QUARTERLY MARKET REVIEW

Market Review

The quarter started well as earnings were generally pretty solid with reports from the likes of Microsoft, Meta, Intel, and Exxon all well received. One notable exception was Tesla, whose profitability suffered after a swath of price cuts across its range and it cautioned investors that "prices would continue to evolve."

Although it took until the end of the quarter, with the major banks passing stress tests, to officially quash worries about financial stability, the market had largely decided to leave any angst on this front behind in quarter one. Although Jamie Dimon, CEO of JPMorgan Chase, warned that the U.S. banking crisis that sent markets careening in March would be felt for years, in truth markets hardly blinked when regulators seized First Republic Bank and sold it to JPMorgan Chase in a fire sale on the last weekend of April.

The inflation and rates narrative continued to have tremendous impact on investor sentiment. In May, Fed Chair Powell said there won't be any rate cuts if inflation remains too high, while a unanimous vote lifted the federal funds rate to a target rate of 5-5.25% – the highest level since 2007. Even though inflation remains stubbornly persistent, the market seemed generally happy to bet that rate cuts were not too far off, and this optimism was at least partially rewarded as the Fed voted unanimously to maintain rates at the June meeting. The Fed did remind investors that, despite the hiatus, they would continue to raise rates and maintain a tough stance on inflation if necessary.

Another backdrop to the investment landscape in May was a looming breach of the U.S. debt ceiling. The market wondered if a deal would be done, and what the consequences would otherwise be. No one seemed to have any idea if the U.S. would default on its debt, whether it would be a technical default, whether all assets would need to be repriced or, on the other hand, if markets would actually care at all. In any event, a deal was struck that seemed to leave both Democrats and Republicans unhappy – usually a sign that the negotiators did a pretty decent job.

The geopolitical situation remains worrying as there is ongoing saber-rattling between the U.S. and China over Taiwan. Although the military drills did not quite match the scale of those seen in the wake of Nancy Pelosi’s visit, China completely encircled the island and practiced simulated strikes on cities and other strategic targets. In Europe, somewhat depressingly, there have still been no positive developments in the war in Ukraine.

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Market Review Cont.

The biggest winners for the quarter were investors in tech stocks that were deemed to be beneficiaries of Artificial Intelligence as these surged. Although it is indeed likely that AI is a game-changer – and we are not suggesting a bubble there yet – the euphoria definitely has overtones of the meteoric and indiscriminate rise in "anything.net" stocks that we saw a little over 20 years ago. Right at the end of the quarter, the consumer confidence report was showing that more people expected stocks to go up rather than down. This was a first since 2022, and one can only wonder if the return of bullish sentiment could be a useful contrarian indicator.

World equities, as measured by MSCI ACWI, returned a very solid 6.2% to build on their strong start to 2023. The U.S. led the way as the S&P 500 posted an impressive 8.7%. Developed markets were far behind, with MSCI EAFE delivering 3.0%, although they were somewhat better in local terms as the dollar was strong for the quarter (4.3% local currency return). MSCI Emerging Markets returned a very ordinary 0.9%, but this was completely due to a sell-off in China; and MSCI Emerging Markets ex-China posted a markedly improved 6.0%. Similar to last quarter, Value was crushed by Growth as Information Technology and mega cap stocks in the U.S. soared, with MSCI ACWI Growth up 9.2%, some 6.2% ahead of the MSCI ACWI Value return of 3.0%. Remarkably, outside the U.S. there was little to choose between the two styles.

Meanwhile, the U.S. yield curve reversed course and climbed solidly. The 2-year yield rose an astonishing 81 bps to finish at 4.87%, while the 10-year yield rose 33 bps to finish at 3.81%. Again, like last quarter, we would note that, as indicators go, an inverted yield curve has historically been a very reliable forerunner of unpleasantness in the markets and the economy. Although we should acknowledge that the optimists believe this time is different as it is just a short-term inflation technicality (or distortion, or whatever). TIPS fared a little worse and the 10-year real yield rose by 43 bps to 1.59%, leaving the 10-year break-even inflation measure down 10 bps at 2.22%.

Against this backdrop, traditional bond investors had a horrible quarter due to duration, but this was largely offset by a decent positive quarter in credit. The Bloomberg U.S. Aggregate index returned -0.8%, in contrast to the ICE BoAML U.S. High Yield index posting 1.6% and the J.P. Morgan EMBIG Diversified index returning 2.2%.

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Market Review Cont.

Outlook

In these uncertain times, it is more important than ever to pay attention to valuation. The selloffs in 2022 made some assets look increasingly interesting and we have continued cautiously adding to risk. Higher rates typically cause people to reassess the fundamental value of investments. This should be particularly bad for anything more speculative in nature while being relatively good for Value and relatively good for non-U.S. equities. The extreme divergence in valuation between the USD and many overseas currencies makes the case to invest outside the U.S. even more compelling.

Our views, and positioning, have not markedly changed and we reiterate many of the suggestions we offered last quarter:

1) Exploit the global Growth bubble with a long cheap Value/short expensive Growth equity strategy.

2) Avoid the Growth bubble by investing in liquid alternatives.

3) Skirt around the Growth bubble by pivoting your equity exposure to EM and developed ex-U.S, focusing on Value and Deep Value in particular.

4) Although U.S. equities in general look to be the most expensive, the relative pricing of the cheapest fifth of the market, or Deep Value, looks to be an intriguing opportunity.