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Investing with Caution – Caught in the Middle

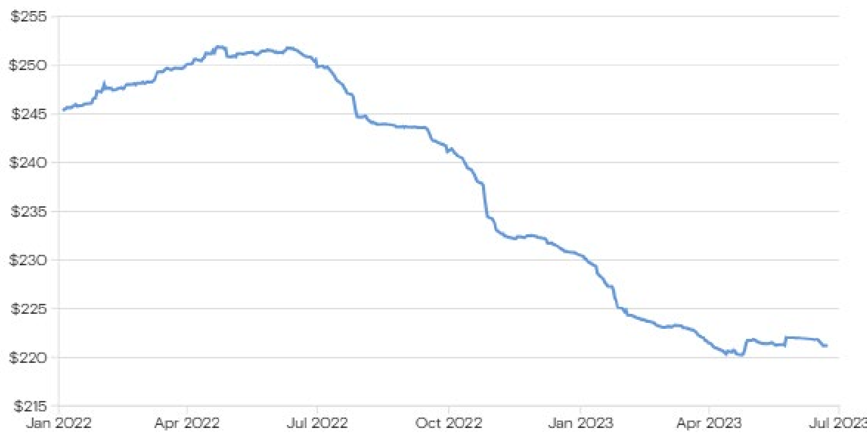
Q2 2023

Stocks and bonds have had a buoyant start to the year due to resilient economic data, improved earnings, and the Fed taking a pause on rate hikes. While stocks and bonds have bounced off their lows of 2022, commodities are down due to cooling energy prices and weakening global manufacturing demand. Technology and consumer cyclical stocks lead the list of best performers during the second quarter, as they continue to rebound from the battering they suffered last year. We are seeing stability in the financial sector, which is a welcomed reprieve after the first quarter's bank run. Inflation continues to cool, the Fed has finally hit the pause button on rate hikes, and earnings estimates have stabilized. All of which provide a strong backdrop for in improving market. We will review the second quarter, give an update on bonds, and our outlook for the remainder of the year.

Quarter End Review

The most popular prediction of 2023 was that markets would suffer through a rough first half but would rally by year end. This has not entirely been the case so far despite plenty of bad news that could have derailed the rally. Most economists still expect a recession in the next 12-18 months, albeit a mild one. The resilient consumer and strong labor market has stymied it so far. Despite the improving market conditions, investors remain defensive. We are caught between a stabilizing market after the peak of inflation, and a still inverted yield curve and broadly agreed upon impending recession. After the mauling the market has taken over the past year and a half, investors are rightfully cautious. Not everyone has bought into the Tech rally this year, with good reason.

Broad market gains in the US have been unbalanced with narrow leadership. The technology sector has been driving the markets higher, with the enthusiasm surrounding artificial intelligence a key contributor. The subtle upward shift is supported by a few key factors. First, strong first-quarter earnings have driven upward revisions in consensus expectations. Earnings expectations had declined for four consecutive quarters in a row.

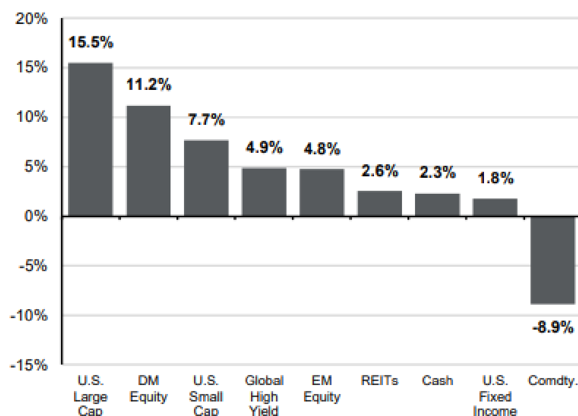


However, the Tech rally is imbalanced, with the top five performing large cap stocks accounting for more than half of the gains realized over the past 6 months. This narrow breadth is not a bullish sign, and many investors are questioning if the Nasdaq can continue to rise. Despite the powerful rally, it still has not returned to historic highs. Technically there is some more room for it to run, but is it too fast too soon?

The Nasdaq is a far different image compared to the Dow Jones. The Dow and S&P are caught in what technicians call channels. A divergence in the major indices is rarely a positive sign, but if the Dow could catch up and resemble the Nasdaq, that would be extremely bullish. The Dow continues to put

in higher lows which is a good sign (see the arrows below), we would like to see a breakout to the upside to confirm the channel is broken and the Dow is ready to make a run.

The bottom line with the indices is that they are either on the cusp of a breakout, or already enjoying a rally. A pullback with the Nasdaq would be quite healthy, given the momentum it has started this year with. What we are looking to see is if there will be a leadership rotation in the second half of the year.



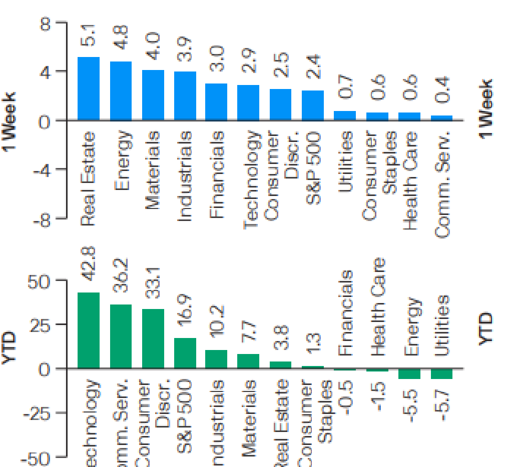
Style Returns

1 Week

	V	B	G
L	2.9	2.4	2.2
M	4.0	3.9	3.7
S	3.8	3.7	3.7

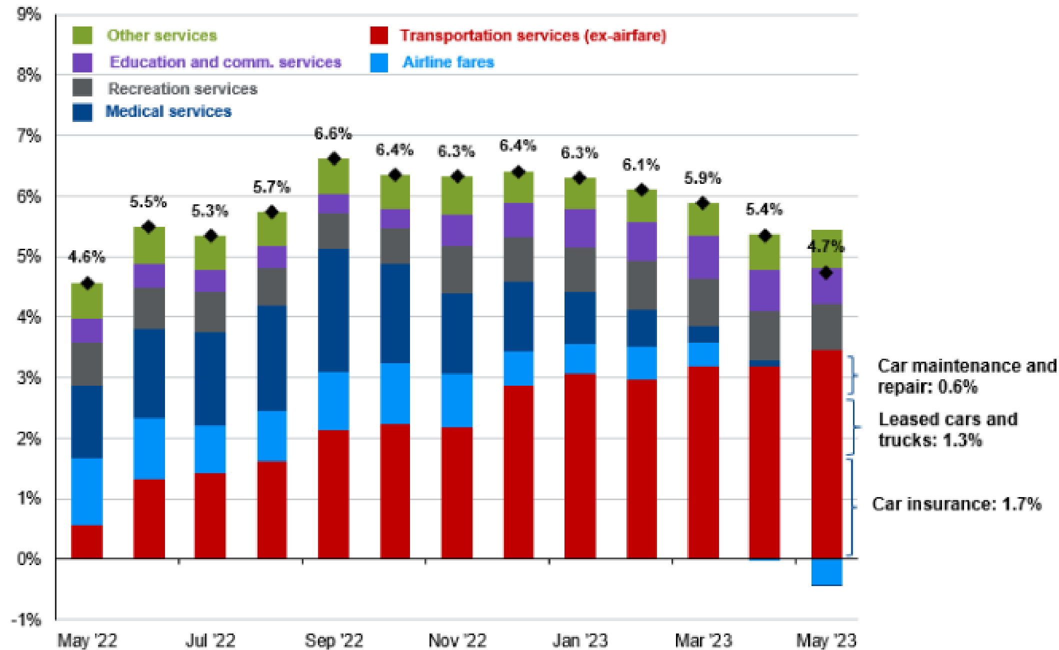
YTD

	V	B	G
L	5.1	16.9	29.0
M	5.2	9.0	15.9
S	2.5	8.1	13.6



The investment landscape is heavily influenced by the Fed. I have been asked this question several times lately: is the Fed getting inflation wrong? The May consumer price index (CPI) showed inflation is continuing to decelerate. This has allowed the Fed to take a pause on raising rates. CPI itself peaked last year at 9.1%, and currently sits at about 4%. However, the Fed is paying specific attention to the

sleeve of inflation excluding food, energy, and shelter. This so-called "super core" inflation measure has been slower to come down compared to the headline measure[1]. Jerome Powell has commented that progress will have to come through either softening demand or softening labor market conditions, neither of which have been seen yet. I would argue that inflation has cooled and the announcement of two additional rate hikes this year is premature. I understand that Powell is trying to prime the market so it can bake in the impending hikes. However, I feel inflation is getting under control, and the downstream effects on the economy with higher interest rates is not worth price of getting inflation down to 2%.



One of the key factors that have calmed the markets down is that the financial sector is stabilizing. We are also seeing a tectonic shift in the overall space. Since 2008 banks have gradually lost their dominance amid new regulations, technologies, and competitors. This years tumult put a spotlight on the risks of uninsured deposits, especially at US regional banks. It also drastically accelerated the shift from bank deposits to money market mutual funds. In 15 months, about $1 trillion has left the US bank deposits, about 6% of the total,[2] and moved into money market funds. Part of the shift is due to the fact that money market funds have been quicker to offer higher interest rates during the rate hikes. We have seen some key changes as a result: increased consolidation among smaller banks, banks curbing lending, and private credit is filling that void. This could potentially reshape the future of the banking and financial industry. This is something we are going to keep our eyes on.

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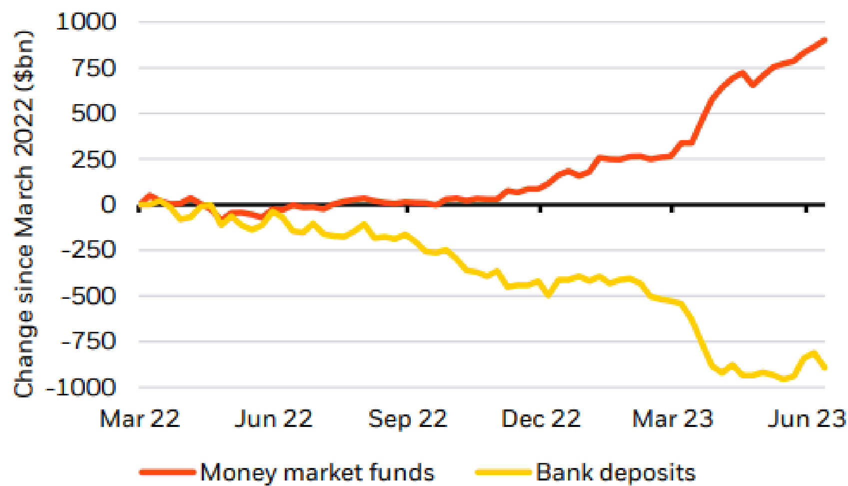
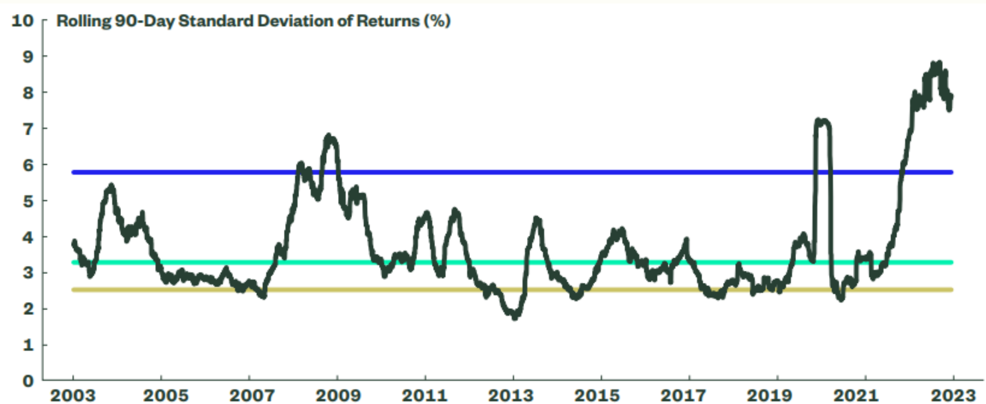
[1] JP Morgan – Is the Fed getting inflation wrong. June 14, 2023

[2] Blackrock – 2023 midyear outlook – new regime, new opportunities.



What is Happening in the Bond Market?

Uncertain environments tend to be good for fixed income, especially after the broad market repricing last year. We are keenly aware that bond market prices have been very volatile under the Fed's rate hikes.



We have seen a broad pick up and stabilization in the bond market over the first half of the year. Risk is at the forefront of our mind with the bond market, but that risk analysis has shifted lately. Central bank policy remains the most powerful influence on the bond market. Changing the price of borrowing has created a credit tightening cycle. This is different than what happened last year, which saw a large repricing of bonds in reaction to the rate hikes. Now we are in a different cycle of credit, where risk is going to be severely driven by the company as opposed to the market.

The banking sector stress reinforces our cautious approach toward corporate bonds. Companies have had to weather a multi-year storm. First with Covid, then with supply chain issues, then with inflation, and now with higher interest rates. Any one of these events could put pressure on a company, however, all four would be a lot for any company to manage through. Tight valuations are not backed by robust fundamental strength. Q1 earnings growth for high yield issuers was negative. Ratings

actions and default expectations add to the uneven sentiment in the high yield space. Downgrades have outpaced upgrades for four consecutive quarters. Default rates have also ticked higher, increasing from .6% to 2.1%.

To navigate this difficult market, we have shortened our maturities drastically over the past year. Shortening our duration lowers our risk to further interest rate hikes. Short-term bonds are still yielding +5% and provide us with flexibility in our approach to the market. We also are being very conservative about which companies we are exposed to. Fundamentals and financial strength are the key drivers to our investment selection. We believe that fixed income will continue to improve and stabilize despite further Fed hikes. We will continue to closely monitor any struggling companies and adjust our holdings accordingly.

What is Winans outlook?

We will continue to be active and diversified with our portfolios. We do expect a rotation in leadership to happen with the stocks. Tech cannot continue with the level of momentum it has had, therefore we expect that to slow down. This will drive us to be nimble with our portfolios to adjust to the new upswings.

We also expect the bonds to continue to rally, but with riskier bonds coming under more price pressure. This means spreads will tighten and yields will come down. That does not mean you cannot find good bonds; it just means we must work harder to find them. Even with future rate hikes impending, we still expect the fixed income space to continue to improve.

We are on recession watch as well. We continue to monitor the inverted yield curve, the labor market, and corporate earnings. So far the market has shrugged off recession fears, which is reassuring for equity investors.

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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