Graves Light Lenhart
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Graves Light Lenhart May '23 Market Commentary

A Narrow Market Recovery Continues

Market Overview:

Markets were generally mixed during May, highlighted by the standout performance of a handful of large Technology stocks reacting positively to the future potential of Artificial Intelligence (AI). Additionally, the ongoing "on-and-off-and-now-on again" negotiations resulted in a debt ceiling deal at the eleventh hour. While the equity markets were generally unbothered by the political uncertainty generated over the course of the month, short-term Treasury Bill yields suggested elevated default concerns as talks went down to the wire. Those concerns have now dissipated with the proposed deal now in the final stages of being signed into law.

On the economic front, while many strategists have been predicting an imminent recession, the US economy has remained surprisingly resilient. At the end of the month, the Atlanta Fed released its GDPNow calculation showing that Q2 '23 (June-end quarter) is now tracking at a 2.0% annualized rate with real personal consumption expenditures (PCE) remaining firmly in positive territory. While the recent banking crisis seems to have stabilized, economic pessimists continue to posit that the Federal Reserve isn't finished raising interest rates because inflation isn't coming down fast enough, with markets discounting an additional 25 basis point (0.25%) rate hike at some point to a range of 5.25-5.50%. As monetary policy acts with a lag, we recognize that the lingering effects from the rapid escalation in rate hikes since early last year are still making their way through the economy and constitute a legitimate signal that a recession very well may occur later this year.

Separately, most recent inflation data – as represented by CPI – rose at only 4.9% in the 12 months to April, down from 5.0% a month before. The "core" index, which excludes food and energy, dipped from +5.6% to 5.5%. Encouragingly, services inflation, which are particularly driven by wages, also edged lower from elevated levels. While both price and wage moderation is welcome and lessens the risk of a dreaded "wage-price spiral", their too-high-for-comfort levels do suggest that the Federal Reserve will not relent on rates any time soon.

Asset Performance:

Key US Index Returns	YTD '23	May '23
S&P 500	+9.7%	+0.4%
Nasdaq	+24.1%	+5.9%
Dow Jones Industrial Average	+0.3%	-3.2%

Relevant Fixed Income Yields	YE 2022	May '23
US 10-Year Treasury Note	3.88%	3.63%
Investment Grade Corp. (C0A0)	5.5%	5.4%
High Yield Corp. (H0A0)	9.0%	8.8%

Source: Factset as of 06/01/23

While uncertainty reigned across US markets during May, better-than-expected earnings broadly helped stabilize stocks. While the S&P 500 posted a gain of 0.4%, this was entirely fueled by the strength of Mega-cap shares. Technology stocks, in particular, were back with a vengeance after their dreadful 2022. While good performance by the biggest companies isn't unusual, so far, the equal-weighted S&P 500 trails its cap-weighted version by the most on record. According to Ned Davis Research, year-to-date, only 24.5% of stocks have outperformed the index. If this metric holds through to the end of the year, it would be the lowest percent outperforming the index on record, going back to 1973. In short, the year-to-date S&P 500 recovery of +9.7% has been exceptionally narrow with the median stock being down 1.6% through the end of May.

Fixed income performance was broadly negative as interest rates, on balance, moved higher during the month. Within fixed income, we closely monitor credit spreads, which are a useful measure to track implied default risk for US corporates carrying debt on their balance sheets. By historical standards, credit spreads remain within their long-term averages and have actually lowered (or tightened) – which is a positive signal – from their recent March peak when banking sector fears were at their worst. This suggests limited carnage wrought to the riskier corners of the US debt markets. At yield levels of just north of 8.5% (depending on the benchmark cited), we see semi-liquid credit markets as an opportunity to capture equity-like returns over a multi-year horizon. Separately, we remain constructive on short duration, high quality/Investment Grade fixed income markets, where yield levels provide a palatable return profile with improved diversification benefits relative to the interest-rate backdrop observed prior to the Fed's hiking cycle.

Summary Thoughts:

While relative returns reached extreme levels over the past few months, is a concentrated market recovery a negative sign? From our perspective, not necessarily, yet it does warrant some caution in that for a healthy market recovery to be sustained, we need to see a greater breadth of recovery for the balance of the market. We sum it up with an old battlefield analogy. In this example, the generals represent the narrow set of market leaders, the troops represent everything else. If the troops aren't on the battlefield, the generals need to protect themselves. In order for the ongoing equity recovery to be sustained, the rest of the market can't be permanently missing in action (MIA).

Warm regards,

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