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Where Do We Go From Here?

Q1 2023

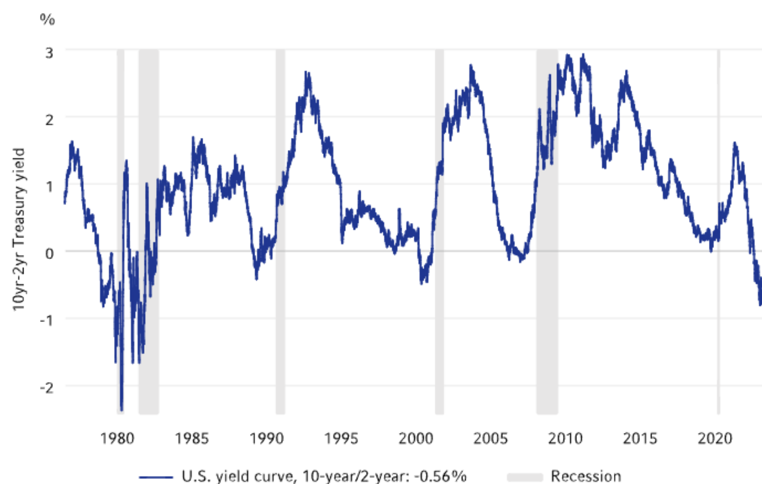
The volatility of 2022 has followed the market into the new year. Last year's sell-off was dominated by rapidly rising bond yields, high inflation, tightening monetary policy, and rising recession risks. These trends have continued into 2023; however, with a new credit risk fears after the collapse of Silicon Valley Bank. Several other banks have come under immense scrutiny. The collapse of SVB highlights the dangers caused by rapid monetary tightening. The only bright spot is that inflation is slowing despite ongoing strong jobs reports. We will review the quarter and highlight the strategy moving forward to navigate this market.

Quarter End Review

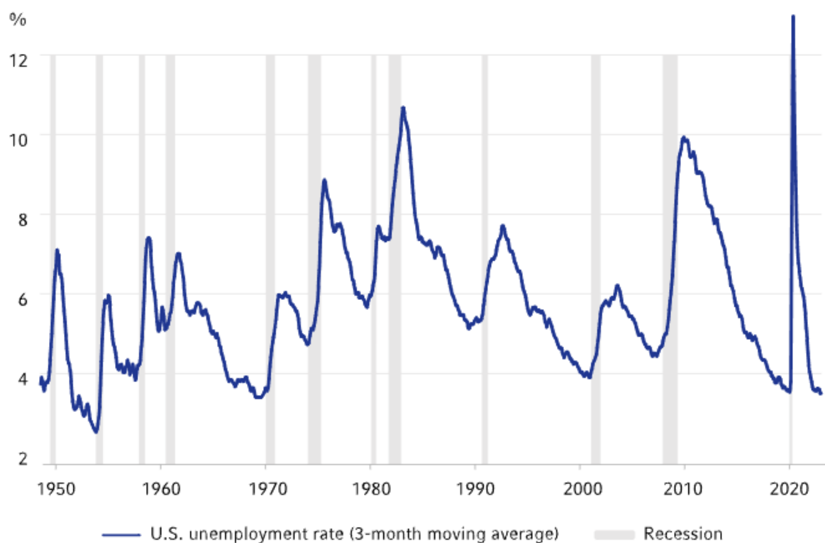
The Fed's dilemma continues. How do we solve the inflation problem without kneecapping the labor market, and add further pressure to our banking system. Income and spending continue to remain solid as does the overall labor market. Earnings reports for the 4th quarter were mixed. Companies are still struggling with rising costs and lingering recession fears. Several high-profile companies have laid off large blocks of their employees, notably Meta, Disney, Amazon, and Microsoft. Companies are trying to staunch the bleeding from their bottom line, by shoring up their balance sheet.

Not all news throughout the quarter was bad. After a sluggish start to January, the market had a nice mini rally, especially in the Tech sector. However, the SVB collapse sent fresh shock waves throughout the market. It is important to note that while several banks came under intense scrutiny, a domino effect did not manifest. It did cause minor panic, but we do note the stability over the past week.

Our view is that a mild recession is likely in the US over the next year. The yield curve has been inverted this quarter and has not shown signs of reversing. One of the most recognized signals for a recession.



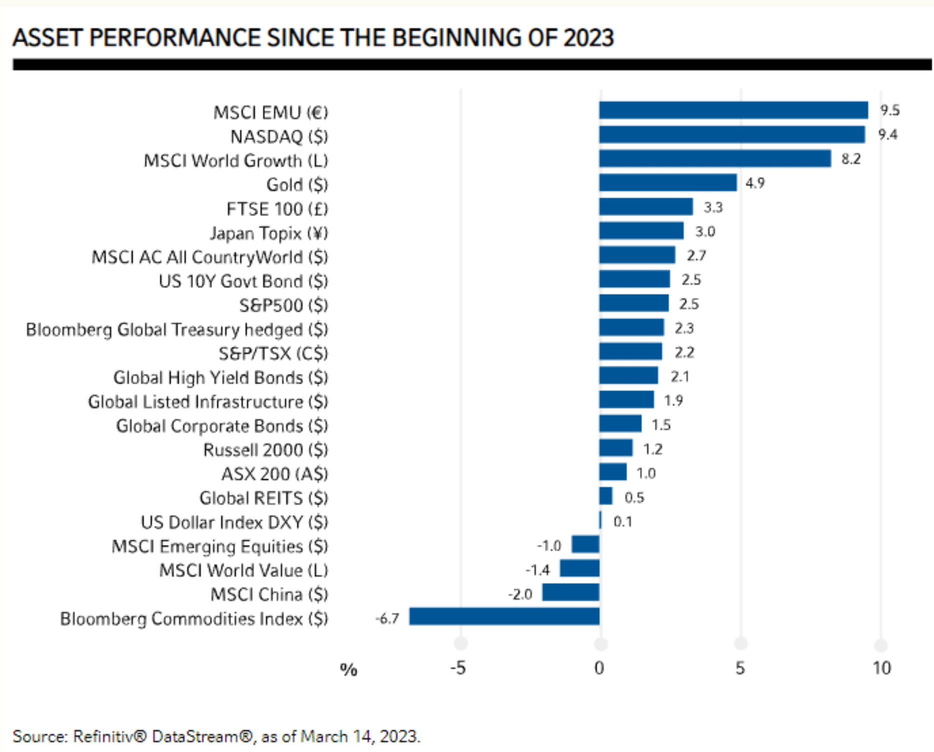
Strong households and corporate finances are likely to limit the downturn to a mild recession. The labor market is currently the biggest imbalance in the US economy. Wage inflation has spiked to a 40-year high, and there are currently more job vacancies than unemployed people[1]. It is oxymoronic to think about considering all the high profile layoffs. However, due to the strong demand for employment, we feel the effects from the layoffs will be mildly felt by the economy. We are at historically low unemployment numbers.



[1] 2023 Global Market Outlook, Russell Investments

We believe the volatility will continue until the Fed has finished tightening. The turning point will come when the interest rate hikes pause or potentially reverse. The expectation is for the Fed to do a further 25bps hike, but there could be a chance the Fed holds. It is a bit difficult for the Fed to justify pausing the rate hike until the jobs market cools down and inflation resumes its decline. The consumer price index gained 6% year-over-year in February, down from the peak of 9.1% in June of 2022. We are still much higher than the Fed's desired 2%; however, we are heading in the right direction. The collapse of SVB and pressure on the US banking system is the only new wild card that makes the Fed's goal of a soft landing difficult.

There is currently a quick readjustment to investors' earnings expectations for the quarter. Fourth-quarter earnings season was mixed, and analysts have a somewhat bleak outlook for the first half of 2023. Time will tell soon what the continued damage is with the Q1 earnings season fast approaching. If Q4 was any indication, the S&P 500 companies reported a -4.8% year-over-year decline in earnings[2]. The below table shows the performance by asset class to start the year. It is a very mixed bag on where performance is sourced from, and a marked rotation from the previous years. With the volatility continuing into 2023, we started the year defensively. We have the portfolios hedged, have raised cash, and rotated out or reduced our exposure to poor performing stocks.



[2] 2023 Global Market Outlook, Russell Investments

What is Happening in the Bond Market?

2022 was a truly historic year in the bond market, and the volatility has continued into 2023. The multiple headwinds in the market have created a challenging investment environment. However, investors are adjusting to the volatility and stepping into fixed income. The sharp rise in yields in 2022 has created attractive income and total return potential on the bond side. We are in a new era for the financial markets, one without an easy policy to lift all assets. The trick is going to be to stay selective in the bonds we buy, the sectors we invest in, and the duration of the bond ladders we create. Let me explain.

The bond market has currently several defining factors.

1) The longer the bonds maturity, the higher the exposure to interest rate changes, and therefore pricing is much lower.
2) High yield bonds have had higher price pressure put on them than investment grade bonds.
3) Shorter term bonds have stronger pricing, but the yields are significantly lower.

What all of this tells us that if you want higher quality bonds and shorter maturities, you will get significantly lower yields. Which is why selection and diversification is going to be key. Here is a snapshot of the bond yields and spreads as of year-end. Notice the yield diffenrece between High Yield and Investment Grade.

	Yield (%)				Spread (basis points)			
	Last	1 Year Ago	Last 10 Year Average	Ratio to Last 10 Year Average (x)	Last	1 Year Ago	Last 10 Year Average	Last 10 Year Percentile
Investment Grade Credit								
US IG	5.5	2.4	3.2	1.7	138	97	133	60
EUR IG	4.2	0.5	1.2	3.6	166	97	120	92
High Yield Credit								
US HY	9.0	4.3	6.2	1.4	479	309	448	70
EUR HY	7.6	2.9	4.0	1.9	494	332	406	81
Structured Credit								
US MBS	4.7	1.9	2.5	1.8	49	16	34	82
US ABS	5.8	1.5	2.1	2.8	147	79	86	93
US CMBS	4.6	1.5	2.3	2.0	59	35	53	73
Emerging Market Debt								
External EMD	8.6	5.3	5.8	1.5	452	368	372	88

Source: Macrobond, Goldman Sachs Asset Management, ICE BoFAML and J.P.Morgan. As of December 30, 2022.

This is why we have seen significantly more volatility in our bond portfolios than normal. Any bond that is High Yield and slightly long (5-8+ year maturity) has seen significant price volatility. Our outlook is positive in the bond space. We have seen prices pick up in 2023, despite the financial scare with Silicon Valley Bank. Default rates are still below historical averages given strong corporate balance sheets and limited near-term refinancing needs. Despite this we have shortened our maturities

significantly and have purchased higher quality bonds this year. Our overall bond portfolio is quite strong, with only a few companies going through difficult transitions. The bonds are still paying the dividends, default risk generally is low, and we have been very active taking advantage of the dislocation in this market to secure high yield.

What is Winans outlook?

The market was remarkably resilient in March, especially given the uncertainty radiating from the banking sector and tightening credit markets. Tech stocks rallied in recent weeks, however, on low volume. The S&P 500 also did not drop below its December low in the first quarter, which is historically a bullish sign for the rest of the year. The markets are currently close to the top of their trading range, and our near-term market forecast is that it will need to see a turnaround in leading economic indicators to break through this top range. We do expect stocks to remain rangebound over the next several months. We also believe there is a strong chance that headwinds could turn into tailwinds later this year. We expect to see economic growth pick back up, Monetary policy to pause maybe even pivot, inflation to moderate over the course of the year, and interest rates to slow or possibly reverse some.

Average Annual Interest Rate Forecasts (%)

Interest Rate (%)	2023E	2024E	2025E	2026E
Federal Funds	4.92	3.48	1.58	1.48
10-Year UST	3.50	2.75	2.25	2.50

Source: Morningstar. Data as of Mar. 27, 2023.

We believe that companies with strong balance sheets that can make it through a recession, are profitable and have sustainable business models. These companies will be rewarded over the full cycle. That is why our continued rotation away from struggling stocks and our selection of new ones will be key. We do have concerns that rallies can fail, and we have already seen one this year. Shocks to the market can also come out of nowhere, SVB for example, which is why we still have our hedge in place. Active management and a disciplined approach will allow our portfolios to stay strong through difficult markets.

Questions? Please let us know if you have any questions or concerns. We are closely monitoring the markets and the impactful events that will affect them. We will send out the quarterly reports next week and they should be in the mail or in your portal. Please let us know if you have any questions. Stay safe and be well.

Winans Investments Team

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