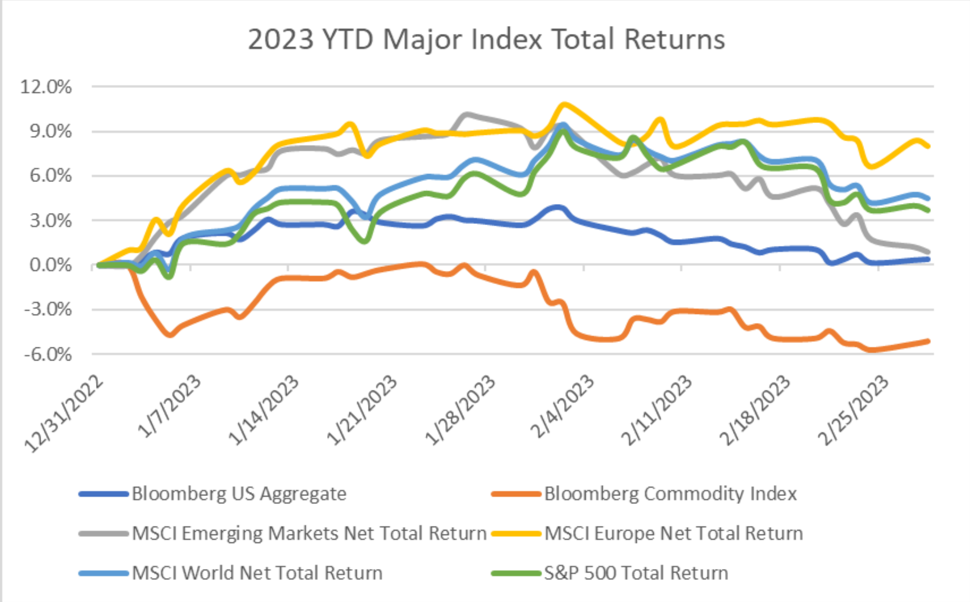
ENCORE INVESTMENT ADVISORS

FEBRUARY 2023 MARKET REVIEW

Market Recap: Last month we discussed the evidence supporting the possibility of soft and hard landings. A soft landing would be characterized by the avoidance of a recession, coupled with further easing of inflationary pressures. A hard landing would be characterized by a moderate or severe recession in which a spike in unemployment and lower consumption ultimately lead to lower inflation. There is, however, a third potential scenario whereby the economy does not enter a recession and inflation remains stubbornly high. To combat this sticky inflation, policy rates are kept at elevated levels longer than expected. This third scenario is being termed as a ”no landing” and has garnered significant attention over the past month. Cases can be made for each of these scenarios as there is no clear-cut path forward, which makes portfolio positioning quite difficult at the moment.

Given the incredibly strong financial market returns in January, it is no surprise that there was indeed a small pullback in February. Global equities fell -2.4% and US bonds struggled, falling -2.6% for the month. The short end of the yield curve has continued to shift higher, with 6-month treasury bills yielding 5.2% currently; 40 basis points higher than two months ago. Not only has a portion of the treasury curve shifted higher, investors are now pricing in additional Fed rate hikes in 2023 with a peak Fed funds rate between 5.25% and 5.5%. The January inflation readings and the employment market reports came in stronger than expected, driving interest rates and expectations of the Fed Funds rate higher, and equities lower. The market seems to be stuck in this “good news is bad news” mindset, where positive economic data leads to a negative outcome for equities.

How does this impact our perspective? The past five months have brought about a recovery in equity and fixed income markets from the late September lows. We continue to believe that future portfolio returns will be determined by the path of inflation, and the knock-on effects of inflation to interest rates, as well as the value of the dollar relative to other currencies. As we think through the above-mentioned possible outcomes, portfolios will obviously perform differently in each of these scenarios – in a hard landing, bonds should outperform equities; in a soft landing, equities should outperform bonds; but, a “no landing” scenario is a wild card. Much of our asset allocation work involves studying previous environments with similar attributes as those of the current market. The difficulty with this approach is that the economy today is much different than it has been in previous bouts of inflation, and therefore any indications from the past need to be taken with a grain of salt. One aspect is certain - yield curve inversion (short term rates being higher than long term rates) like we have seen recently, has historically always led to a recession (with a lag). Will this time be any different? Unfortunately, only time will tell. There have been many surprises over the past three years; avoiding a recession in 2023 or 2024 would be another surprise to us.



Data Source: Y Charts

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