	1.70%

ALTERNATIVES (INDEX TOTAL RETURN)	LAST WEEK	YEAR-TO-DATE
REAL ESTATE (FTSE NAREIT)	-1.93%	-1.80%
COMMODITIES (DJ)	-0.01%	-8.71%
GLOBAL LISTED PRIVATE EQUITY (RED ROCKS)	0.32%	7.94%
CURRENCIES (DB CURRENCY FUTURE HARVEST)	1.64%	3.71%

The outlook for the U.S. equity market remains uninspiring. A near-term pause in Fed rate hikes may help extend the economic cycle and provide temporary support to risk assets. However, expectations for a sustained rate-cutting phase later this year are unlikely to be validated given the persistence of elevated core inflation and the tight labor market. Earnings have held up better than feared but estimates for the second half remain too high given the backdrop of slowing economic growth and the high starting point for profit margins. Even if one assumes that earnings forecasts will hold up, the equity market is trading at its highest valuation (based on the 12-month forward P/E ratio) outside of the dot-com bubble and the pandemic overshoot. A sustained advance of stock prices requires a further expansion of valuations or a significant re-acceleration in earnings, neither of which is likely. Our near-term view is that stock prices will remain stuck in the trading range that has prevailed over the past year. Equity returns will be constrained going forward, given the uncertainties stemming from the debt ceiling standoff, ongoing issues in the regional banking sector, slowing economic momentum, and no longer oversold conditions. While the equity averages have proven resilient, market breadth has deteriorated since early March, as evidenced by the divergence in performance between the market cap-weighted S&P 500 and its equal-weighted counterpart, as well as between large and small-cap stocks. Deteriorating breadth warns that the strength of the market advance has lost momentum under the surface.

CONCLUSION:

Investors need to maintain tight stops as the cyclical outlook remains negative. As a result, we remain cautious.

Data from Bloomberg, as of 5/19/2023.

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