EQIS

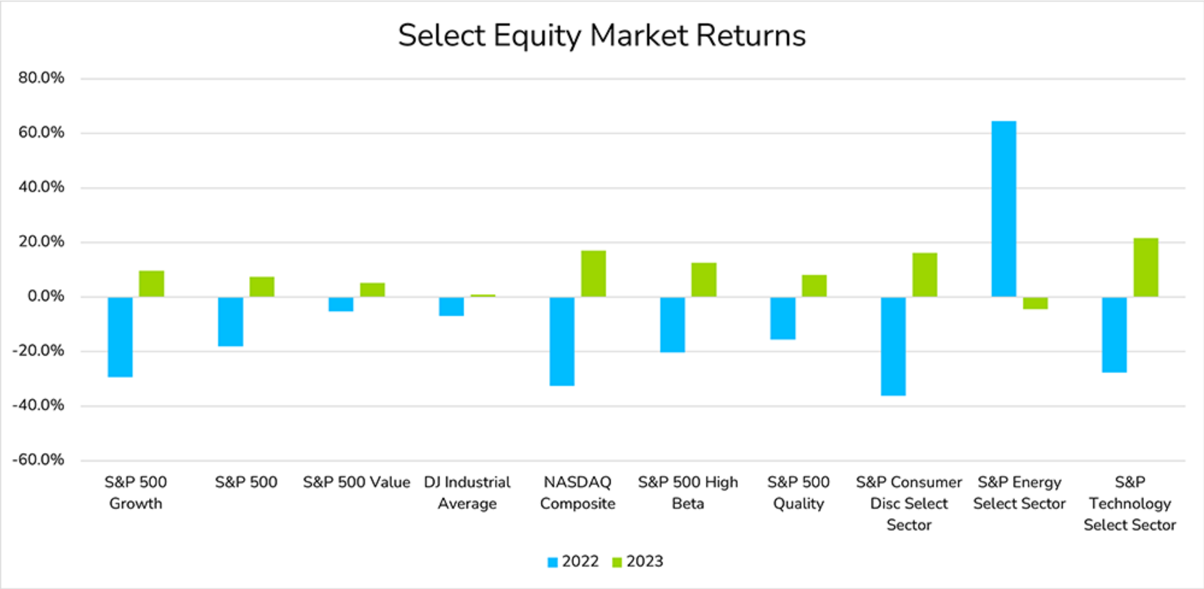
# EQIS Quarterly Commentary

Q1 2023

## Banking Turmoil Raises Liquidity Concerns Across Economy

The first quarter of 2023 was defined by the collapse of Silicon Valley Bank (SVB). In early March, SVB announced that it was experiencing steep losses on government bonds in which it had invested and left unhedged against interest rate risk. These positions suffered as rising interest rates lowered the value of the bonds and SVB announced it would need to raise capital to cover the losses. The bank experienced a rapid outflow of deposits as businesses became concerned over the safety of their uninsured cash. Once regulators determined that SVB was no longer solvent, they stepped in and placed a receivership on the bank and another on Signature Bank. The ripple effects led to an exodus of deposits from small and regional banks and panic selling by investors of SVB's stock. The contagion quickly brought down the equities of the entire financial sector, and many companies that had markedly different businesses were caught up in the turmoil. Deposit flight slowed once the FDIC guaranteed all the deposits, not just those covered under the $250,000 limit. Also, a consortium of large US banks committed $30 billion in deposits to First Republic Bank.

Despite the collapse of Silicon Valley Bank and Signature Bank, and the acquisition of Credit Suisse, equity markets posted stronger than anticipated returns as the large and mega-cap tech names retook their positions on top of the markets. The Nasdaq Composite posted a total return of 17.05% for the quarter, with the S&P 500, Russell 2000 and Dow Jones Industrial Average posting returns of 7.5%, 2.74% and 0.93%, respectively. In a noticeable change from 2022, many sectors and equity styles that were out of favor reversed course and led the way in the first quarter. The growth, information technology, tech-heavy Nasdaq Composite, and consumer discretionary were some of the worst performers in 2022 but led the way in Q1, while the energy sector, which single-handedly kept the S&P 500 in positive territory last year, has so far lost its luster.



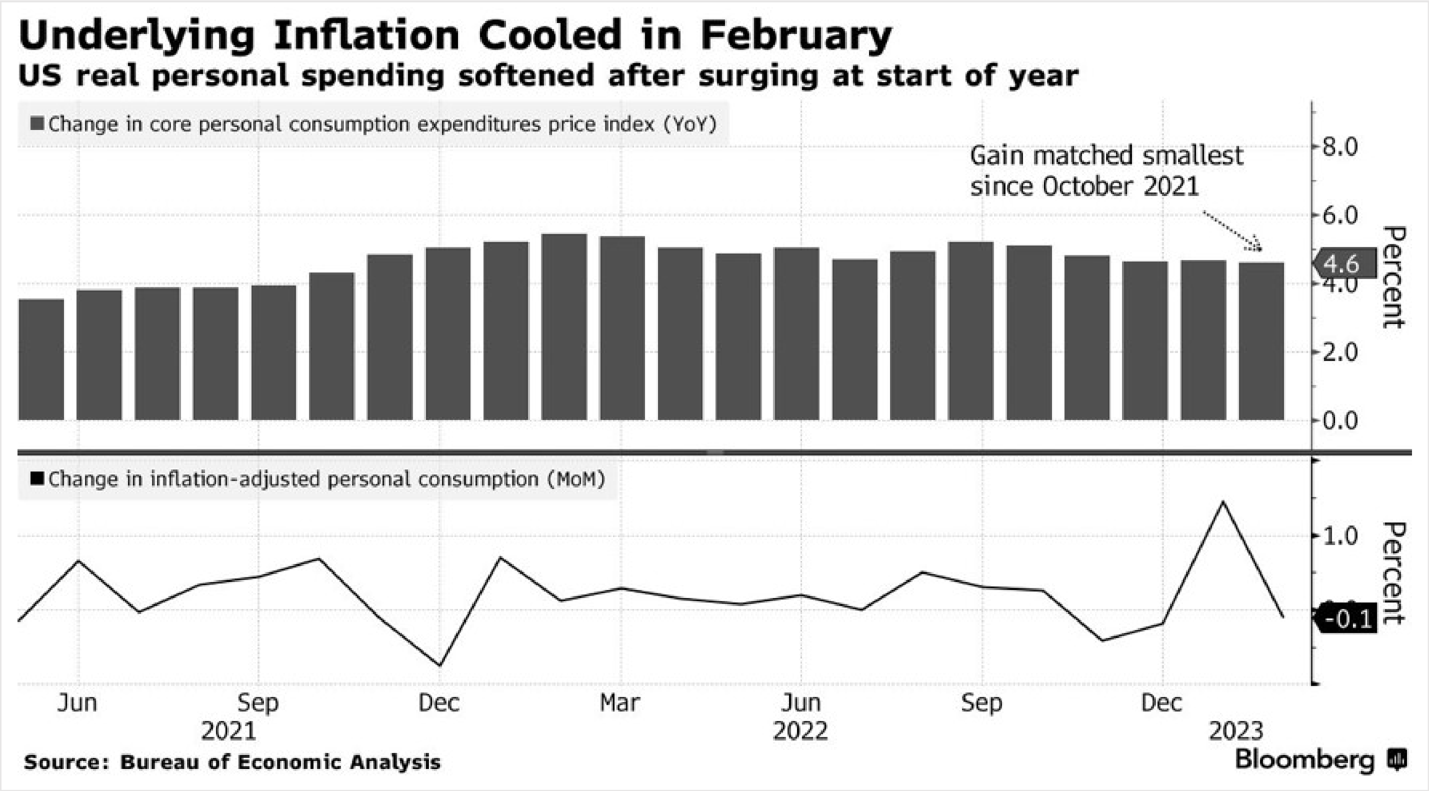

Source: Morningstar Direct

While the recent stresses in the financial sector remind investors of the Great Financial Crisis of 2008, the current issues look to have been contained to a few banks and have not created a broader systematic issue. The closing of two banks and regional stress emphasizes the Federal Reserve's ability to maintain financial stability as it continues the fight to lower inflation.

## Domestic Fixed Income Markets

In its most recent meeting, the Fed unanimously decided to increase the federal funds rate by a quarter point from 4.75% to 5.00%. Federal Reserve Chair Jerome Powell had initially opened the door for a 50-basis-point hike before the banking sector chaos but took a dovish position as the central bank emphasized the need to fight high inflation while managing financial stability.

The Fed's key gauge on inflation, core personal consumption expenditures (Core PCE), fell in February but less than forecast. In February, the index rose 0.3% after the prior month was revised slightly downward, and the year-over-year index showed a 4.6% increase, matching the smallest increase since October 2021.




Source: https://www.bloomberg.com/news/articles/2023-03-31/us-inflation-rises-by-less-than-forecast-spending-moderates

The step down in inflation was a welcomed sign as investors hoped the Fed might be nearing the end of the rate hiking cycle. While the level of inflation is still much higher than the Fed would like, the recent collapse of banks and ripple effects mean that the Fed will now also need to keep a close eye on maintaining financial stability to avoid further deterioration in the banking sector. Bloomberg Economists Jonathan Church, Stuart Paul and Eliza Winger noted, "Together with our expectation of tighter financial conditions following Silicon Valley Bank's collapse, the PCE data showing a faster-than-expected pace of disinflation suggest the peak for the Fed funds rate isn't far away."

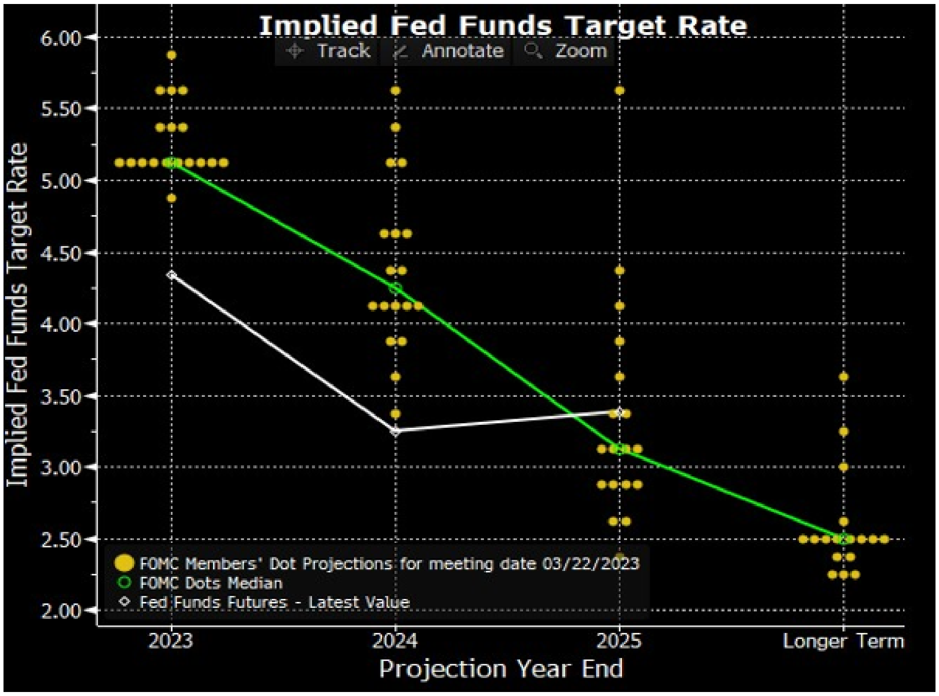
On the heels of the PCE index was the release of the February job openings and labor turnover survey report (JOLTS), which showed a decrease in the number of job openings to below 10 million for the first time in almost two years. The seasonally adjusted openings came in at 9.9 million, down from a revised downward report in January of 10.6 million. While the current level still sits above the pre-pandemic February level of 7 million, it shows a decrease in openings of

10% since the end of 2022. However, the job openings still far exceed the 5.9 million unemployed people seeking work, keeping the ratio of job openings per job seeker at 1.8.


Source: https://www.wsj.com/articles/u-s-job-openings-dropped-in-february-d797e86b?mod=djemRTE_h

Labor markets continue to be a concern as the Fed will only end its tightening campaign when it feels confident the labor market has cooled sufficiently. However, wage inflation measures remained in the 5-6% range, above the 2% consumer price inflation level and still above the 4% level the central bank would like to see.

The lag in a rate hiking cycle can take, on average, two and half years before being felt in the form of a recession. In contrast, the most recent cycle began in March 2022 and the variable lag is still filtering through the broader markets. Unhedged positions on long-dated government bonds led to the collapse of SVB and highlighted the dangers of rapid interest rate hikes.




Source: Bloomberg

The messaging from the Fed meeting continues to stand at odds with market expectations of a pivot to rate cuts in 2023. The Federal Open Market Committee (FOMC) members project cuts to occur in 2024 at the earliest. Recent market pricing on federal funds futures indicates an expected cut near the July FOMC meeting. Chair Powell mentioned that the rate cut criteria are higher than in the past. The committee is unlikely to pre-emptively ease monetary policy given the current strength of the labor markets and inflation levels.

Bond yields continue to be higher than at any point in recent memory. With the Fed nearing its terminal rate, the returns across maturities and fixed income asset classes have been markedly better than in 2022. The returns across government bonds on the longer end of the curve have been strong as the 10-, 20- and 30-year treasuries returned 4.23%, 5.52% and 6.32%, respectively. In sector returns for the quarter, in addition to long treasuries, the strongest performance came from convertibles, corporate high yield, leveraged loans, and New York municipals.

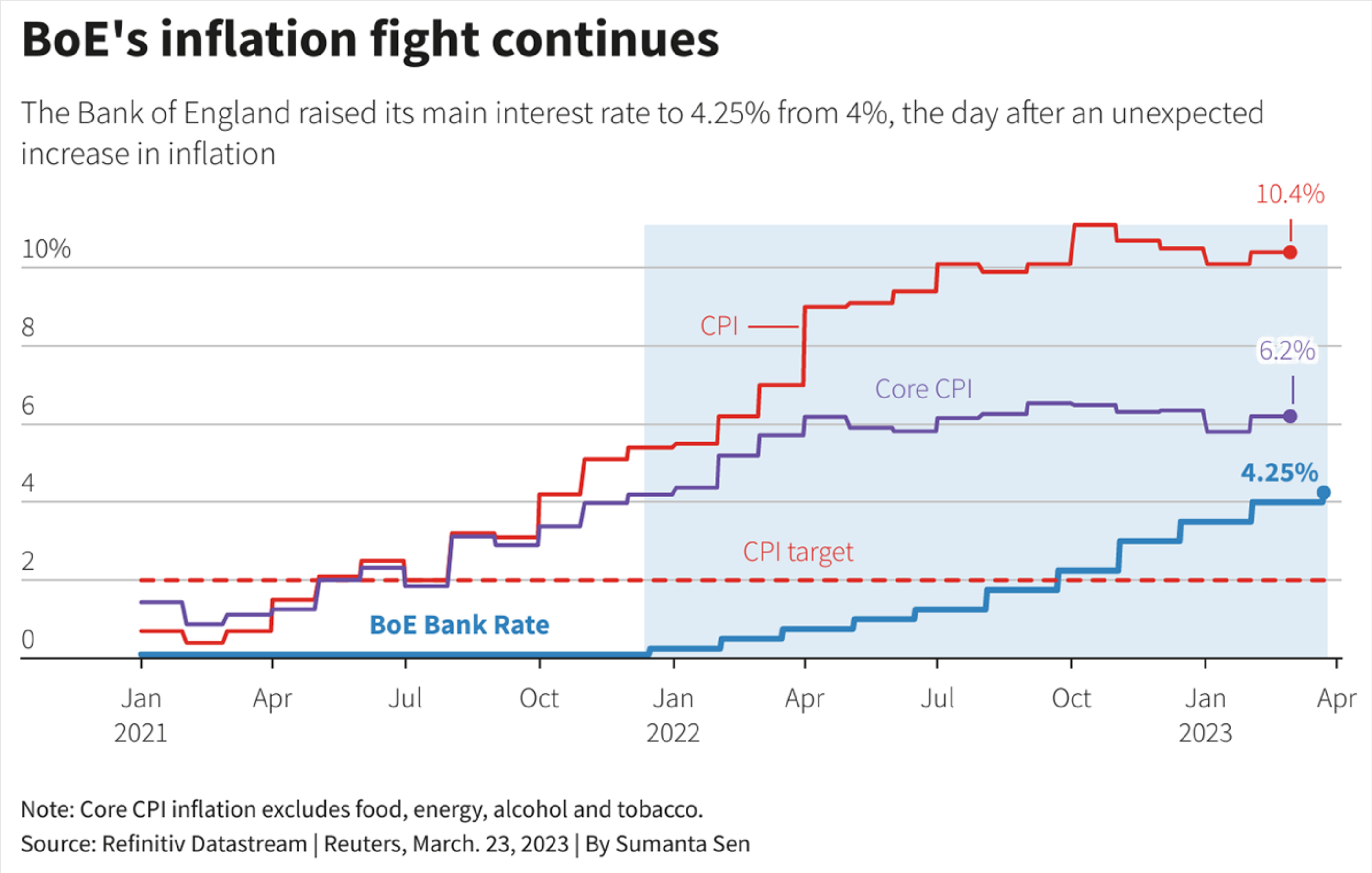
| Rates | QTD% |
|---|---|
| USTREAS T-Bill Cnst Mat Rate 1 Mon | 0.39 |
| USTREAS T-Bill Cnst Mat Rate 3 Mon | 0.41 |
| USTREAS T-Bill Cnst Mat Rate 2 Yr | 1.77 |
| USTREAS T-Bill Cnst Mat Rate 10 Yr | 3.99 |
| USTREAS T-Bill Cnst Mat Rate 30 Yr | 5.03 |
| Benchmark 1: Bloomberg US Treasury Bills TR USD | 0.44 |

| Sector Performance | QTD% |
|---|---|
| Bloomberg US Treasury 20+ Yr TR USD | 6.56 |
| Bloomberg US Convertible Comp TR USD | 4.47 |
| Bloomberg Treasury 7-20 Yr TR USD | 4.31 |
| Bloomberg US Corporate High Yield TR USD | 3.57 |
| ICE BofA US Corporate TR USD | 3.45 |
| Morningstar LSTA US LL Perf Index TR USD | 3.32 |
| Bloomberg Municipal New York Exempt TR | 3.22 |
| **Bloomberg US Agg Bond TR USD** | **2.96** |

Source: Morningstar Direct

## International Fixed Income Markets

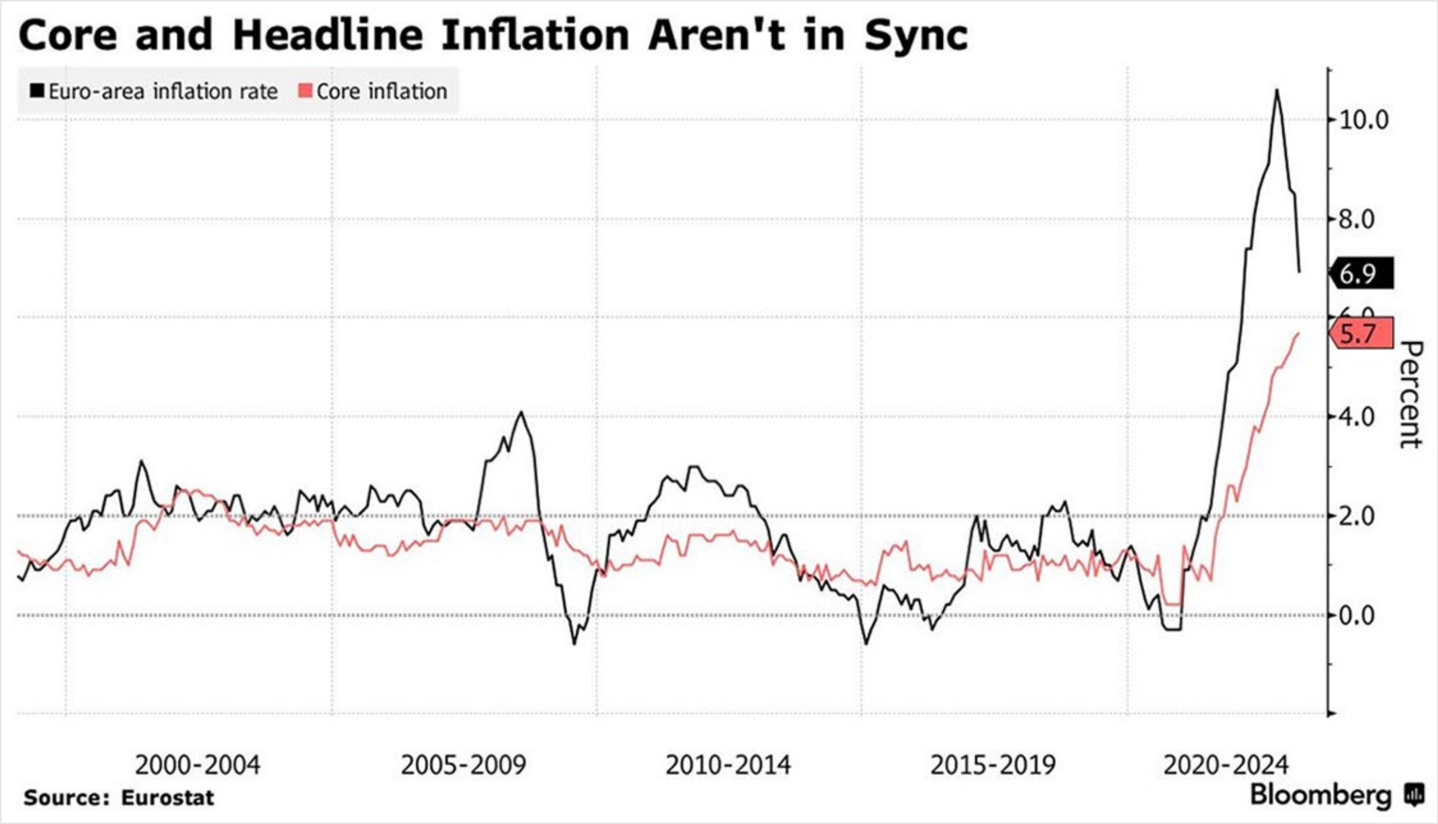
The European and UK markets performed better than anticipated, with some near-term headwinds easing, but there are renewed signs that the economy is starting to cool in the UK. Bank of England (BoE) Governor Andrew Bailey recently signaled a less aggressive stance on further rate hikes. Markets expect one more 25-basis-point hike that will take the policy rate to 4.25%. The BoE seems likely to pause ahead of the Fed and European Central Bank (ECB). Investors have priced at least one more quarter-point hike at the next meeting on May 11 but many economists believe the BoE has reached the end of its rate-hiking cycle. Governor Bailey was non-committal when pressed about rate hikes and repeated his previous sentiment about needing to see more persistent pressure to tighten any further.




Source: https://www.reuters.com/world/uk/inflation-shock-puts-bank-england-course-raise-rates-again-2023-03-23/#:~:text=Sounding%20more%20upbeat%20about%20the,by%20economists%20polled%20by%20Reuters.

The BoE expects GDP to grow slightly in the second quarter but is also worried about wage growth and worker shortages. The inflationary pressures of wage growth remain above historical trends and worker shortages are expected to rise at a slower pace in the future.

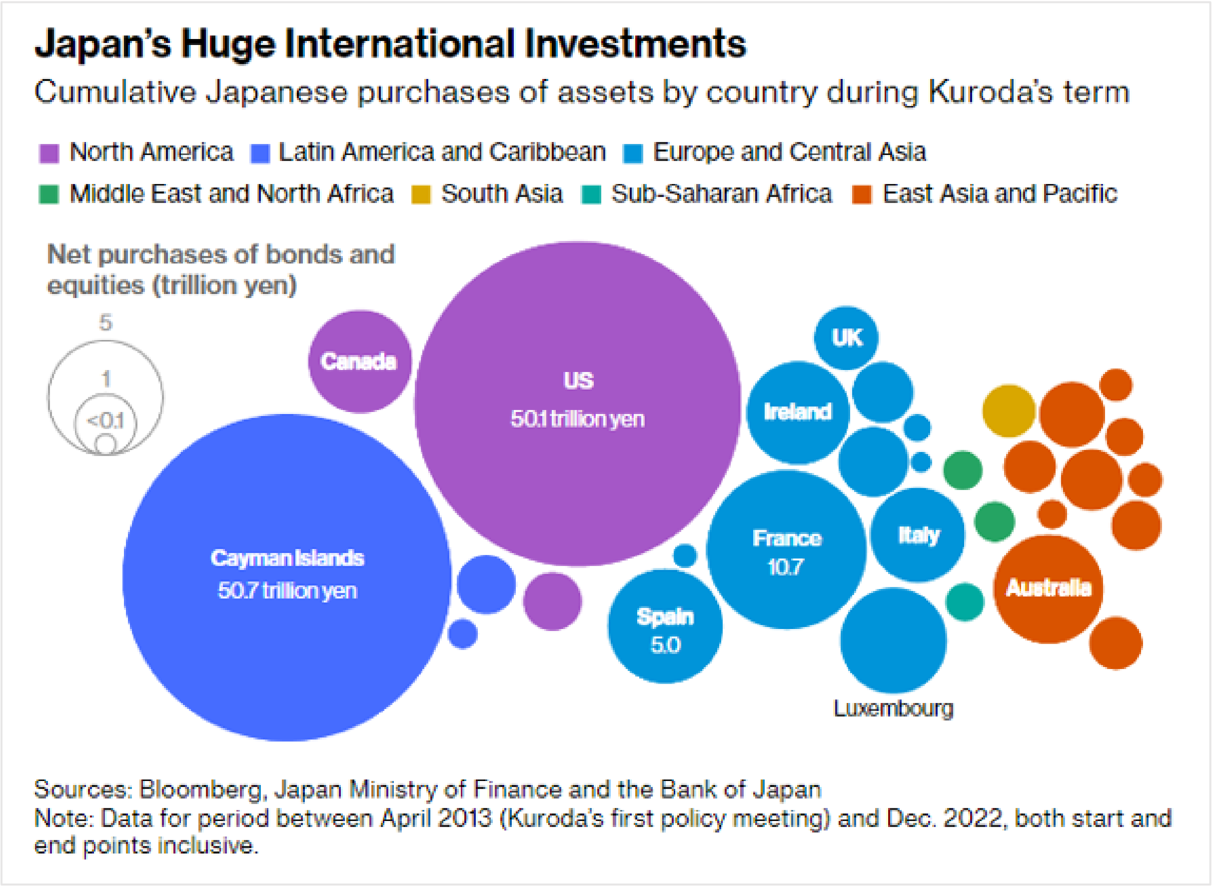
In Europe, the ECB increased rates by 50 basis points to 3.00% at its most recent meeting and the outlook for monetary policy is expected to continue to be more restrictive going forward. Klass Knot, the Dutch central bank chief and a Governing Council of the ECB, noted that, "We are certainly not done with interest-rate hikes… Core inflation in the Eurozone is now almost 6%, and you can't fight that with an interest rate of 3%."




Source: https://www.bloomberg.com/news/articles/2023-04-07/ecb-certainly-isn-t-done-with-interest-rate-hikes-knot-says

While Knot signaled that he might be open to continuing rate hikes at a 50-basis-point pace, other policymakers are more dovish and concerned with recent financial sector issues. While more increases are expected, some believe that subdued bank lending and shrinking economic expansion may help their efforts to bring inflation in line with the bank's 2% target.

A significant shift is underway at the Bank of Japan (BOJ) as Governor Haruhiko Kuroda steps down and is replaced by Kazuo Ueda. The change in central bank leadership may see a reverse in the flow of $3.4 trillion invested overseas as the BOJ is one of the largest foreign holders of US Treasuries as well as Brazilian and European debt. Investors are preparing for an end to the ultra-low interest rate environment that existed under Kuroda that suppressed bond yields, punished domestic savers and sent investments abroad worth more than two-thirds of Japan's economy. The expected rise in borrowing costs in Japan comes as other major central banks have been tightening and further threatening to tighten credit standards. Jean Boivin, head of BlackRock Investment Institute, noted that, "A change in policy in Japan is an additional force that is not being appreciated" and "all G-3 economies in one way or another will be reducing their balance sheets and tightening policy."




Source: https://www.bloomberg.com/news/articles/2023-03-30/boj-s-ueda-could-shake-global-financial-markets-by-changing-kuroda-policy?srnd=markets-vp

The flow of funds has already started as Japanese investors sold a record amount of debt last year as speculation rose that the BOJ would normalize policy rates. Then last December, Kuroda relaxed the bank's grip on yields and the market reaction sent the yen skyrocketing and Japanese government bonds down. Markets worldwide were impacted immediately after that shift in policy, from US Treasuries to the Australian dollar.

Investors and economists expect that Kazuo Ueda will increase the pace of policy tightening and potentially loosen control on its yield control program. However, a recent summary of opinions from the BOJ's March 9-10 meeting showed the bank remains cautious about changing policy before it achieves its inflation target as the country set a four-decade high of 4.2% in January.

## US Equity Markets

Equities have remained resilient this quarter despite rising interest rates, falling corporate profits, slowing growth, and bank collapses at home and abroad. The popular mega-cap tech names led the way during the quarter as investors piled back into the stocks in anticipation of a potential cut in interest rates. The sector has recently been battered, but its strong balance sheets make it a potential shelter for investors during a market downturn. Analysts and market strategists continue to warn that the threat of a hard landing with a profit recession and stagflation risks exists. The assumption that falling interest rates will boost equity prices contrasts with the reality of slower GDP growth, increasing unemployment and rising credit costs. Lisa Shalett, chief investment officer at Morgan Stanley Wealth Management, noted, "The single-minded focus on falling interest rates alone borders on magical thinking...this is a question of huge amounts of excess liquidity meeting a long business cycle where investors have unlearned the lessons of history. Investors have been trained to believe in outsized returns and brief bear markets where the Fed will come to the rescue."

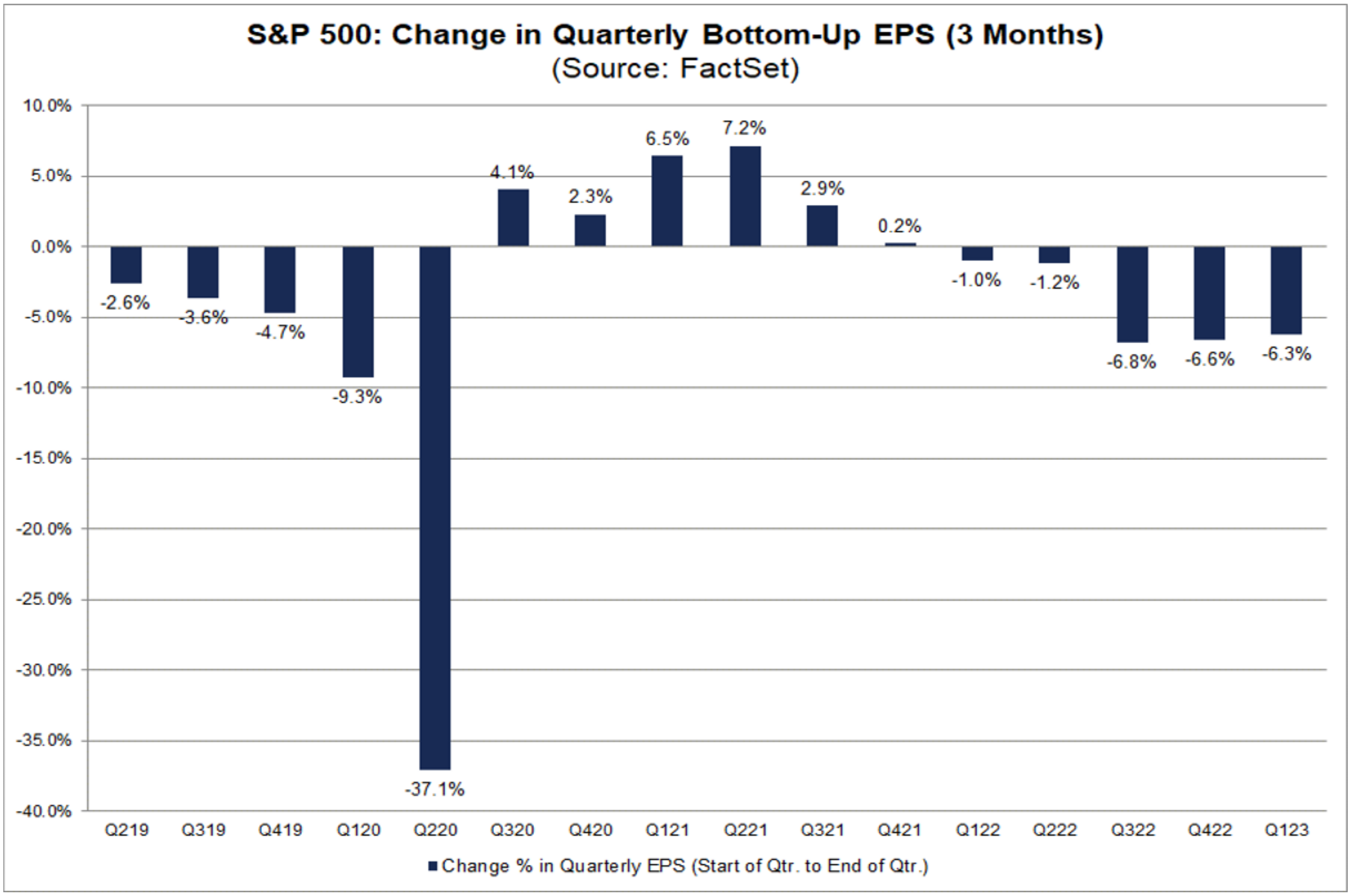
Equity markets initially got off to a hot start as investors returned to risk on high-beta names, but as the quarter went on, the markets retreated somewhat but posted solid returns. At the sector level, the strongest performance came from the information technology, consumer discretionary and materials sectors, which returned 21.65%, 16.16% and 4.29%, respectively. In addition, in the size and style category, growth outperformed in large, medium and small-cap stocks, while large-cap stocks outperformed mid-cap and small-cap stocks.

| Sector Performance | QTD% |
|---|---|
| S&P Cons Staples Select Sector TR USD | 0.72 |
| S&P Consumer Disc Select Sector TR USD | 16.16 |
| S&P Energy Select Sector TR USD | -4.37 |
| S&P Financial Select Sector TR USD | -5.56 |
| S&P Health Care Select Sector TR USD | -4.31 |
| S&P Industrial Select Sector TR USD | 3.47 |
| S&P Materials Select Sector TR USD | 4.29 |
| S&P Real Estate Select Sector TR USD | 1.95 |
| S&P Technology Select Sector TR USD | 21.65 |
| S&P Telecom Select Industry TR USD | -0.31 |
| S&P Utilities Select Sector TR USD | -3.24 |
| **Benchmark 1: S&P 500 TR USD** | **7.50** |

| US Equity Size | QTD% |
|---|---|
| Russell 1000 Growth TR USD | 14.37 |
| Russell 1000 TR USD | 7.46 |
| Russell 1000 Value TR USD | 1.01 |
| Russell Mid Cap Growth TR USD | 9.14 |
| Russell Mid Cap TR USD | 4.06 |
| Russell Mid Cap Value TR USD | 1.32 |
| Russell 2000 Growth TR USD | 6.07 |
| Russell 2000 TR USD | 2.74 |
| Russell 2000 Value TR USD | -0.66 |
| **Benchmark 1: Russell 3000 TR USD** | **7.18** |

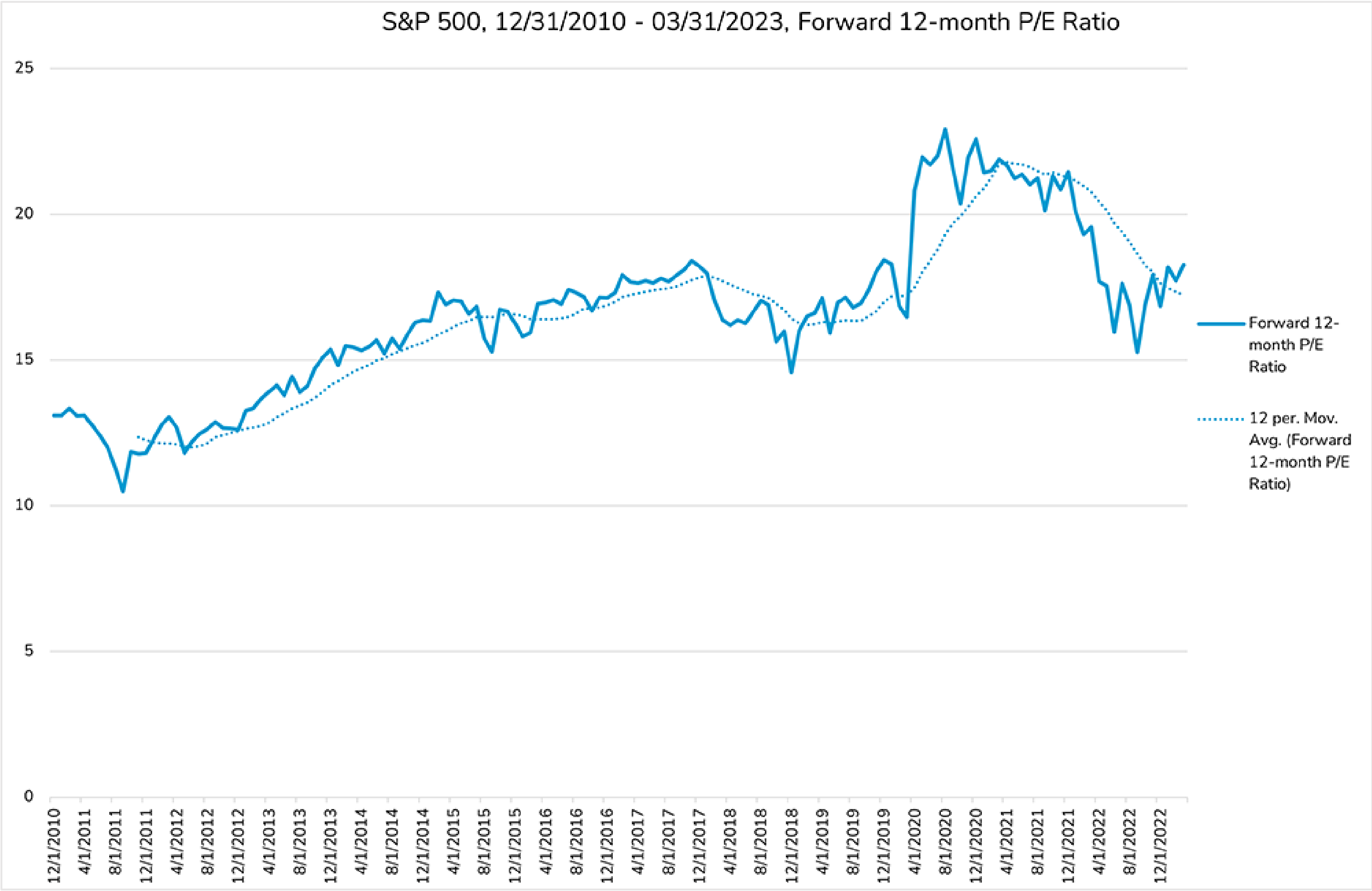
Source: Morningstar Direct

Earnings estimates for the first quarter of 2023 saw a downward revision from concerns over bank liquidity and broader economic weakness. As a result, analysts lowered EPS estimates by a more significant margin during the quarter than the 5-, 10-, 15-, and 20-year history. The downward revision for bottoms-up EPS calculation showed a 6.3% decrease. However, this has been a decreasing trend as the previous two quarters saw downward revisions of 6.8% and 6.6%, respectively.




Source: https://insight.factset.com/larger-cuts-than-average-to-eps-estimates-for-sp-500-companies-for-q1?utm_source=Direct&utm_medium=Email&utm_campaign=feedotter-03-31-2023&utm_content=httpsinsightfactsetcomlargercutsthanaveragetoepsestimatesforsp500companiesforq1

The decrease of 6.3% for the quarter also helped push up the forward 12-month price-to-earnings (P/E) ratio for the S&P 500 as rising equity prices combined with lower earnings to raise the forward P/E ratio from 16.7 in December 2022 to 17.8. The forward P/E ratio for the S&P 500 has continued to drift downward from its pre-pandemic 3-year average of 17.08.




Source: Bloomberg

## International Equity Markets

European equities had a strong quarter as a warmer-than-expected winter combined with a weakening US dollar, the reopening of the Chinese economy and a subsequent boost to goods exports helped provide a tailwind. The positive economic developments helped push the S&P Euro (350 Eurozone) to a double-digit return of 12.48% for the quarter. The region experienced strong returns as 14 of the 16 countries contributed positively to the pan-European index. France, Germany and the Netherlands had the most considerable contribution returning 13.88%, 13.87% and 16.14%, respectively. European information technology led the way at the sector level as it returned 20.30%, while materials dragged, falling 7.90% for the quarter. European equities have continued to outperform their US counterparts over the last six months as the S&P Europe 350 has returned 32.33% vs. the S&P 500’s 15.62%.

The impact of lower-than-expected energy prices and positive economic news is that the ECB can maintain a hawkish stance in combating core inflation at 5.30%. In March, the ECB raised the key policy rate to 3.00%, a 50-basis point hike, and left the door open for further increases this year.

The UK experienced a similar outcome in the first quarter of 2023 with warmer than anticipated weather, fiscal support to balance the costs of rising energy prices and avoiding a near-term recession helped the region post a 5.75% return. However, medium-term headwinds include rising interest rates and a tight labor market generating high wage growth that may prevent inflation from reaching the Bank of England's 2% target. As a result, the economy is cooling, and the Bank of England may pause on further rate hikes. In addition, the British pound is undervalued against the US dollar and large-cap UK equities have benefited from exposure to health, financials and consumer staples. Still, they may face headwinds soon due to their biases. Nonetheless, UK equities are attractive in the longer term.

The Chinese economy is reopening after the COVID-19 lockdowns. The government has announced a gross domestic product (GDP) growth target of around 5%. This year's growth will depend on the consumer, given the slowing global economy and the government's preference not to let property construction aggressively expand. Chinese consumers' excess savings were notably lower than developed economies as the Chinese government did not undertake support payments through the lockdown. Geopolitical tensions remain elevated, with the most notable development being the US government's ban on exporting high-end semiconductor chips. These are important for some of the strategic goals of the Chinese economy. Fiscal policy will be less supportive of the economy than last year. The government has announced that the augmented fiscal deficit (central government plus local government financing vehicles) will modestly tighten this year. Monetary policy, however, will remain accommodative since inflation remains low.

| Intl Equity | QTD% |
|---|---|
| MSCI China NR USD | 4.71 |
| MSCI AC Asia NR USD | 5.00 |
| MSCI EM Asia NR USD | 4.81 |
| MSCI FM Asia NR USD | 2.86 |
| MSCI ACWI NR USD | 7.31 |
| MSCI World ex USA NR USD | 8.02 |
| MSCI ACWI Ex USA PR USD | 6.18 |
| MSCI EAFE PR USD | 7.65 |
| MSCI Europe NR USD | 10.56 |
| MSCI EM NR USD | 3.96 |
| MSCI EM Latin America NR USD | 3.93 |
| Nikkei 225 Average NR JPY | 8.31 |
| **Benchmark 1: MSCI ACWI Ex USA NR USD** | **6.87** |

Source: Morningstar Direct

Brent Crude Futures were jolted at the start of April as OPEC+ announced cuts that would start at the end of the month. The OPEC+ cartel, which includes Russia, sent a shock wave through crude oil futures as the immediate announcement caused an 8% increase in Brent Crude prices. The move, reminiscent of the supply shocks in the 1970s and recent cuts after the Russian invasion of Ukraine, threatens to stoke upward inflationary pressure on a global economy that is slowly working its way out of record-high levels of price increases. Moreover, a price rise has recently correlated with improving market conditions as the pair followed each other upwards until a divergence in the summer of 2022 ended the run.


Source: https://www.bloomberg.com/opinion/articles/2023-04-04/opec-fails-to-shock-in-that-70s-show-oil-price-rerun

Traders and market participants have interpreted the move higher in prices as a defensive move in response to falling prices. However, the likely impact of causing upward inflation pressure is expected to be minor, if any, as the 10-year breakeven level showed little reaction to the sudden price jump. Instead, the likely impact is slowing growth and falling expectations for equity earnings.

## Investment Strategy and Outlook

With the closing of the first quarter, we see some of the near-term headwinds ease a bit as continued tightening of monetary policy, hot inflation and rising interest rates all seem to be easing. However, the potential for a recession continues to be a significant headwind for US and global equities with exposure to the US. The turning point may only come when the Fed decides a rate-cutting cycle is necessary.

Deposits at banks continued to see outflows following the collapse in early March and extended the inflows into money market accounts. In the aftermath of the recent turmoil, regional banks may be pressured to raise capital, increase deposit rates to stay competitive and raise loan rates. All of these forces have the combined effect of constraining liquidity and tightening lending to businesses. The small regional banks account for roughly half of all commercial and industrial loans, 70% of all commercial real estate loans, and almost 40% of residential home loans. Any tightening in these sectors will impact jobs and consumers directly.

The macroeconomic impact of the rate hikes and tightening of liquidity in the system may lead to reduced lending to small and mid-size businesses as regional banks look to reduce lending or increase the borrowing costs for firms. Other companies may find it challenging to locate lenders willing to take on new business, and those with lower credit ratings may be unable to roll over debt when current loans mature. The near-term impacts on equity markets could a meaningful slowdown in earnings expectations for the remainder of 2023 and may lead to a broader risk-off sentiment to investors.

The continued tightening of financial conditions by the Federal Reserve and the increasing recession risks have only reinforced the need to hold high-quality bonds. Moreover, government bonds are attractive as inflation is expected to continue downward, and central banks may pause rate hikes soon. High yield bonds are currently in focus as a rise in credit spreads from the SVB collapse has increased risks in the market and provided upward pressure on credit spreads. With widening credit spreads and increasing risks from rising defaults we remain neutral on credit while potentially looking to cut exposure as the economic picture becomes clearer during the year.

Additionally, European equities offer an attractive dividend yield and total return potential. The more diversified revenue stream than US equities and the recent outperformance provide an attractive position to allocate to in the near term.

[See commentary from our sister company, 3D→]

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