2Q23 Market Commentary
A Bull-Bear Tango

We acknowledge that the economy has been resilient in the face of many headwinds this year and it is easy to assume that growth can continue uninterrupted since the labor market is so strong. Unfortunately, we are less optimistic about the economic outlook over the next 12 months. In this quarterly outlook we highlight our concerns over the continuation of this economic expansion and offer our view on the central bank's path. We will also discuss why we are hesitant to chase this momentum driven equity rally and outline where we see value in fixed income and alternatives.

There has been little to disrupt the rally that equity investors have experienced in the first half of 2023. Global equities as measured by the MSCI AC World Index jumped into bull market territory in 2Q23 (a gain of more than 20% from the October 2022 lows) with every major global index (except Asia ex Japan) posting positive gains for the quarter. Within the U.S., the craze around artificial intelligence has kept the gains highly concentrated in technology with the NASDAQ posting its best start to a year since 1983. It seems that investors have looked beyond inflation that remains elevated, a deeply contracting manufacturing sector, an earnings recession and slowing global economic growth. Instead, the focus has turned to the likelihood that the central bank tightening cycle is near an end and optimism that the Fed can orchestrate a soft landing in the U.S. economy.

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Soft Landing – An Unlikely Outcome

A strong labor market, robust service sector and resilient consumer are just some of the driving forces behind economists pushing the odds and timing of a recession out into 2H23. **(Chart 1).** At the start of 2023, economists had forecast U.S. GDP to decline in 2Q and 3Q23 before a modest recovery in 4Q23. However, there has been growing optimism that because of the strong labor market, the Fed can orchestrate a soft landing for the economy after the most aggressive tightening cycle since the 1980s. We find this too optimistic for the following reasons:

- **Yield curve is rarely wrong:** Going back to the early 1970s when the yield curve inverts (10YR Treasury yield minus the Fed funds rate), it has been a leading indicator for a recession in every occurrence except one (when Long Term Capital Management failed in 1998). Currently, the Fed funds rate is ~130 bps above the 10YR Treasury yield, the most inverted yield curve since the early 1980s. **(Chart 2 – next page).** Historically, when this curve inverts a recession occurs, on average, 11 months later. Since this curve inverted in November 2022, history would suggest a recession in 4Q23.

Chart 1

Timeline and Odds for Recession Pushed Out

Data is as of July 21, 2023. Data Source: Bloomberg Finance LP, Verdence Capital Advisors.

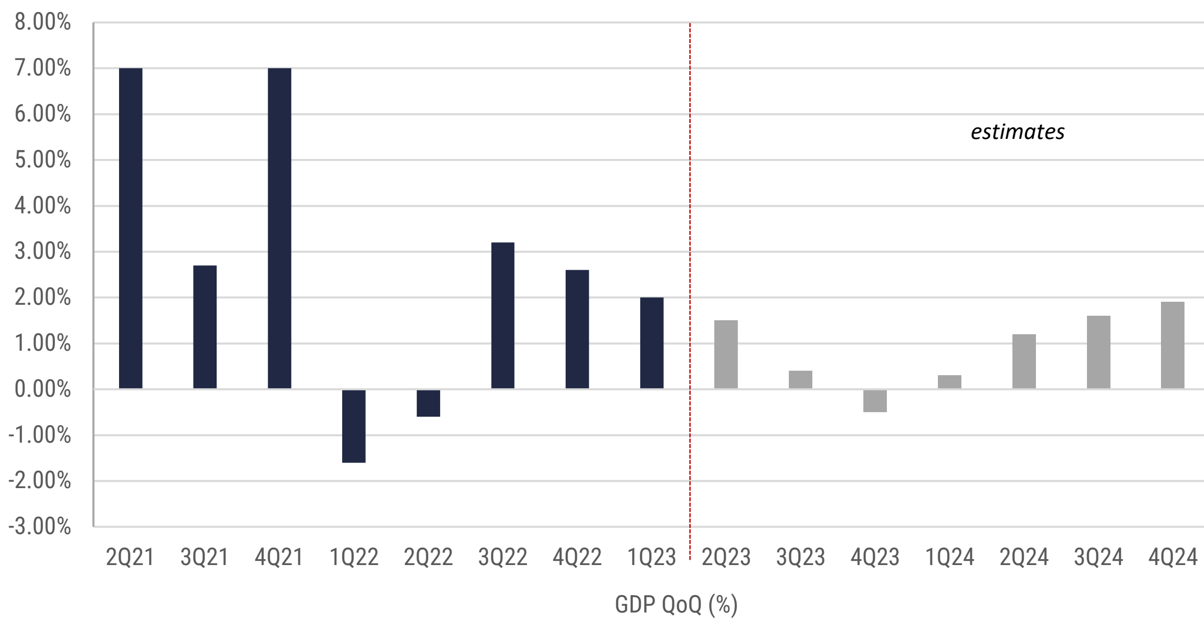

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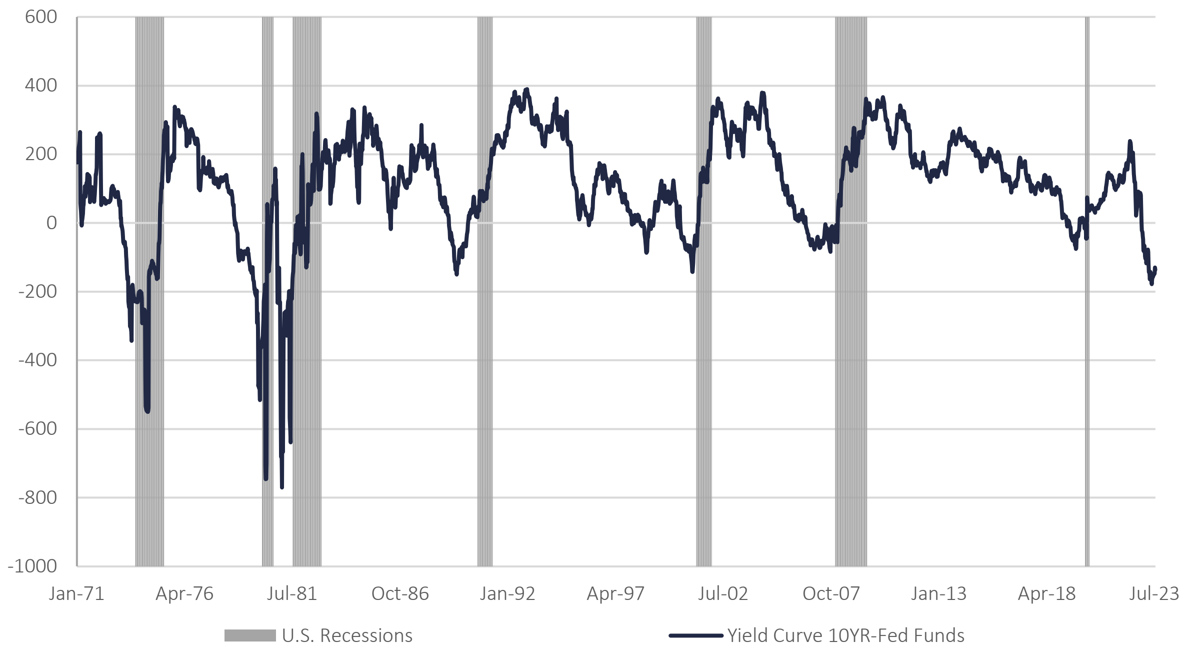
Chart 2

Inverted Yield Curve Historically Predicts Recession

Data is weekly and as of July 14, 2023. Data Source: Bloomberg Finance LP, Verdence Capital Advisors.



- **Consumer makes up most of GDP:** Data on the consumer has been mixed year to date. Real personal spending has been flat for three of the first five months of the year. However, retail sales have been relatively resilient (which are not inflation adjusted). We are increasingly concerned about the consumers' ability to continue to spend. Consumers have been relying heavily on credit card debt to support their spending habits, even with credit card rates at a record high. Now we are seeing credit card and auto loan delinquencies rise. Lastly, the repayment of student loan debt adds another burden on more than 40 million Americans with an average monthly payment of almost $400.

- **Tighter lending conditions:** As a result of the small and midsize banking crisis earlier this year, banks (both big and small) are tightening lending conditions. Tight lending conditions have not only always coincided with a recession, but they have also resulted in higher unemployment. **(Chart 3 – next page).** In addition, tighter lending conditions put pressure on small businesses who rely on bank funding and commercial real estate that has a significant amount of debt coming due to refinance in the coming years.

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- **International growth at a standstill:** While the U.S. has been able to absorb the aggressive Fed tightening relatively well, it has not been as easy for international economies to absorb their central banks' policy. The European Central Bank has raised their benchmark rate to the highest level since 2008. As a result, Germany is in a technical recession (i.e., two consecutive quarters of negative GDP) and Eurozone industrial production has been rapidly declining. In addition, China's reopening has been disappointing, and the government is being forced to consider stimulus measures to save the ailing property market and boost demand. The U.S. is not immune to a slowdown impacting their international trading partners.

- **Employment is a lagging indicator:** There are some structural challenges in the labor market that are keeping the unemployment rate low despite weaker economic fundamentals (e.g., demographics, immigration). However, history tells us that the labor market is a lagging indicator. Going back to all the recessions since 1953, the unemployment rate bottoms, on average, two months before the recession starts. It peaks, on average, three months after the recession ends. **(Chart 4 – next page).** Employers wait until the economy is significantly slowing before they cut workers. In fact, one thing they will do is start cutting the workweek and reducing temporary workers, both we have seen materializing in recent months.

Chart 3

Tighter Lending Conditions a Headwind

Bank conditions are as of April 2023, unemployment rate is as of June 2023. Data Source: Bloomberg Finance LP, Verdence Capital Advisors.

Chart 4

Unemployment Rate is a Lagging Indicator

Data is as of June 2023. Data Source: Bloomberg Finance LP, Verdence Capital Advisors.

Unfortunately, the optimism around the outlook for the economy may be premature. While history doesn't always repeat itself, it often rhymes. There are too many headwinds stacking up against the economy and we have not even fully touched areas in distress like commercial real estate. We are not calling for a calamitous recession but do see one as unavoidable. The labor market, while expected to weaken, may be what helps the U.S. avoid a long and prolonged recession. The unemployment rate has risen in every recession in history but there are some structural issues that may temper the rise relative to past recessions.

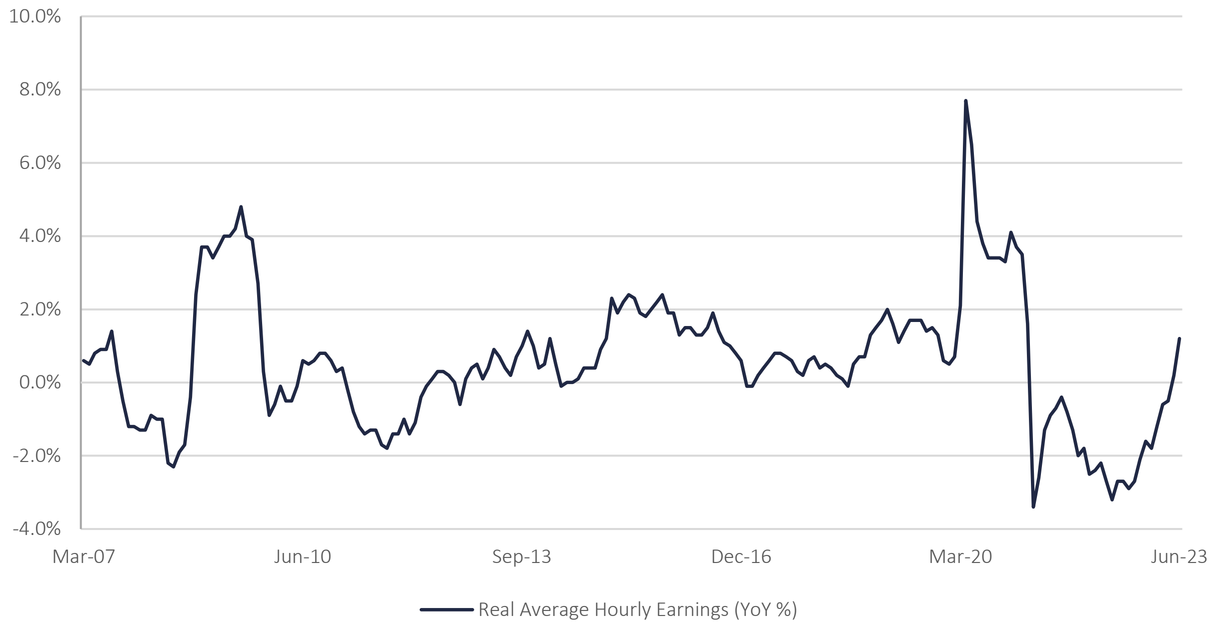
Monetary policy – Inflation Matters More than Growth

We agree with the market expectations that the Fed is likely near or at the end of the current tightening cycle. However, we are not as optimistic that they can cut rates and rescue the economy when the downturn begins. The Fed and other central banks have made it clear that they will sacrifice economic growth to keep inflation under control. They cannot back down from that hawkish rhetoric. We have witnessed what has happened because of the Fed pausing their tightening cycle in June. We are seeing asset prices rise and confidence return. Unfortunately, that can have ripple effects on inflation. For the Fed, they are focused on a trifecta of factors, housing inflation, wage inflation and services inflation. Until these indicators see considerable improvement, we do not see a path where the Fed can cut rates. In addition, with the moderation in inflation we are seeing real wages enter positive territory **(Chart 5).** This is particularly concerning for the Fed because wage inflation is "sticky" and can have a multiplier effect. As employees earn more, they spend more and demand more, causing companies to raise prices to keep pace. It becomes a dicey inflation circle. In addition, the Fed does not want a repeat of the 1970s and 1980s when stop and go monetary policy resulted in several recessions and heightened unemployment. Therefore, we believe they will keep rates higher for longer at the expense of economic growth.

Chart 5

Wage Pressures Remain an Inflation Risk

Data is as of June 2023. Data Source: Bloomberg Finance LP, Verdence Capital Advisors.



Global Equities – Do Not Chase Momentum

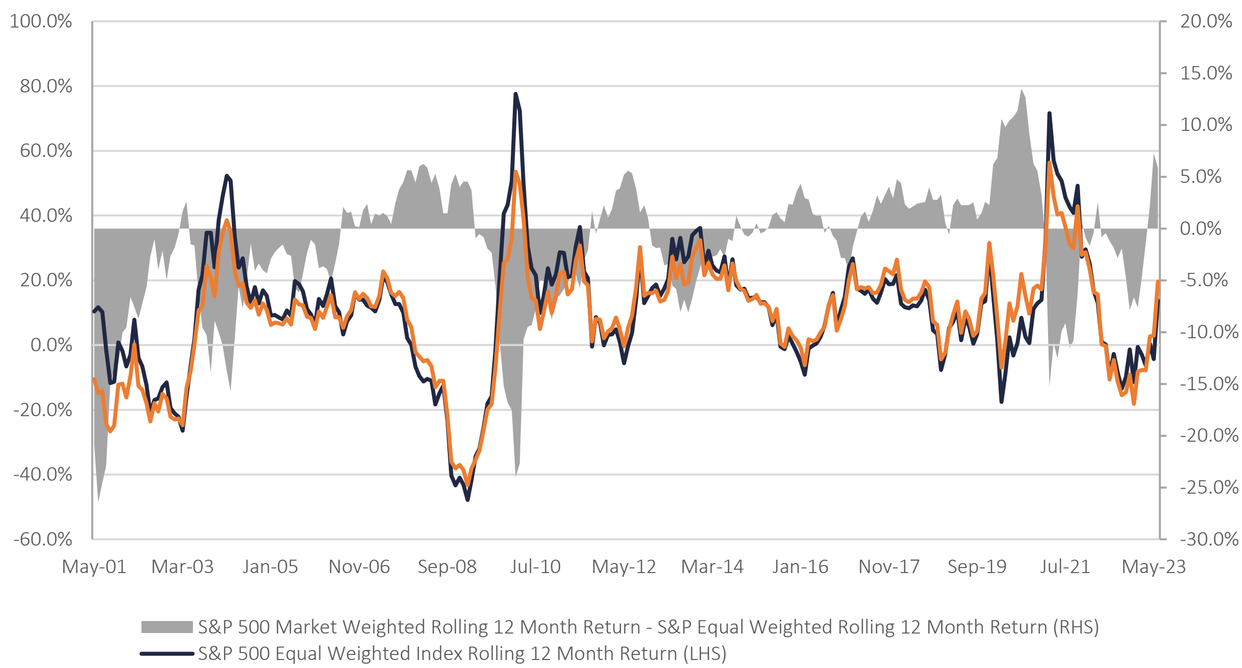
We have witnessed a “melt up” in equities this year as investors have looked beyond the current earnings recession, uncertain economic outlook, and hawkish central bank rhetoric, instead focusing on a brighter future of lower interest rates and perfect soft-landing scenario for the economy. In addition, within the U.S. the frenzy around anything “AI” (artificial intelligence) is leading to outsized valuations that we do not believe are justified with our economic outlook. We admit that equity markets are forward looking but we think the rally we have seen this year may be borrowing from future returns. We remain cautious on global equities for the following reasons:

- **Is it really a bull market?** The bulk of the return for the S&P 500 has been concentrated in the technology and communication services sectors. These are the two sectors that would benefit from a less aggressive Federal Reserve and the AI craze. The S&P 500 is a market cap weighted index which means the largest companies have an outsized impact on performance. The S&P 500 Market Cap Weighted Index has been outperforming the S&P 500 Equal Weighted Index on a rolling 12-month basis for the past three consecutive months. **(Chart 6).** This is in stark contrast to what was witnessed in 2022 when the equal weighted index outperformed in the face of higher interest rates and slowing economic growth. In addition, since the bear market bottom in October 2022, the top 10 companies in the S&P 500 by market cap have made up 40% of the total return.

Chart 6

Market Cap Weighted Rally in 2023

Data is as of June 2023. Data Source: Bloomberg Finance LP, Verdence Capital Advisors.



- **Economy does not warrant an overweight.** While equity investors are typically forward looking, we think the recent rally may be overstating the probability that the Fed can orchestrate a soft landing. Economic leading indicators are deeply in negative territory and historically have been correlated with weak equity returns **(Chart 7).** In addition, going back to all the recessions since 1929, the S&P 500 has never bottomed before a recession begins. If we believe a recession is likely over the next 12 months that leaves additional downside for equities.

- **Valuations pricing in perfection.** Higher interest rates are a headwind for price to earnings multiples, especially real rates (taking into consideration inflation). While the Fed is likely close to the end of their tightening cycle, we are seeing real rates rise as inflation moderates. Given our expectation that the real Fed Funds rate can rise to 2.5% or more over the next 12 months, the current price to earnings multiple of the S&P 500 (21x) is above the historical fair value multiple when the real Fed Funds rate is 2.5% or more. **(Chart 8 – next page).**

Chart 7

Weaker Growth a Challenge for Equities

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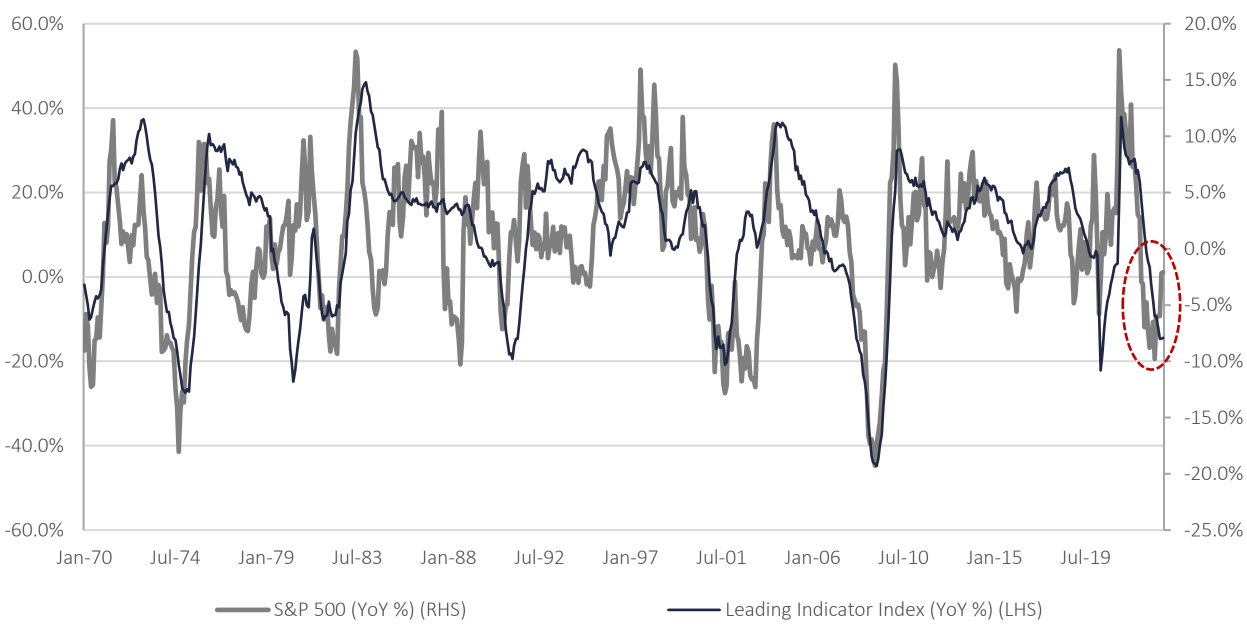

While we are cautious in the near term on global equities, we would look at pullbacks as potential buying opportunities. We still believe equities are the best long-term play for investors. However, with so much uncertainty in the economy and so much optimism already being priced in, we do not think investors are being rewarded for the risk at current valuations. One of our biggest concerns is the complacency around interest rate policy and what the Fed can and cannot do when the economy begins to turn. The recent run up we have seen in equities seems to indicate that investors believe the Fed can come in and cut rates at any sign of economic weakness. With the precarious inflation situation, this is unlikely, and investors need to adjust to a new interest rate regime.

Chart 8

Valutations Stretched Given Interest Rate Environment

Data is as of July 18, 2023. Data Source: Bloomberg Finance LP, Verdence Capital Advisors.

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Fixed Income – Opportunities Beginning to Arise

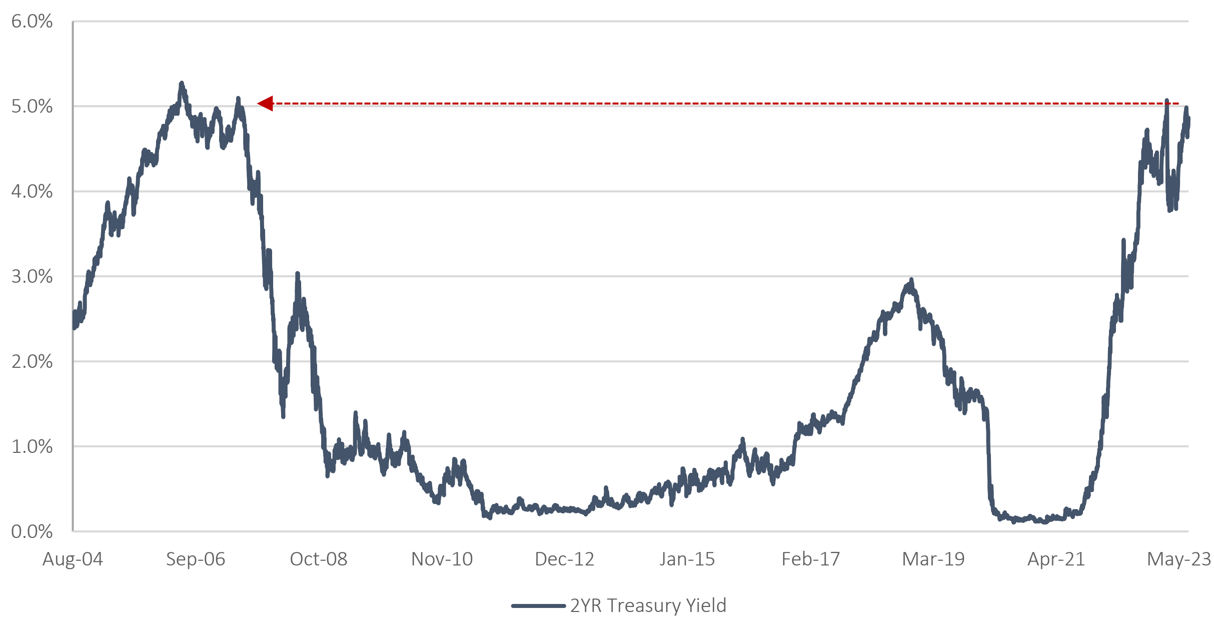
After decades of historically low interest rates, fixed income investors are finally able to earn yield on bonds. While the yield curve remains deeply inverted (i.e., short term rates are higher than long term rates), there is value in short term yields and cash. In fact, the two-year Treasury note is at the highest level since 2007. **(Chart 9)** We still favor equities over bonds for the long run but with equity valuations stretched, we think keeping a healthy position of your overall asset allocation in cash and earning an attractive yield is prudent. Within fixed income we recommend the following positioning:

- **Start to move duration…a little** – Long term bond yields (10YR Treasury) have risen in recent months with optimism that the U.S. economy will avert a recession. We have long been recommending that bond investors focus on short term bonds over long term bonds given the elevated interest rate risk in long term bonds. While we still see some interest rate risk in long term bonds, we think it is a good time to start moving from ultra short maturing bonds to some intermediate bonds. We are not advocating for long bonds (10 – 30-year bonds) but think some intermediate exposure can offer price appreciation as economic growth weakens.

Chart 9

Short Term Bonds Offering Attractive Yield

Data is as of July 20, 2023. Data Source: Bloomberg Finance LP, Verdence Capital Advisors.



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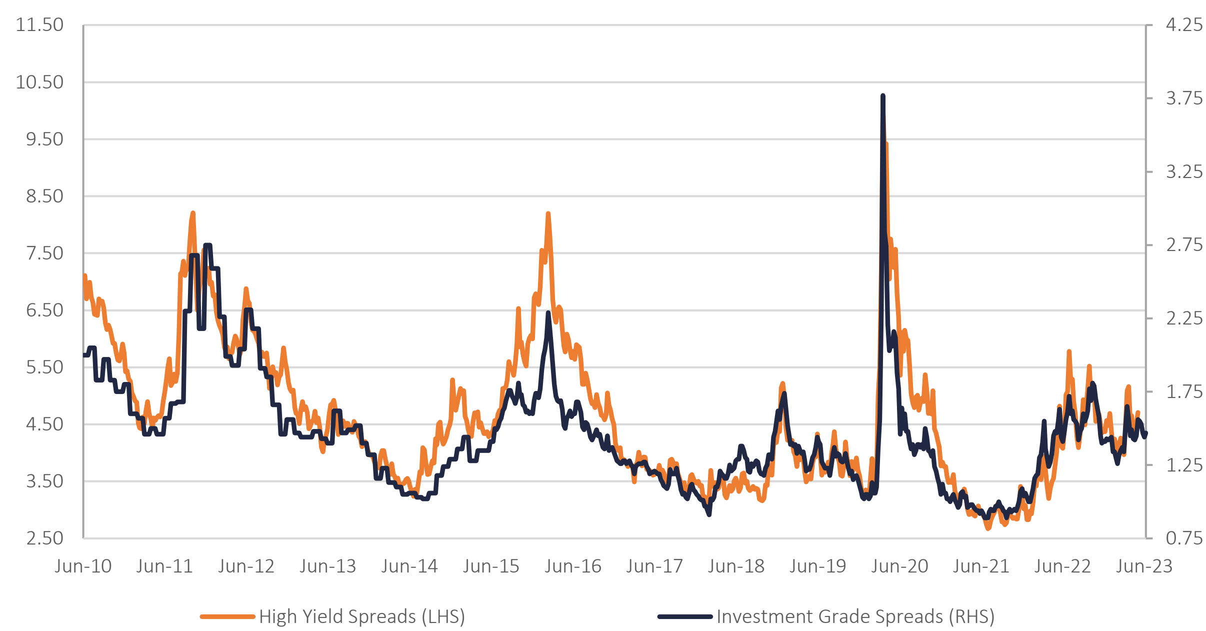
- **Credit still not attractive** – Despite the absolute yield on high yield and investment grade bonds looking attractive (e.g., 5.4% and 8.3%, respectively)[1] the extra yield investors are earning to take on the credit risk over the safety of Treasuries (i.e., spreads) is still too tight. **(Chart 10).** Historically, in every economic slowdown and/or recession, spreads widen and that is when a good opportunity to buy corporate debt often emerges. In addition, we think corporate debt is expensive given the expected economic downturn, higher interest rates and likely pick up in corporate defaults over the next 12 months. In fact, according to Moody's, the global default rate is expected to rise to 5.0% by April 2024, compared to ~1.0% in May 2023.

With yields rising, bonds are offering some attractive opportunities. Bonds have historically offered an attractive return when the economic outlook deteriorates (yields fall, prices rise). We will continue to monitor the economic outlook and adjust duration if necessary. We are also anxiously awaiting an opportunity to invest in corporate bonds. Historically, corporate bonds offer good returns when investors are compensated for the extra risk (e.g., spreads widen).

Chart 10

No Reward for Risk in Corporate Debt

Data is weekly and as of July 14, 2023. Data Source: Bloomberg Finance LP, Verdence Capital Advisors.



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Alternatives: Diversify in an Economic Downturn

Alternative investments can perform well in periods of economic uncertainty and even periods of tighter lending conditions. On the private side, managers have more flexibility and time to be able to find and make good long-term investments. For clients that invest in private investments they are spared the daily volatility seen in public markets and offered an uncorrelated asset with robust risk adjusted return. Sectors in the private alternative space that we favor for qualified investors include:

- **Low volatility hedge funds** can offer another layer of diversification, add return potential, and serve as a hedge for investors' public market equity exposure.
- **Real assets** offer a low correlation to other asset classes, diversification and in some cases an inflation hedge. We would focus on real asset investments like infrastructure, land and select opportunities in the real estate space (e.g., flex industrial).
- **Private credit:** We believe the publicly traded corporate bond market is unrealistic about the upcoming economic downturn. In addition, with small and mid-sized banks having less ability to lend, sources in the private market may benefit (e.g., private credit managers). Due diligence is crucial in this space, especially as defaults are likely to rise and demand for credit in the private space has been strong.

One area of the alternative market that we are looking for as an opportunity this year is the commodity space. Typically, commodities fall after the economy has already turned. Past recessions have offered good opportunities to enter this space. In addition, we have not solved the energy shortage and/or food shortage around the world so commodities have the potential to represent a good long-term investment.

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Bottom Line:

This year has offered relief to investors who had little chance to avoid double digit losses in 2022. While some of the factors driving markets lower in 2022 have faded (e.g., Fed nearing end of tightening cycle instead of aggressively raising rates), this is not the time to get complacent. Equity markets are rallying thanks to a handful of stocks (e.g., technology) and despite some signs of rotation, the difference between the best performing sector in the S&P 500 (i.e., technology) and the worst performing sector (i.e., utilities) is still more than 50%![2] We believe this is unsustainable and investors have been too quick to get optimistic about the economic outlook and interest rate regime. At this point with valuations in the equity market fully reflecting a soft-landing scenario, we would be patient and hold a healthy cash position. We anticipate when valuations get more realistic given the expected downturn and the Fed's unlikeliness to save the economy, there will be better buying opportunities. Cash is not the enemy anymore and is offering an attractive yield to investors. We will continue to assess pullbacks and potential buying opportunities but will consider valuations and the outlook before putting our cash to work.

As always, if you have any questions about our perspective, please do not hesitate to reach out to your advisor.

[1] Yields are referring to Bloomberg Investment Grade and Bloomberg High Yield Index as of July 20, 2023.
[2] As of July 19, 2023.

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