1st Quarter North American Market Commentary – 2023

Key Take-aways:

- The S&P500 posted +7.03% for Q1 2023. Seven high growth companies represented 90% of the S&P500's gain in Q1.
- Inflation is not decelerating quick enough nor near its 2% target for the FED to pause rates let alone begin cutting.
- On March 22nd FED Chairman Powell raised rates an additional 0.25% for the 9th consecutive time. This is now the highest FED Funds Rate since September 2007.
- The rate of change of the US economy continues to slow at a faster pace. Companies and analysts are late to revise forecasts. The return of elevated equity volatility is probable.
- The US consumer is not well positioned for this downturn.
- In a typical hiking cycle, cracks begin to appear from the second year on. Conditions are in place and credit events are beginning to appear.
- If the FED does pivot, cutting rates mean the economy is worse than most market participants believe.
- Current bank stress represents the biggest challenge to financial stability since the Great Financial Crisis in 2008.
- Q2 2023 is shaping up to be a difficult period with a climatic point being the debt ceiling debate in June.

Positioning:

- Monetary policy is still very restrictive and the damages to the economy are still rolling through at a considerable lag. The way forward is risk managing a recession.
- Maintain US dollar exposure. Amid a poor global economic setup among developed countries, the Dollar remains strong.
- US 10yr & 20yr Yields are falling as economic data continues to slow. Introduce fixed income exposure to set up for the recessionary GDP that should be reported by April.
- Maintain defensive posture, add utilities, consumer staples and health care, focusing on investible volatility and reducing net market exposure.
- Execute on selective shorts on vulnerable sectors/indexes such as high beta, cyclical growth and high yield bonds.
- With inflation peaking and the FED tightening (that is negative real rates) this environment supports an allocation to precious metals.
- Beware bear-market bounces and position for weaker corporate earnings.

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Q1 2023 brought shifts in investors' expectations regarding falling interest rates, disinflation, the economic outlook, and more recently, the health of the banking system. The S&P500 posted +7.03% for Q1 2023. Seven high growth companies represented 90% of the S&P500's gain in Q1, AAPL and MSFT alone were 40% of it. Trading volumes continue to accelerate on down days and decelerate on up days. These results are very narrow and not indicative of a healthy market. To believe S&P500 postive performance is sustainable we must disprove the prospect of a recession. Since 1957 the S&P500 has never bottomed before a recession even began.

On February 1st and March 22nd Chairman Powell raised rates for the 8th and 9th consecutive time by an additional 50bps. This is now the highest FED Funds' Rate since September 2007. The FED has embarked on its most aggressive series of rate hikes since the 1980s. In the 1980s, FED Chair Volcker tried to tame inflation by raising the FED funds rate up two-fold from 10% to 20%. FED Chair Powell in 2022/23 has so far increased rates 19 - fold from 0.25% to 4.75%. As can be seen, the 2022/23 version of rate hikes on a rate of change basis, is far more aggressive. Monetary policy has a delayed effect as inflation stays higher for longer than investors expect, central bankers raise rates for higher and longer than expected, and ultimately the economic data slowing is greater than expected. We remain in a new inflation volatility regime, significantly skewed to the upside of what was previously considered normal.

Further on the inflation front, there's an interesting picture emerging where following a period of disinflation from the June 2022 highs, the pace of disinflation is not quick enough for the FED and this will represent the conundrum for the FED as levels of unemployment will likely still be too low and inflation still too high to justify the highly-anticipated pivot. Unemployment is a lagging indicator. Low unemployment, similar to today, occurs before things turn for the worse. High unemployment occrurs before things turn for the better. In the 1980's FED Chair Volcker began to pivot when he started to see a material increase in jobless claims. For context on today's jobless claims, while the rate of change on weekly continuing jobless claims are rising, unemployment levels remain near historic lows and suggesting current FED tightening cycle is nowhere near complete. The problem is that despite the lagging labor market data, the U.S. Treasury Yield Curves, bank lending standards, and leading economic indicators have only served to reinforce the recession forecast.

In a typical hiking cycle, cracks begin to appear from the second year on. The FED's 2022 policy mistake of raising rates into a slowdown have contributed to multiple historic regional bank failures in the USA, a systemic global bank (Credit Suisse) first needing central bank intervention to initially shore up its capital base, then days later being forced to a merger with its peer UBS, and now a number of regional banks in the USA struggling when customer confidence plummets in spite of extraordinary support

from regulators and government. Regional banks are facing a flight of deposits, as some customers lose confidence in the institutions, putting their ability to continue lending at risk. JPMorgan was said to be the largest beneficiary of the regional bank outflows with an estimated $50 billion increase in deposits. Attention has rightly been focused on the prospect of further bank runs and the knock-on effects of FED policy on banking institutions. With mobile banking, instant liquidity was perhaps not fully appreciated by the FED and FDIC and this should further open the eyes of traditional bankers and regulators. Another driver of the drawdown in deposits is the high yield available at money market funds. In a perfectly rational move, depositors are moving from low yielding deposits to money market funds that are paying out high yields with short-term rates in the 4%-to-5% range. To deflect criticism the FED, Washington and FDIC would like us to believe the bank runs and subsequent closures were the result of a few reckless bankers with concentrated business models in technology and digital assets and not the overreach of goverment to statbalize consumer confidence for their policy mistake. The root issues of unrealized losses on banks' balance sheets caused by the rising rate environment, coupled with concentrated and flighty deposits, have yet to be resolved and likely to take some time to resolve. We continue to watch signs of stress on the banking system as this would contribute to ongoing market volatility.

The equity markets continue pricing in the assumption that the economic slowdown will be mild and quick. Growth is slowing, monetary conditions are tightening, and inflation remains elevated. Credit risk rises during developing corporate recessions. US 2-10 year spread is at -68 bps. If that weren't enough, the spread between 10-year and 1-year Treasury yields sits at -1.24%, the most inverted curve since September 1981. The 3-Month Treasury bill yield of 5.14% is now 1.72% higher than the 10-Year Treasury bond yield (3.42%). From here, we would expect long-term yields to drift lower as real US GDP slows materially. With data going back to 1962, only the 1980 recession had a more inverted yield curve than today. The last 8 recessions in the US were all preceded by an inversion in this yield curve relationship. In other words, lots of bullish investors continue to misunderstand the FED's true intentions. FED pivots are defined by rate cuts not sustained periods of elevated rates. Recession risks now exceed inflation risks and remains the principal feature defining the current macro trajectory. The way forward is risk managing a recession.

On the consumer, data and business trends continue to signal slowing growth and is proving to us that the US consumer is not well positioned for this downturn and deteriorating at an accelerating rate. Elevated interest rates will only continue to weaken the consumer. The natural deterioration in the credit profile of the consumer had already begun and now looks to worsen. The speed with which the consumer's fundamentals have deteriorated has been remarkable. Further disinflation is

ahead, but the consumer is still seeing prices at retail up double digits from a year ago, outpacing household income as they continue to look to stretch their budgets. Consumers are tapping high-interest credit lines to make ends meet. We remain concerned about the stress being shouldered by increasingly tapped out U.S. consumers.

As it relates to expectations of earnings, equity valuations remain vulnerable as corporates continue to absorb the effects of higher interest rates, higher cost of capital, softening fundamentals, and capital constraints. Inventories continue to balloon at the corporate level and corporate margins are not yet recovering. Accelerating costs and decelerating revenue will continue to make the recovery in margins and profits delayed. Labour market deterioration is beginning to show up more frequently. As growth slows, earnings will inevitably slow. Companies analysts are late to revise 2023 forecasts. The risk is to the downside until equities price in the decelerating data fundamentals.

Important signals for our process remains cross asset volatility, USD dollar strength, and the activity coming out of fixed income markets. Being macro aware and data driven, we had pivoted to a more defensive portfolio, adding macro hedges such as being overweight the USD dollar and shorting select indexes and high yield bonds. With inflation having peaked and the FED tightening (that is negative real rates) this environment also supports an allocation to precious metals. High beta, secular and cyclical growth, and leverage are among the worst performing equities factors in this environment and thus further cements our underweight positioning. Market participants are still not bearish enough nor grasping the scale of the treasury market volatility. Conditions are in place and credit events are appearing before even printing first headline negative GDP of which we expect back to back to be printed. Q2 is shaping up to be a difficult period with a climatic point being the debt ceiling debate in June. Federal tax receipts due April 18th came in weaker than expected, which could result in the US Treasury running out of money before the middle of June unless Congress once again raises the debt ceiling. For reference, the S&P500 fell approximately 20% in the 4 month window from April to August 2011 amid the last debt ceiling showdown.

Investor focus heading into Q2 2023 should turn to the challenge for economic growth rather than the risk of inflation. The rate of change on corporate profits and consumer flexibility is deteriorating. The yield curves

have never been inverted to this degree without signaling a recession. Most analysts, economists and market participants expect a linear and predictable bear market and economic slowdown. Our interpretation is the US economy slows at a faster pace in Q2 vs. Q1. Global liquidity cycles drive changes in asset prices. They influence the direction of global equity markets. They drive fluctuations in bond yields and credit spreads. A reversal in global liquidity is one of, if not the most, important catalysts for a renewed bull market that causes investors to look through the weakness toward a robust recovery in the financial markets and economy. The business cycle leads liquidity and, the ISM is forecasting significant economic weakness ahead. The FED has yet to show signs of a liquidity reversal. The problem is that an expansion in global liquidity tends to loosen financial conditions, which is the opposite of what the FED wants right now. Q1 regional manufacturing surveys, retail sales, housing, bank lending standards, employment trends, weekly continuing jobless claims rate of change, and industrial production data continued to point to dramatic economic slowing. Of all the hiking cycles of the last 70yrs, this one has seen the weakest US growth, one of the largest declines in US housing and manufacturing activity, the worst S&P500 performance, and one of the most inverted yield curves. We are in the early stages of classic credit events and the only unknowns are duration and magnitude. We would suggest caution and not chasing this counter cycle relief rally, although stand ready to take advantage of significant weakness. The recession lights are flashing. The next 2 quarters may be the 2 worst quarters for both US GDP and corporate profits of this particular business cycle. Equity volatility tends to elevate once a recession commences. History warns us there have been several business cycles where FED decision making is not always in line with what is needed for a healthy overall economy. If the FED moves to cut rates it means they are responding to a problem rather than anticipating one. If they move to cut now, it means credit spreads have widened too much, default risk has increased or is imminent and treasury market volatility is building. It would be historically unique for the equity market to have bottomed before a recession occurring. While anxious in the near term, periods of volatility often set up attractive entry points for high conviction plays that suffer from short-term drawdowns as intermarket correlations peak. Patience remains our core allocation.

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Sincerely,

Christopher Panagopoulos, CPA, CA, CFA

The Portfolio Management Team

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