Complimentary Report

MarketDesk

Featured Report *(starts on page 2)*

2Q 2023 Asset Allocator's Guide

Quarterly Roadmap to Enhance Investment Committee Decisions

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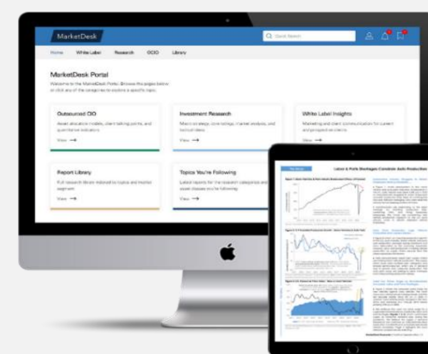

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" I was tired of being pitched the latest & greatest from wholesalers. MarketDesk increased our asset allocation conviction. Clients are happy. We're happy.

Managing Partner at $315M RIA
" MarketDesk is the independent partner we've spent years searching for. It's already replaced multiple resources we previously used.

2Q 2023 Asset Allocator's Guide

MarketDesk Research

Quarterly Report

April 5, 2023

A Roadmap for Getting Back to Fundamentals

Navigating the Delayed Impact of Fed Tigthening

Current Market Themes & Portfolio Implications

The market is struggling to establish one coherent view. It is difficult to imagine a scenario where inflation pressures ease, the Fed pulls off a soft landing, the U.S. financial system remains stable, and the Fed cuts interest rate in late 2023. Combating inflation will require the Fed to break something more than just regional banks, which decreases the probability of a soft landing and makes the financial system less stable. Pulling off a soft landing and avoiding financial instability requires the Fed to adopt a more dovish stance, which increases the probability that inflation will remain sticky given recent economic momentum. Late 2023 interest rate cuts mean something has gone terribly wrong this year, in which case the soft landing scenario is off the table and financial system stress rises. The market needs to decide what scenario and combination of above outcomes it believes in, because having all four outcomes is unrealistic.

Our combination of outcomes is as follows: Inflation eases but becomes stuck in the 2-4% range, which the Fed reluctantly accepts. The U.S. economy experiences a landing somewhere between soft and hard – slower economic activity and negative growth but not to the level of 2008. Financial stress builds as the Fed works to undo its pandemic-era balance sheet expansion, which leads to tighter lending standards, rising default rates, reduced financial market liquidity, and declining equity prices. The Fed pushes through 1 or 2 more rate hikes and then keeps interest rates restrictive for most of 2023 to prevent inflation from re-emerging 1970s style, but the central bank struggles with a steady climb in unemployment. Late 2023 rate cuts, if there are any, are likely to be few and small.

How is this view translated into portfolios? In the equity sleeve, our preference is to decrease beta by emphasizing defensive sectors and factors with a tilt toward Large Caps. In the credit sleeve, our emphasis is on higher quality credits, such as U.S. treasuries and AAA agency mortgage-backed securities, and extending duration. Refer to the ***OCIO Model*** for more detailed positioning.

Notable Positioning Views

- ► **Large vs Small Caps:** Remain OW Large Caps due to EPS contraction risk (**Figures 12-14**)
- ► **Value vs Growth:** Remain Neutral both factors for now; Balancing Value's cyclical exposure (i.e., higher risk of earnings drawdowns) with Growth's YTD multiple expansion (**Figures 15-17**)
- ► **U.S. Sectors:** No change to our views; Maintain defensive sector overweight (**Figures 18-20**)
- ► **International:** Remain OW EM as USD stabalizes & DM normalizes monetary policy (**Figures 21-23**)
- ► **Credit Duration:** Maintain Long Duration OW as credit quality becomes bigger risk (**Figures 24-26**)
- ► **Credit Quality:** Remain UW High Yield as lending standards will further tighten (**Figures 27-29**)

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Core Asset Allocation Ratings

Long-term View & Rationale

- Overweight (OW) — Favor actively holding a higher weight than the broad index. Comfortable letting winners run and increasing exposure after selloffs.
- Marketweight / Neutral (N) — Market areas offering limited differentiation vs the broad index.
- Underweight (UW) — Favor actively holding a lower weight than the broad index. Potential areas of risk (i.e. underperformance, macro / thematic headwinds).

Asset Class	Allocation View				Rationale
	Chg.	UW	N	OW	
U.S. Equities					
Large Caps		•	•	●	Growth OW less of a headwind as tightening cycle ends; Outperforms as BBB credit spreads tighten (**1Q23 AA Guide Fig 13**)
Mid Caps		•	●	•	Remain Neutral rated due to mixture of Large & Small Cap fundamentals
Small Caps		●	•	•	Higher risk of profit margin contraction (**3Q22 AA Guide Fig 13**) & negative EPS revisions (**3Q22 AA Guide Fig 14**) than Large Caps
International Equities					
Emerging		•	•	●	China regulatory policy still a risk, but reopening benefits consumption (**1Q23 AA Guide Fig 23**) & broader Asia-Pacific region
ACWI ex U.S.		•	●	•	USD strength less of a risk near-term, but could be a headwind in 2H 2023 as macro conditions deteriorate (**2Q23 AA Guide Fig 21**)
Developed		●	•	•	Outperformer in 2023 after Europe managed to avoid an energy crisis; Favor Min. Volatility factor to protect against ECB tightening
Fixed Income					
EM Sovereign		•	•	●	Fed & EM central bank rate hikes already priced in; Favor local currency -- refer to 4/22/22 tactical report
MBS		•	•	●	Low prepayment & extension risk with a higher risk free yield than U.S. Treasuries; Refer to 11/21/22 tactical report
Investment Grade		•	•	●	Lower credit risk vs HY = Less risk of credit spread expansion; Favor extending duration with a focus on higher quality bonds
Long Duration		•	•	●	Favor extending duration to protect against macro backdrop & unknown risks (**2Q23 AA Guide Figs 24 & 26**)
Preferreds		•	●	•	Recent bank failures weighed on preferred stocks (**2Q23 AA Guide Fig 29**); Likely more attractive tactically in coming months
Municipals		•	●	•	Decision to not raise individual & corporate tax rates decreases value of tax benefit
TIPS		•	●	•	% Y/Y growth already at multi-decade high; Inflation pressures easing, but could remain stuck above Fed's 2% target
High Yield		●	•	•	Corp fundamentals weaker than they appear; Tighter lending standards = increased refinancing & default risk
U.S. Sectors					
Cons Staples		•	•	●	Defensive sector with less cyclicality & lower downside capture; Favor earnings stability & lower beta in the coming quarters
Utilities		•	•	●	Defensive sector with less cyclicality & lower downside capture; Favor earnings stability & lower beta in the coming quarters
Health Care		•	●	•	Another defensive sector option to implement in place of Cons Staples / Utilities
Financials		•	●	•	Headwinds > tailwinds — Late economic cycle + rising interest rates = increased recession / default risk; Loan loss provisions a risk
Tech		•	●	•	More attractive as tightening cycle nears a definitive end, but near-term overbought (**2Q23 AA Guide Fig 19**)
Comm Svcs		•	●	•	Mixture of Growth & low-beta telecom; Regulatory risk & decreased advertising spending = significant headwind for social media
Energy		•	●	•	Drilling activity rebounding as oil prices rise; Accelerated Fed tightening increases recession risk & lowers oil demand
REITs		•	●	•	Risk of property valuations declining further & owners unable to refinance due to tighter lending standards; Cap rates too low
Cons Disc		•	●	•	Consumer spending above pre-pandemic trend, but inflation & elevated recession risk = potential headwinds
Industrials		●	•	•	Industrial & manufacturing activity slowing as rate hikes take effect; Cyclicality is a risk as macro conditions deteriorate
Materials		●	•	•	Industrial & manufacturing activity slowing as rate hikes take effect; Cyclicality is a risk as macro conditions deteriorate
U.S. Equity Factors					
Minimum Volatility		•	•	●	Protects against market volatility as macro conditions deteriorate; Another option to use in place of individual low beta sectors
Growth		•	●	•	P/E multiple compression less of a risk as tightening cycle ends; Less risk of profit margin contraction than cyclical Value
Value		•	●	•	More cyclical sector exposure creates an elevated risk of negative EPS surprises as ISM Mfg PMI declines (**3Q22 AA Guide Fig 17**)
Momentum		•	●	•	Odd sector exposure after Nov. 2022 index reconstitution; Uncertain / volatile macro trends increase risk that momentum shifts
High Dividend		•	●	•	Defensive sector OW with Tech UW; Favor active security selection with emphasis on quality dividend payers
High Beta		●	•	•	Broad mixture of factor & industry exposure – Volatility shifting from Covid-19 to 'Growth-style' selloff & idiosyncratic events

Note: The ratings represent our asset allocation view for the next 6-12 months. Arrows indicate a positive (▲) or negative (▼) change in view since the prior report.

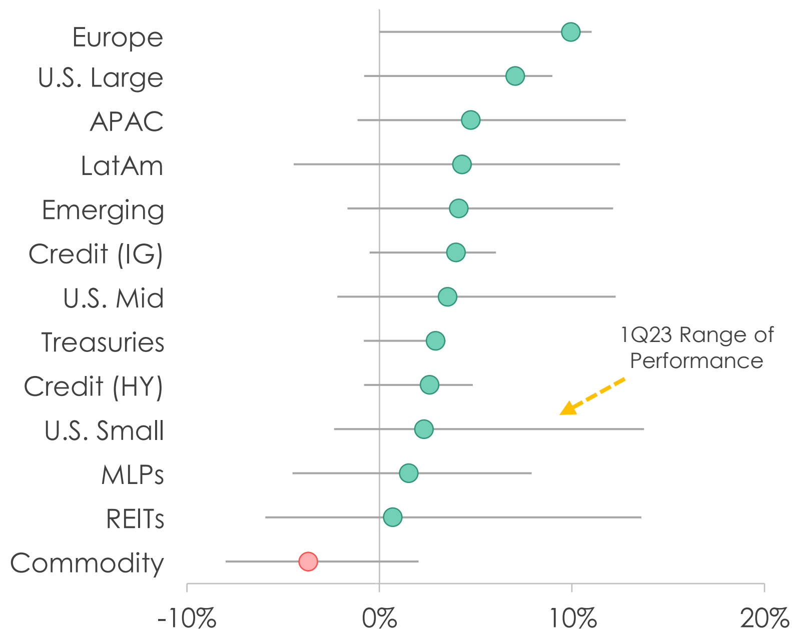
Asset Class Performance

Recap since last edition of the Asset Allocator's Guide

Asset Class	Total Return (%)			Valuation & Yield			Asset Flows[1]		Price Chart
Global Equities	**1Q'23**	**1Yr**	**3Yr**	**NTM P/E**	**P/B**	**Div Yld**	**1Q'23**	**Last 2Yrs**	**YTD**
U.S. Large Caps	7.5	-7.8	66.3	17.7x	3.9x	1.6%	↓ 2.1%		
U.S. Mid Caps	3.8	-5.2	80.9	13.5x	2.2x	1.3%	↑ 0.9%		
U.S. Small Caps	2.7	-11.7	61.9	20.1x	1.9x	1.6%	↑ 0.6%		
Europe	10.3	1.3	53.7	12.7x	1.9x	3.1%	↑ 25.9%		
Asia-Pacific	4.8	-8.0	19.5	13.2x	1.6x	1.5%	↑ 7.4%		
Latin America	4.3	-11.4	63.1	7.1x	1.4x	12.2%	↓ 2.0%		
Developed	9.0	-0.2	45.4	12.7x	1.7x	2.5%	↑ 0.3%		
Emerging	4.1	-10.5	22.7	12.0x	1.6x	2.4%	↑ 3.0%		
U.S. Sectors									
Comm Services	17.9	-18.7	30.4	17.8x	2.4x	0.9%	↑ 0.2%		
Cons Discretionary	16.1	-18.3	56.2	23.5x	8.2x	1.0%	↓ 6.0%		
Cons Staples	0.7	1.0	48.2	19.8x	6.1x	2.5%	↑ 0.0%		
Energy	-4.3	13.0	227.9	10.0x	2.2x	4.0%	↓ 2.0%		
Financials	-5.5	-14.3	64.0	12.6x	1.7x	2.2%	↑ 0.7%		
Health	-4.3	-4.0	53.1	16.8x	4.6x	1.6%	↓ 0.8%		
Industrials	3.4	0.0	79.7	18.3x	5.2x	1.6%	↓ 1.9%		
Materials	4.3	-6.4	90.2	16.4x	2.8x	2.2%	↑ 4.8%		
Tech	21.6	-4.0	93.0	23.0x	8.1x	0.9%	↓ 2.0%		
Utilities	-3.3	-6.3	34.0	17.7x	2.1x	3.1%	↓ 2.1%		
Fixed Income									
Treasuries	3.3	-4.4	-12.4	-	-	1.9%	↑ 4.1%		
Invest. Grade	4.7	-6.3	-3.6	-	-	3.4%	↓ 1.3%		
High Yield	3.7	-3.1	13.2	-	-	5.4%	↓ 24.9%		
Alternatives									
REITs	1.7	-20.2	32.4	16.2x	2.3x	4.1%	↓ 1.0%		
MLPs	3.5	9.0	195.5	10.4x	2.0x	7.7%	↓ 0.7%		
Commodities	-3.7	-8.4	112.3	-	-	-	↓ 9.4%		

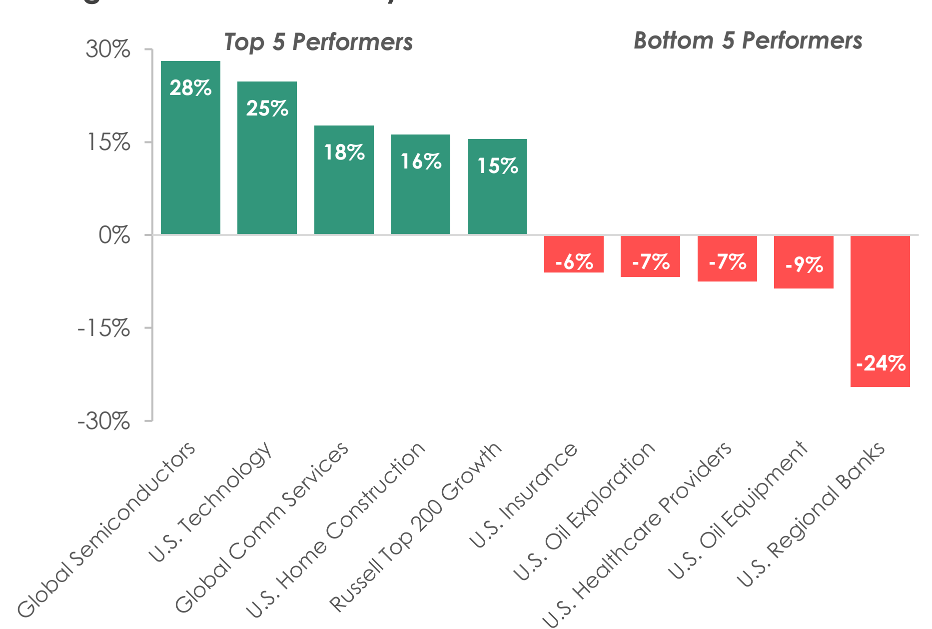
[1] *Asset Flows are calculated using 5 largest ETFs for each category.*

Figure 1: Asset Class Performance — 1Q 2023



Source: MarketDesk

Figure 2: Global Industry Performance — 1Q 2023

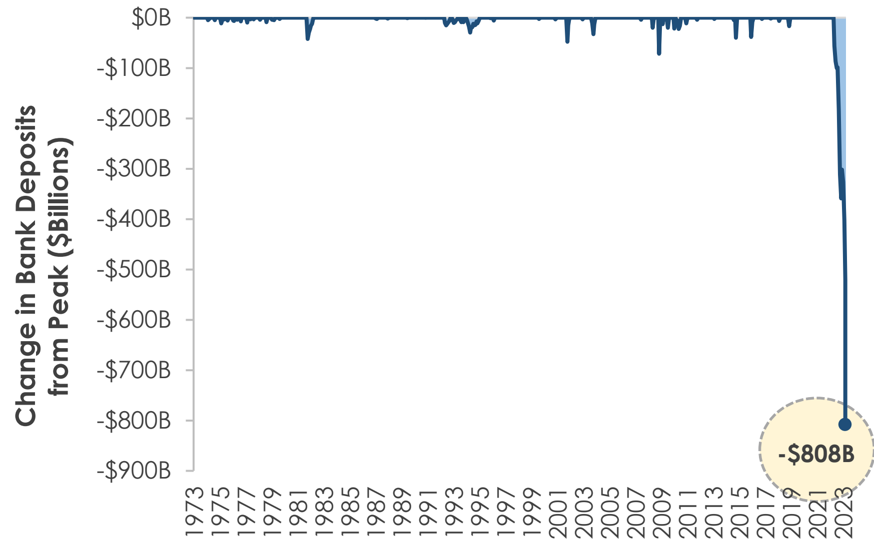


Source: MarketDesk

Charts That Will Shape 2Q 2023

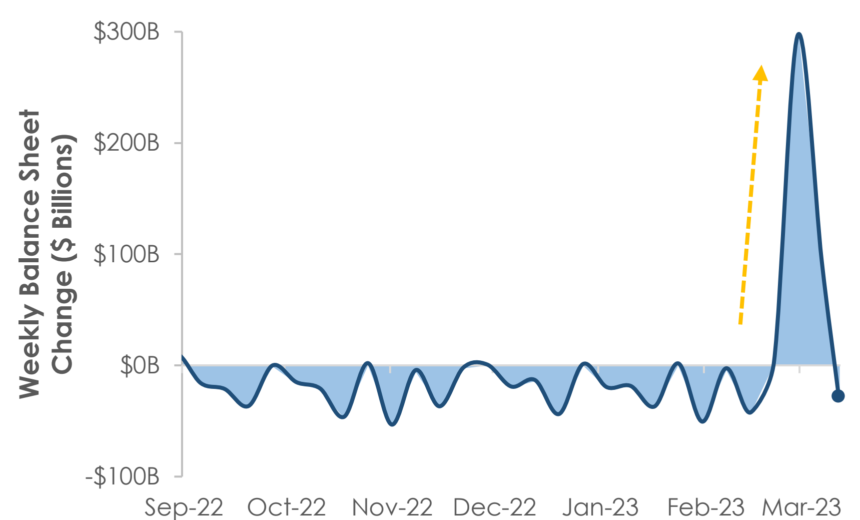
Six charts likely to drive the market narrative this quarter

Figure 3: Biggest Commercial Bank Deposit Withdrawal on Record



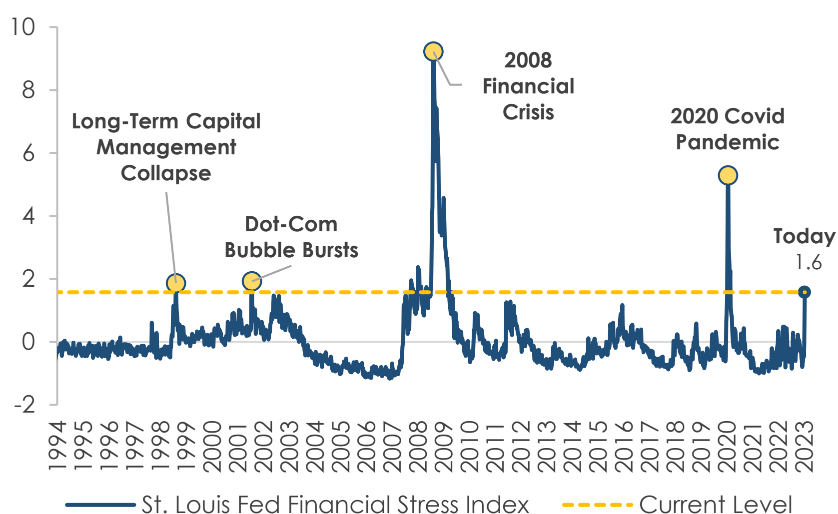
Source: MarketDesk, Federal Reserve

Figure 4: Federal Reserve Replaces Deposits via Lending Program



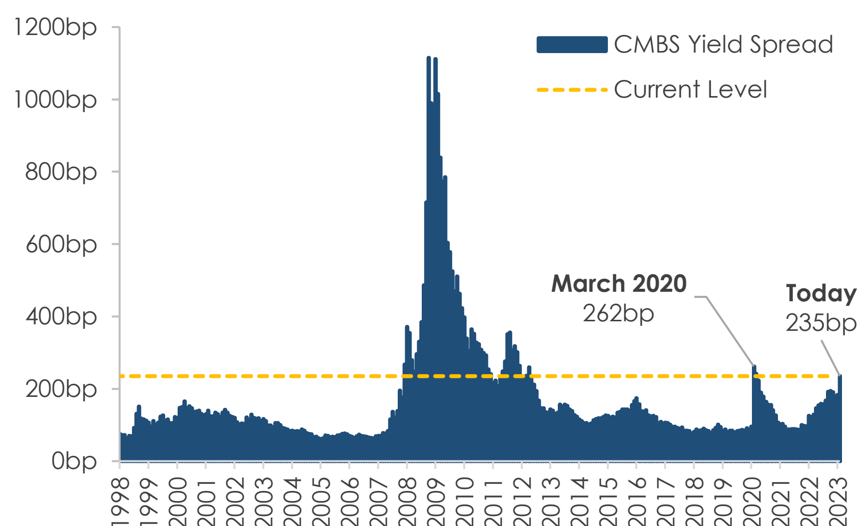
Source: MarketDesk, Federal Reserve

Figure 5: Financial Stress Increases



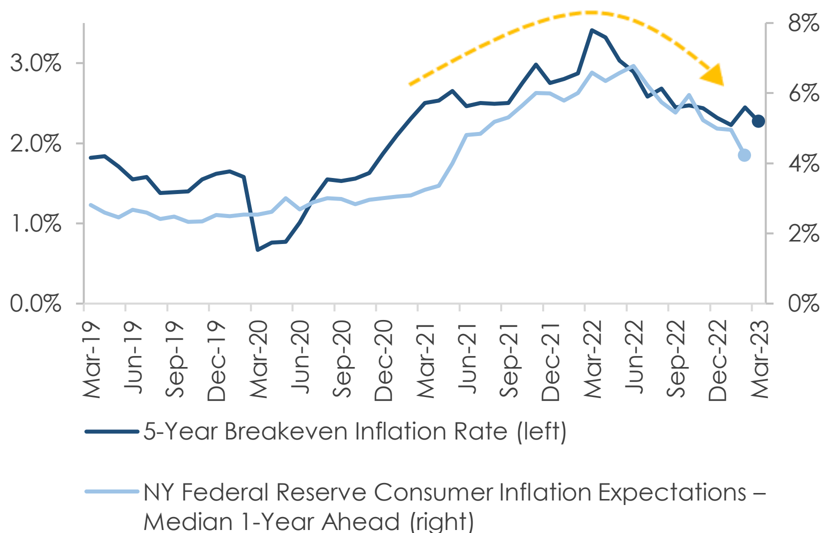
Source: MarketDesk, St. Louis Fed

Figure 6: CMBS Credit Spreads Climb to 2008 & Pandemic Levels



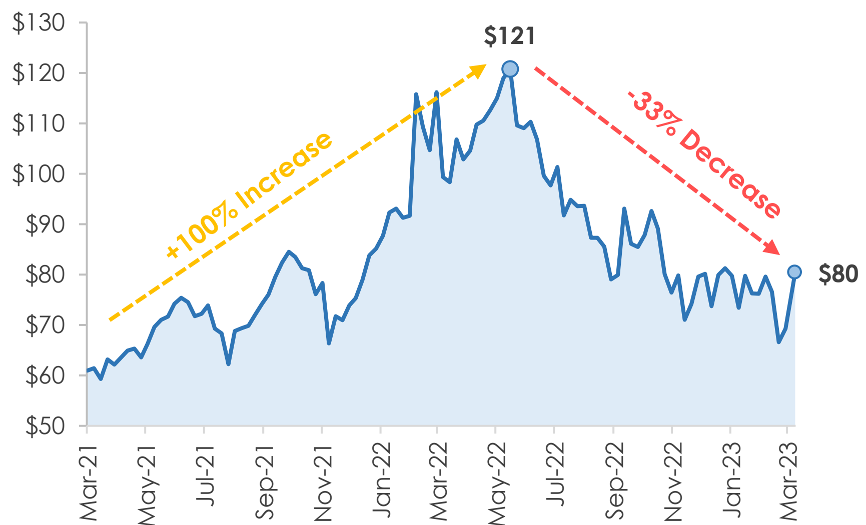
Source: MarketDesk. Analysis is based on ICE BofA US Fixed Rate CMBS.

Figure 7: Market & Survey Inflation Expectations are Falling



Source: MarketDesk, Federal Reserve

Figure 8: Where Do Oil Prices Trade From Current Levels?

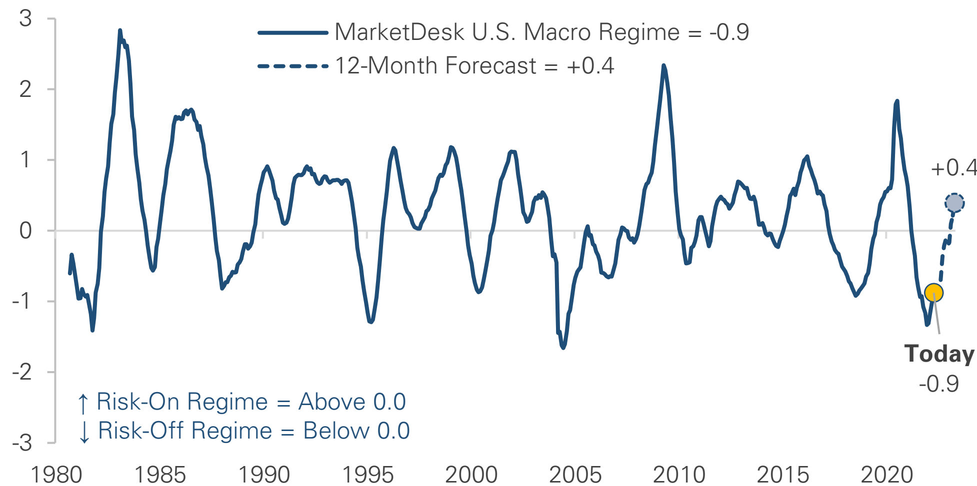


Source: MarketDesk

Unfolding Economic Themes

► **Back to the Fundamentals:** Corporate fundamentals and macro data will become more important this year. Forward-looking indicators forecast a challenging macro environment throughout 2023, with some improvement anticipated in late 4Q 2023 and early 2024. These forecasts include a continued decline in the ISM Mfg PMI, a steady climb in the unemployment rate, and further tightening in bank lending standards. Our view remains that the risk/reward setup is negatively skewed, with limited upside and a heightened risk of downside. As mentioned in prior *AAGuides* , this forecast, as well as uncertainty about the direction of Fed policy, favors a risk-off approach that protects capital. When constructing portfolios, we continue to prefer a lower beta approach with an emphasis on higher quality equity and credit classes.

Figure 9: MarketDesk U.S. Macro Regime Indicator (USMRI)



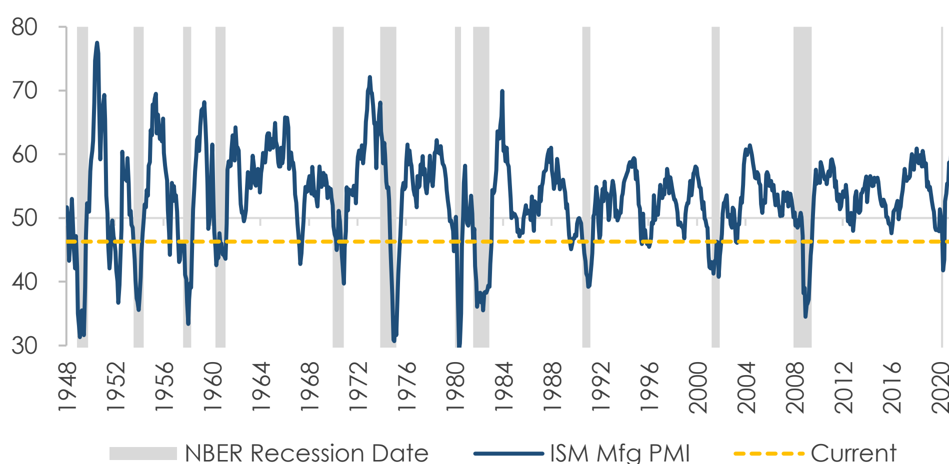
Source: MarketDesk Quant Pack

Introducing the MarketDesk U.S. Macro Regime Indicator …

● Figure 9 graphs our U.S. Macro Regime Indicator (USMRI), which aggregates 20+ ***Quant Pack*** indicators across U.S. economics, equities, and credit and distills them into one straightforward signal. A reading above (below) zero signals a risk-on (risk-off) regime and indicates investors should increase (decrease) overall portfolio risk.

● USMRI currently sits at -0.9 but is forecasted to rise to +0.4 during the next 12 months, crossing above 0 in January 2024. Pages 6-7 in the *Quant Pack* provide more information on USMRI, and our team will publish a primer in the *4/14 Snapshot* .

Figure 10: Manufacturing PMI vs NBER Recession Dates



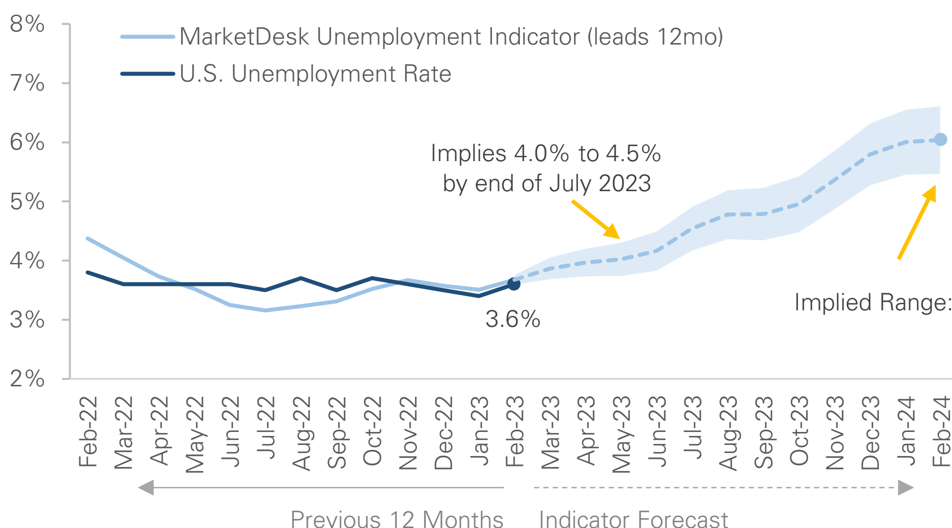
Source: MarketDesk, NBER, ISM

Current Manufacturing PMI Level Signals High Probability of Recession …

● Figure 10 graphs the headline ISM Mfg PMI, which came in at 46.3 in March 2023 (vs the 47.5 consensus). It is the lowest since May 2020, an indication U.S. manufacturing is experiencing a sharp slowdown. Looking out over the next 6 months, our PMI Leading Indicator on p.17 in the Quant Pack forecasts a continued decline.

● The Mfg PMI has been at current levels 16 times since 1948. In those 16 instances, 8 saw the U.S. already in a recession, and 4 brought a recession in less than eight months. That is a 75% accuracy rate, making it a solid recession indicator.

Figure 11: MarketDesk U.S. Unemployment Indicator



Source: MarketDesk Quant Pack, U.S. Department of Labor

A Forecasted Rise in Unemployment Could Distract the Fed From Inflation …

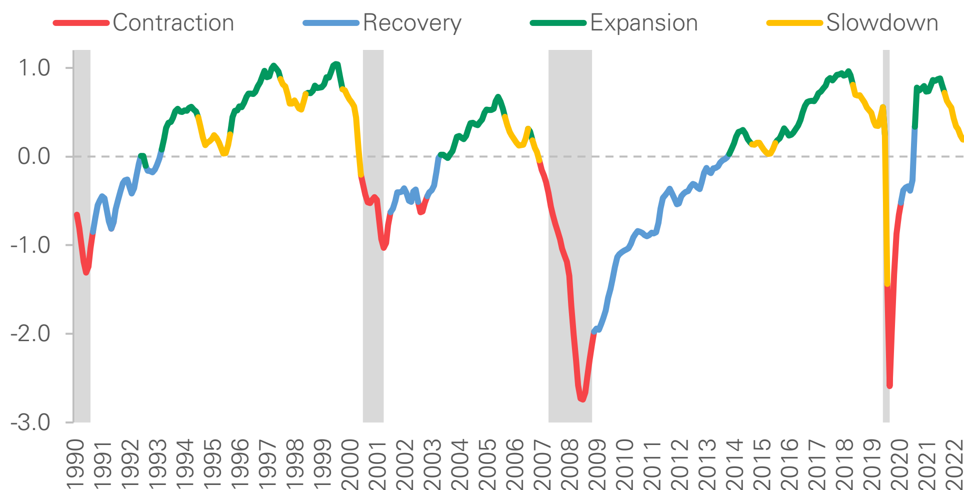
● Figure 11 graphs our U.S. Unemployment Indicator, which forecasts a steady climb in unemployment throughout 2023. The Fed's dual mandate is price stability AND maximum employment. The Fed is heavily focused on price stability currently, but the indicator suggests its focus could shift to unemployment in 2H 2023.

● This raises multiple questions about the direction of Fed policy. (1) What level of unemployment will prompt the Fed to take action? (2) In a scenario where inflation and unemployment are both elevated, which issue will the Fed prioritize? The answer to both questions will influence the direction of equity and credit markets in 2023.

Size — Large Caps vs Small Caps

► **Maintain Large Cap OW & Small Cap UW.** Our U.S. Business Cycle Indicator shows the U.S. economy entered the slowdown phase in May 2022 and remains there (*Figure 12*). Performance data shows Large Caps historically outperform Small Caps late in the cycle, which we attribute to their differing risk profiles (*Figure 13*). Furthermore, we believe there is a high probability that corporate profit margins are overstated after soaring to record highs during the pandemic (*Figure 14*). Large Caps are more financially stable with diversified revenue streams and an established presence in their markets. A clear illustration of this can be seen in the recent bank failures, when depositors shifted money away from smaller regional and community banks to large, money-center banks. Size matters late in the economic cycle.

Figure 12: MarketDesk Business Cycle Indicator



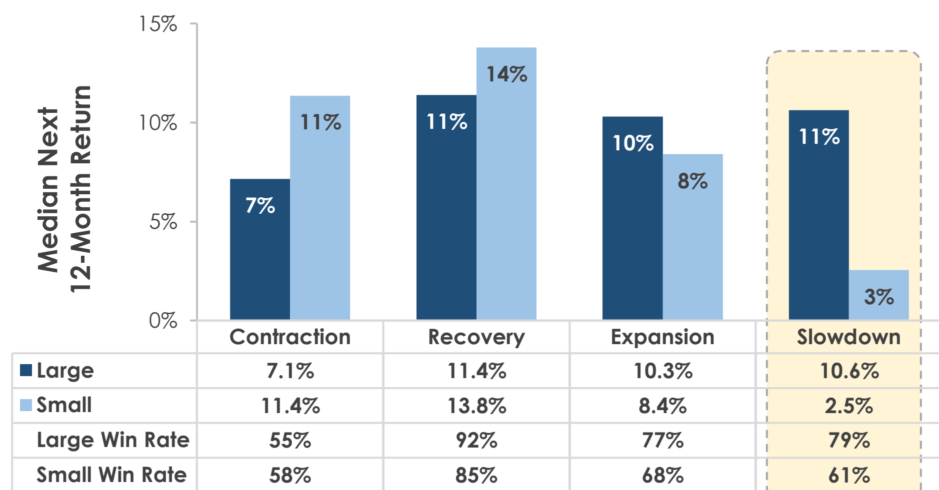
Source: MarketDesk Quant Pack

U.S. Economy Remains in the Slowdown Phase of the Business Cycle …

● Figure 12 graphs our U.S. Business Cycle Indicator, showing the U.S. entered the slowdown phase in May 2022. This view is supported by economic data with the LEI declining each of the past 11 months, housing activity slowing as mortgage rates spike, corporate earnings growth peaking, and consumer spending flatlining.

● Our base case continues to be that the U.S. economy will slow throughout 2023. One theme to note – the indicator, which is intended to be real-time, historically enters contraction territory before a recession is formally declared.

Figure 13: Large vs Small Return Gap Based on Business Cycle Phase



	Contraction	Recovery	Expansion	Slowdown
Large	7.1%	11.4%	10.3%	10.6%
Small	11.4%	13.8%	8.4%	2.5%
Large Win Rate	55%	92%	77%	79%
Small Win Rate	58%	85%	68%	61%

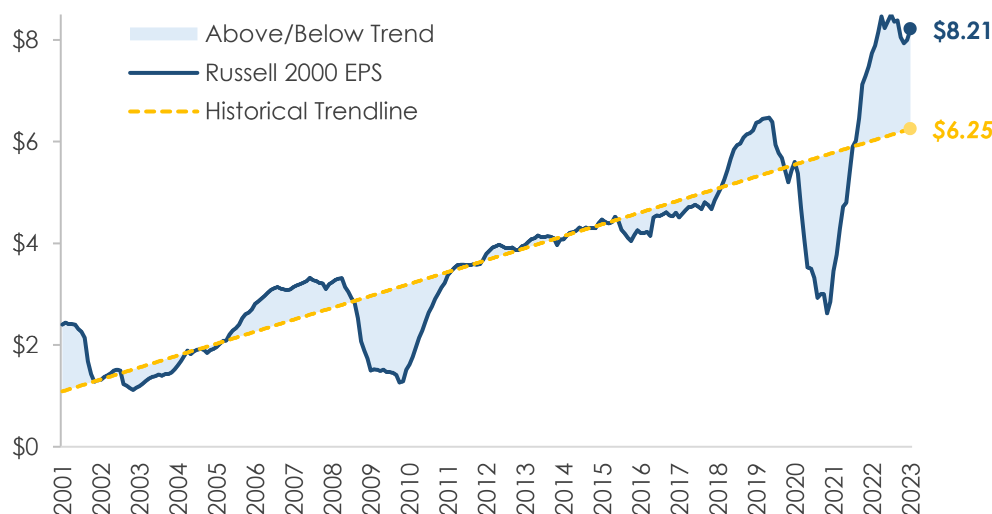
Source: MarketDesk. Analysis compares the S&P 500 and Russell 2000 indices.

Small Historically Underperforms Large Late in the Business Cycle …

● Figure 13 compares the Large vs Small price return gap based on our U.S. Business Cycle Indicator (*Figure 12*). Small historically outperforms early in the business cycle (i.e., contraction & recovery), but the risk/reward setup reverses in the final two stages of the business cycle when Small underperforms with a significantly lower win rate.

● The Small size factor is more attractive early in the cycle as earnings recover and P/E multiples expand. Until our *Quant Pack* indicators point to an improving macro backdrop, we favor Large's lower beta and earnings stability.

Figure 14: Small Cap Earnings Remain +30% Above Historical Trend



Source: MarketDesk. Analysis uses iShares' IWM ETF as a proxy for Russell 2000 Index.

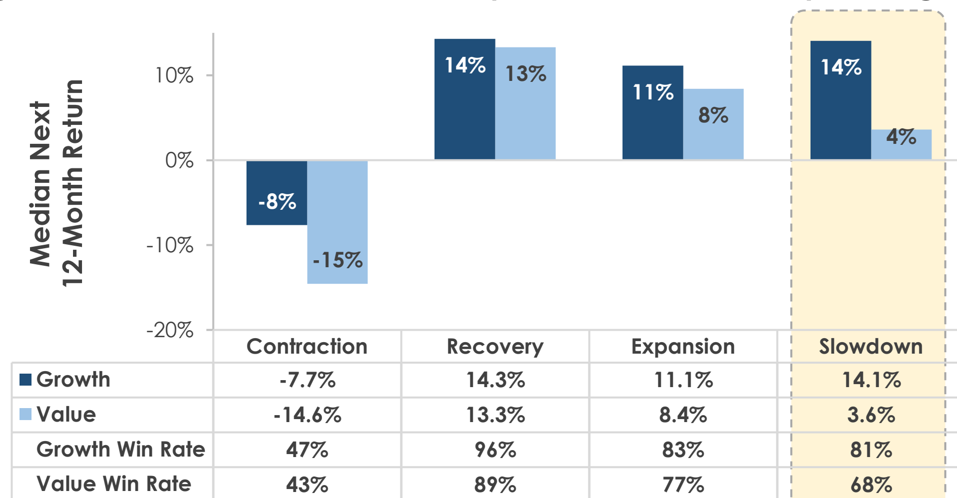
Small Cap Earnings Remain Significantly Above Trend (with Downside Risk) …

● Figure 14 graphs rolling last 12-month EPS for the Russell 2000 Small Cap Index. It shows Small Cap earnings have declined from their recent peak but still significantly above their pre-pandemic trend. Overstated earnings continue to be our primary concern in the Small Cap universe.

● Our view is that Small Caps appear optically cheap after profit margins soared to record highs during the pandemic. The risk is profit margins contract and earnings plunge in a recession, like 2008 and 2020, at which point Small Caps will not look nearly as cheap.

► **Remain Neutral Growth & Value:** The current late-economic cycle favors Growth stocks, which tend to be higher quality businesses with stronger fundamentals and more stable earnings (*Figures 15-16*). Multiple regional bank failures this year have demonstrated this dynamic by pressuring Value's Financial sector OW. While the macro backdrop and risk of negative EPS revisions favor Growth stocks, there are two themes preventing us from upgrading Growth to OW. First, Growth stocks are significantly outperforming the S&P 500 and Value factor YTD (*Figure 19*), which puts them at risk of being near-term overbought. Second, accelerated tech adoption during the pandemic led many Growth companies to increase their headcounts and expand operations. Companies have started to unwind their pandemic operational growth, but profit margins could remain weak.

Figure 15: Growth vs Value Return Gap Based on Business Cycle Stage



	Contraction	Recovery	Expansion	Slowdown
Growth	-7.7%	14.3%	11.1%	14.1%
Value	-14.6%	13.3%	8.4%	3.6%
Growth Win Rate	47%	96%	83%	81%
Value Win Rate	43%	89%	77%	68%

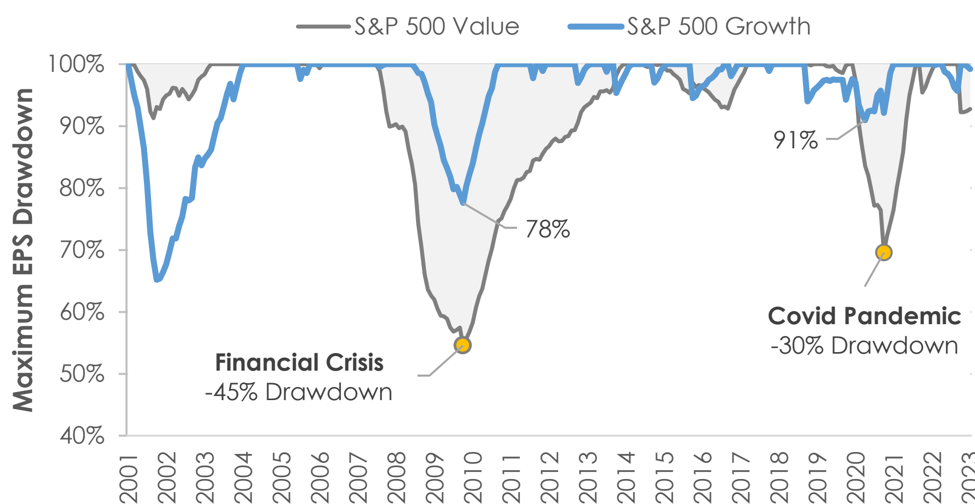
Source: MarketDesk. Analysis compares the S&P 500 Growth and Value indices.

Value Historically Underperforms Growth in the Slowdown & Contraction Phases …

- Figure 15 is the same concept as *Figure 13*, but compares the Growth vs Value price return gap. Growth's superior fundamentals and less cyclical exposure are clear differentiators during the slowdown and contraction phases, where it has a noticeably higher median return and win rate.

- In contrast, the Growth vs Value decision is more complex in the recovery and expansion phases, where the forward returns and win rates are similar. While the overall Growth vs Value return gap is not as wide as Large vs Small (*Figure 13*), it does highlight Value's more cyclical exposure.

Figure 16: Earnings Drawdown – S&P 500 Growth vs Value



Source: MarketDesk. Analysis uses SPYG and SPYV as proxies for S&P 500 Growth and Value, respectively.

Growth's Earnings Are Historically Less Cyclical Than Value's Earnings …

- Figure 16 compares Growth and Value earning drawdowns. With our S&P 500 Earnings Indicator forecasting -23% y/y growth, our focus is on big drawdowns around 2008 and Covid-19. In both instances, Growth's earnings were more resilient.

- Growth's earnings are historically less sensitive to economic activity and more stable than Value, a theme we expect investors to focus on as earnings deteriorate. Valuation is a function of EPS and P/E multiples, and we expect factors with greater stability to outperform on a relative basis in the event of a significant earnings contraction.

Figure 17: Next 12-Month P/E Valuation Gap – Growth vs Value

Source: MarketDesk. Analysis uses SPYG and SPYV as proxies for S&P 500 Growth and Value, respectively.

Checking In On The S&P 500 Growth vs Value Valuation Gap …

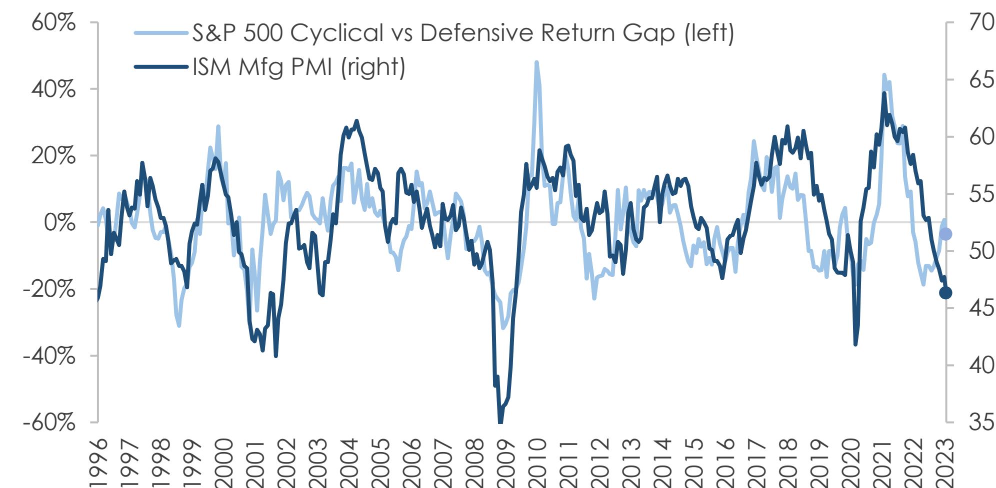
- Figure 17 graphs the NTM P/E multiple gap between S&P 500 Growth and Value. The gap peaked at +13.6x in November 2021 as the Fed cut interest rates to 0% and Growth stock valuations soared. While Growth still trades at a premium to Value stocks, the gap has tightened to +3.9x, in line with the 2009-2016 period.

- Like Small (*Figure 14*), our concern is Value's earnings will deteriorate more than Growth. The risk preventing us from upgrading Growth to OW is accelerated tech adoption during the pandemic and companies' related headcount / operational growth, which could depress profit margins.

Sectors & Industries

► **Maintain Defensive Sector Overweight:** There is no change to our sector ratings or views. Cyclical sectors ended 2022 with strong performance in the fourth quarter, and with the exception of Financials, have mostly traded sideways in early 2023. There is a clear divergence forming between the ISM Mfg PMI and cyclical/defensive sector return gap (*Figure 18*). Our view is the market is prematurely attempting to call the bottom in cyclical sectors and factors. Our PMI Leading Indicator forecasts the ISM Mfg PMI will continue to decline into the low 40s during the summer months. This forecast suggest defensive sectors can outperform and is a catalyst behind our decision to maintain the tactical Property & Casualty Insurance position (*Figure 20*).

Figure 18: ISM Mfg PMI vs Cyclical/Defensive Sector Return Gap



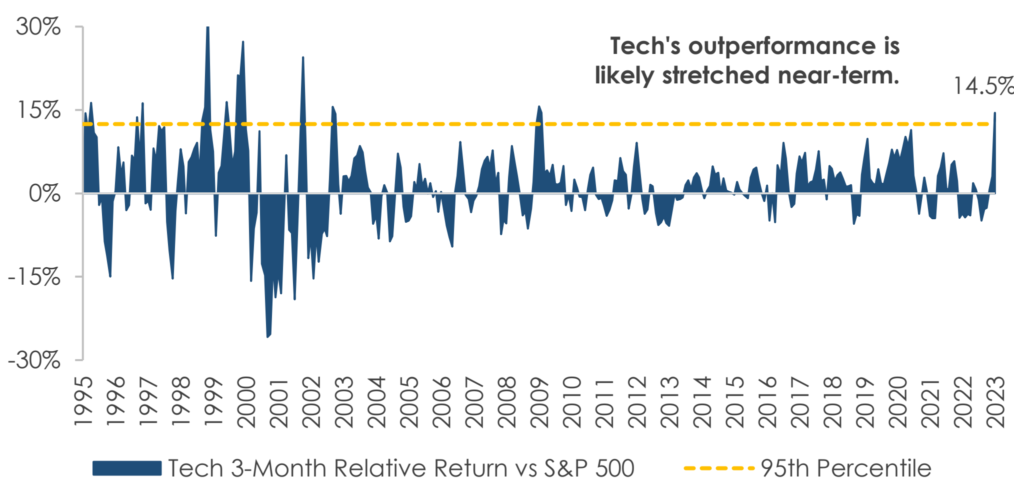
Source: MarketDesk, ISM. Defensive Sectors: Utilities, Health Care, & Cons Staples. Cyclical Sectors: Industrials, Materials, & Financials.

Cyclical Sectors Outperform Despite Forecast for Continued Mfg PMI Decline …

● Figure 18 graphs the S&P 500 Cyclical vs Defensive rolling 12-month return gap against ISM Mfg PMI. Cyclical sectors historically outperform as the Mfg PMI increases, and vice versa. The chart also shows the cyclical vs defensive return gap historically leads Mfg PMI, a theme we attribute to the market's forward-looking nature.

● Cyclical sectors outperformed in 4Q 2022, which continued into early 2023. However, our PMI Leading Indicator forecasts Mfg PMI will continue to decline and approach 40. Our view – investors are too early in calling the cyclical sector bottom.

Figure 19: 3-Month Relative Price Return Gap – Tech vs S&P 500



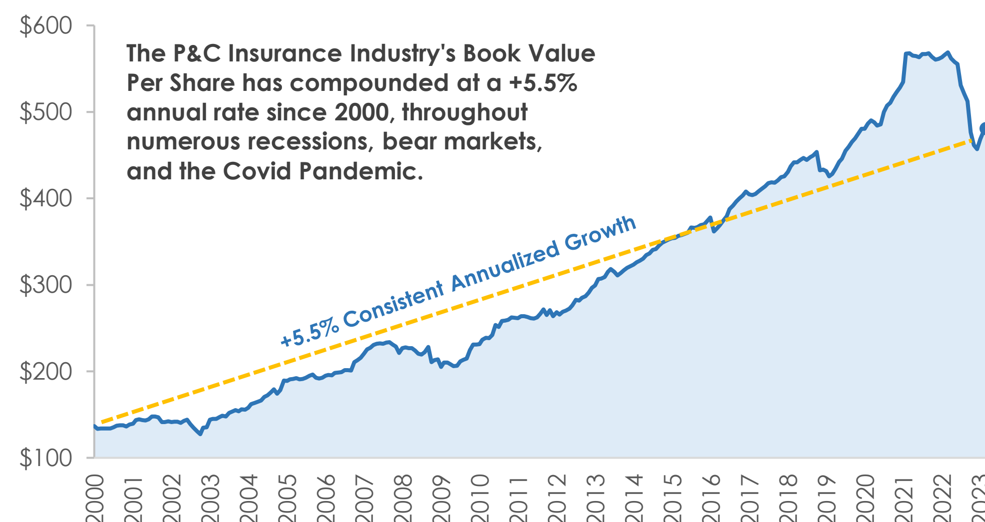
Source: MarketDesk

Tech's 3-Month Relative Outperformance vs S&P 500 Sits At 2009 Levels …

● Figure 19 graphs the rolling 3-month return gap between S&P 500 Tech and S&P 500 Index. Tech has returned +21.5% YTD, outperforming the S&P 500's +7.0% return. The yellow line shows the YTD outperformance ranks above the 95th percentile.

● The Tech sector, as well as other Growth-style sectors, are exhibiting strong price momentum to start 2023. The group's underperformance in 2022, the approaching end of the tightening cycle, and investors' rush to quality served as catalysts for the YTD outperformance. However, Tech and other Growth-style sectors appear stretched near-term.

Figure 20: S&P 1500 Property & Casualty Insurance – Book Value Per Share



Source: MarketDesk

Reiterating Our Tactical Property & Casualty Insurance Position …

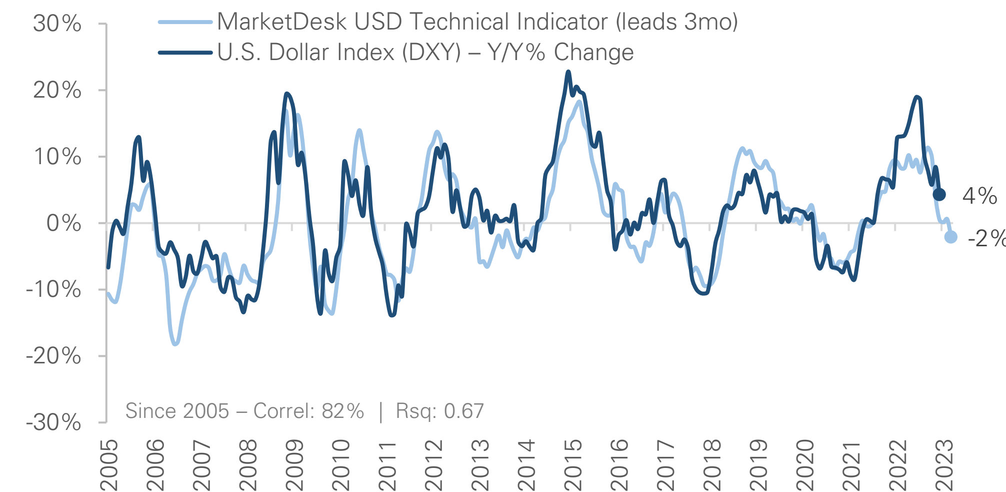
● Figure 20 graphs the P&C Insurance industry's book value per share. Book value increased early in the pandemic as the Fed cut interest rates to 0% and insurers recognized gains on their bond portfolios. After Fed rate hikes forced insurers to recognize bond portfolio losses in 2022, book value now sits in line with the pre-pandemic trend.

● Investors are questioning financial sector balance sheets after recent bank failures. P&C insurers were swept up in the sell-off, returning -6.1% despite owning shorter duration bonds, classifying them as 'available-for-sale', and already recognizing losses in 2022. We reiterate our ***tactical P&C position*** from 12/17/2023.

International Markets

► **Remain OW Emerging & UW Developed:** Following six months of macro turbulence, our base case is USD stabilizes in 2Q 2023 (*Figure 21*). The stabilization should eliminate a headwind for international equities, particularly EM equities, which are more sensitive to shifts in USD than DM. When allocating to global markets, investors should be mindful of the divergences in monetary policy that exist among countries. EM centrals banks pursued a more conventional monetary policy approach during the last decade, while DM centrals banks spent the past decade experimenting with various unconventional policy approaches. The result could be noticeable in the coming years as DM countries dig out from a period of unconventional policy that distorted financial systems and economies. Investors only need to look at recent U.S. bank failures to see the risks of unconventional monetary policy.

Figure 21: MarketDesk USD Technical Indicator

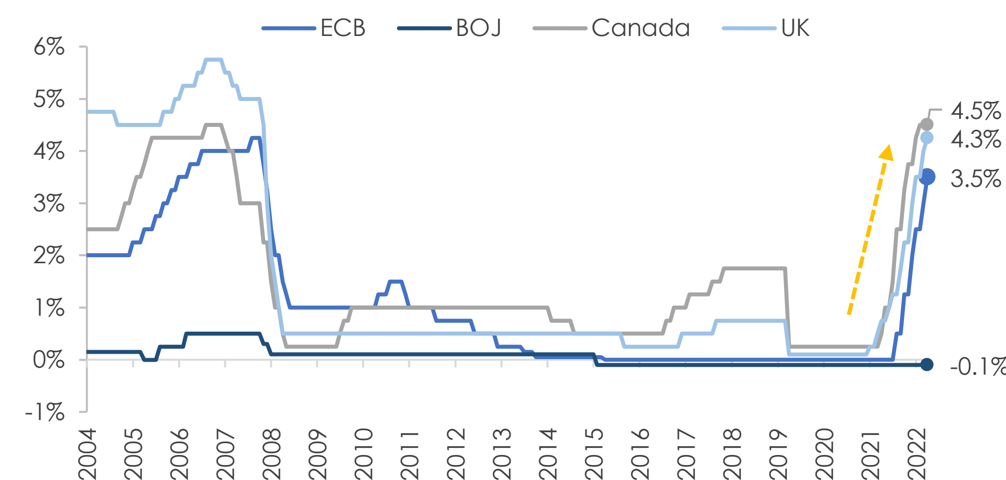


Source: MarketDesk Quant Pack

Our USD Technical Indicator Forecasts a Flat to Slightly Weaker USD in 2Q 2023 …

- Figure 21 graphs our USD Technical Indicator, which forecasts a stable / slightly weaker USD. Our view is similar to the indicator as we see few catalysts to strengthen USD. Bank failures (1) give the Fed less room to tighten and (2) show the financial system stress created by 2022's rate hikes.
- Both a lower terminal rate and elevated U.S. systemic risk should limit USD's strength, removing a potential headwind for international equities. However, the setup could reverse in 2H 2023 if a rapidly deteriorating global backdrop pushes investors toward USD's relative safety.

Figure 22: Developed Market Central Bank Policy Rates

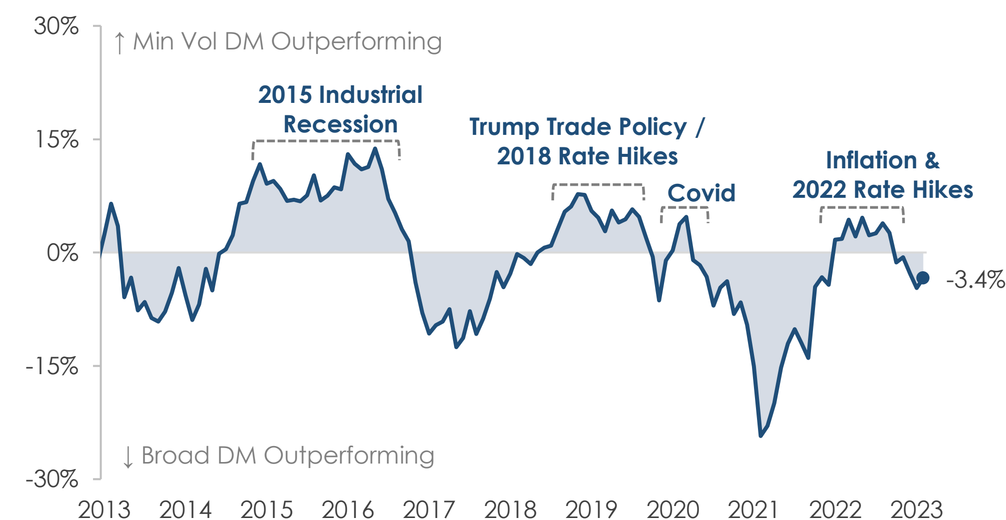


Source: MarketDesk, Various Central Banks

Emerging Market Central Bank Policy More Conventional Than Developed Market …

- Figure 22 charts policy rates across multiple DM central banks. Policymakers cut interest rates to 0% in 2008, left rates near 0% for a decade, and experimented with unconventional policy tools. In contrast, EM monetary policy was noticeably more conventional during the past decade.
- Interest rates are significantly higher, and bank failures highlight the systemic risk created by unconventional monetary policy. Given the policy divergence, EM economies may face less financial stress than prior cycles, removing a potential headwind for EM equities.

Figure 23: Rolling 12-Month Return Gap – Broad DM vs Min Volatility DM



Source: MarketDesk. Analysis uses iShares' EFA and EFAV ETFs as proxies for broad Developed and Minimum Volatility factor, respectively.

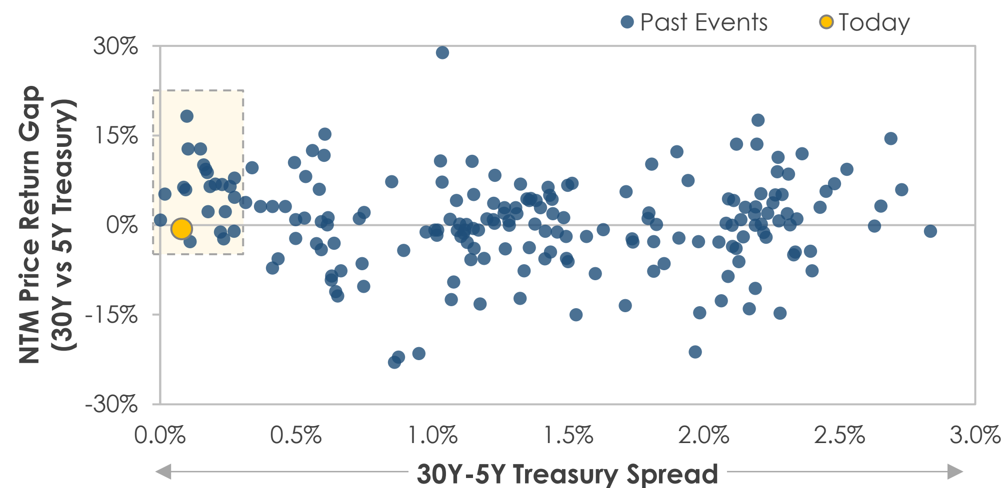
Developed Market Minimum Volatility Factor Protects Against Macro Uncertainty…

- Figure 23 graphs the rolling 12-month price return gap between the broad Developed index and Developed Minimum Volatility factor. Min Vol historically outperforms during period of macro volatility and underperforms during risk-on periods.
- A comparison between DM Min Vol (EFAV) and broad DM (EFA) shows Min Vol is OW defensive sectors (Con Staples, Comm Svcs, Utilities, & Health Care) and UW cyclical sectors (Cons Disc, Tech, Energy, Financials, & Materials). This lower beta, defensive sector exposure aligns with our USMRI (*Figure 9*) and forecast for a further decline in the ISM Mfg PMI (*Figure 18*).

Credit Duration — Long vs Short

► **Maintain Long Duration OW:** An uncertain macro landscape is the driving factor behind our continued Long Duration OW. A tight 30Y-5Y Treasury spread gives Long Duration a statistical advantage (*Figure 24*), with Long Duration historically acting as a hedge against both known and unknown macro risks (*Figure 26*). While Long Duration protects against deteriorating macro conditions and unknown systemic risks, there is a cost to protecting portfolios. Credit market volatility sits at 2008 levels as the Fed and investors navigate a confusing macro backdrop (*Figure 25*). For now, our focus is on bank failures and the risk that Fed tightening will break more parts of the economy and/or financial system.

Figure 24: Forward Price Return Gap Based on 30Y-5Y Treasury Spread



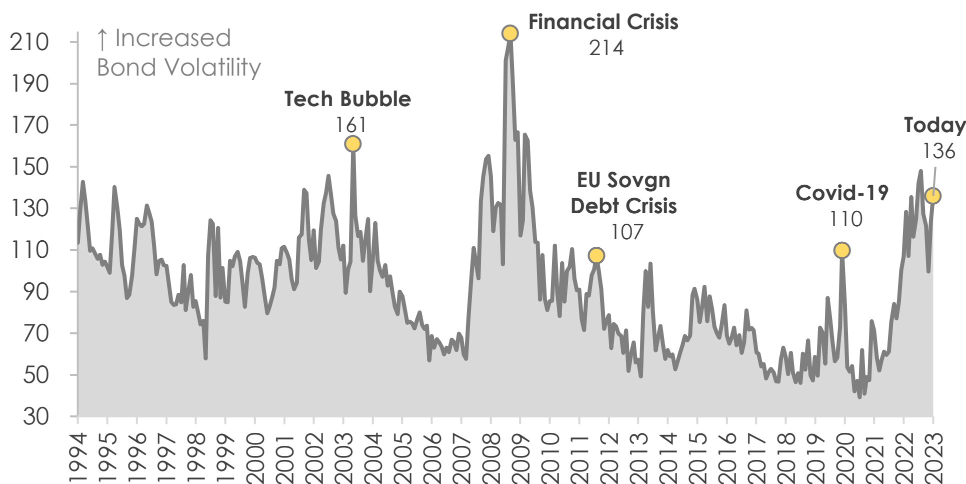
Source: MarketDesk, U.S. Treasury. Analysis is based on monthly datapoints since 2006.

Tight Treasury Spread Favors Long Duration During the Next 12 Months …

● Figure 24 plots the 12-month forward price return gap between 30Y and 5Y Treasury bonds based on the current 30Y-5Y spread. For reference, the yellow dot shows the 30Y-5Y spread currently sits at 0.08%, near the upper end of its 7-month range.

● History shows the range of possible outcomes widens when the spread is > 0.40%. As the spread tightens, the 30Y's win rate and median outperformance both increase. The yellow shaded box shows the 30Y outperforms with a high win rate when spreads are < 0.40%, such as today.

Figure 25: U.S. Treasury Market Volatility – MOVE Index (1994-Present)



Source: MarketDesk, ICE

Interest Rate Volatility Approaches 2008 Peak & Could Remain Elevated …

● Figure 25 graphs the MOVE Index, a measure of Treasury yield volatility. Interest rate volatility rose throughout 2022 as inflation soared and the Fed tightened. Volatility declined to start 2023 but has since reversed higher as investors and the Fed navigate mixed signals around strong economic data, persistent inflation, and bank failures.

● While a tight 30Y-5Y spread favors Long Duration during the next 12 months, interest rate volatility will make the path uneven and volatile. Our base case is Treasury yield and Long Duration volatility ease but remain elevated during 2Q 2023.

Figure 26: Long Duration Treasury vs Corporate Price Return Gap

Source: MarketDesk. Analysis is based on the ICE BofA US Treasury (+10Y) and ICE BofA US Corporate (+10Y) indices.

Long Duration Treasuries Outperform Long Duration Corporates In Times of Stress …

● Figure 26 charts the rolling 12-month price return gap between long duration treasuries and long duration corporate investment grade. Not surprisingly, treasuries historically outperform during periods of macro weakness and financial stress. The data is another timely reminder to tailor duration to the current macro regime.

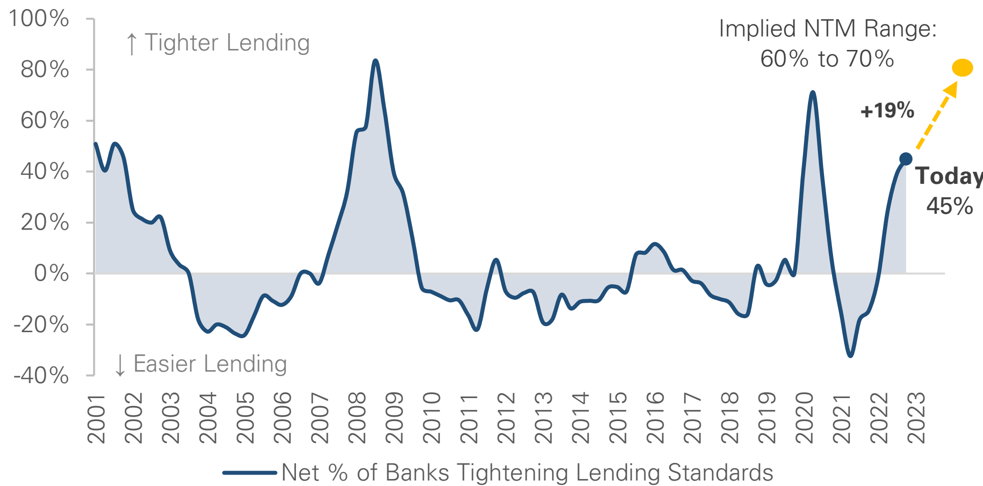
● Our Long Duration OW is driven by an uncertain macro landscape and concern that more stress may be hiding in the financial system. Interest rate volatility could be a headwind near-term, but we view Long Duration as a tool to protect portfolios against a deteriorating macro outlook.

Credit Quality — HY vs IG

► **Remain OW Corp IG & Corp HY:** Credit risk continues to rise as lending standards tighten, macro conditions deteriorate, and corporate fundamentals weaken. Borrowers are living off a decade of low interest rates, but time is running out as debt maturities approach and fundamentals weaken. Riskier credits remain an UW, including Corp HY, leveraged loans, and private market debt.

► **Add Preferred Stocks to Watchlist:** Preferred stocks, which are primarily issued by financial institutions, traded lower in March as three regional banks failed. The magnitude of the held-to-maturity bond losses is widely known, but the risk of losses on commercial real estate and other loans is still unknown. Invesco's PGF ETF, which owns financial sector preferred stocks, is on our buy watchlist.

Figure 27: MarketDesk U.S. Lending Standards Indicator



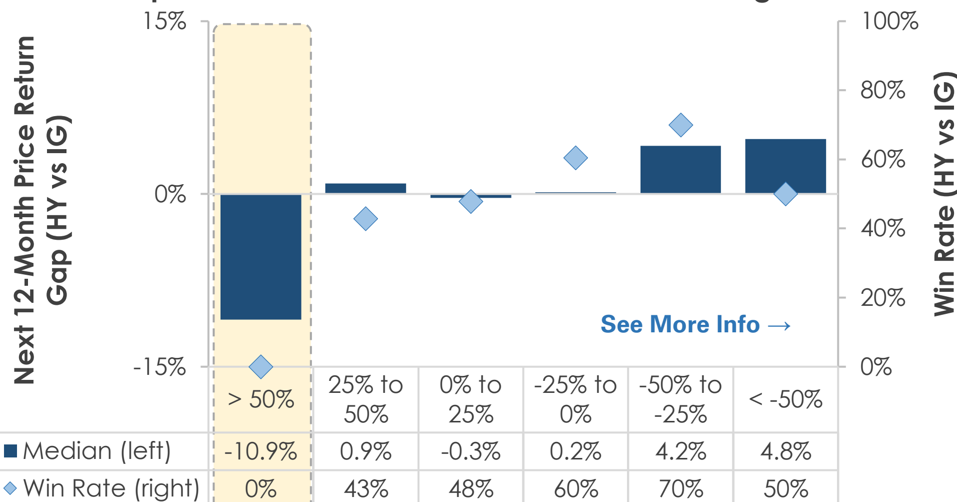
Source: MarketDesk Quant Pack, Federal Reserve

Bank Lending Standards Forecasted to Tighten Further During the Next 12 Months …

● Figure 27 graphs our U.S. Lending Standards Indicator. The pace of tightening is forecasted to slow over the next 12 months, but overall lending standards are forecasted to tighten. The ***3/24/23 Weekly Note*** discusses how recent bank failures could add to the tightening as banks respond to a weak economy and deposit flight risk.

● Bank lending standards is our leadoff chart for a second consecutive *AAGuide*. Credit access is a key driver of economic growth and promotes financial stability, two reasons why reduced lending increases overall credit risk.

Figure 28: Corporate Bond Price Returns Based on Lending Standards



	> 50%	25% to 50%	0% to 25%	-25% to 0%	-50% to -25%	< -50%
■ Median (left)	-10.9%	0.9%	-0.3%	0.2%	4.2%	4.8%
◆ Win Rate (right)	0%	43%	48%	60%	70%	50%

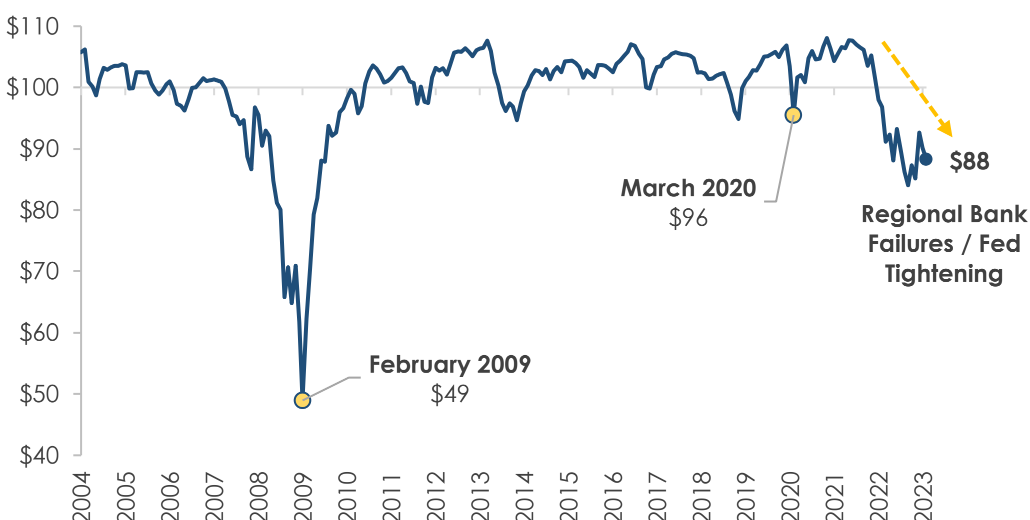
Source: MarketDesk. Analysis is based on the ICE BofA US Corp and ICE BofA US High Yield indices.

High Yield Historically Underperforms After Banks Tighten Lending Standards …

● Figure 28 pulls *Figure 6* from the ***3/10/23 Strategy Snapshot*** on bank lending standards. The yellow box shows HY significantly underperforms IG after banks aggressively tighten lending standards, such as today. In contrast, HY's biggest outperformance and highest win rates typically occur after banks relax lending standards.

● Tighter lending standards increase default and refinancing risk, resulting in wider credit spreads (***1Q23 AAGuide Fig 27***) and negative HY returns. Click '*More Info*' to see credit return statistics, and refer to the *3/10 Snapshot* for more commentary.

Figure 29: Preferred Stock Price Index (2003-Present)



Source: MarketDesk. Analysis is based on the ICE BofA Fixed Rate Preferred Index.

Bank Failures Weigh on Preferred Stocks …

● Figure 29 charts the price of the fixed rate preferred stock index. Like most credit classes, preferred stocks traded lower in 2022 as the Fed tightened. While most credit classes are trading higher in 2023, preferred stocks are trading lower due to recent bank failures. Financial institutions are the primary issuers of preferred stock, and investors are concerned about banks' capital strength due to bond portfolio and loan losses.

● Preferred stocks trade at their lowest price level and offer their highest yield since 2008. Held-to-maturity bond and loan losses still represent a risk to bank balance sheets, but preferreds will become more attractive tactically as the dust settles.

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Quarterly Roadmap to Enhance Investment Committee Decisions

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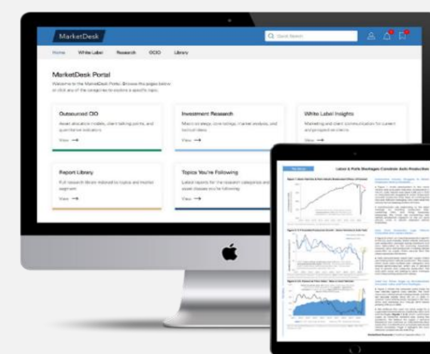

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