



A Freedom Advisors Company

Out of Breadth

May 2023 Market Commentary



Key Benchmarks: Performance and Characteristics as of 5/31/2023

Equities	MTD	QTD	YTD	1-Yr Fwd P/E: Current vs 10-Yr Range			
S&P 500	0.4%	2.0%	9.6%	18.3x	13.8x	22.9x	
MSCI EAFE	-4.2%	-1.5%	6.8%	13.0x	11.2x	18.2x	
MSCI Emerging	-1.7%	-2.8%	1.1%	11.7x	9.4x	15.2x	
Fixed Income	MTD	QTD	YTD	Real Assets	MTD	QTD	YTD
Bloomberg Barc U.S. Aggregate	-1.1%	-0.5%	2.5%	US REITs	-4.2%	-3.9%	-2.2%
Bloomberg Barc High Yield	-0.9%	0.1%	3.6%	GSCI Commodities	-6.1%	-6.8%	-11.4%
Bloomberg Barc Global Agg ex U.S.	-2.7%	-2.4%	0.6%	GSCI Prec Metals	-1.8%	-0.5%	6.8%

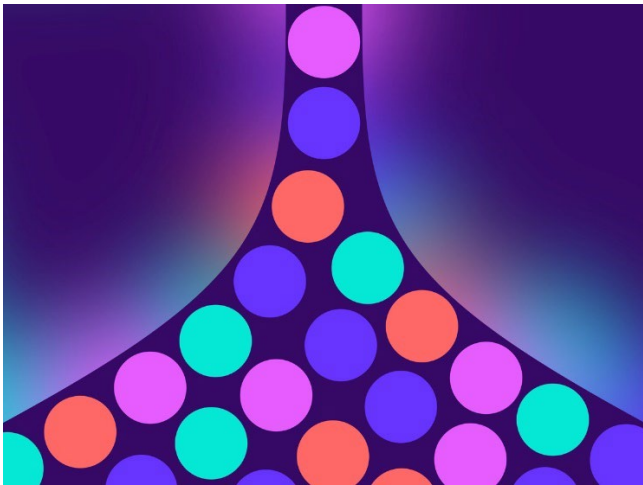
Data Source: Bloomberg

May 2023 Highlights:

- Global equity markets were marginally down in May, although the aggregate market return masks some deep divergences between U.S. large caps (particularly mega-cap growth stocks) versus the rest of the world. Uncertainty over 1) the U.S. debt ceiling, 2) heightened inflation across Europe, and 3) a lackluster post-COVID economic recovery in China weighed on global market sentiment. However, strong forward guidance from key U.S. technology companies, especially over the prospects of generative artificial intelligence and large language models, drove a month-end frenzy into AI-themed stocks, reminiscent of the late-1990s dotcom bubble. In May, the MSCI All-Country World Index (ACWI) dropped 1.1%.
- Across major regions, Japan and U.S. equity markets outperformed with MSCI Japan returning +1.9% followed by the S&P 500 (+0.4%). Other major regions were down in May with MSCI Emerging Markets returning -1.7% followed by MSCI Pacific ex-Japan (-2.4%) and MSCI Europe (-5.9%), the latter having surrendered some of its YTD leadership. The U.S. dollar appreciated from the recent bottom reached toward the end of March as angst over the regional banking crisis started to fade and expectations that the Fed would continue with rate hikes.

- Within the U.S., small caps continue to struggle against large caps, although the underperformance of both pure value and pure growth stocks versus the broader market averages underscores the narrowness of the U.S. market advance. The S&P 600 Index returned -1.8% versus +0.4% for the S&P 500. S&P Pure Value marginally underperformed Pure Growth, returning -6.0% versus -5.8%, respectively.
- Across sectors, mega-cap heavy sectors (Technology, Communication Services and Consumer Discretionary) were the only positive performing sectors, significantly outperforming traditional cyclicals, financials and defensive sectors. Materials and Energy were the main laggards as both suffered from lower commodity prices.
- Risk factors struggled again in May as only High Quality (dominated by profitable technology stocks) handily outperformed the other major risk factors. MSCI Momentum had its semi-annual rebalance whereby its sector exposure will dramatically shift from defensives and energy to technology.
- Fixed income market returns dropped in May as interest rates rose in anticipation of further Federal Reserve tightening in the face of elevated inflation. The Bloomberg U.S. Aggregate Bond Index returned -1.1% for the month while the Global ex-U.S. Aggregate returned -2.7%, hurt by both higher interest rates, especially in the U.K., and an appreciating U.S. dollar. The 10-Year U.S. Treasury yield ended the month at 3.6%, up from 3.4% at the beginning of the month.
- Emerging market local currency bonds performed nearly in line with U.S. bonds, although the former was hurt by end of month sell-offs in the Turkish Lira (following elections) and South African Rand (heightened political uncertainty). U.S. high yield outperformed investment grade corporates as credit spreads remain stable. The Bloomberg US High Yield Index returned -0.9% and the Bloomberg/Barclays Emerging Market Debt LC returned -1.0%.
- Within equity alternatives, commodities underperformed the broader risk markets, hurt by a drop in energy prices and industrial metals as investors anticipate a demand slowdown with more signs of a lackluster recovery in China's industrial activity. Real Estate underperformed due to ongoing stress across commercial properties (notably the Office sector where vacancy rates have risen across key metro areas). Precious Metals also underperformed as gold prices retreated from their recent highs. The S&P GSCI Commodities Index dropped 6.1% for the month, the Dow Jones REIT Index returned -4.2% and the S&P GSCI Precious Metals Index returned -1.8%. Commodity weakness was mainly driven by lower energy prices and key construction materials (copper and lumber) while precious metals and periphery agriculture outperformed.
- As post-COVID global growth becomes less of a certainty and global events induce more economic volatility, investors seem to flock to these perceived tech-focused safe havens viewed as less susceptible to forces afflicting more traditional economic sectors (finance, industrial), smaller companies (witness the increasing haves vs have-nots within retailing), and regions outside the U.S. (economic weakness spreading across Europe and China).

Out of Breadth



Source: istockphoto.com

“Never buy anything from someone who is out of breath. It is not hard to make money in the market. What is hard to avoid is the alluring temptation to throw your money away on short, get-rich-quick speculative binges. It is an obvious lesson, but one frequently ignored.”

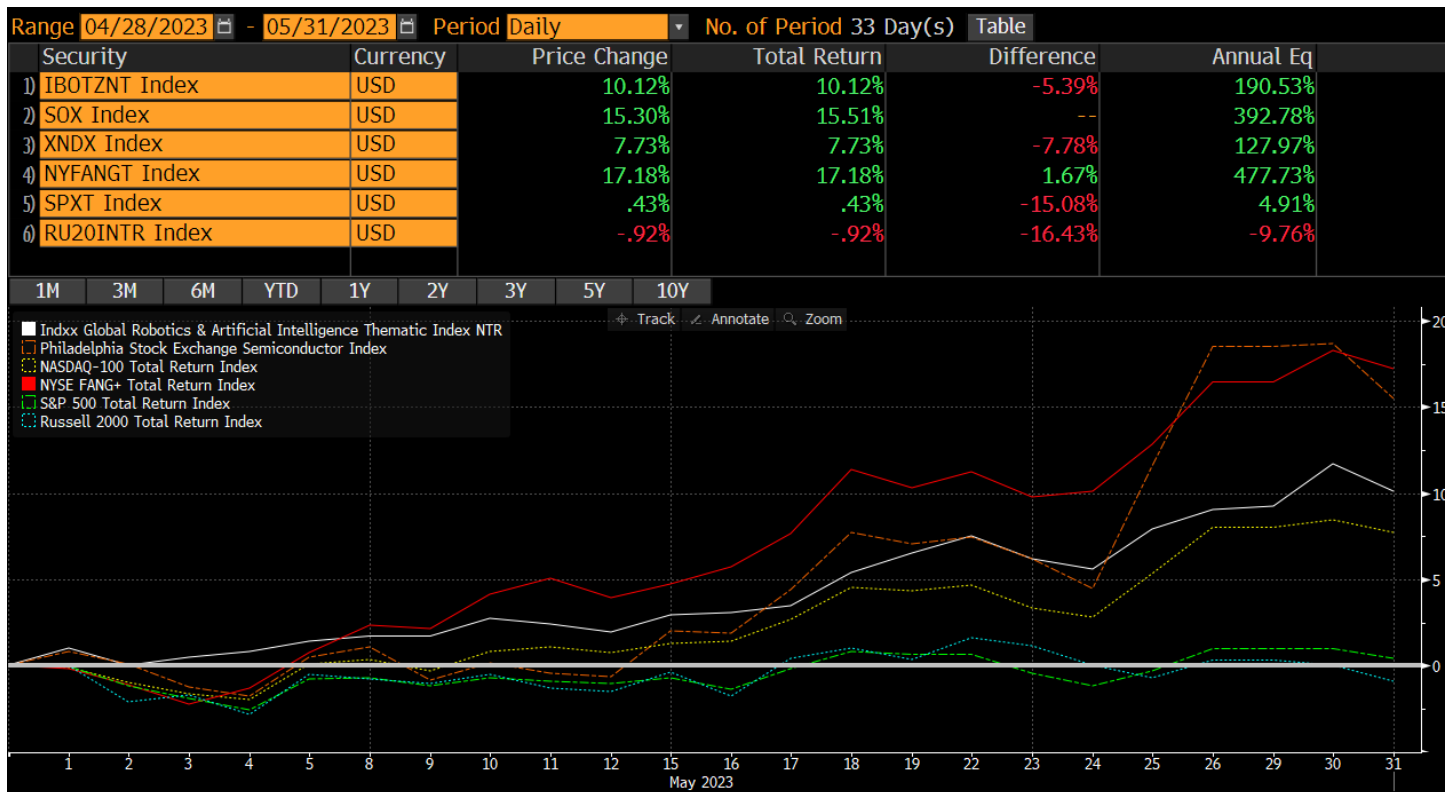
– Burton G. Malkiel, “A Random Walk Down Wall Street”

One can be forgiven if “breadth” and “breath” are used interchangeably, although in the world of investing, the former represents depth of stock market participation, while the latter represents our lung capacity (and not much capacity for value investors so far this year). This year’s U.S. market returns can be characterized as possessing narrow breadth, as in outsized gains from a handful of stocks, namely mega-cap technology and consumer growth stocks, are driving the broader indices, many of which are market capitalization weighted.

This year’s narrow breadth has sucked the breath out of investment portfolios built on bedrock principles, such as diversification and price consciousness. Indeed, this year’s safe havens from a widely expected recession (based on economic consensus) are those companies with moat-like characteristics of solid profitability, inelastic customer demand, and exponential growth prospects, such as generative artificial intelligence that we first touched upon in our [February 2023 Market Commentary](#).

Figure 1 highlights the major divergences seen underneath the surface of the market average. In May, the Indxx Global Robotics & Artificial Intelligence Index rose 10.1%, helped by strong performance from the Philadelphia Semiconductor Index (the upstream of AI thematic plays) which was up 15.5%. The tech-heavy Nasdaq 100 Index rose 7.7% while the NYSE FANG+ Index (a proxy for the mega-cap technology growth stocks) rose 17.2% versus the broader market return of 0.4% as proxied by the S&P 500 Index and -0.92% of the Russell 2000 Index, a proxy for U.S. small caps.

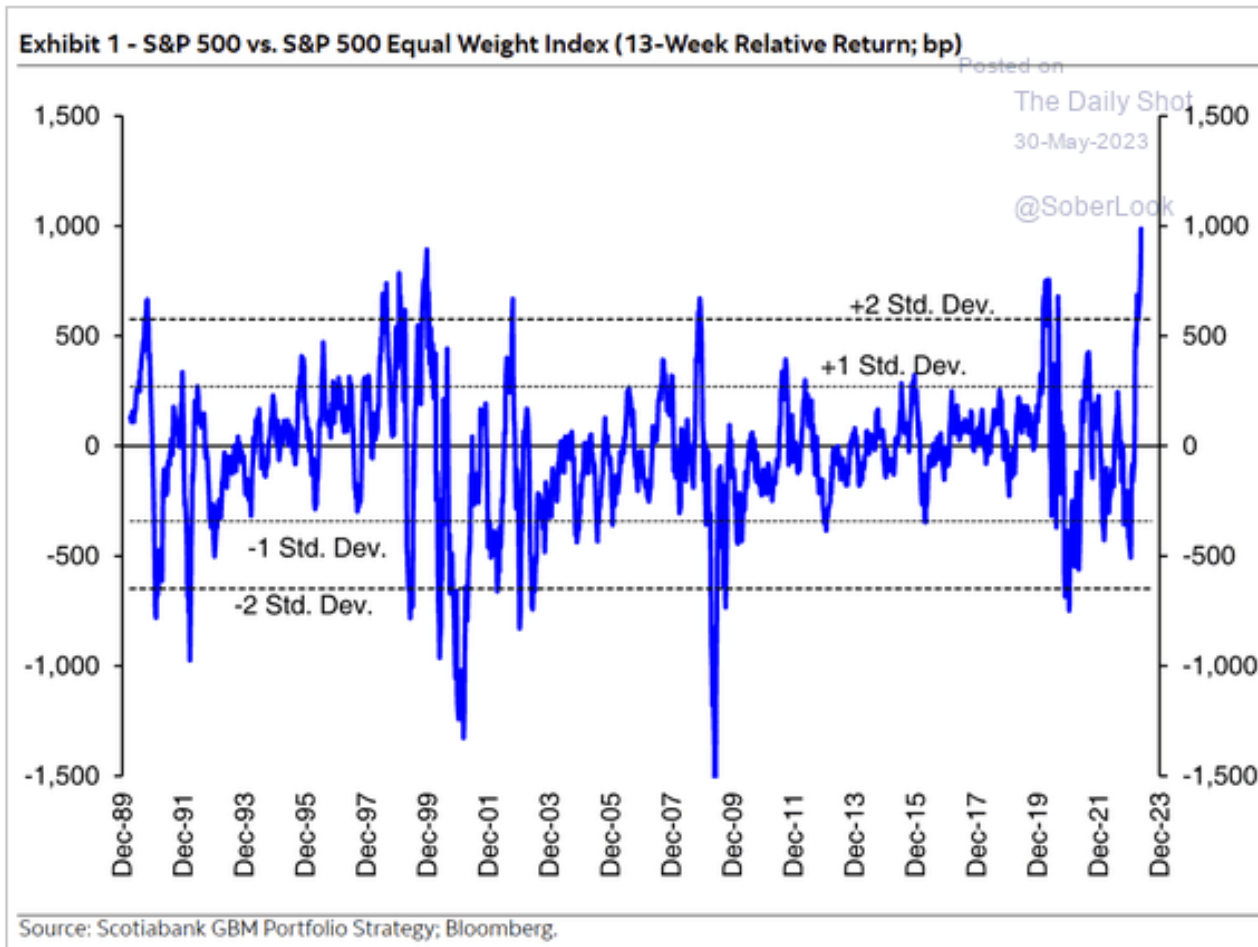
Figure 1 – May Saw a Frenzy in Technology and Artificial Intelligence Themes



Source: Bloomberg

Figure 2 presents another perspective of this month's narrow market breadth as the equal-weighted S&P 500 Index experienced a near-historic level of underperformance versus the cap-weighted S&P 500 on a rolling 3-month basis. Markets represent the final arbiters of company valuation, but so far this year investors are behaving as if the only value worth assigning are the dominant technology and consumer growth names. For instance, Apple's market valuation alone exceeds that of the entire Russell 2000 company universe¹.

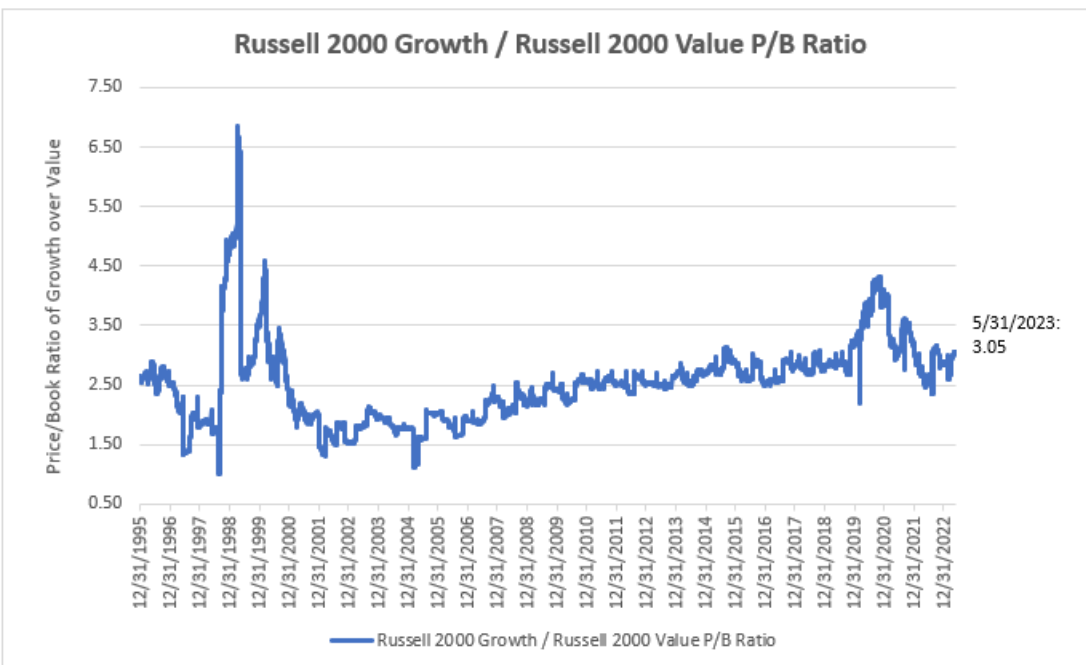
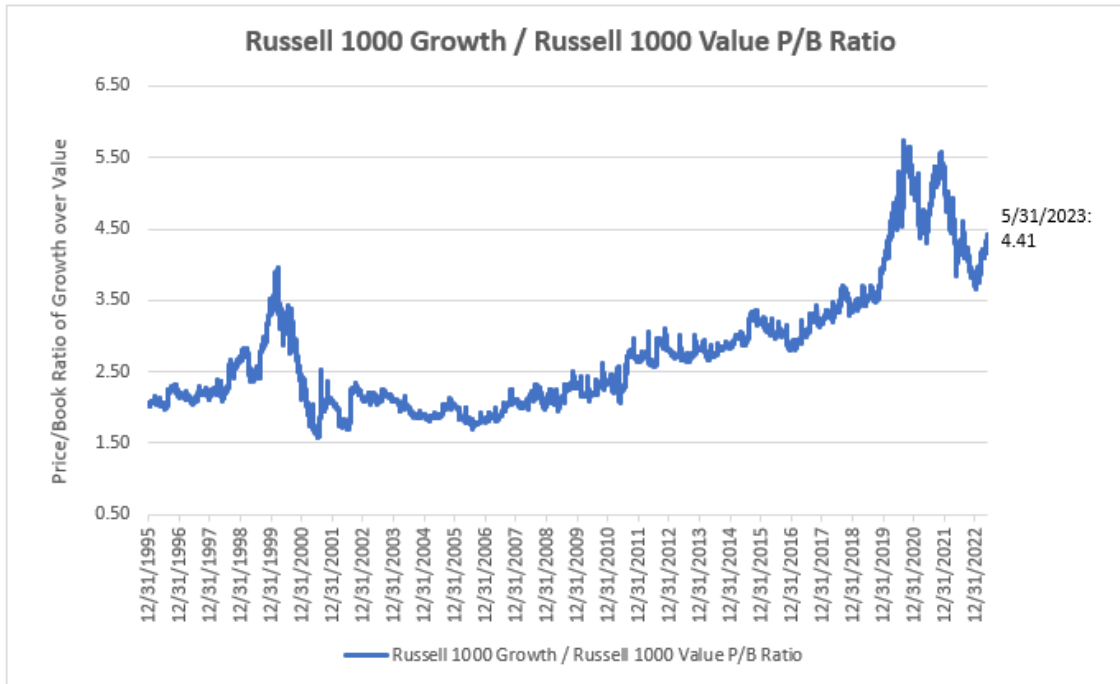
Figure 2 – Near Historic Levels of Narrow Market Breadth (Equal-Weight vs Cap-Weight S&P)



¹ "Top-heavy market rally may be more fragile than it appears," Irish Times 5/23/2023

The frenzied rush back into growth technology plays that had badly lagged in 2022 also re-widened the valuation gaps between value and growth stock indices, more so across large caps than small caps (**Figures 3a and 3b**).

Figures 3a and 3b – Valuation Gaps Re-Widen Between Growth and Value Stocks



Data Source: Bloomberg

As post-COVID global growth becomes less of a certainty and global events induce more economic volatility, investors seem to flock to these perceived tech-focused safe havens² viewed less susceptible to forces afflicting more traditional economic sectors (finance, industrial), smaller companies (witness the increasing haves vs have-nots within retailing), and regions outside the U.S. (economic weakness spreading across Europe and China).

Prior to some key technology-focused earnings releases in late May, much of the market's attention had been fixated on ongoing stresses within the regional banking sector (now fading as deposit outflows seem to be alleviating) and whether the U.S. debt ceiling would be resolved in time for the "x date" estimated to occur in early June. A debt ceiling resolution negotiated by the Biden Administration and Congressional Republicans passed the U.S. House of Representatives³ and the U.S. Senate in time prior to the x date. The debt ceiling deal effectively freezes the increase in government spending (albeit from a post-pandemic high levels) through 2025 in exchange for lifting the \$31.4 trillion ceiling to \$34 trillion through 2025 while reducing government deficits by \$1.5 trillion over a decade based on CBO projections versus baseline⁴. Other key aspects of the deal include:

- Military spending would increase by 3% in fiscal 2024, in line with Biden's budget request.
- Discretionary spending pared back next fiscal year and imposition of a 1% spending cap for fiscal 2025, without touching Social Security or Medicare.
- Far-reaching changes to environmental law such as the acceleration of new renewal energy projects and the expediting of the Mountain Valley Pipeline (303-mile natural gas pipeline in West Virginia).
- Changes to eligibility for food-assistance programs (although not Medicaid).

² ["Have Megafirms Like Nvidia Grown Too Big? Investors Believe They Are Only Getting Started,"](#) Wall Street Journal 5/31/2023

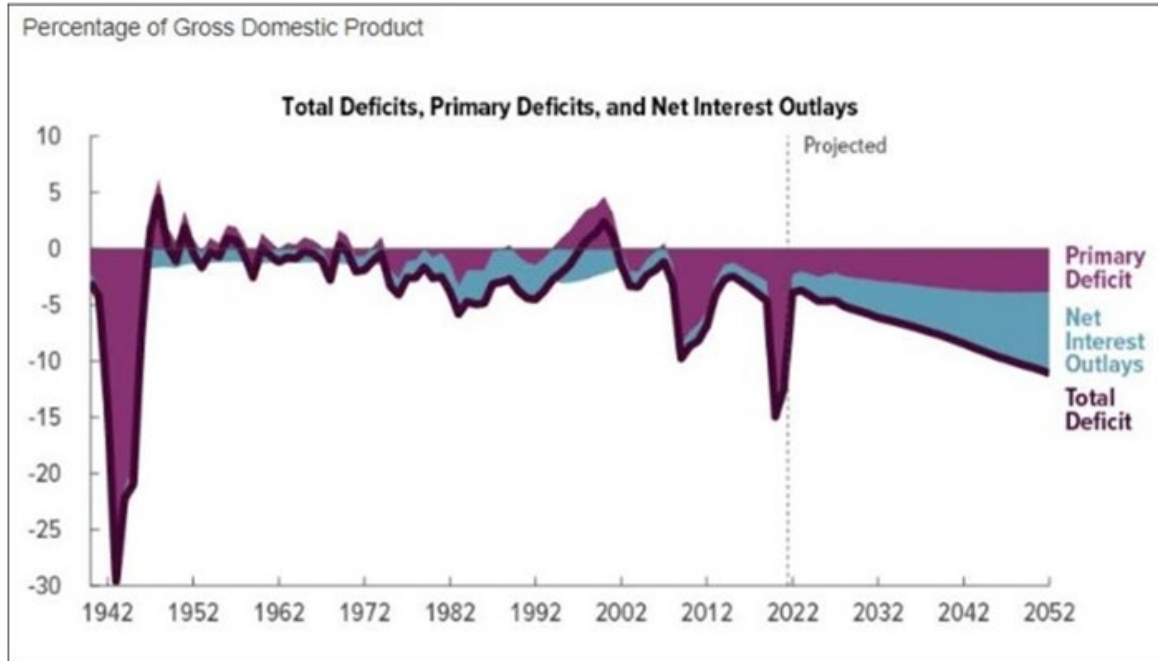
³ ["Debt-Limit Deal Passes the House, Easing US Default Concerns,"](#) Bloomberg 6/1/2023

⁴ ["Senators Seek to Fast Track Debt-Ceiling Vote,"](#) Wall Street Journal 6/1/2023

Although loathed by the more partisan wings of the Republican and Democratic parties, investors breathed a sigh of relief, bidding up financial assets (equities and fixed income) despite longer-term fiscal issues remaining unresolved (such as the increasing portion of interest expenses as projected by the Congressional Budget Office – **Figure 4**).

Figure 4 – Capacity for Debt-Financed Government Spending Running Out of Debt Fuel as Interest Expense Projected to Overtake Primary Deficit (% of GDP)

Deficit and Interest Expense

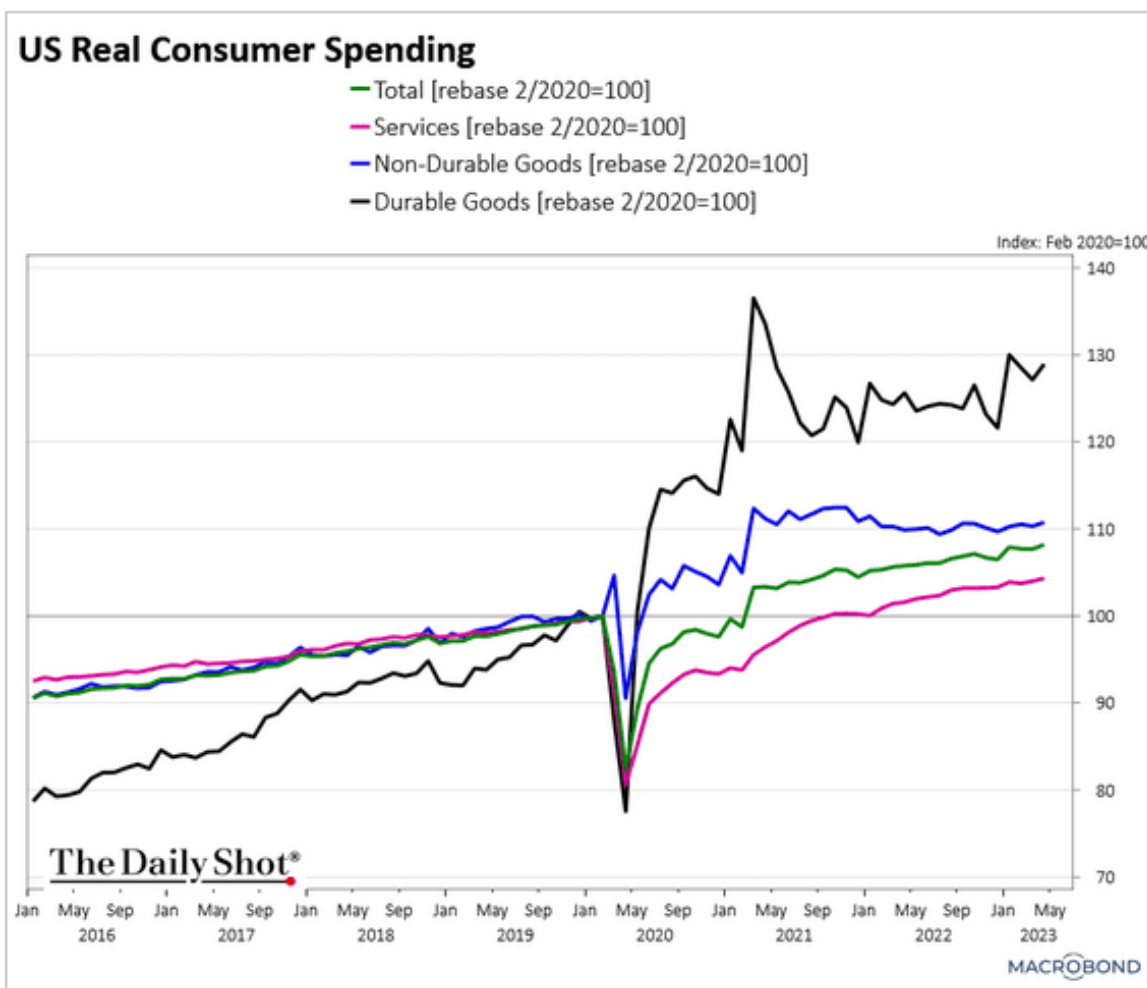


Interest expenses will exceed the primary deficit in the next few years, according to the CBO.

Source: The Bear Traps Report, 6/1/2023

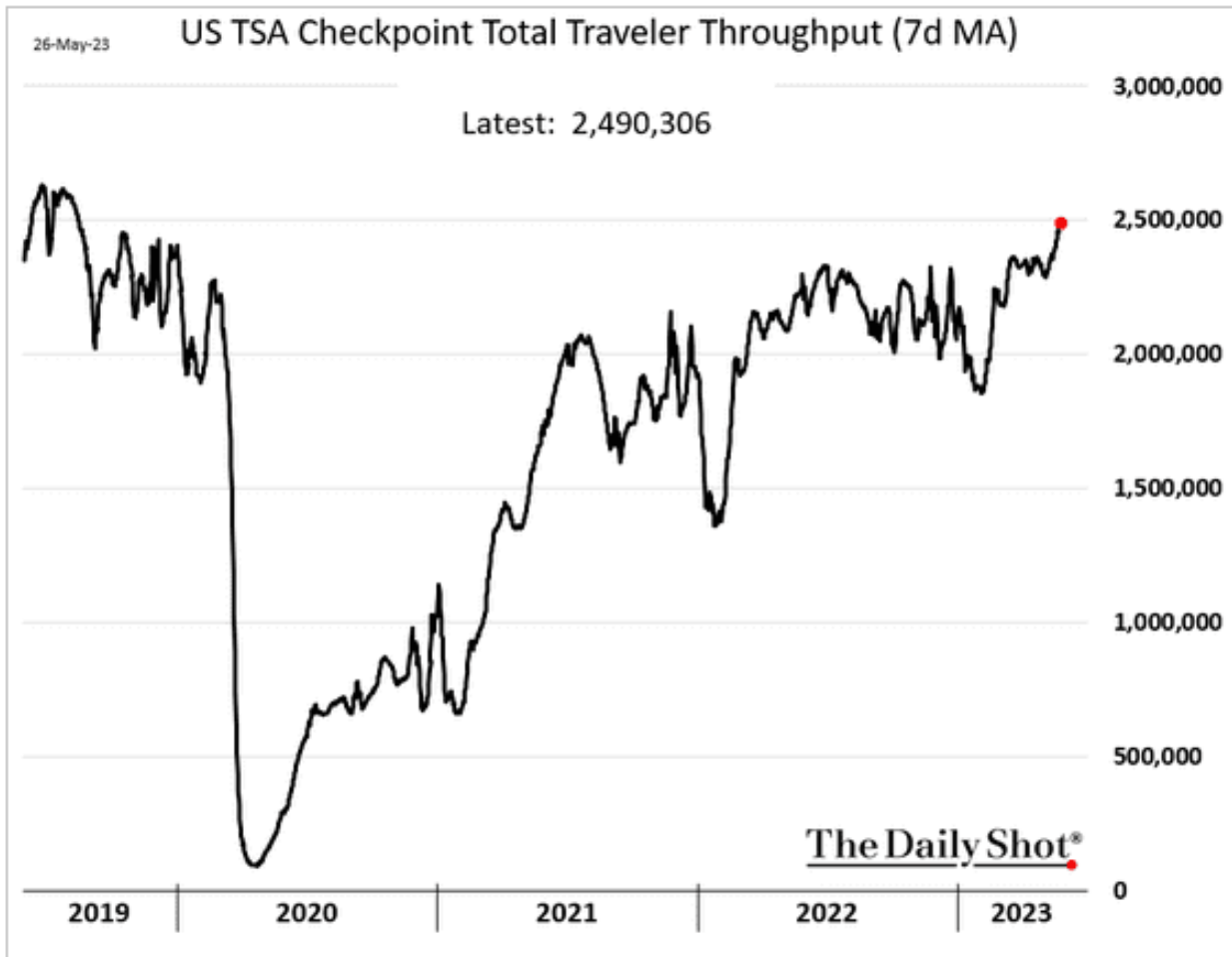
The U.S. economy's main workhorse, the consumer, is showing signs of a slowdown, but not a crash, although earnings releases across the retailers present a mixed picture. According to the Bureau of Economic Analysis (BEA), inflation-adjusted (real) consumer spending continues its upward post-COVID trend (**Figure 5**) while TSA checkpoint data (**Figure 6**) reveals travel demand now exceeding pre-COVID activity. Those expecting a recession keep delaying their timetable as long as consumer spending remains buoyant, helped by strong labor market conditions (albeit also showing signs of a slowdown). If there is a recession later this year, then expect some fiscal support even if the debt ceiling deal is expected to shave off about 0.2% from GDP growth⁵. With the 2024 election season coming up, one should expect both political parties to increase the fiscal largess to appease their main constituents for the upcoming fiscal year even if bound by the cap on discretionary spending.

Figure 5 – Real Consumer Spending Remains on its Post-COVID Upward Trend



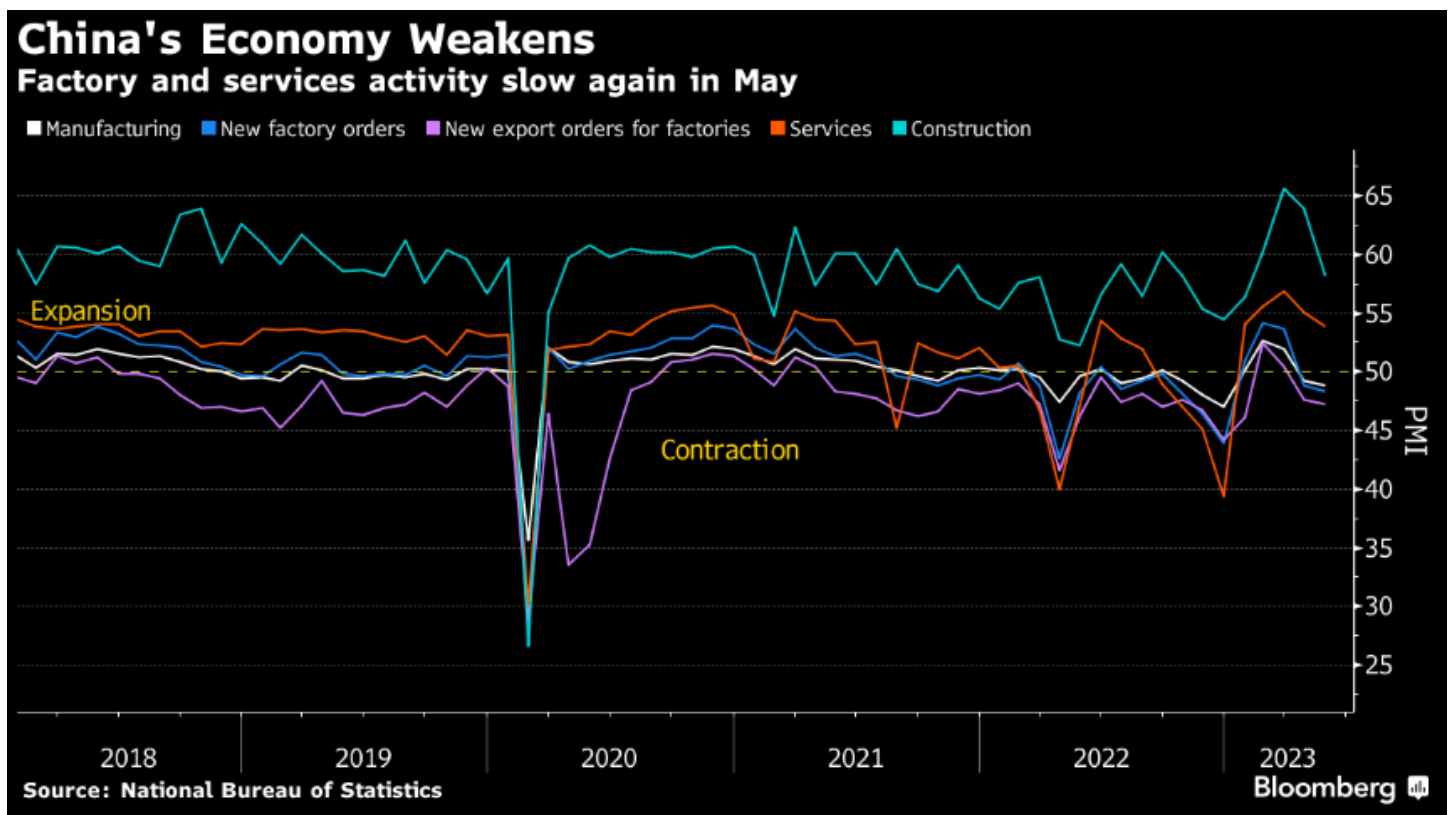
⁵ [“Debt ceiling deal won’t have much impact on the US economy, analysts say,” CNN, 5/31/2023](#)

Figure 6 – TSA Checkpoint Data Shows Air Travel Close to Exceeding Pre-COVID Activity



Economic weakness is starting to surface, but more so outside the U.S., specifically China and Europe. Although Chinese export activity remains robust, the post-COVID recovery has proven to be lackluster as evidenced by weakening industrial and property activity (**Figure 7**) burdened by debt-fueled spending⁶, a depreciating currency (CNY/USD breaking the psychological 7.00 threshold), and price drops across key industrial commodities most sensitive to Chinese demand (see the end of this commentary). China's import activity has also slowed, which helps explain some of the weakness in Europe (both exports to China as well as exhaustion in some of the luxury names seen as tied to Chinese demand). It is expected that further weakness will be met with fiscal and monetary support, but to what extent can such measures be applied given the outstanding state and local government debt burdens.⁷

Figure 7 – China Showing Further Slowdowns in Economic Activity



⁶ [“China’s Fading Recovery Reveals Deeper Economic Struggles,”](#) Wall Street Journal 5/30/2023

⁷ [“China Manufacturing Slump Heightens Risk of ‘Downward Spiral’,”](#) Bloomberg 5/30/2023

With near-term concerns of depositor flight from regional banks on the wane, Federal Reserve officials reiterated their tightening stance by leaving the door open for additional rate hikes beyond the 5.25% target rate while pushing back on market expectations that the Fed would cut rates by the end of the year. Month-end Federal Funds futures (**Figure 8**) projects the Fed to hike again either at the June or July FOMC (latest Fed official comments point to July with a “pause” in June to assess the incoming data on inflation and labor market conditions⁸).

Figure 8 – Fed Funds Futures Pricing in One Rate Hike in July and One Rate Cut by Year-End

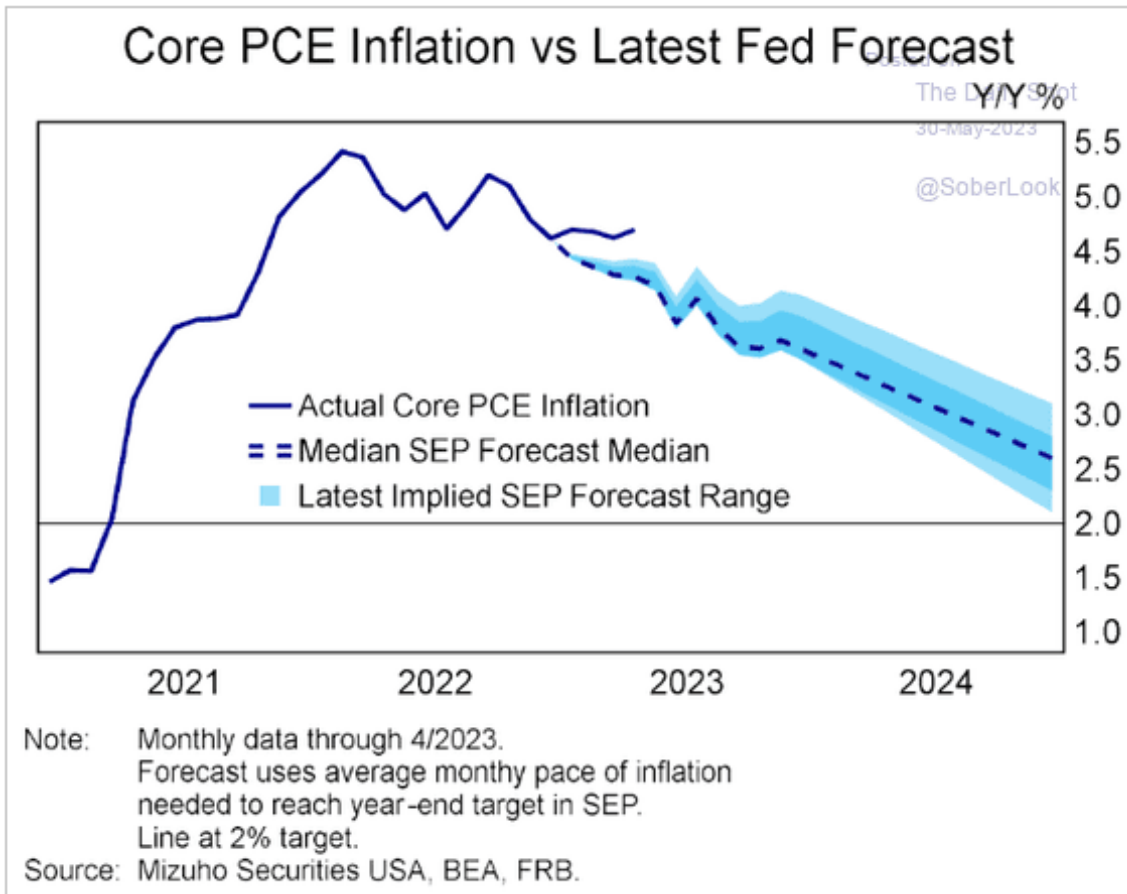
Region: United States »		Instrument: Fed Funds Futures »				
Target Rate	5.25	Pricing Date	05/31/2023 📅			
Effective Rate	5.08	Cur. Imp. O/N Rate	5.078			
Meeting	#Hikes/Cuts	%Hike/Cut	Imp. Rate Δ	Implied Rate	A.R.M.	
06/14/2023	+0.364	+36.4%	+0.091	5.169	0.250	
07/26/2023	+0.829	+46.5%	+0.207	5.285	0.250	
09/20/2023	+0.579	-25.0%	+0.145	5.223	0.250	
11/01/2023	+0.020	-55.9%	+0.005	5.083	0.250	
12/13/2023	-0.678	-69.8%	-0.169	4.908	0.250	
01/31/2024	-1.431	-75.3%	-0.358	4.720	0.250	

Source: Bloomberg World Interest Rate Probability 5/31/2023

⁸ [“Fed Signal for Rate Pause Takes Pressure Off Hot Jobs Report,”](#) Bloomberg 5/31/2023

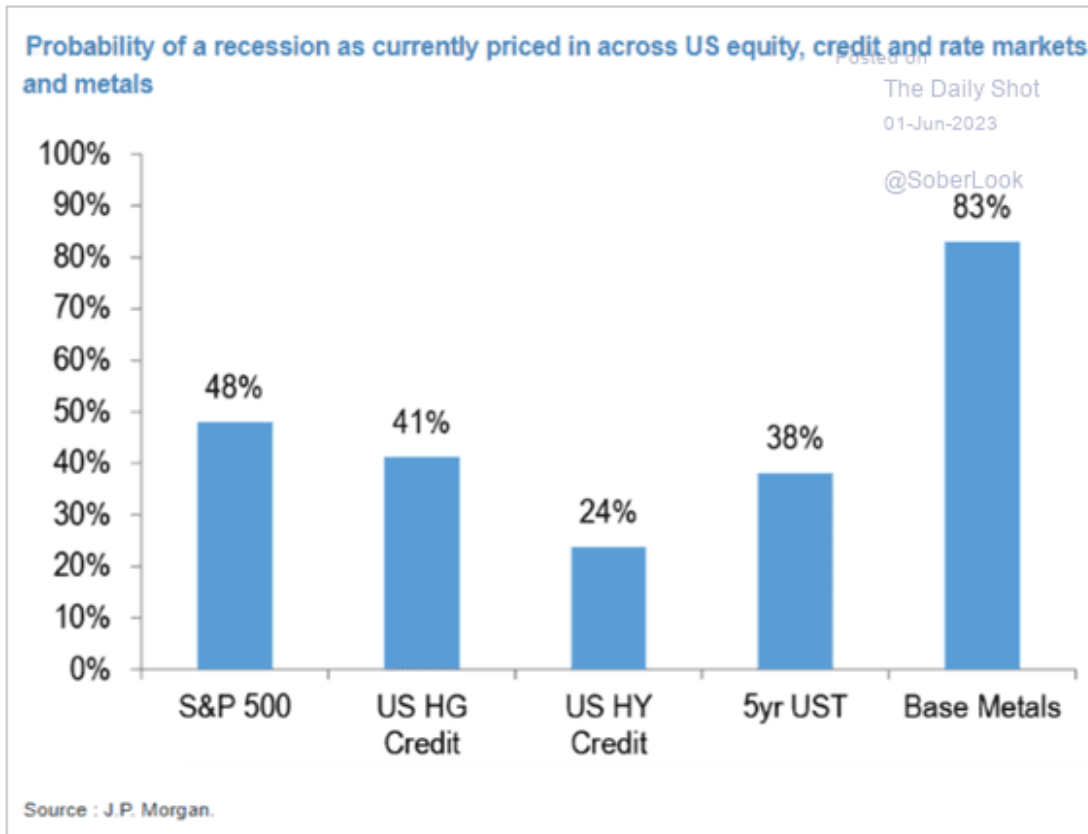
Inflation has slowed down, but is it slowing down enough for the Fed to pause its rate tightening campaign? The last Core PCE Inflation is still tracking above the SEP forecast range set by Federal Reserve officials (**Figure 9**), even if elevated inflation readings are driven by lagging effects from housing (based on slowing lease rates).

Figure 9 – Core Inflation Still Tracking Above Fed Official Forecasts



The Fed has become increasingly data-dependent when communicating policy preferences, yet financial markets present a mixed picture on implied recession probabilities (**Figure 10**), with the commodities market implying the highest probability, although more likely due to perceived slowdown in Chinese demand.

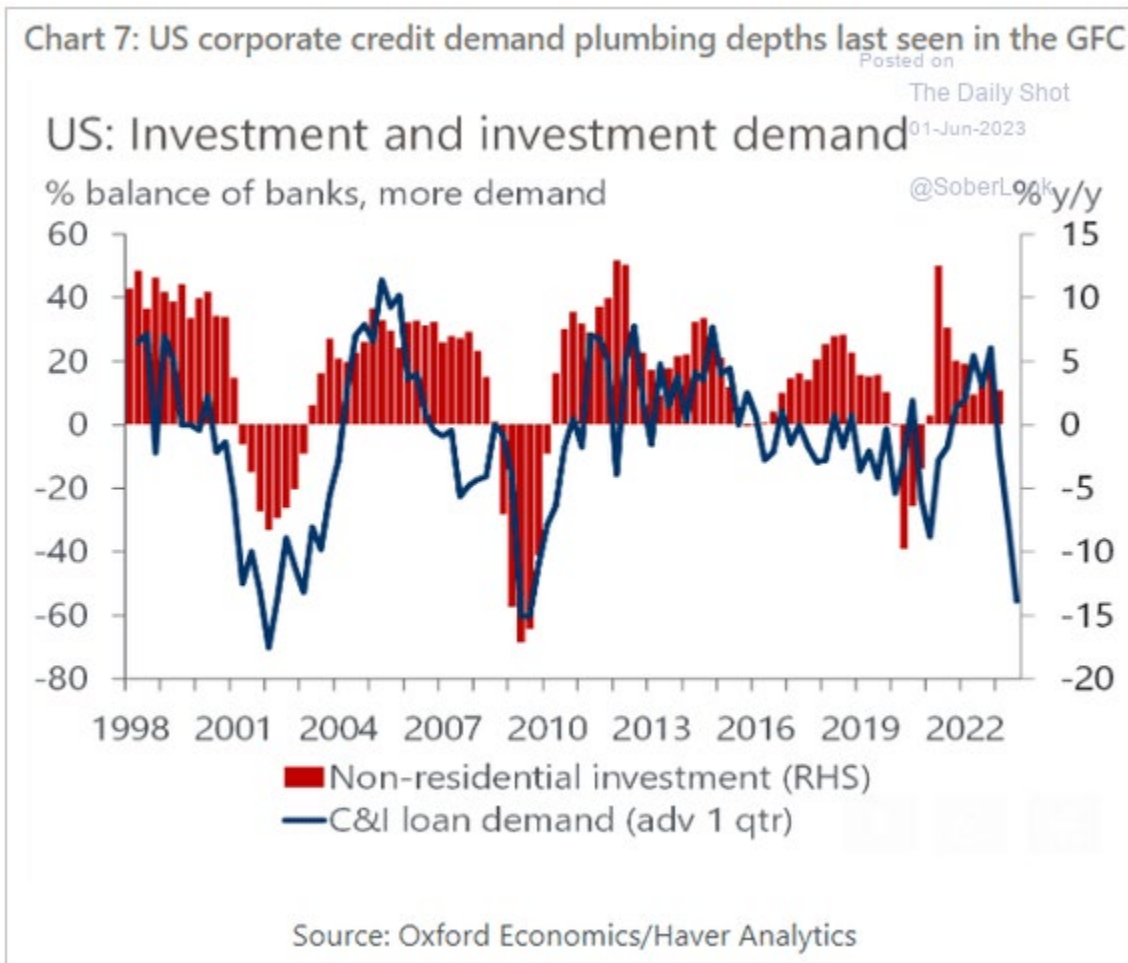
Figure 10 – Mixed Picture on Whether Financial Markets Are Pricing in a Recession



Source: [JP Morgan Research](#); [III Capital Management](#)

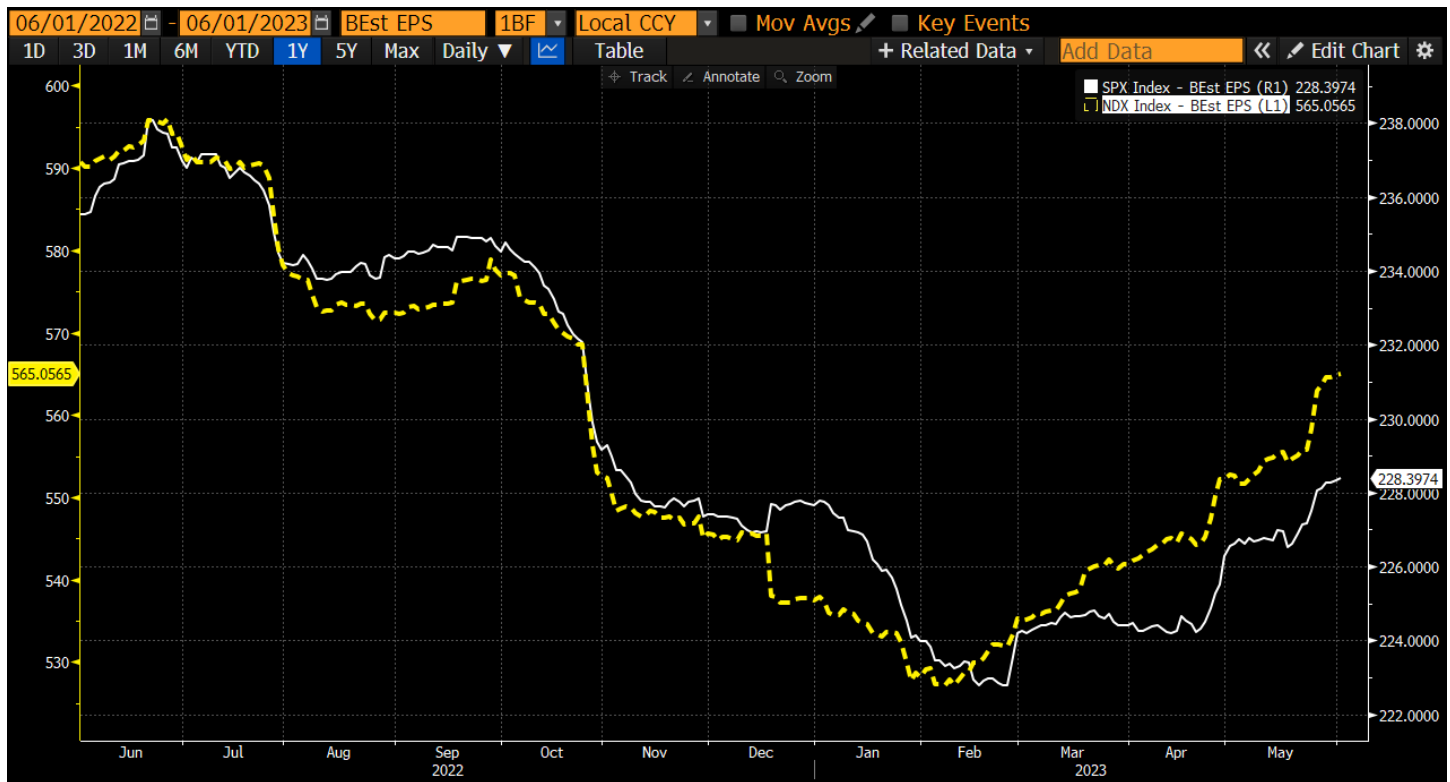
The Fed is also attuned to the state of lending conditions (both willingness to lend and willingness to borrow). A lower willingness to lend, particularly commercial lending, from the lending banks has been met with lower commercial borrowing demand (**Figure 11**). This weakening demand could be indicative of a further slowdown in industrial activity, although construction activity remains strong due to backlogs of residential housing built up from the pandemic.

Figure 11 – Weakening Demand from Commercial Borrowers at a Pace Not Seen Since 2008



So, it is understandable if investors flock to the “sure” thing when the economic environment is mixed at best. Even with an impending recession, or at least a slowdown from the post-pandemic growth pace, Wall Street analysts have been raising their forward earnings estimates on U.S. large companies, especially technology companies (**Figure 12**), viewed as less exposed to a slowdown as the enterprise level of technology spending is expected to see a surge in AI-driven investments. Whether ebullient investors reconsider what price they’re willing to pay for such economic resiliency and growth potential, time will tell.

Figure 12 – Sell-Side Analysts Raising Earnings Forecasts for U.S. Stocks (Particularly Tech)



Source: Bloomberg B(EST) Consensus Forecasts 12 Months Forward for the S&P 500 and Nasdaq 100

May 2023 Market Review

Global equity markets were marginally down in May, although the aggregate market return masks some deep divergences between U.S. large caps (particularly mega-cap growth stocks) versus the rest of the world. Uncertainty over 1) the U.S. debt ceiling, 2) heightened inflation across Europe, and 3) a lackluster post-COVID economic recovery in China weighed on global market sentiment. However, strong forward guidance from key U.S. technology companies, especially over the prospects of generative artificial intelligence and large language models, drove a month-end frenzy into AI-themed stocks, reminiscent of the late-1990s dotcom bubble. In May, the MSCI All-Country World Index (ACWI) dropped 1.1%.

Across major regions (**Figure 13**), Japan and U.S. equity markets outperformed with MSCI Japan returning +1.9% followed by the S&P 500 (+0.4%). Other major regions were down in May with MSCI Emerging Markets returning -1.7% followed by MSCI Pacific ex-Japan (-2.4%) and MSCI Europe (-5.9%), the latter having surrendered some of its YTD leadership. The U.S. dollar (**Figure 14**) appreciated from the recent bottom reached towards the end of March as angst over the regional banking faded started to fade and expectations that the Fed would continue with its rate hike campaign.

Figure 13 – Japan and the U.S. Outperform the Other Major Regions

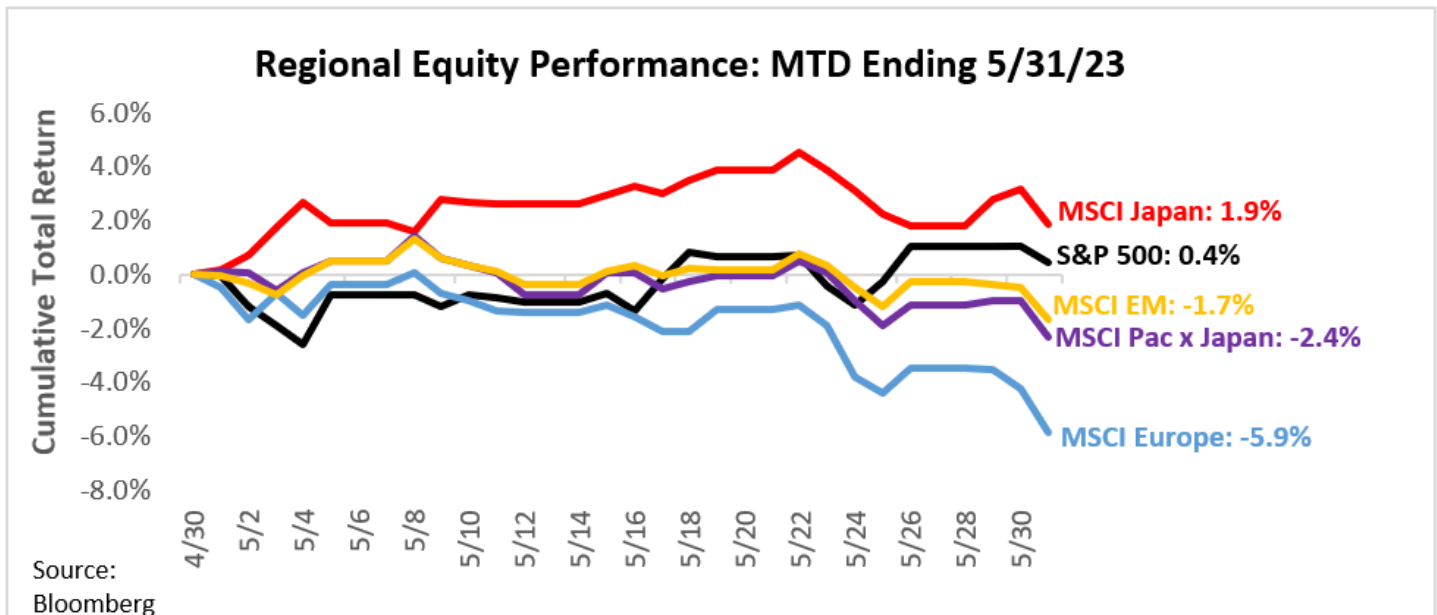
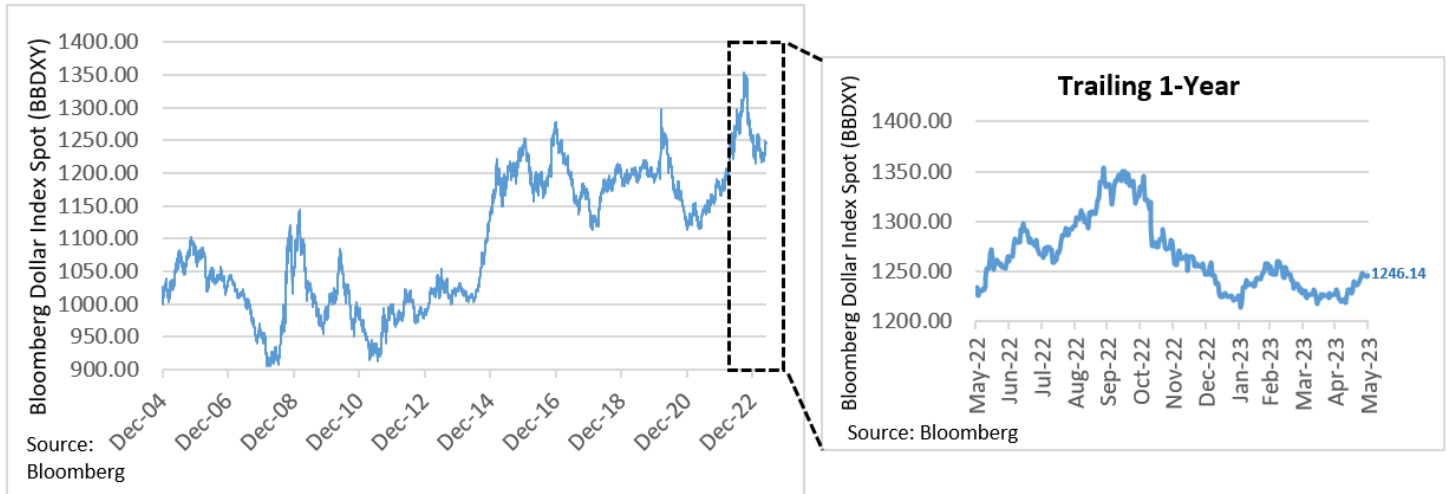
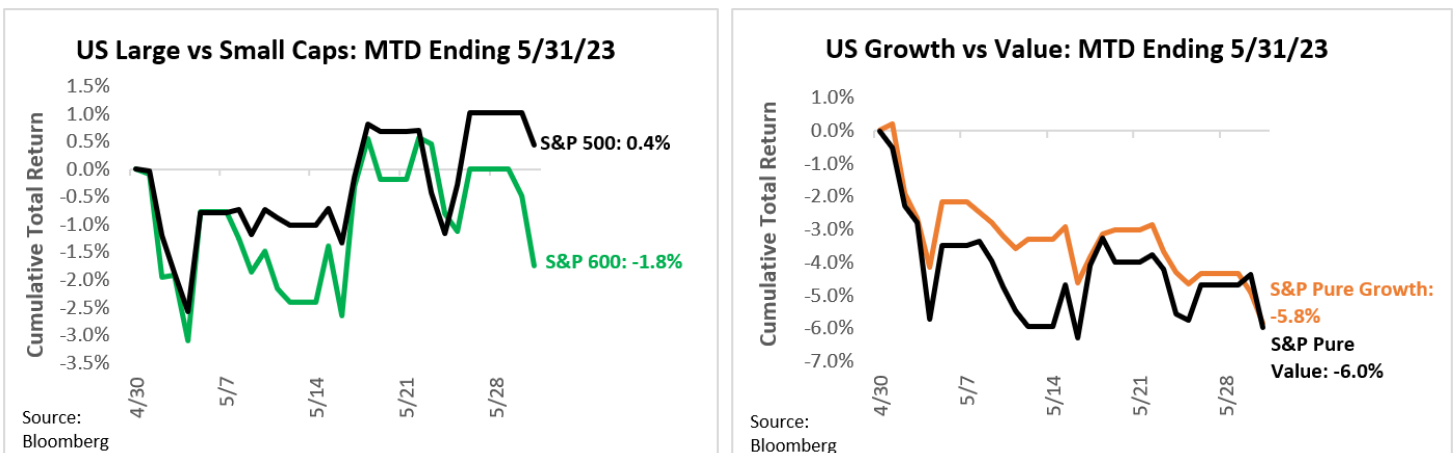


Figure 14 – The U.S. Dollar Recovers From Its Recent Bottom as Angst over Regional Banking Stress Fades



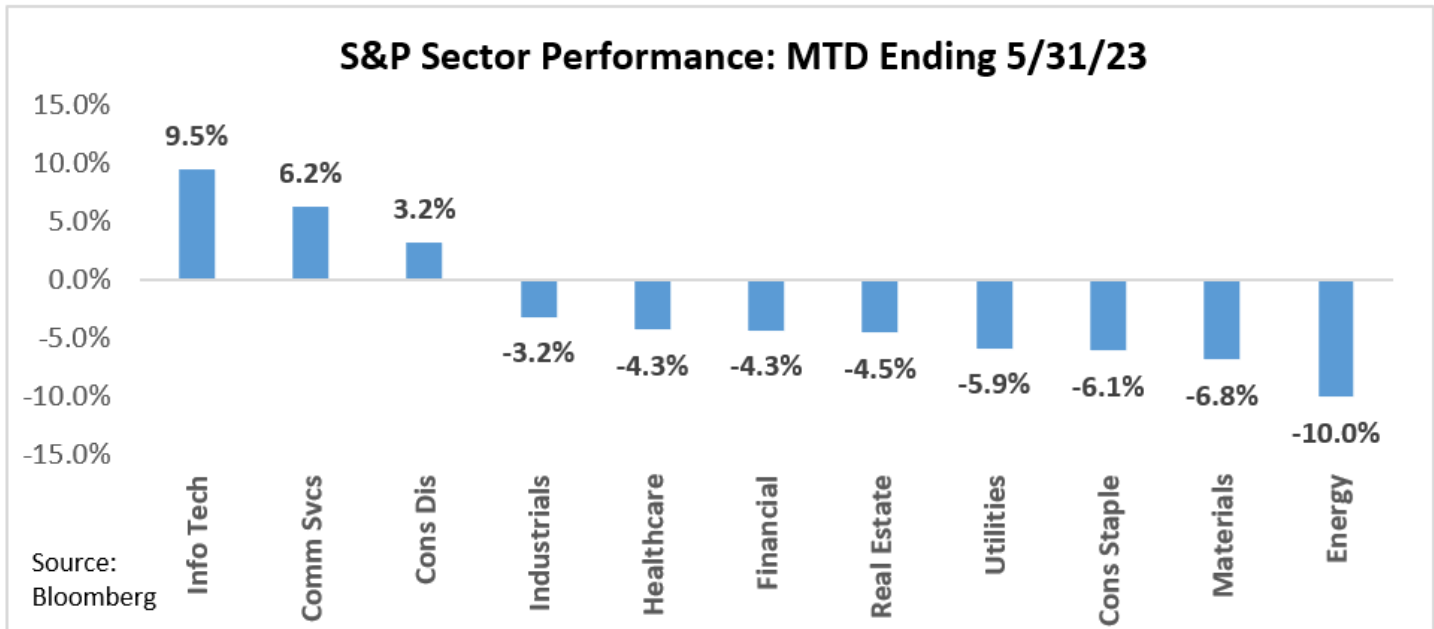
Within the U.S., small caps continue to struggle against large caps, although the underperformance of both pure value and pure growth stocks versus the broader market averages underscores the narrowness of the U.S. market advance. The S&P 600 Index returned -1.8% versus +0.4% for the S&P 500. S&P Pure Value marginally underperformed Pure Growth, returning -6.0% versus -5.8%, respectively (Figure 15).

Figure 15 – Small Caps Underperformed Large Caps and Value Underperformed Growth



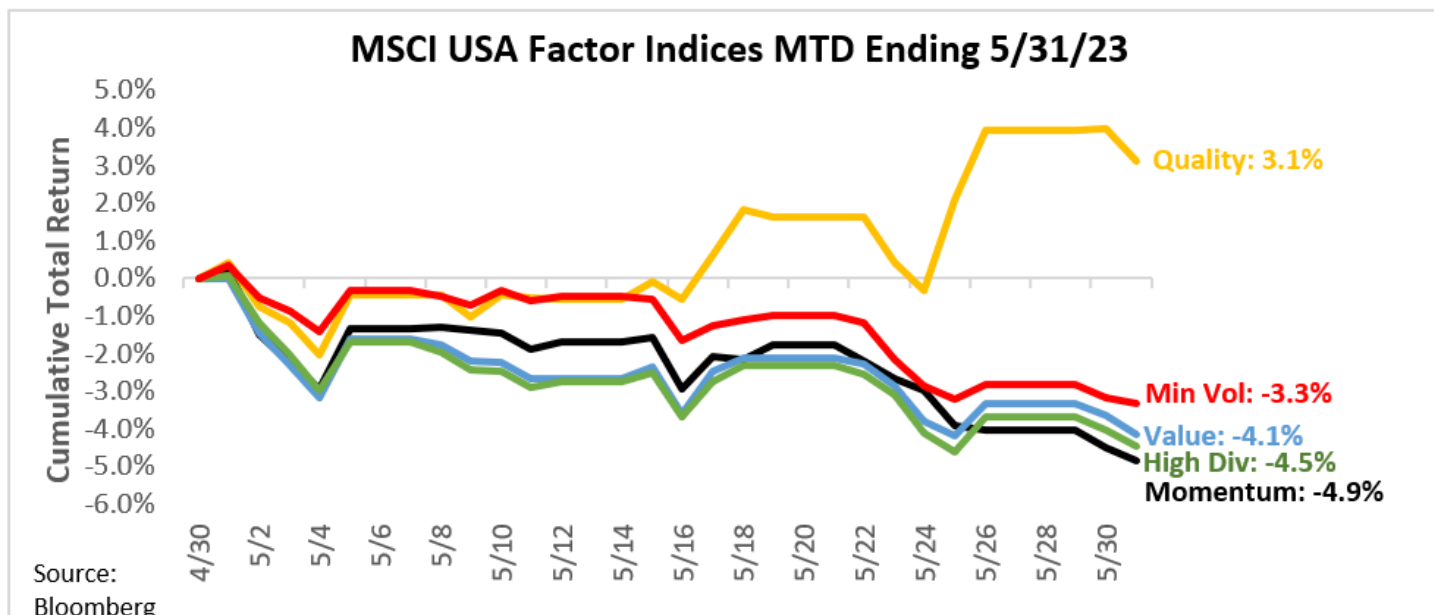
Across sectors (**Figure 16**), mega-cap heavy sectors (Technology, Communication Services, and Consumer Discretionary) were the only positive performing sectors, significantly outperforming traditional cyclicals, financials and defensive sectors. Materials and Energy were the main laggards as both suffered from lower commodity prices.

Figure 16 – Mega-Cap Heavy Sectors Outperformed



Risk factors struggled again in May as only High Quality (dominated by profitable technology stocks) handily outperformed the other major risk factors (**Figure 17**). MSCI Momentum had its semi-annual rebalance whereby its sector exposure will dramatically shift from defensives and energy to technology.

Figure 17 – Tech-Heavy High Quality Outperformed the Other Major Risk Factors



Fixed Income market returns dropped in May as interest rates rose in anticipation of further Federal Reserve tightening in the face of elevated inflation. The Bloomberg U.S. Aggregate Bond Index returned -1.1% for the month (**Figure 18**) while the Global ex-U.S. Aggregate returned -2.7%, hurt by both higher interest rates, especially in the U.K. (**Figure 19**), and an appreciating U.S. dollar. The 10-Year U.S. Treasury yield ended the month at 3.6%, up from 3.4% at the beginning of the month, while the 2-10 Year Term structure (**Figure 20**) remains deeply inverted and inflation expectations implied by breakeven rates between TIPS vs Nominal Treasury yields continue to remain above 2%. Emerging market local currency bonds performed nearly in line with U.S. bonds, although the former was hurt by end of month sell-offs in the Turkish Lira (following elections) and South African Rand (heightened political uncertainty). U.S. high yield outperformed investment grade corporates as credit spreads remain stable (**Figure 21**). The Bloomberg US High Yield Index returned -0.9% and the Bloomberg/Barclays Emerging Market Debt LC returned -1.0%.

Figure 18 – Fixed Income Markets Dropped as Interest Rates Rose

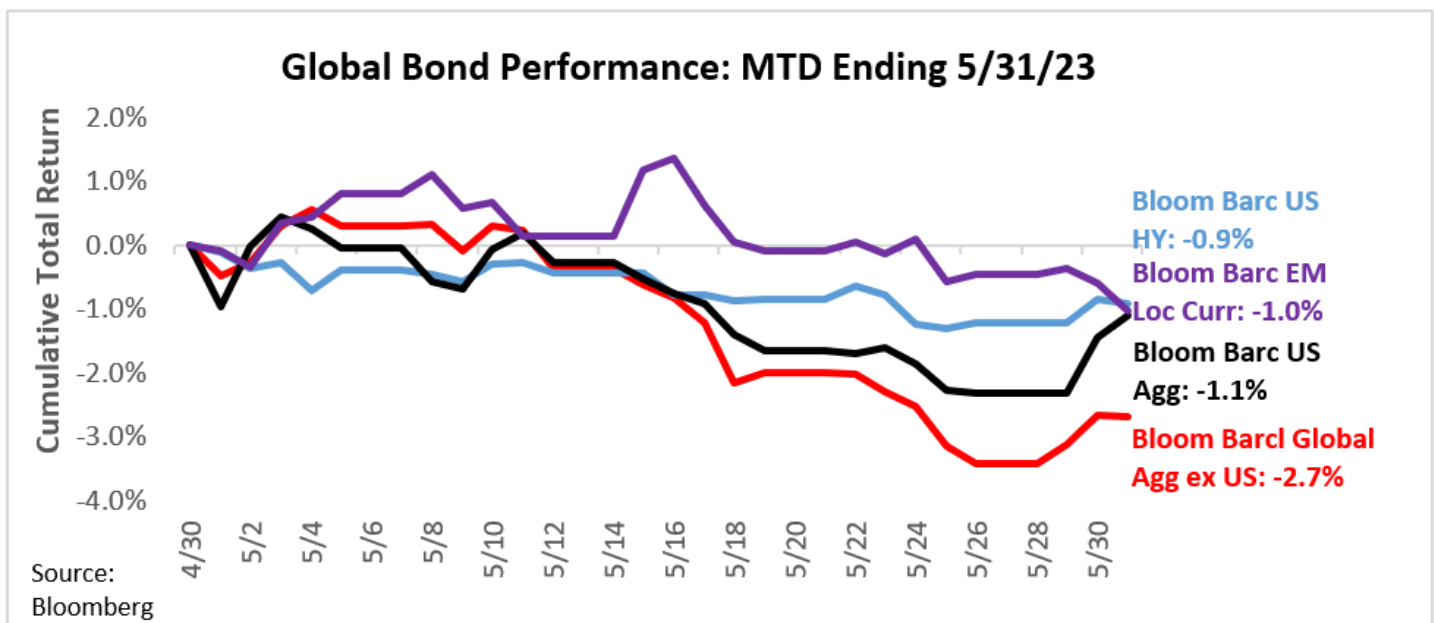


Figure 19 – The 10-Year U.S. Treasury Yield Bounced Off the Lower End of its 6-Month Range While the U.K. Gilt Yield Spiked Due to Elevated Inflation

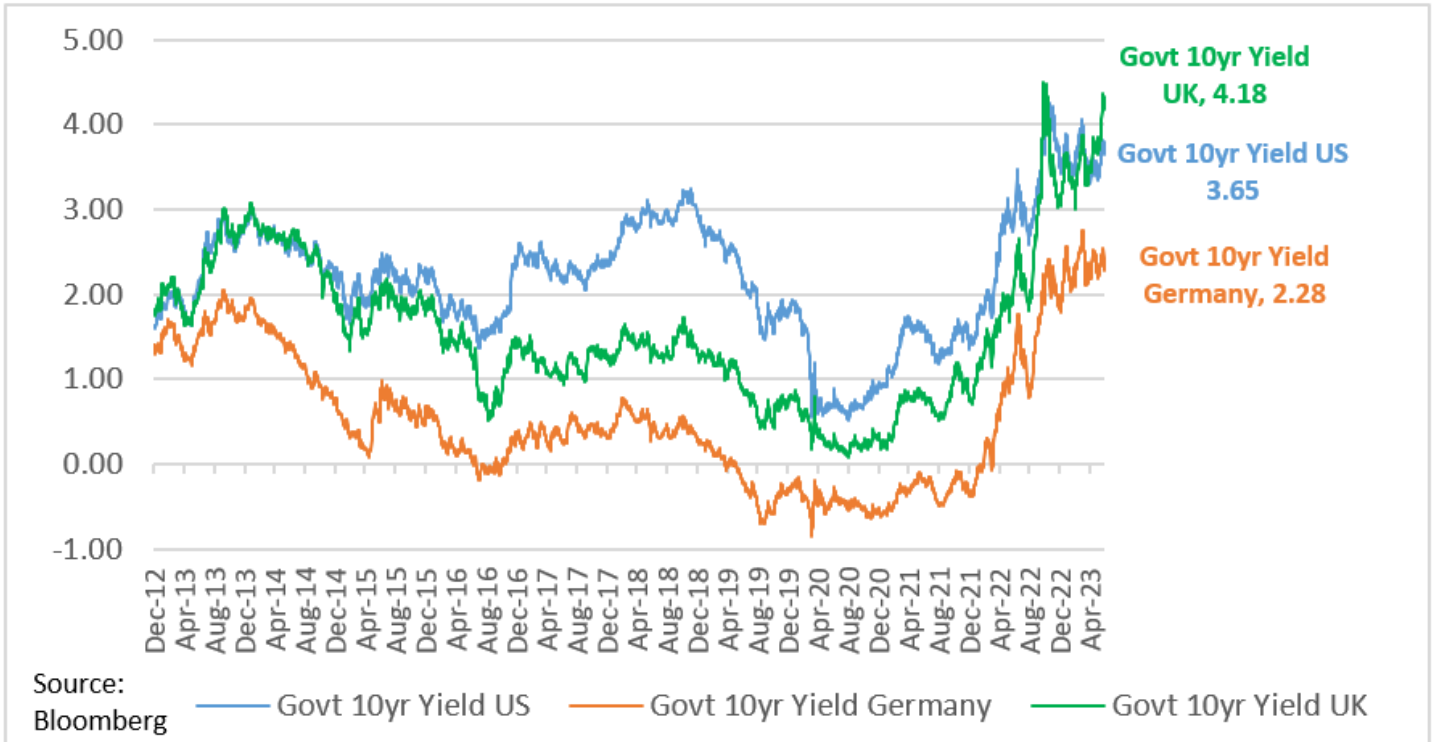


Figure 20 – 2-10 Year Term Structure Remains Deeply Inverted While Inflation Expectations (Breakeven Rates Between TIPS vs Nominal Treasuries) Remain Stable Despite Rising Short-Term Inflation Expectations

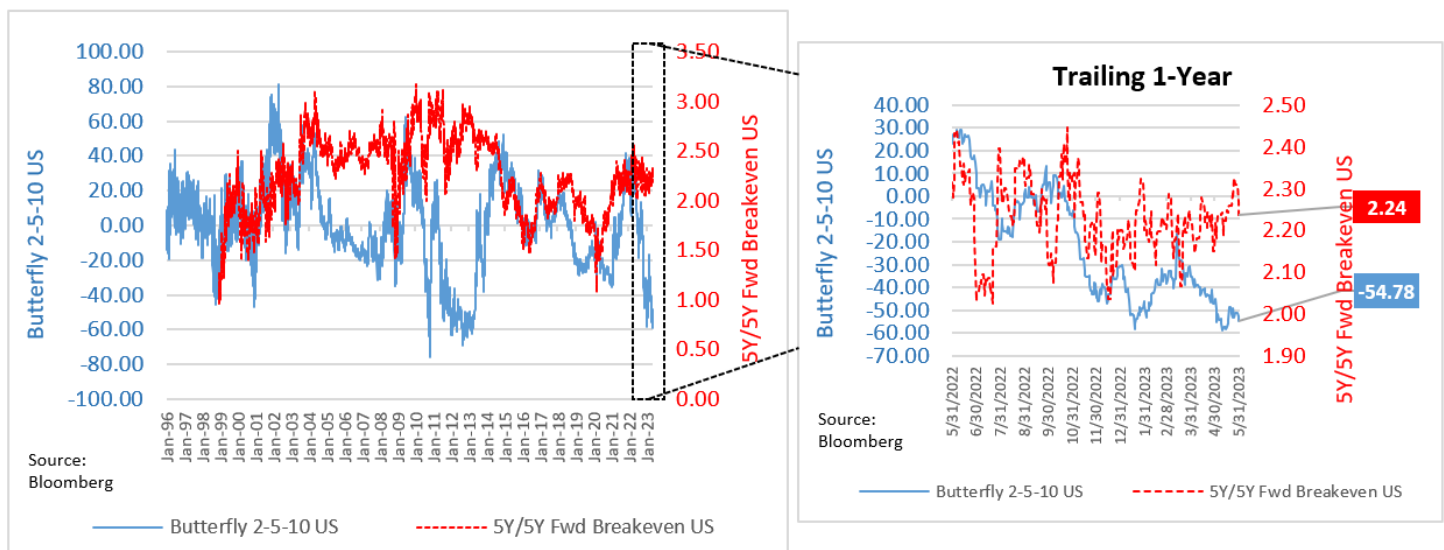
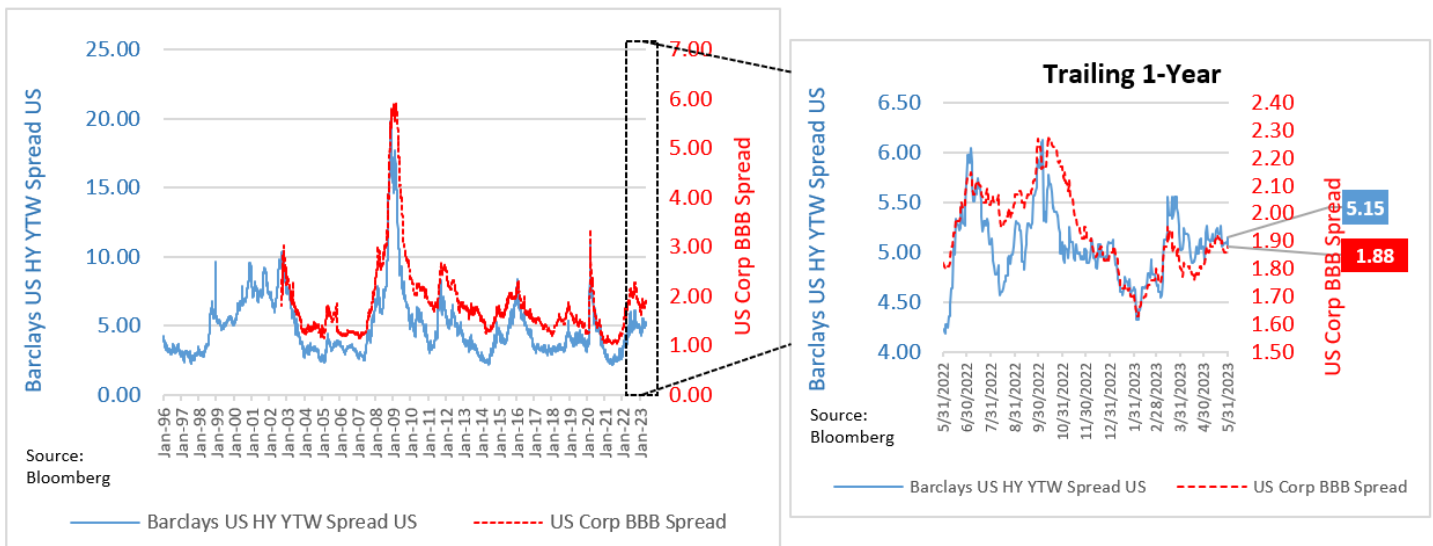


Figure 21 – Corporate Credit Spreads Remain Stable but at the Upper End of 6-Month Range



Within equity alternatives (Figure 22), commodities underperformed the broader risk markets, hurt by a drop in energy prices and industrial metals (Figure 23) as investors anticipate a demand slowdown with more signs of a lackluster recovery in China's industrial activity. Real Estate underperformed due to ongoing stress across commercial properties (notably the Office sector where vacancy rates have risen across key metro areas). Precious Metals also underperformed as gold prices retreated from their recent highs. The S&P GSCI Commodities Index returned -6.1% for the month, the Dow Jones REIT Index returned -4.2% and the S&P GSCI Precious Metals Index returned -1.8%. Commodity weakness was mainly driven by lower energy prices and key construction materials (copper and lumber) while precious metals and periphery agriculture outperformed (Figure 24).

Figure 22 – Equity Alternatives Came Under Pressure in May

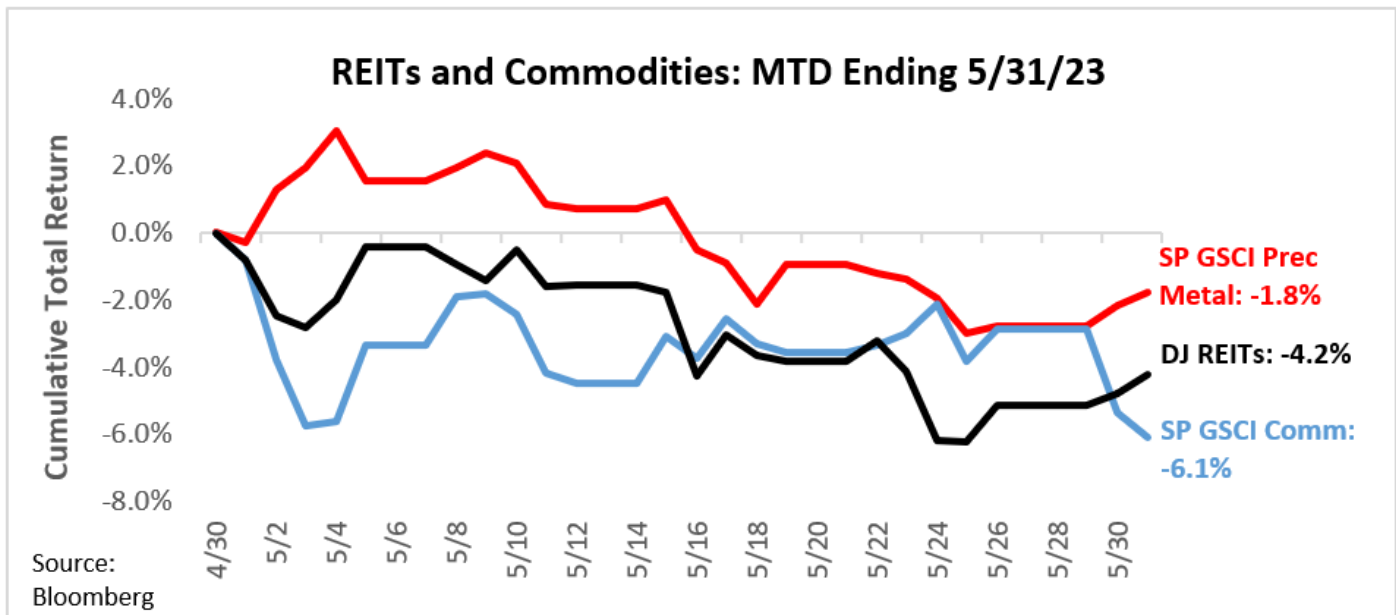


Figure 23 – Industrial Metals and Energy Were Weak in May Driven by Diminishing Industrial-Driven Demand from China

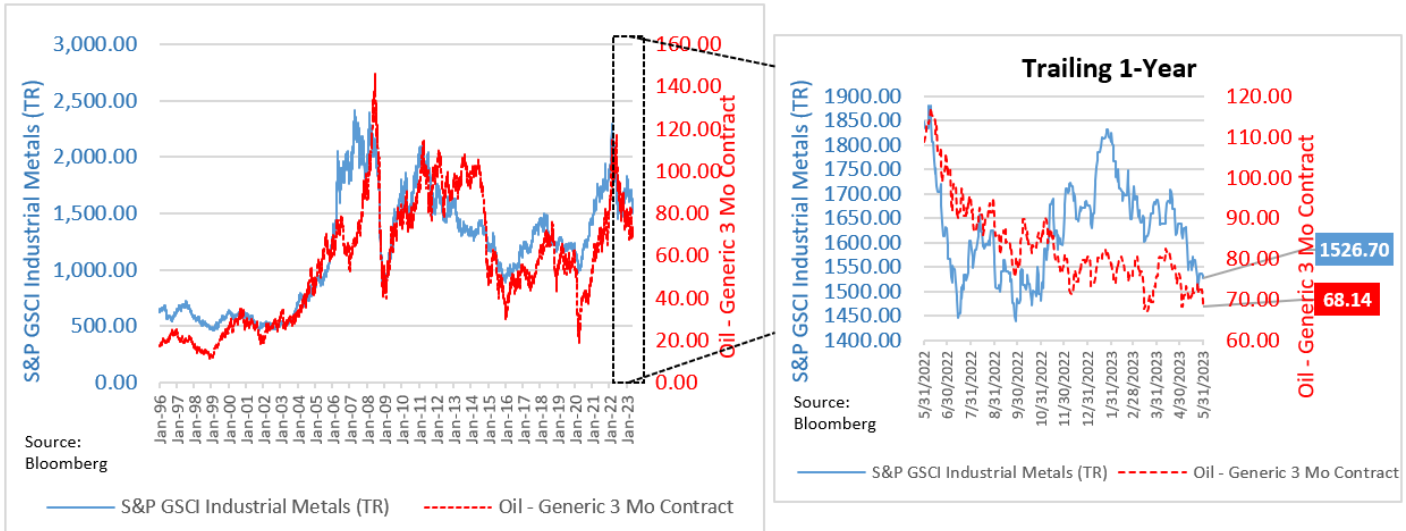
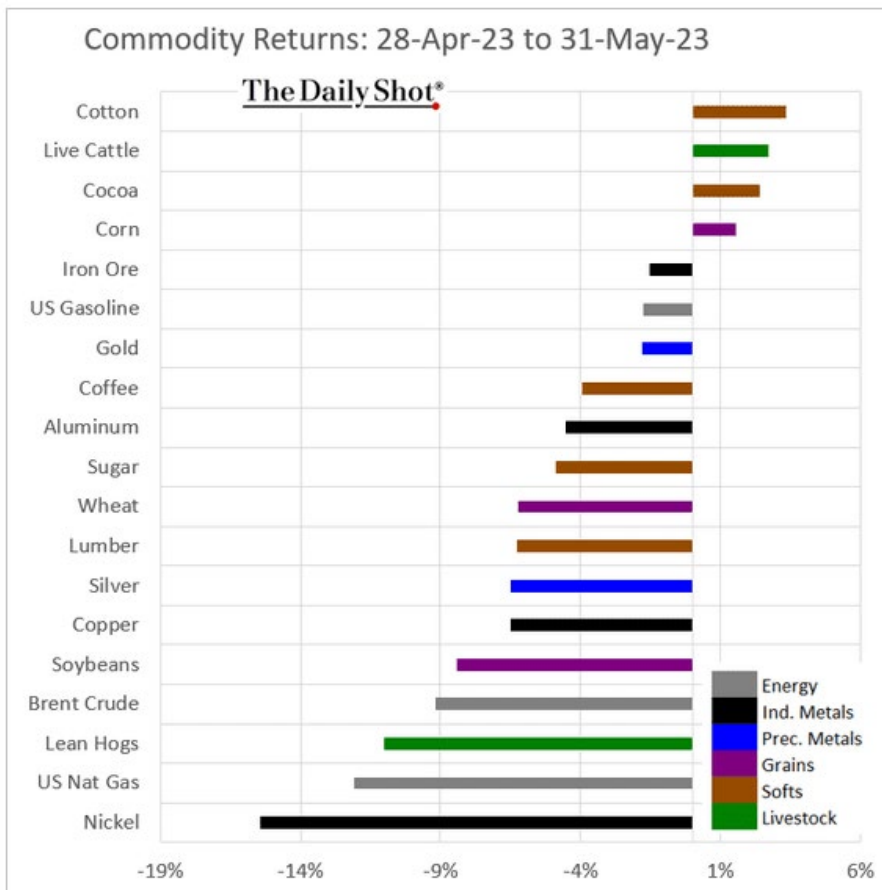


Figure 24 – Commodity Weakness Was Mainly Driven by Lower Energy Prices and Key Industrial Materials





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Disclosure:

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