



A Freedom Advisors Company

# February 2023 Market Commentary

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## Hyped Up Over AI



## Key Benchmarks: Performance and Characteristics as of 2/28/2023

Equities	MTD	QTD	YTD	1-Yr Fwd P/E: Current vs 10-Yr Range	
S&P 500	-2.4%	3.7%	3.7%	17.7x	
MSCI EAFE	-2.1%	5.8%	5.8%	13.1x	
MSCI Emerging	-6.5%	0.9%	0.9%	11.0x	

Fixed Income	MTD	QTD	YTD	Real Assets	MTD	QTD	YTD
Bloomberg Barc U.S. Aggregate	-2.6%	0.4%	0.4%	US REITs	-5.9%	3.6%	3.6%
Bloomberg Barc US High Yield	-1.3%	2.5%	2.5%	GSCI Commodities	-3.8%	-3.9%	-3.9%
Bloomberg Barc Global Agg ex U.S.	-4.0%	-0.6%	-0.6%	GSCI Prec Metals	-5.9%	-0.8%	-0.8%

Data Source: Bloomberg

## February 2023 Highlights:

- After initially rallying on January's strong start to the year, global equity markets pulled back reflecting increased uncertainty over the macroeconomic, geopolitical, and corporate profitability outlook, despite signs that the global economy was not facing imminent recession. Ongoing favorable winter and net energy demand reductions continue to help the European outlook as European equity markets have led global markets this year while emerging markets and pan-Asian markets pulled back as investor sentiment soured on China over renewed regulatory crackdowns and potential sanction risk if reports of China's arms sales to Russia come to fruition. In February, the MSCI All-Country World Index (ACWI) dropped -2.9%.

- Across major regions, Europe and U.S. markets outperformed Pan-Asia. In February, MSCI Europe and the S&P 500 returned -0.6% and -2.4%, respectively, while MSCI Japan dropped 6.5% followed by MSCI Emerging Markets (-6.5%) and MSCI Pacific ex-Japan (-6.8%). The U.S. dollar recovered from January's depreciation in response to higher inflation readings that would likely prompt a more hawkish policy response from the Federal Reserve.
- Within the U.S., U.S. small caps continued to benefit from a high beta rally outperforming large caps, while value stocks underperformed growth stocks, dragged down by late cyclicals such as Energy; however both Pure Style Indices underperformed the S&P 500. The S&P 600 Index returned -1.2% versus -2.4% for the S&P 500. S&P Pure Value underperformed Pure Growth, returning -5.9% versus -3.2%, respectively.
- Across sectors, large cap growth stocks that comprise the majority of sector weightings across Technology and Consumer Discretionary along with Industrials contributed to the sector outperformance while defensive sectors such as Healthcare, and Utilities along with Real Estate and Energy lagged; the Energy sector was hurt by lower commodity prices, particularly natural gas.
- February was another challenging month for Risk Factor performance as all major risk factors, except High Quality, underperformed the broader market. Among Risk Factors, High Quality outperformed Value, High Dividend, Minimum Volatility, and Momentum all clustered together.
- Fixed Income market returns also declined in February with the rise in interest rates, a reversal from the drop seen in January. The Bloomberg U.S. Aggregate Bond Index declined 2.6% for the month while the Global ex-U.S. Aggregate dropped 4.0%, pressured by a strengthening dollar against local currencies. The 10-Year U.S. Treasury yield ended the month at 3.9%, up from 3.5% at the beginning of the month.
- Non-U.S. bonds and emerging market local currency bonds underperformed U.S. bonds hurt by U.S. dollar strength. U.S. high yield outperformed investment grade corporates due to a combination of lower interest rate sensitivity (lower duration) and stable credit spreads versus widening investment grade spreads that hurt the former. The Bloomberg US High Yield Index dropped 1.3%, while Bloomberg/Barclays Emerging Market Debt LC dropped 4.0%.
- Within equity alternatives, Commodities outperformed Real Estate and Precious Metals although all three were down in February. The S&P GSCI Commodities Index returned -3.8% for the month while both the Dow Jones REIT Index and the S&P GSCI Precious Metals Index dropped 5.9%. Industrial metals dropped over diminishing industrial-driven demand coming out of China while oil prices remain range-bound between \$70-\$80/barrel. Commodity market weakness was broad-based across agriculture and industrials with only Cocoa, Coffee, and Live Cattle up for the month.

## Hyped Up Over AI



Source: istockphoto.com

*“ChatGPT and other Generative AI platforms will have huge implications for business productivity...In a world where ChatGPT and other AI apps can do many things humans once needed to do themselves or needed to hire other humans to do, the question of ‘how will I add value?’ becomes more relevant than ever.”*

*– Hendrith Vanlon Smith Jr, CEO of Mayflower-Plymouth, Business Essentials*

*“Part of the inhumanity of the computer is that, once it is competently programmed and working smoothly, it is completely honest.”*

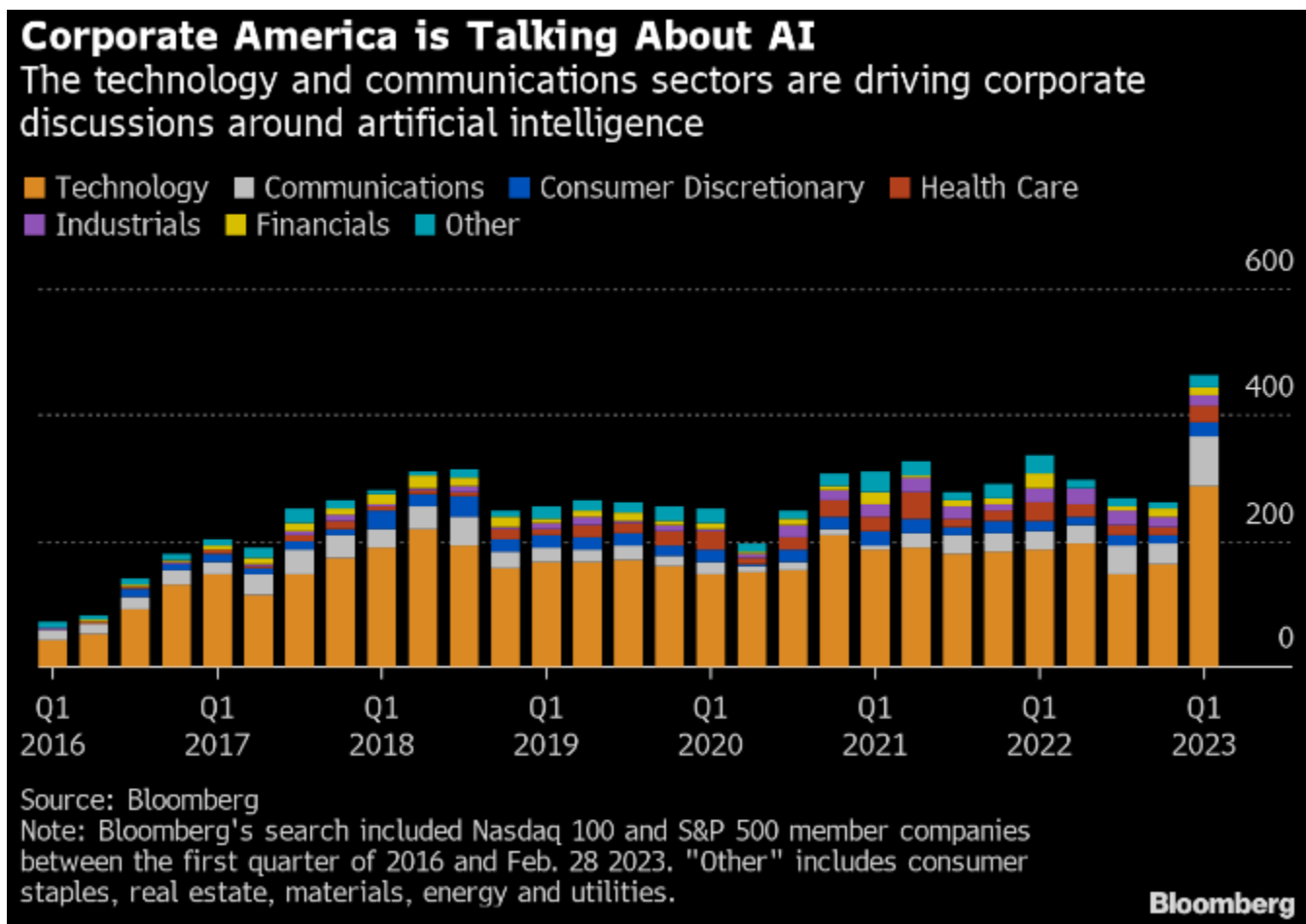
*– Isaac Asimov, “Change! 71 Glimpses of the Future”*

The launch of [ChatGPT](#) in November 2022 has kicked off a new gold rush in futuretech, namely the buildout of artificial intelligence capabilities to enhance industrial productivity and competitiveness (not to mention [writing term papers](#)). Growth-minded investors have shifted their focus from digital assets/cryptocurrencies to the metaverse and now to artificial intelligence as ChatGPT, which has helped bridge the practical to the theoretical based on “artificial general intelligence [built on deep learning and leveraging large amounts of data]...that can solve human-level problems (OpenAI).” Beyond ChatGPT, [the potential for promising applications from AI-driven solutions and assistance](#) seem endless. Some examples:

- Enhanced web searches and targeted advertising (i.e. more direct engagement),
- Medical treatments/diagnoses,
- Business productivity covering investment management and cybersecurity, and
- Enhanced customer service and social engagement.

1<sup>st</sup> quarter earnings calls were flooded with company management tripping over each other mentioning the growth potential of their AI initiatives (**Figure 1**), with the perception that the returns from AI are “more tangible, more real and happening right now,” according to Matthew Kanterman, director of research at Roundhill Investments.

Figure 1 – Corporate America Gets the AI Memo



This year, we're witnessing a gold rush for the AI ecosystem, particularly in the [picks-and-shovel plays](#) of the component providers needed to generate the [intense computation power](#) for AI programming and ongoing support. This year has seen a tremendous rally in beaten-up technology and communication service plays from 2022 that we highlighted in our [January 2023 Market Commentary](#). The Philadelphia Stock Exchange Semiconductor Index (SOX) and the Indxx Global Robotics & Artificial Intelligence Thematic Index are up 17.1% and 14.3%, respectively, so far this year, handily outperforming the 10.3% return of the tech-heavy Nasdaq 100 Index. Regardless, of whether the global economy is facing a growth slowdown while still struggling with high inflation, investors are flocking to the next big thing that promises to transform how we conduct business and interact with each other.

Figure 2 – A New Gold Rush as Investors Chase the AI Ecosystem



Source: Bloomberg

We covered much of the current macro perspective (namely the shift from a hard landing narrative to a no-landing narrative) in our February blog article, “[Flipping Out Over the Big Flip.](#)” Sentiment favoring the No-Landing scenario has picked up momentum since our publication as short-term inflation expectations have risen over 3% (**Figure 3**) with Fed Funds futures now pricing in a 5.5% terminal fed funds rate by July (**Figure 4**), up from 4.75% at the end of January. Rates derivative traders are also [pricing out any rate cuts for 2023](#) (**Figure 5**), whereas traders had previously expected at least 0.50% reduction in the Fed Funds rate by the end of 2023 prior to the February releases. This new terminal rate level now exceeds the expected rates in the Fed's dot plot forecasts; the Fed dot plot projections had been more aggressive than what the market had been expecting. Long-term government bond yields have also surged from their year-to-date lows (**Figure 6**), reflecting a no-landing environment of elevated inflation that is not coming down as fast as the market had expected.

Figure 3 – The TIPS Market Pricing in Higher Inflation Over the Next One to Two Years

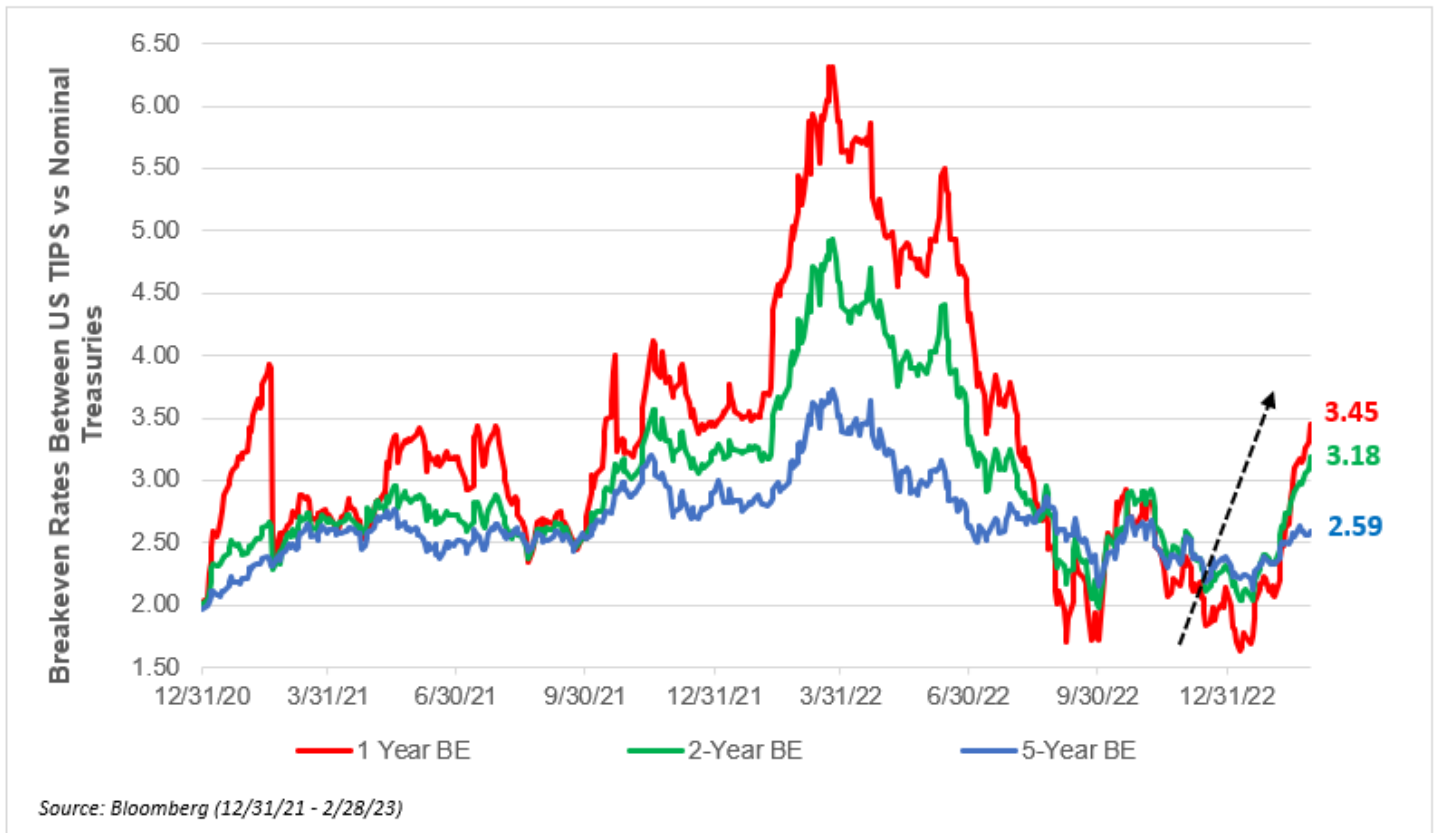


Figure 4 – Fed Funds Futures Now Expect ~5.5% Peak Fed Funds Rate by the Summer of 2023

Region: United States »		Instrument: Fed Funds Futures »	
Target Rate	4.75	Pricing Date	02/28/2023
Effective Rate	4.57	Cur. Imp. 0/N Rate	4.576

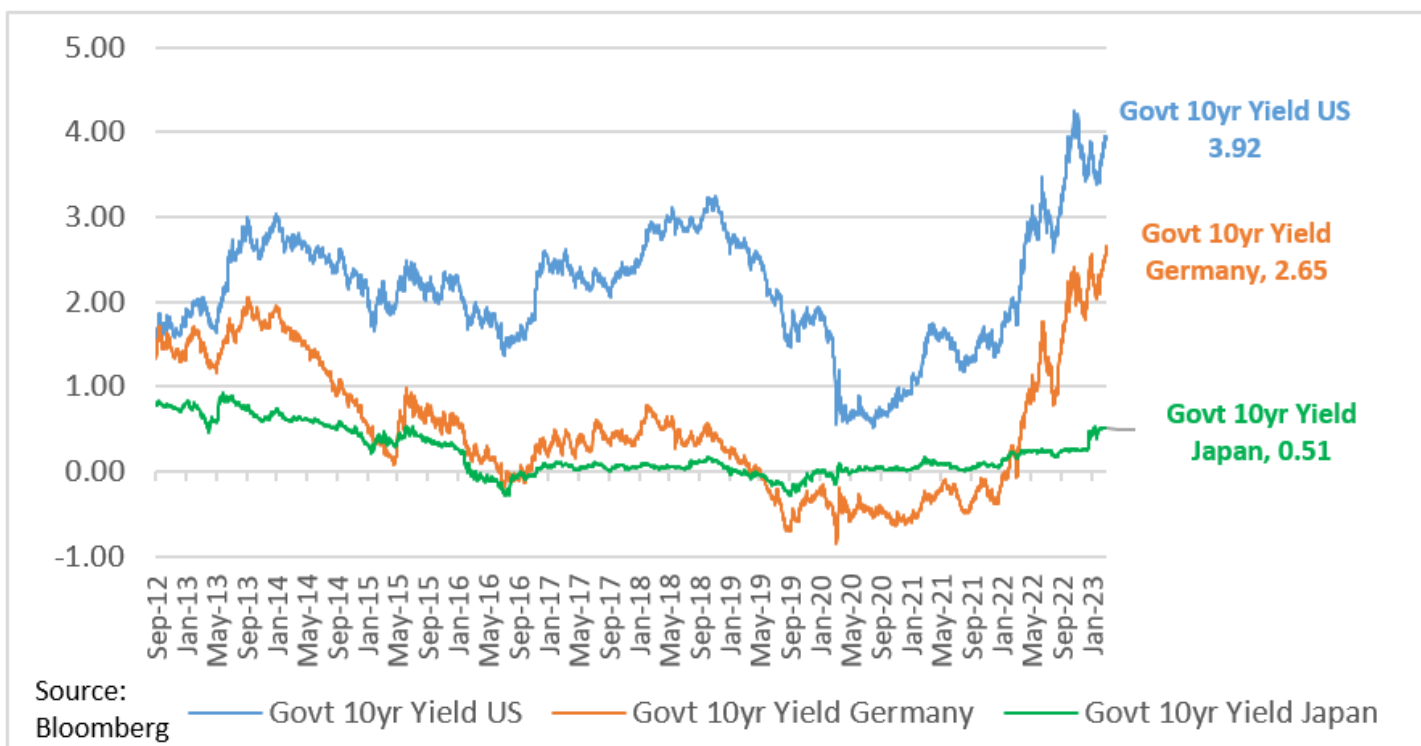
Meeting	#Hikes/Cuts	%Hike/Cut	Imp. Rate Δ	Implied Rate	A.R.M.
03/22/2023	+1.205	+120.5%	+0.301	4.878	0.250
05/03/2023	+2.245	+104.1%	+0.561	5.138	0.250
06/14/2023	+2.979	+73.3%	+0.745	5.321	0.250
07/26/2023	+3.345	+36.6%	+0.836	5.413	0.250
09/20/2023	+3.355	+1.0%	+0.839	5.415	0.250
11/01/2023	+3.158	-19.7%	+0.789	5.366	0.250
12/13/2023	+2.816	-34.1%	+0.704	5.280	0.250
01/31/2024	+2.365	-45.2%	+0.591	5.168	0.250

Source: Bloomberg World Interest Rate Probability (WIRP)

Figure 5 – SOFR Traders Now Pricing Out Any Rate Cuts in 2023

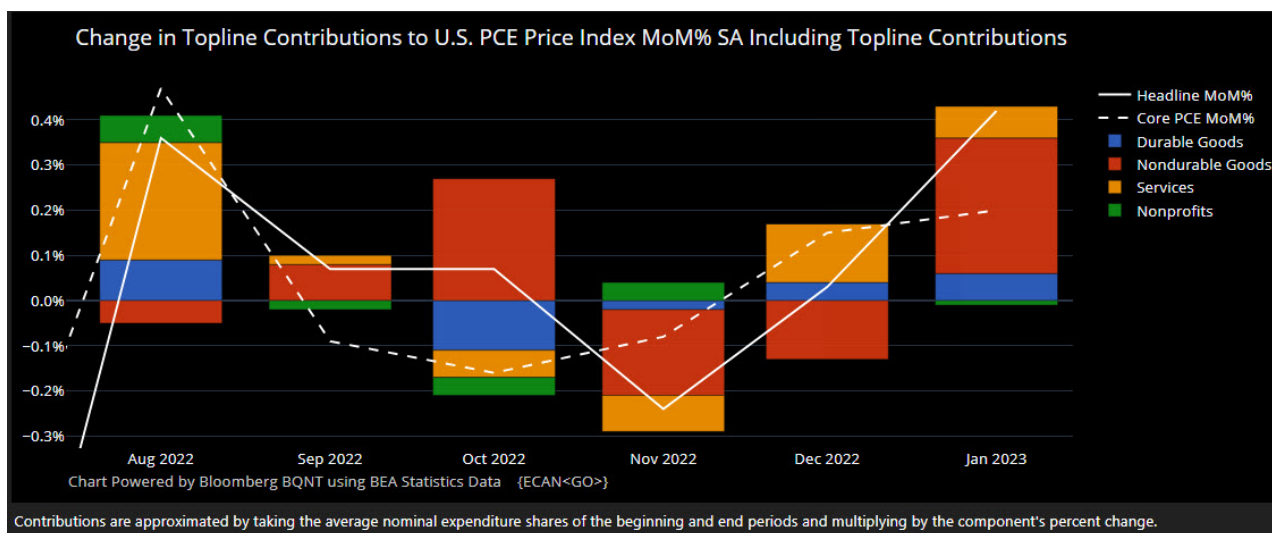


Figure 6 – Long-Term Government Bond Yields Well Off the 2023 YTD Lows



It is astonishing how quickly expectations have turned following February's economic releases showing robust labor market conditions and elevated inflation, notably the Personal Consumption Expenditures (PCE) release (**Figure 7**) that the Federal Reserve tracks as a gauge of inflation trends. Rather than continuing to trend down, the inflation readings (CPI, PPI, PCE) have turned up with the January data, particularly across nondurable goods and services. The Fed is [increasingly betting on higher unemployment](#) and looser labor market conditions to engineer that soft landing of low inflation-adjusted growth without falling into a deflationary recession.

**Figure 7 – Inflation Readings Moving the Wrong Direction as Inflation Picked Up in January**



The consensus among mainstream economists that the U.S. would enter recession 2023 has also shifted in the face of a resilient labor market and demand-driven inflationary pressures. Bloomberg consensus 2023 GDP growth forecasts have been revised up from 0.3% expected at the end of 2022 to 0.7% as of February 2023. The rest of the major economies have also seen upward revisions for 2023 GDP growth.

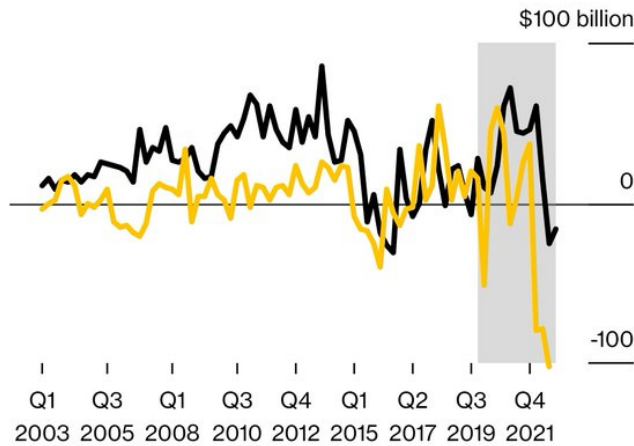
There are mixed reports on the [strength and durability of China's post-COVID recovery](#), but indications point toward more robust domestic-driven consumption/travel and less industrial and export-driven demand as well as ongoing deleveraging across the real estate sector, which comprises nearly a third of China's economy. Whether China seeks to reallocate growth priorities to domestic consumption from a mercantilist export model remains to be seen, but economists do not expect a major stimulus package to support growth unlike prior downturns going back to the 2008 Financial Crisis. U.S.-China relations have also deteriorated as the U.S. has imposed trade restrictions covering key technology sectors, such as high-end semiconductors. There are increased pressures and incentives [for multi-nationals to disengage from China](#) and re-shore operations in North America (the Inflation Reduction Act provides incentives for North American-based alternative energy and green-focused production). Indeed, foreign direct investment in China has plummeted over the post-pandemic period (**Figure 8**).

**Figure 8 – China Has Seen Foreign Direct Investment Plummet Over the Post-Pandemic Period**

### Investment Into China Slumped in 2022

Foreign direct investment fell and portfolio investment dropped as well

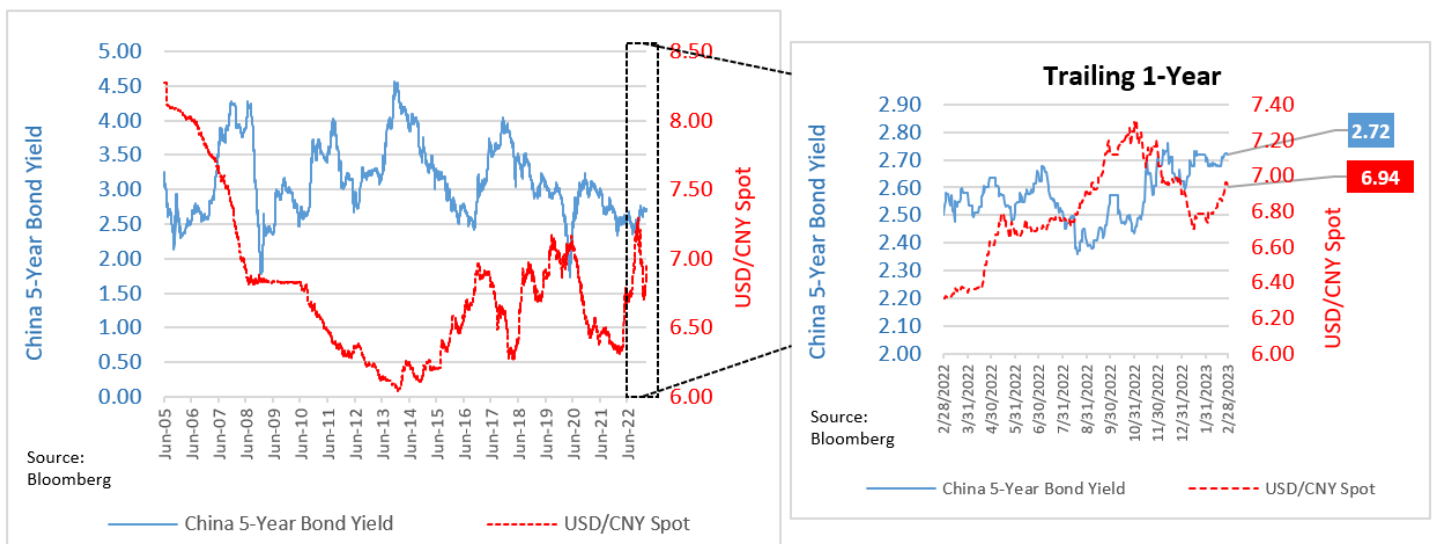
/ Net foreign direct investment    / Net portfolio investment  
 Pandemic



Source: State Administration of Foreign Exchange  
 Note: 4Q data for portfolio investment no available yet

These mixed signals coming out of China can also be seen in government bond yields (which continue to rise as economic prospects improve) and a depreciating currency versus the U.S. dollar (**Figure 9**). Currency traders are focusing on the volatility of USD/CNY as an indicator of rising geopolitical tensions and overall U.S. dollar funding stress across the global financial system.

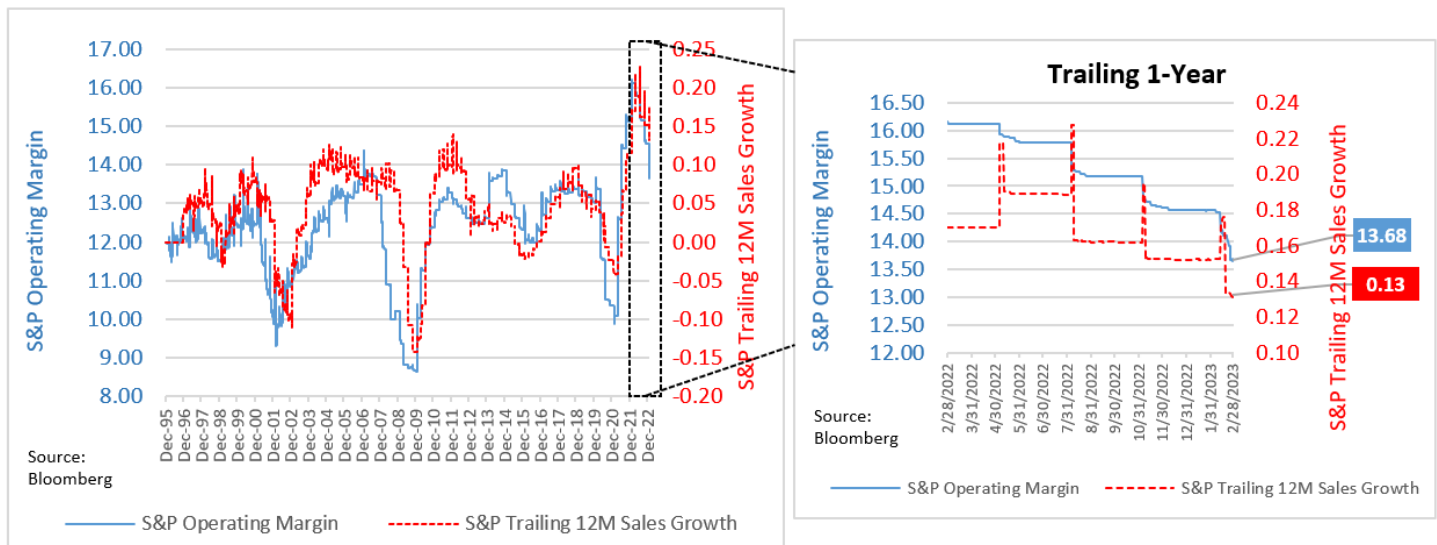
**Figure 9 – China Government Bond Yields Rise as Economic Prospects Improve but a Depreciating Yuan vs the U.S. Dollar Could Indicate Increased Geopolitical Tension**



Besides China, the geopolitical wall-of-worry includes the ongoing Russia/Ukraine conflict (not helped by U.S. State Department accusations of China providing arms to Russia), the upcoming U.S. debt ceiling showdown, and debt servicing stress that is about to hit the U.S. consumer such as the resumption of past-due [student loan payments](#) (payment moratorium likely to end this summer and the Supreme Court review of Biden’s loan forgiveness executive order) along with rising interest costs on auto loans and credit cards.

And then there is the question of corporate earnings growth, or the vanishing expectation that there will be any growth in 2023 as sales growth slows and profit margins compress due to higher input costs (**Figure 10**). As most S&P 500 companies have reported 4<sup>th</sup> quarter 2022 earnings, the blended growth rate for the S&P resulted in a decline of 4.8%, marking the first year-over-year decline since Q3-2020 according to [Factset Earnings Insight 2/24/2023](#). The Materials, Communication Services, and Consumer Discretionary sectors contributed most to the Y/Y decline offset by positive results from Energy and Industrials. So far, the consensus outlook for S&P 500 CY-2023 earnings growth remains slightly positive at 2.2% on revenue growth of 2.2% - we suspect that few analysts are willing to call for an outright calendar year earnings decline unless confirmed by company releases later in the year. And many companies are [increasingly stretching on reported earnings](#) as accruals (the difference between accounting earnings and actual cash flow) have reached their highest level on record; hence, today’s earnings releases are deemed lower quality and are more susceptible to a downgrade in the event the assumptions underlying accruals (accounts receivables and accumulated inventory) do not pan out into actual cash receipts.

**Figure 10 – The S&P Faces Slowing Revenue Growth and Declining Profit Margins (Albeit from Attractive Peak Levels)**



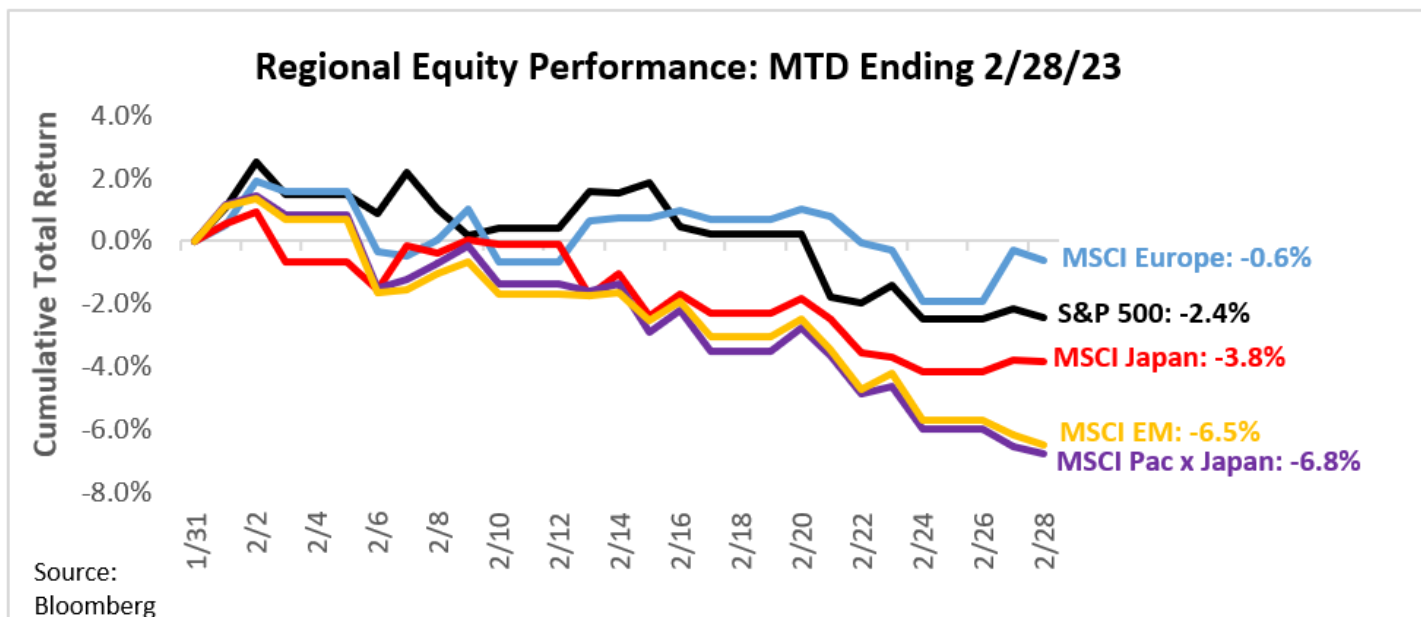
Equity market valuations continue to trade below 10-year peak levels, more so with international markets than the U.S. reflecting these wall-of-worry concerns, but equities must also compete with increasingly attractive yields and rates, particularly short-term rates yielding 5% in line with expected Fed rate hikes. What kind of landing the U.S. economy experiences remains to be seen, but the lower valuations reflect this higher uncertainty of what lies ahead.

## February 2023 Market Review

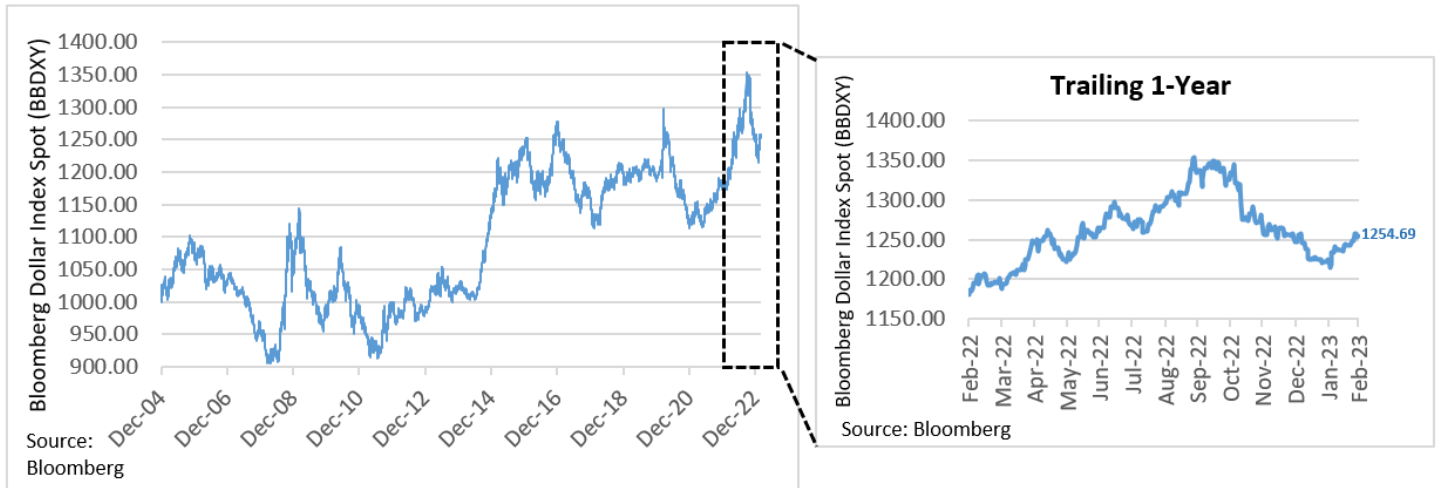
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Across major regions (**Figure 11**), Europe and U.S. markets outperformed Pan-Asia. In February, MSCI Europe and the S&P 500 returned -0.6% and -2.4%, respectively, while MSCI Japan dropped 6.5% followed by MSCI Emerging Markets (-6.5%) and MSCI Pacific ex-Japan (-6.8%). The U.S. dollar (**Figure 12**) recovered from January’s depreciation in response to higher inflation readings that would likely prompt a more hawkish policy response from the Federal Reserve.

**Figure 11 – Europe and the U.S. Outperform Pan-Asia and Emerging Markets**

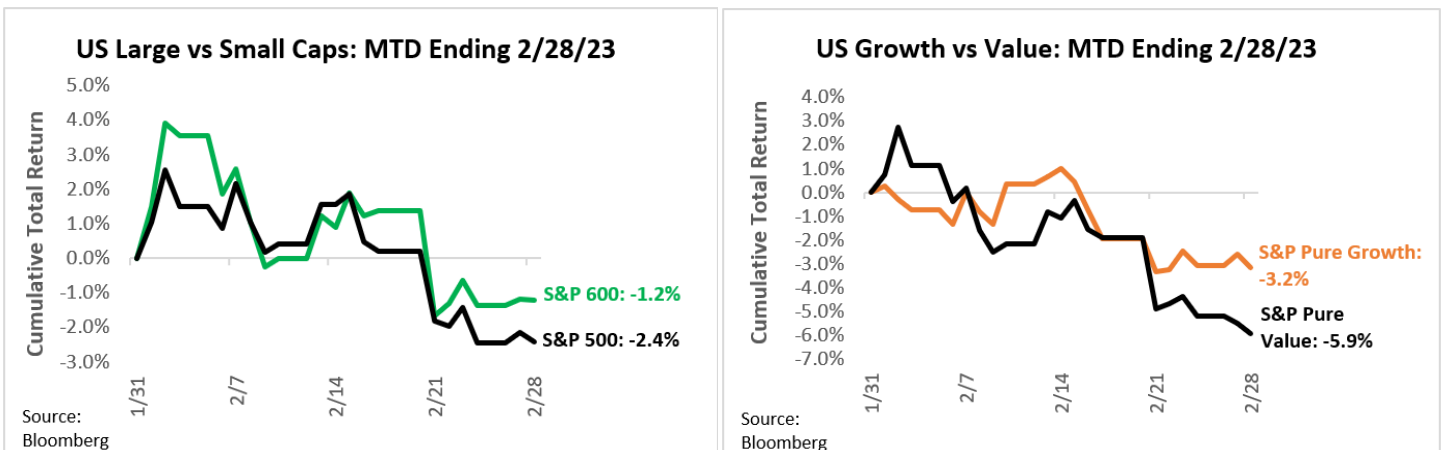


**Figure 12 – The U.S. Dollar Recovers Some of Near-Term Depreciation As Prospects for Tighter Monetary Policy Increased Over Inflation Readings**



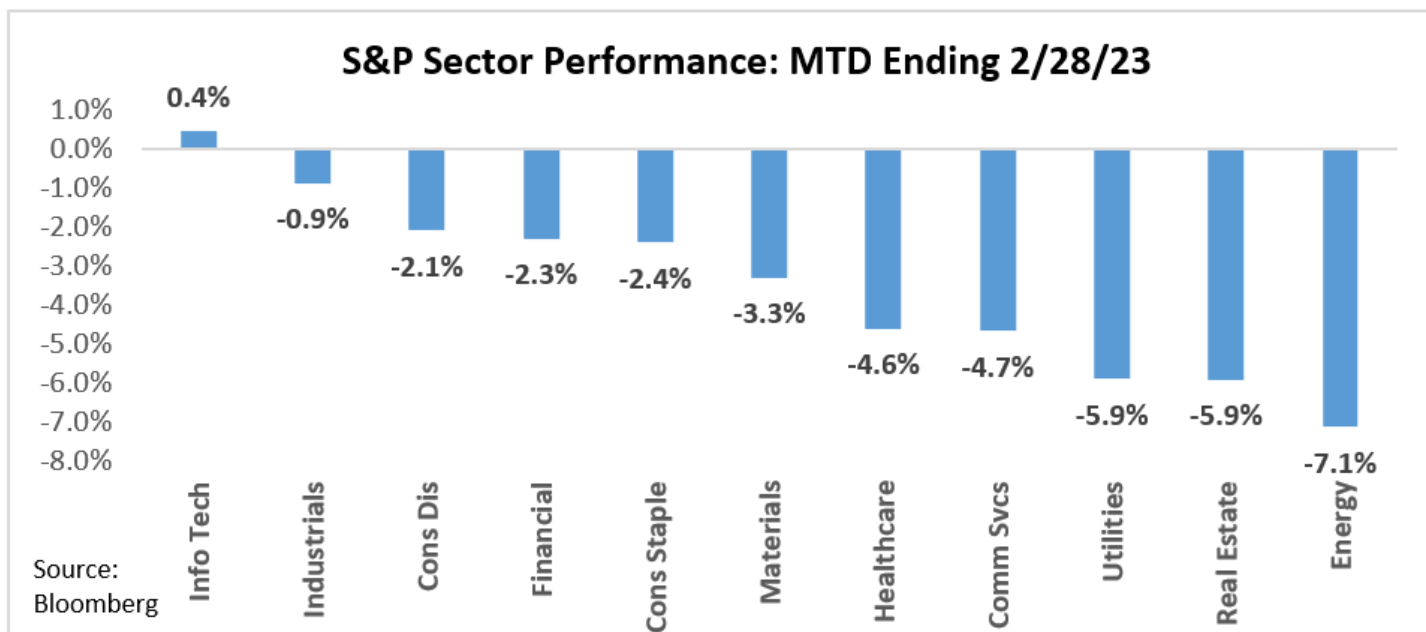
Within the U.S., U.S. small caps continued to benefit from a high beta rally outperforming large caps, while value stocks underperformed growth stocks, dragged down by late cyclicals such as Energy; however both Pure Style Indices underperformed the S&P 500. The S&P 600 Index returned -1.2% versus -2.4% for the S&P 500. S&P Pure Value underperformed Pure Growth, returning -5.9% versus -3.2%, respectively (**Figure 13**).

**Figure 13 – Small Caps Outperformed Large Caps While Value Outperformed Growth**



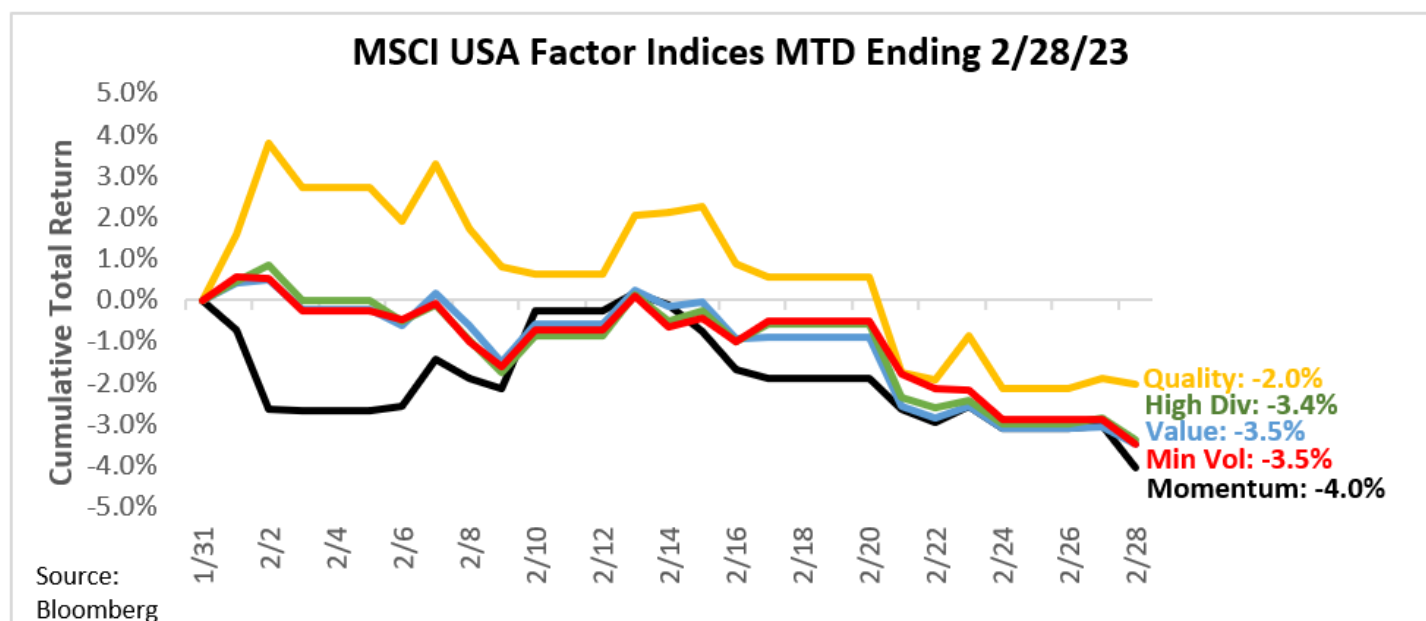
Across sectors (**Figure 14**), large cap growth stocks that comprise the majority of sector weightings across Technology and Consumer Discretionary along with Industrials contributed to the sector outperformance while defensive sectors such as Healthcare, and Utilities along with Real Estate and Energy lagged; the Energy sector was hurt by lower commodity prices, particularly natural gas.

Figure 14 – Growth Sectors (Consumer Discretionary and Technology) Along with Industrials Outperformed Defensives (Healthcare, Utilities), Real Estate, and Energy



February was another challenging month for Risk Factor performance as all major risk factors, except High Quality, underperformed the broader market (Figure 15). Among Risk Factors, High Quality outperformed Value, High Dividend, Minimum Volatility, and Momentum all clustered together.

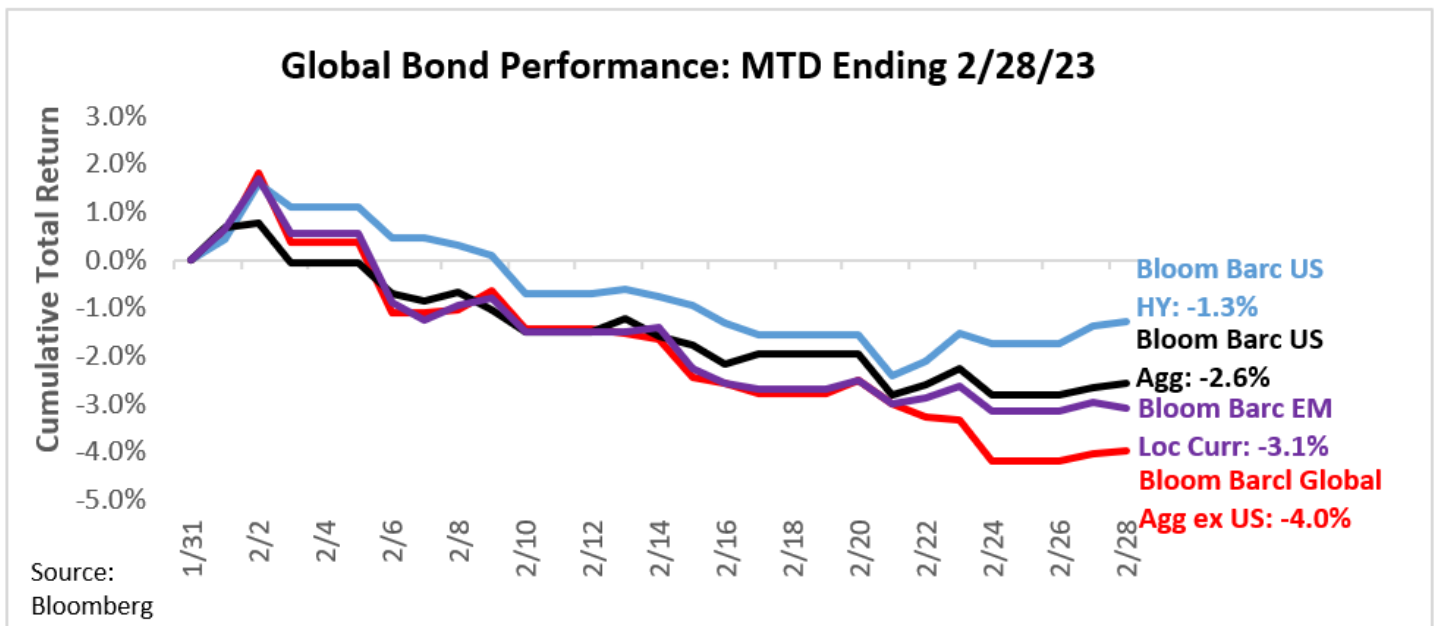
Figure 15 – All Major Risk Factors Underperformed the Broader Market in January



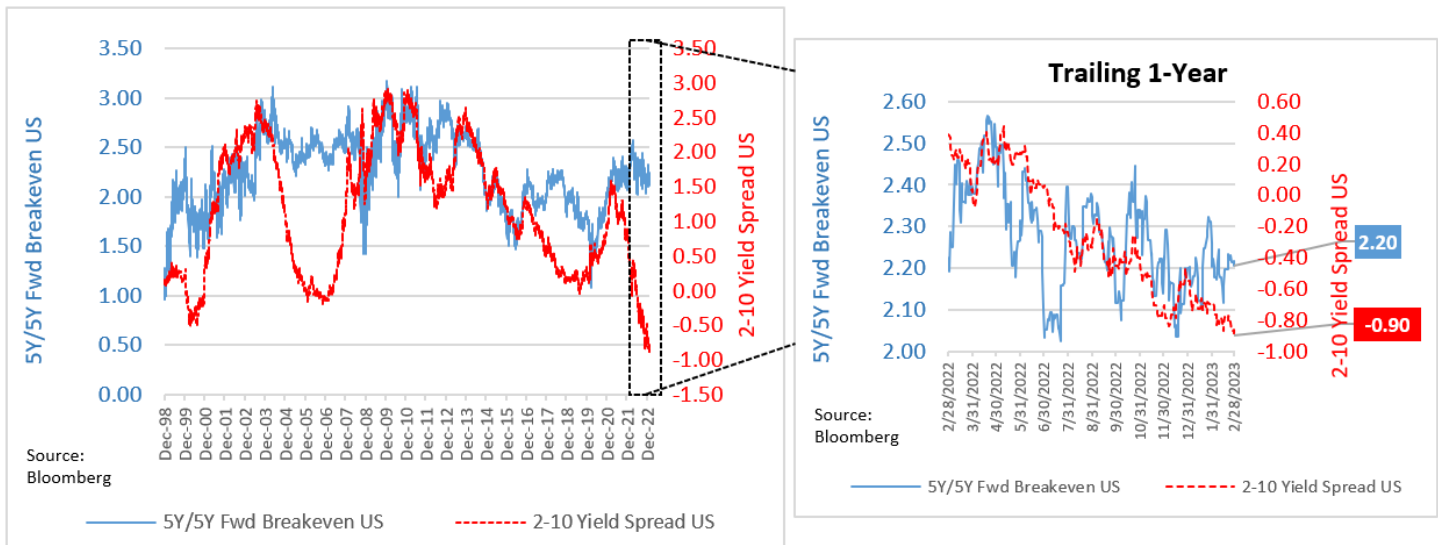
Fixed Income market returns also declined in February with the rise in interest rates, a reversal from the drop seen in January. The Bloomberg U.S. Aggregate Bond Index declined 2.6% for the month (Figure 16) while the Global ex-U.S.

Aggregate dropped 4.0%, pressured by a strengthening dollar against local currencies. The 10-Year U.S. Treasury yield ended the month at 3.9%, up from 3.5% at the beginning of the month, while the 2-10 Year Term structure (**Figure 17**) remains deeply inverted even though inflation expectations implied by breakeven rates between TIPS vs Nominal Treasury yields remain elevated (yet lower than short-term breakeven rates). Non-U.S. bonds and emerging market local currency bonds underperformed U.S. bonds hurt by U.S. dollar strength. U.S. high yield outperformed investment grade corporates due to a combination of lower interest rate sensitivity (lower duration) and stable credit spreads versus widening investment grade spreads that hurt the former (**Figure 18**). The Bloomberg US High Yield Index dropped 1.3%, while Bloomberg/Barclays Emerging Market Debt LC dropped 4.0%.

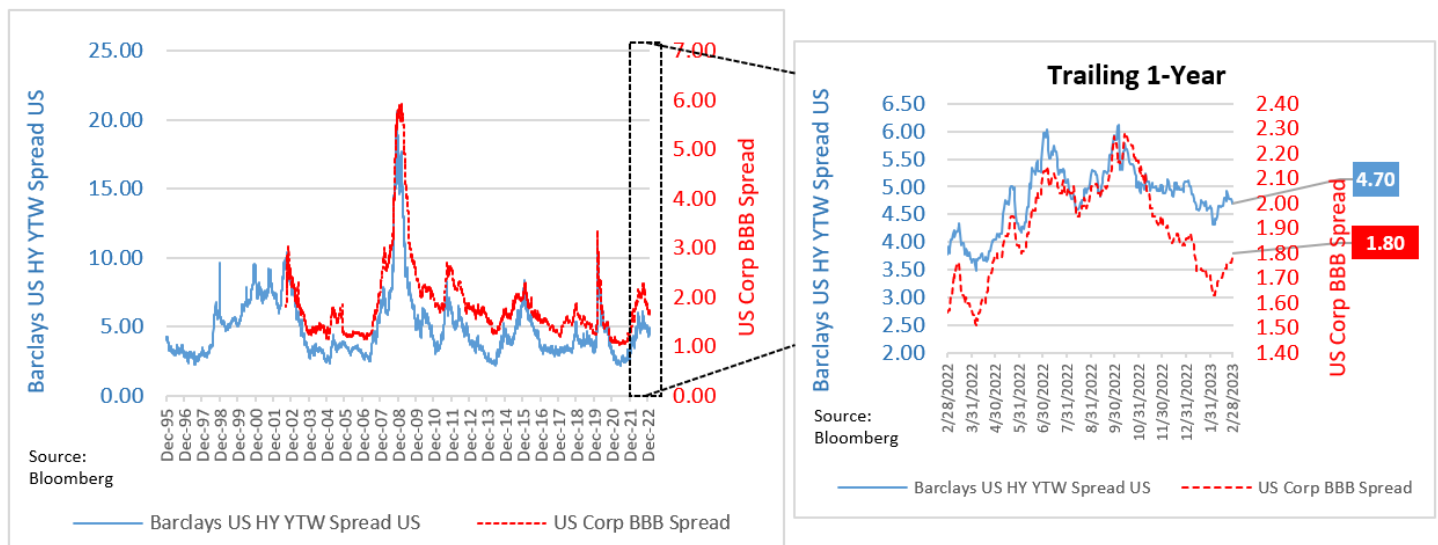
**Figure 16 – Fixed Income Markets Were Hurt by Rising Interest Rates**



**Figure 17 – 2-10 Year Term Structure Remains Deeply Inverted While Inflation Expectations (Breakeven Rates Between TIPS vs Nominal Treasuries) Remain Stable Despite Rising Short-Term Inflation Expectations**



**Figure 18 – High Yield Credit Spreads Remain Stable but Investment Grade Spreads Widened**



Within equity alternatives (**Figure 19**), Commodities outperformed Real Estate and Precious Metals although all three were down in February. The S&P GSCI Commodities Index returned -3.8% for the month while both the Dow Jones REIT Index and the S&P GSCI Precious Metals Index dropped 5.9%. Industrial metals dropped over diminishing industrial-driven demand coming out of China while oil prices remain range-bound between \$70-\$80/barrel (**Figure 20**). Commodity market weakness was broad-based across agriculture and industrials with only Cocoa, Coffee, and Live Cattle up for the month (**Figure 21**).

Figure 19 – Real Estate and Commodities Underperformed Global Equities in February

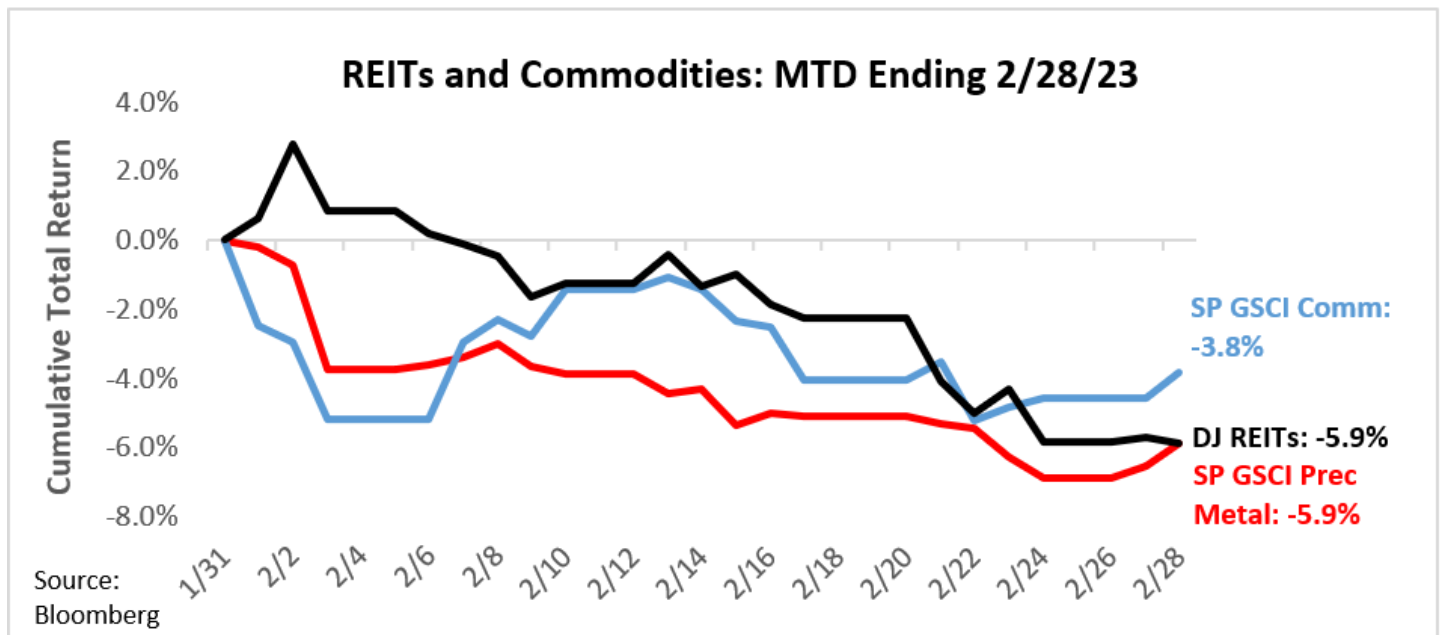


Figure 20 – Industrial Metals Dropped Over Diminishing Industrial-Driven Demand from China While Oil Prices Remain Rangebound Between \$70-80/Barrel

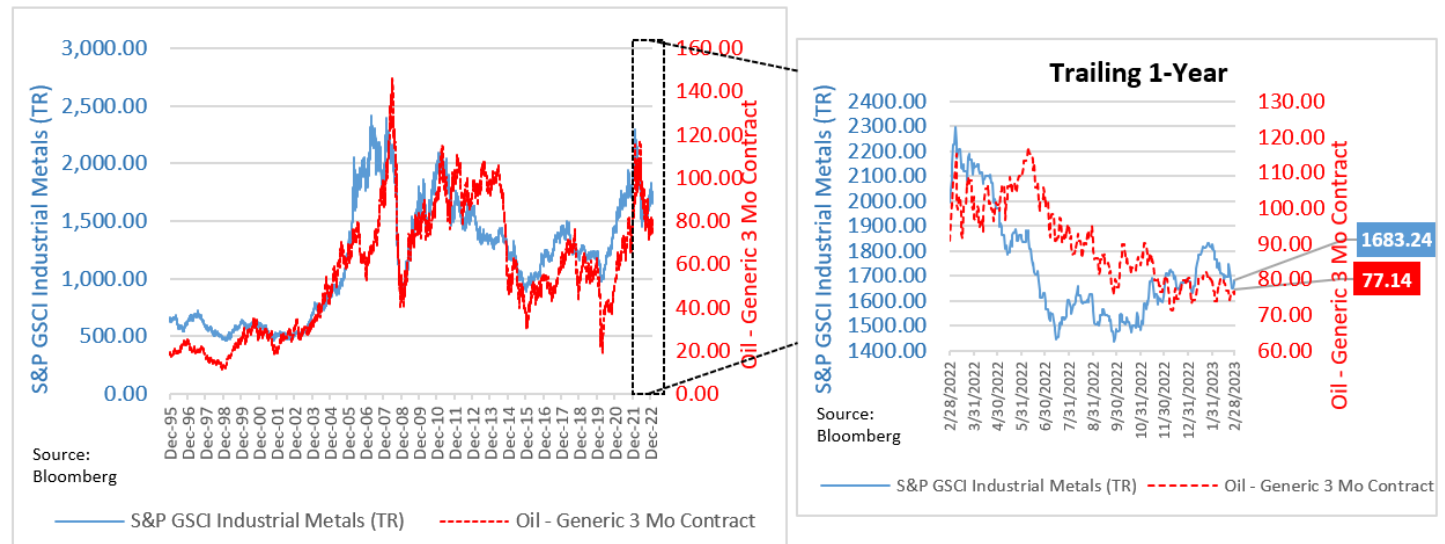
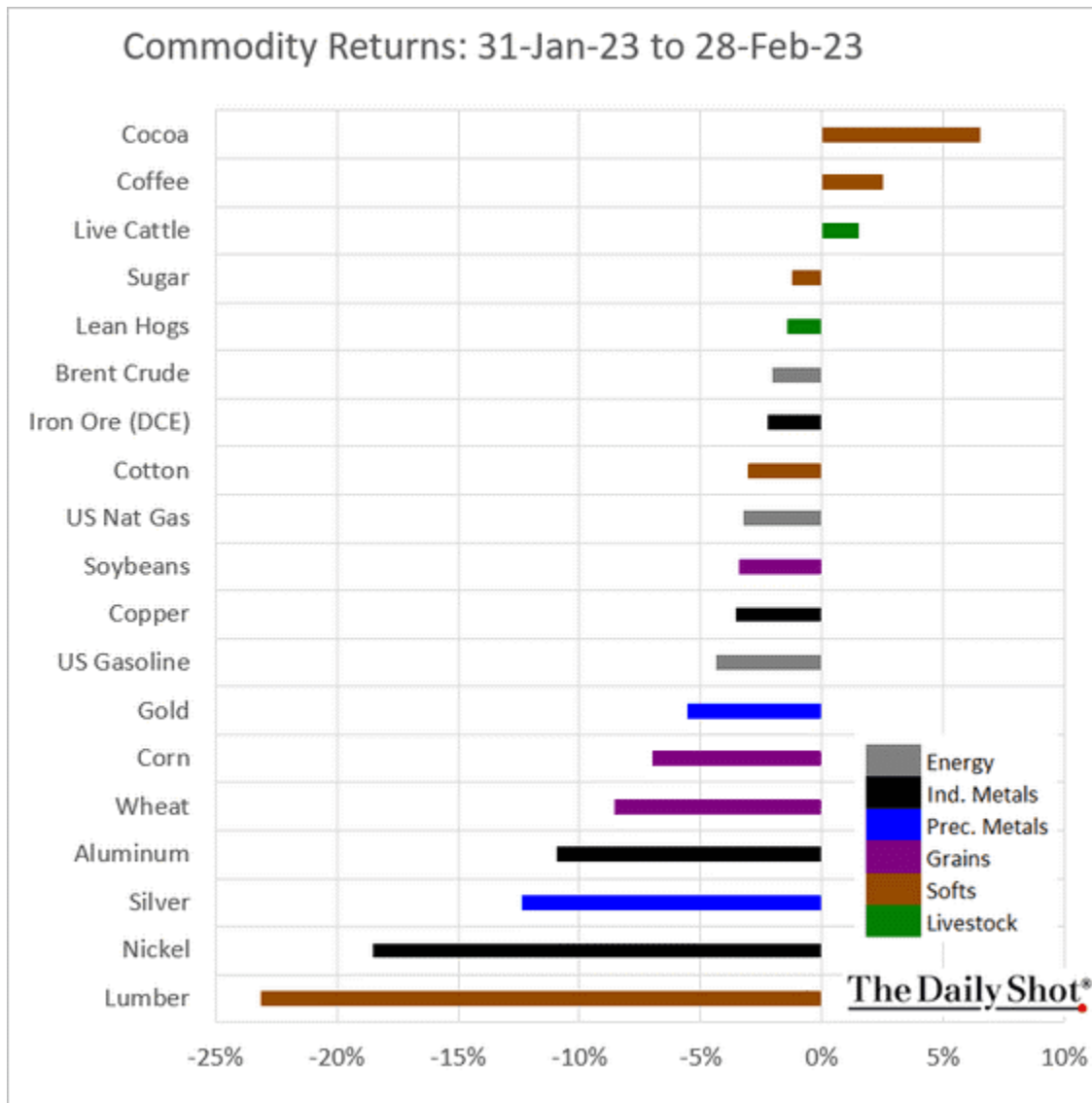


Figure 21 – Commodity Weakness Was Broad-Based Across Industrials and Agriculture





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