Quarterly Market Overview
2Q 2023

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MWC Group
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"People should like something less when its price rises, but in investing they often like it more."

- Howard Marks. Co-founder and Co-Chairman of Oaktree Capital Management

These have been good times for those who participated in 2023's equity market rally. Such rallies can become self-sustaining, particularly if investors fear that they may be missing out. A more sober assessment would suggest that not only have market returns been highly distorted by the distinct outperformance of a few significantly-weighted names, but also that the macro environment remains highly uncertain. Beware of complacency. A recession may still happen, particularly since Central Banks continue to struggle to repress inflationary pressures and stand committed in their fight to quash inflation fully. Further tightening until something breaks may well be the order of the day. Nonetheless, for as long as the economy is showing resilience and corporate earnings are holding at least stable, equities can remain in vogue, valuation considerations notwithstanding.

Really?

Pinch yourself, but yes, global equities gained 14.0% in the year-to-date, with the S&P 500 Index rising 15.9%. The NASDAQ Index has done even better, up 38.8%. If you'd owned the NYSE FANG+ Index you would have made 74.1%, while holding NVIDIA – the poster child for AI – would have returned investors 189.5% since the start of the year.

These are impressive figures, but they are also suggestive of a very distorted market. Consider that three stocks (NVIDIA, Apple and Tesla) have been responsible for circa 40% of the S&P 500 Index's return year-to-date, while if you were to add in Microsoft and Amazon, then this quintet would account for over 60% of the Index's return. Put another way, fewer than 30% of the names within the S&P 500 Index have beaten the Index year-to-date, a lower figure than at the peak of the 1999 TMT boom and indeed the lowest in 32 years.

A more sobering picture is presented when you consider the equal-weighted return for the S&P 500 Index year-to-date: just 6.0%. Data for the MSCI World Index tell a similar story. Consider that on a headline basis, the US constitutes a 68.9% weight in the Index, with its largest constituent (Apple) at a 5.3%. An equal weighted MSCI World Index would have returned 7.7% year-to-date.

Just take a moment to read that last paragraph again. If you are looking at your valuation statement and asking yourself why your portfolio is not up as much as the S&P500 or the Nasdaq, it is because you are not invested in the FAANGs or whichever acronym you prefer. That is not to say that you have no exposure to them or to technology broadly, but the point is that your portfolio is broadly diversified and so an equally-weighted index would be the more representative benchmark to compare against.

Valuations

Take whatever narrative you want, but equities globally are at (or close to) 12-month highs. The upside has been partially driven by the fact that corporate earnings have generally been less bad than feared, sustaining forward estimates for now. Nonetheless, after such a strong H1 rally, the scope for near-term upside to equities should be more limited, even if bubbles can sometimes

prove self-sustaining for longer than expected. Looking ahead, we believe that a higher rate environment where inflation is present only raises the risks to earnings, with visibility for 2024 estimates currently low.

Two other interrelated considerations also deserve clear mention. Don't forget about valuation, particularly in the context of a still very uncertain macro environment. The returns delivered by the handful of companies mentioned above have resulted in the expansion of their price/earnings ratios which is discounting continuing profitability ***tomorrow***, not increased profitability ***today***. Put simply, headline multiples are discounting an awful lot and may not prove sustainable. Investors today are paying a multiple of 205x current earnings for NVIDIA. The 'big-three' names in the S&P 500 Index trade on a P/E of over 60x and the top-5 on a multiple of more than 30x. The rest of the Index, for context, trades on less than 20x (all data cited above, per Bloomberg).

FOMO (the Fear Of Missing Out) has driven a large part of the rally in risk assets year-to-date. As a phenomenon, it's also a classic inflator of bubbles. By not owning the 'obvious' stocks, investors have indeed missed out. However, participating now means paying up. It can sometimes be hard to stand in the way of a herd of bulls. Missing out on rallies can be painful, but so can the hangover after the party, generally even more so. Narrow market leadership is not reason enough to sell but may make the pain worse when the bubble does burst. It is likely that global equities almost certainly did bottom in October 2022 (and few saw the AI rally coming), but this does not mean unambiguous plain sailing from here. Further, without the AI narrative, the market's performance would likely have been be rockier and its participants' optimism less assured.

Interest rates and Yields

Put another way, the rally may fray under the threat of more rate hikes and fears that the full impact of aggressive Central Bank policy has yet to be felt. Whether you like it or not, Central Banks continue to struggle to repress inflationary pressures. Correspondingly, were the Fed (and its peers) to reintroduce an element of fear through its policy decisions, this could presage some form of market collapse. At the very least, we need to be wary of complacency: a recession may still happen. Arguably, it needs to happen, in order to fully quash inflation.

Unquestionably, this has been a highly unusual cycle, with US inflation still at its highest since 1988 and unemployment at its lowest since 1968 (per Bloomberg). The economy's resilience has been impressive – consider recent housing construction and retail sales data points. Central Banks may therefore continue to tighten until something breaks. Listen to the Fed and Jerome Powell says only that the FOMC is "close to where its destination is" on rates. Forget the rhetoric though and look at the 'dot plot' projections of the Open Committee members. Irrespective of June's pause, 16 of the 18 members are calling for at least one more hike before year-end. Other Central Banks around the world also appear resolute in their fight against inflation, with rates having increased in the past month in Australia, Canada, the Eurozone (to the highest level in 20 years), Norway, Switzerland and the UK.

US bond yields have risen from their Q2 lows as the prospect of further rate increases has grown. While we do see a generally better risk-reward profile in bonds versus equities (based on yield), a rally in bonds will only likely prove sustainable once the US economy weakens, inflation falls further, and the Fed potentially capitulates. One lesson investors with experience should probably

take on board is the familiar mantra: don't fight the Fed. Put another way, Central Banks globally are unlikely to waver in their fight against inflation. To have described it (as Jerome Powell did) as 'transitory' was clearly the wrong call. Against this background, Central Banks are unlikely to risk credibility by stopping short of fully quashing inflation. With wages rising at circa 6% and housing costs at circa 8% (on an annual basis) and corporates continuing to pass on price increases as a way of protecting margins, inflation in the US has still to be considered sticky.

The biggest unknown is when 15 months of rate hikes will start to have an impact. There is no historic precedent for avoiding recession with such aggressive hiking and an inverted yield curve. Causation and correlation remain a topic of intense debate, but logically, if you tighten policy hard enough to invert the curve, then it should hardly be surprising if you do get a recession. The US curve (the difference in the yield between 3-month and 10-year Treasuries) is at its most inverted since 1981, excluding March's banking crisis. Bulls may wish to believe otherwise, but the economic cycle has not gone away.

It may not be all bad news

Set against this conflicting macro backdrop, it's important not to forget that markets are very forward looking. We caution against comparing this cycle to prior ones given the unprecedented circumstances of the last three years (the pandemic, supply chain shock and monetary response). Similarly, no two recessions are alike. Nonetheless, what we do know is that there was a major valuation reset last year in both equities and fixed income. Against this background, it would be fair then to recognise that even with a pause in the very near-term, the path of least resistance for both equities and fixed income may be up. As we've noted previously, it may be no more complicated than simply adopting the mantra of follow the money. Put another way, risk assets will likely continue to discount an imminent easing (or at least no further tightening) in Fed policy. At the same time, equities may well be able to weather any recession, simply since its impact could be offset by growing disinflationary forces. In this scenario, lower bond yields would also be supportive in helping to underpin equity multiples.

Investors may yet be able to have their metaphorical cake and eat it. An optimal scenario, which is far from inconceivable, would be one of a mild recession, ongoing disinflation (from its highs) and still positive earnings growth. Set against this dynamic needs to be a recognition that the current combination of still-high inflation and low real GDP growth is neither desirable nor sustainable over the longer-term. The path forward is likely to be far from linear…

Eating our hat?

The reference above comes from the expression: "if <condition met/not met>, then I'll eat my hat!"

We have long been critics of Central Bank policy decisions. We have long decried the extreme measures taken and their duration, particularly those in response to and since the global financial crisis of 2008/09. Specifically, we feel that the lockdowns following the outbreak of Covid, however unnecessary they were, were nevertheless, a political decision and it put the central banks in a very difficult position with respect to their dual mandates of price stability and maximum employment.

Looking at their actions charitably (it must be due to the lovely summer weather), we can say that

the politicians gave the economy a lethal dose of lockdown and then asked the central banks to find the antidote. We agree (this is the charity bit coming up right now) that the correct course of action was to flood the system with money to grease the engine to get it going again. Where we disagree is in the duration and extent of that stimulus. Let us presume that the central bankers wanted to err on the side of caution and make sure that the engine that is the economy was humming along very nicely before reducing the amount of stimulus. Having been a smidgen too cautious before reducing stimulus, the very rapid rise in inflation took them, we believe, off guard such that they were forced to apply the brakes and, to continue with the driving analogy: perform an emergency braking manoeuvre safely without skidding. In stomping on the brakes by front-loading the increase in interest rates, the central bankers may well have staved off rampant inflation, but it remains to be seen whether they have done enough, too much or too little.

In the economy, the forces of inflation, interest rates, availability of labour, remaining supply chain dislocation, sanctions, etc, etc, will eventually coalesce as they converge on economic activity. ***IF*** the central bankers have got it right, inflation will continue to trickle lower and interest rates will eventually follow suit. If too little, interest rates may have to rise until something does actually break, Silicon Valley Bank (SVB) and the like aside. If something significant does break, it will most likely make the SVB collapse look like a picnic in the park. If too much tightening has taken place, they now have the firepower to meaningfully reduce interest rates, should that be appropriate, but there is scant evidence so far that the economy is hurting at current interest rates. Bear in mind that interest rates work with a lag, so what we are beginning to see is the effect of those initial rate increases from last year. What will happen when the effects of the rest of the series of 50bps hikes start to manifest themselves?

…and what if the central banks do start cutting rates, how certain will they be that inflation has been quashed? Would they risk their credibility by cutting rates only to see inflation pick up again?

As you can surmise, the jury is still very much out as to how this will play out. The markets will price the outcomes above appropriately with the goldilocks scenario likely leading to new all-time highs in equity markets. Either side of that lie the (admittedly extreme) scenarios of a ‘hard landing’ or runaway inflation neither of which are likely be pleasant for investors. We think that trying to fine-tune such a bloated financial system is going to be a futile task, but please pass the salt and pepper - just in case we are wrong.

Enough of mixing metaphors and on to the market data…

Economic Data Table

June 2023

Stock Markets	Month	Q2 23	YTD	GDP YoY	Interest Rates	Inflation Rate
United States	6.47%	8.30%	15.91%	1.80%	5.25%	4.00%
Euro Area	4.29%	1.95%	15.96%	1.00%	4.00%	5.50%
Germany	2.97%	0.34%	12.30%	-0.50%	4.00%	6.40%
France	4.25%	1.06%	14.31%	0.90%	4.00%	4.50%
Italy	8.37%	4.12%	19.08%	1.90%	4.00%	6.40%
Spain	6.00%	3.90%	16.57%	4.20%	4.00%	1.90%
Greece	4.92%	21.24%	37.52%	2.10%	4.00%	2.80%
Switzerland	0.56%	1.57%	5.13%	0.60%	1.75%	1.70%
United Kingdom	1.15%	-1.31%	1.07%	0.20%	5.00%	8.70%
Brazil	9.00%	15.91%	7.61%	4.00%	13.75%	3.94%
Russia	2.93%	14.15%	29.86%	-1.80%	7.50%	2.50%
India	3.35%	9.71%	6.37%	6.10%	6.50%	4.25%
China	1.16%	-5.15%	-0.75%	4.50%	3.55%	0.20%
Japan	7.45%	18.36%	27.19%	1.30%	-0.10%	3.20%
MSCI World Equity Index	5.64%	5.58%	12.80%			

Bond Indices	Monthly	Q3 23	YTD
Barclays Capital U.S. Aggregate Bond Index	-0.48%	-1.54%	1.18%
Barclays Global Aggregate ex-USD Float-Adjusted Index (Hedged)	-0.14%	-0.08%	3.06%
J.P. Morgan Government Bond Index Emerging Markets Global Core Index (Local Currency)	2.24%	1.23%	5.49%
Barclays Global Aggregate ex USD 10% Issuer Capped (Hedged) Index	0.18%	0.69%	3.66%
The Bloomberg Barclays Global Aggregate Bond Index	0.19%	0.00%	2.78%

Currencies	Monthly	Q3 23	YTD	Price
EUR/USD	2.08%	0.66%	1.94%	1.09
GBP/USD	2.15%	3.01%	5.02%	1.27
EUR/GBP	-0.06%	-2.29%	-2.93%	0.86
USD/CHF	-1.67%	-2.13%	-3.15%	0.90
EUR/CHF	0.38%	-1.49%	-1.26%	0.98
USD/JPY	3.57%	8.68%	10.08%	144.32
GBP/CHF	0.44%	0.82%	1.72%	1.14

Commodities	Monthly	Q3 23	YTD	Price
Gold	-2.18%	-2.46%	5.22%	1919.57
Oil (WTI Crude, NYMEX)	3.87%	-6.88%	-12.64%	70.37

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