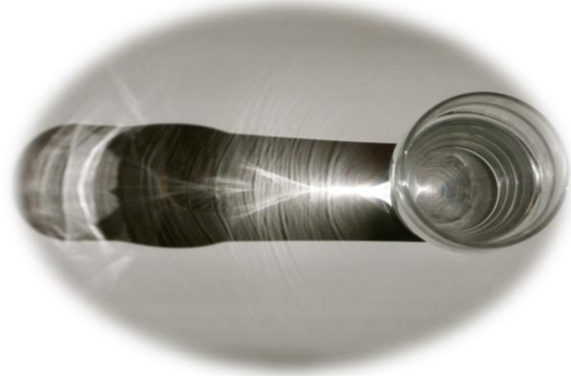
PMI INSIGHTS

April 13, 2023



HALF EMPTY OR HALF FULL.

by Ryan Seale, BBA, CIM - Senior Portfolio Analyst with PMI

Stocks in January had one of the best starts in years (after a disappointing 2022 year) with the market as represented by the S&P 500 Index up 6.6%. **Exhibit 1** below, highlights that last year's winners became this year's losers and vice versa. These moves can be linked to the market at the time discounting a higher probability of a soft-landing or even a no-landing (high inflation coupled with strong growth) economic scenario. However, the market has given up some of those January gains with all the sector returns now lower than they were at the end of January and the SPX Index now slightly negative on a YTD basis, given the concerns surrounding the US regional banking crisis and weaker than expected economic data.

Exhibit 1

	Returns (%)		
	2022	As at 1/31/2023	As at 3/27/2023
SPX Index	-13.1	6.6	-1.2
Energy	57.6	2.8	-9.6
Utilities	2.5	-0.7	-5.7
Consumer Staples	0.4	-0.5	-2.2
Health Care	-7.8	1.9	-4.4
Industrials	-9.8	6.3	1.5
Financials	-12.6	7.1	-6.6
Materials	-13.4	9.6	0.5
Consumer Discretionary	-21.7	14.5	3.6
Information Technology	-25.6	9.9	9.1
Real Estate	-27.5	9.6	-5
Communication Services	-33.7	11.8	8.5

Source: Bloomberg

Where are we now?

The Federal Reserve Bank (the Fed) still has a difficult path ahead of it (to achieve its 2% inflation target) with inflation still running hot and propped up by a relatively strong labour market. However, the magnitude of the Fed's move in its commitment towards higher rates has had unintended consequences which have manifested into a crisis within the US regional banking sector. This has led to the Fed implementing a liquidity backstop through its Bank Term Funding Program (BTFD). With the possibility that we may still be within the early stages of the crisis, some market participants have expressed a view that a need for more liquidity or guarantees may still yet be on the horizon. While this is still in debate, the market took this action as a signal of Fed capitulation and responded with terminal rate expectations falling rapidly (**See Exhibit 2**). Currently the market is pricing in one more rate hike in May and then a sequence of rate reductions leading to a terminal rate of around 4.26% by the December Fed meeting.

PMI is an independent, privately-held financial services firm specializing in the provision of financial solutions in the areas of:

- Investment Management
- Pensions
- Private Wealth Management

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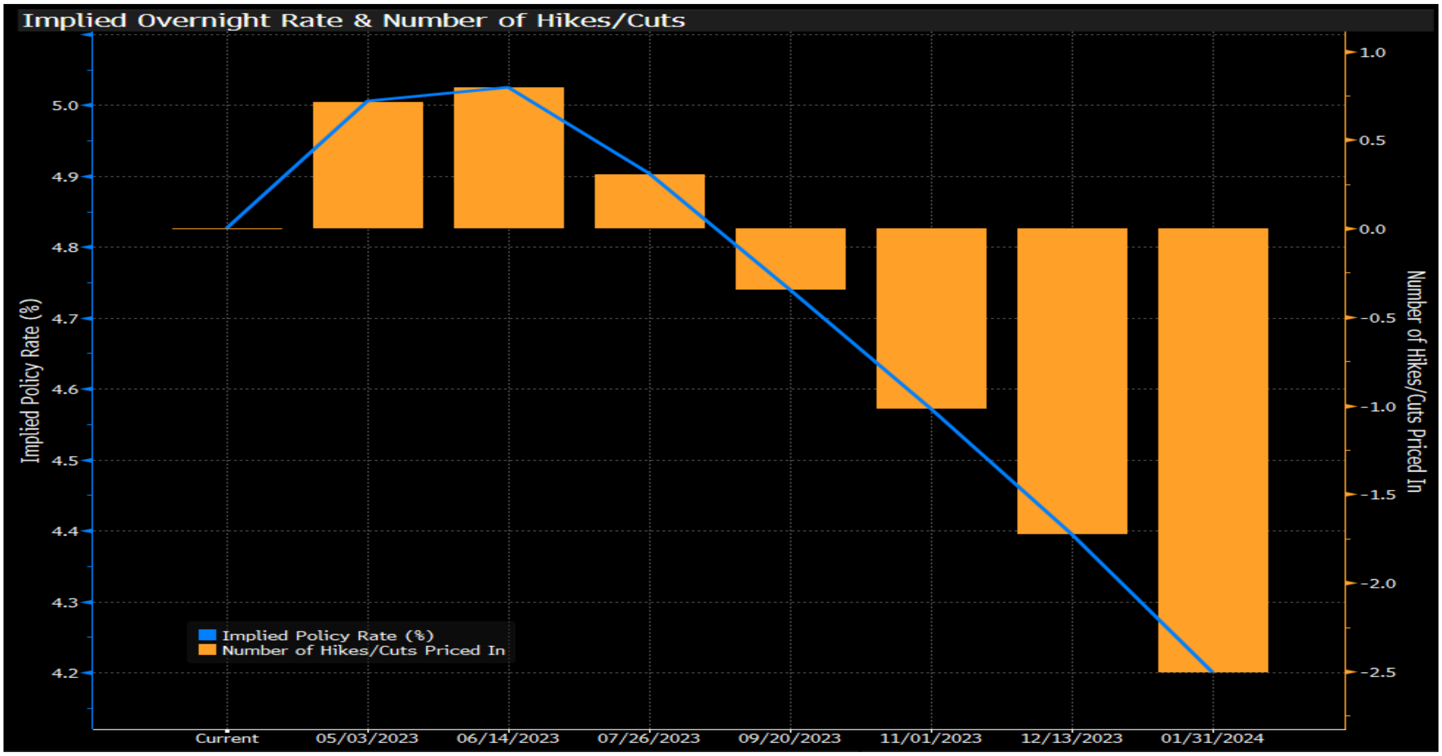
Exhibit 2

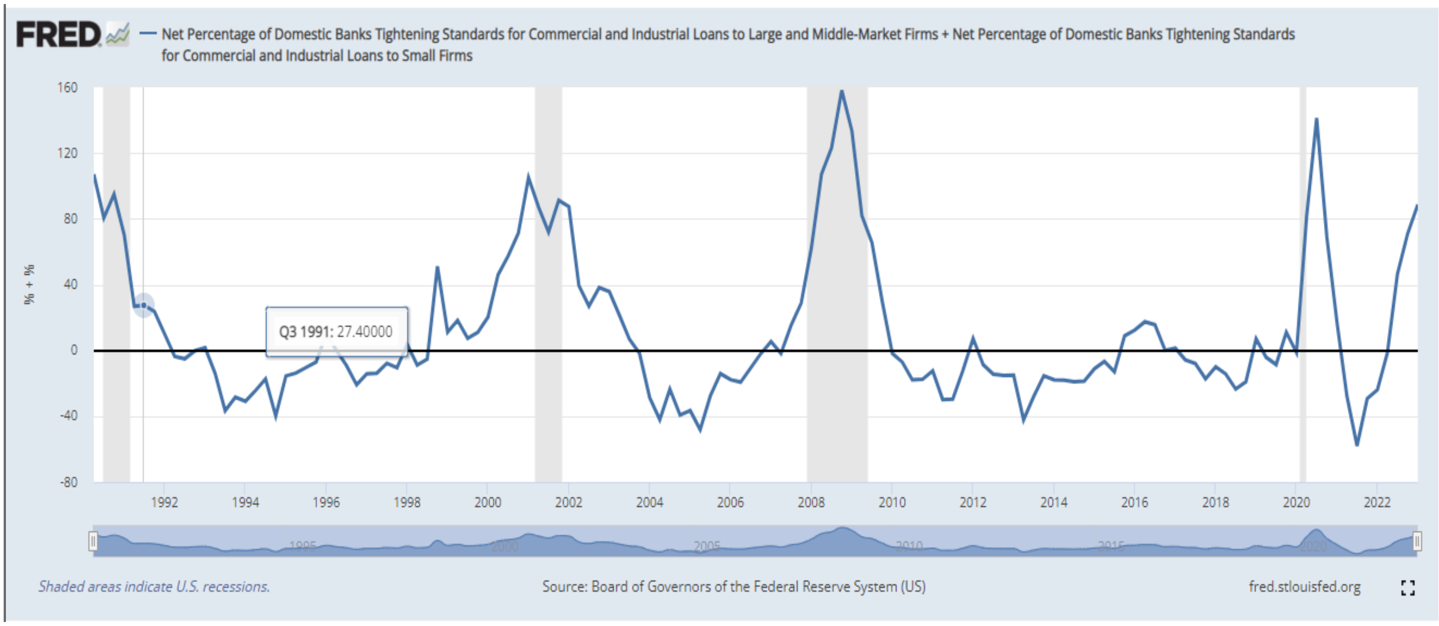


Source: Bloomberg/PMI

Mixed Economic Data

Even before the recent banking turmoil, banks were already tightening their credit standards (**See Exhibit 3**). At present levels, lending standards indicate an increased possibility of a liquidity crunch as levels approach those of previous periods of market distress. This tightening of bank lending standards with a further tightening in monetary policy poses increased risks to a greater slowdown in the economy with other knock-on effects.

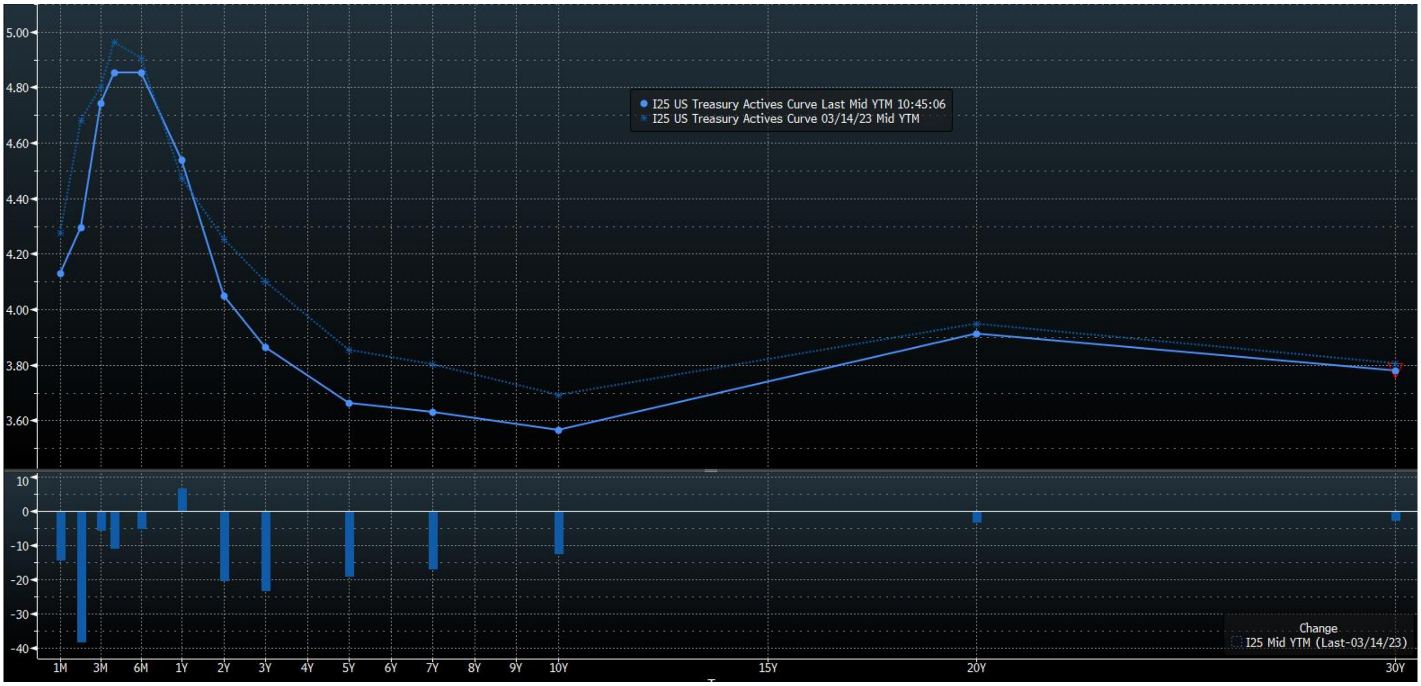
Exhibit 3



Source: Board of Governors of the Federal Reserve System

US treasury yields moved significantly lower over the past few weeks across the curve (exception being the 1yr) signifying the bond market is pricing in an economic slowdown or possible recession (**See Exhibit 4**). However, on its own a decline in yields is typically supportive of stock prices, especially those that are considered long duration names (which is supportive of the recent strength in the Nasdaq Index).

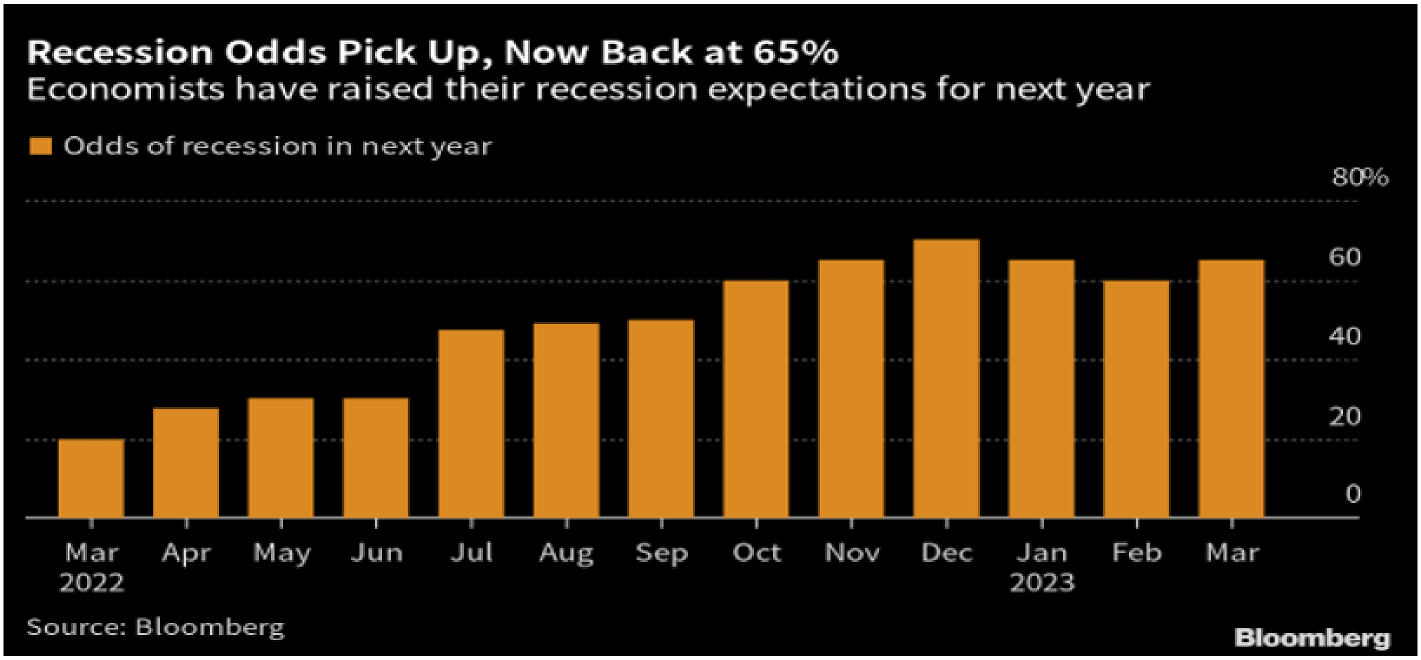
Exhibit 4



Source: Bloomberg/PMI

The odds of the US economy going into a recession in the next 12 months stands at 65% (up from 60% in February) according to the latest Bloomberg monthly survey of economists. (**See Exhibit 5**)

Exhibit 5



Source: Bloomberg

The ISM Manufacturing Purchasing Managers' Index (PMI) for March dropped to 46.3 from 47.7 and was below the consensus expectations of 47.5. This would be the fifth month that manufacturing PMI has been in contractionary territory (i.e., less than 50) signaling a continuing slowdown within the manufacturing industry. The ISM Services PMI (a proxy for the services sector) was also weaker than expected, falling from 55.1 to 51.2, which was below the expected 54.4 market consensus (**See Exhibit 6**).

Exhibit 6

Source: Bloomberg/ PMI

Earnings estimates for the SPX Index remain quite resilient and the most recent data has shown a slight improvement. Therefore, the market is not indicating a material slow-down in economic activity.

Exhibit 7

Source: Bloomberg/PMI

US High Yield spreads over US Investment grade corporate debt has widened to levels typically associated with that of being in a recession (**See Exhibit 8**)

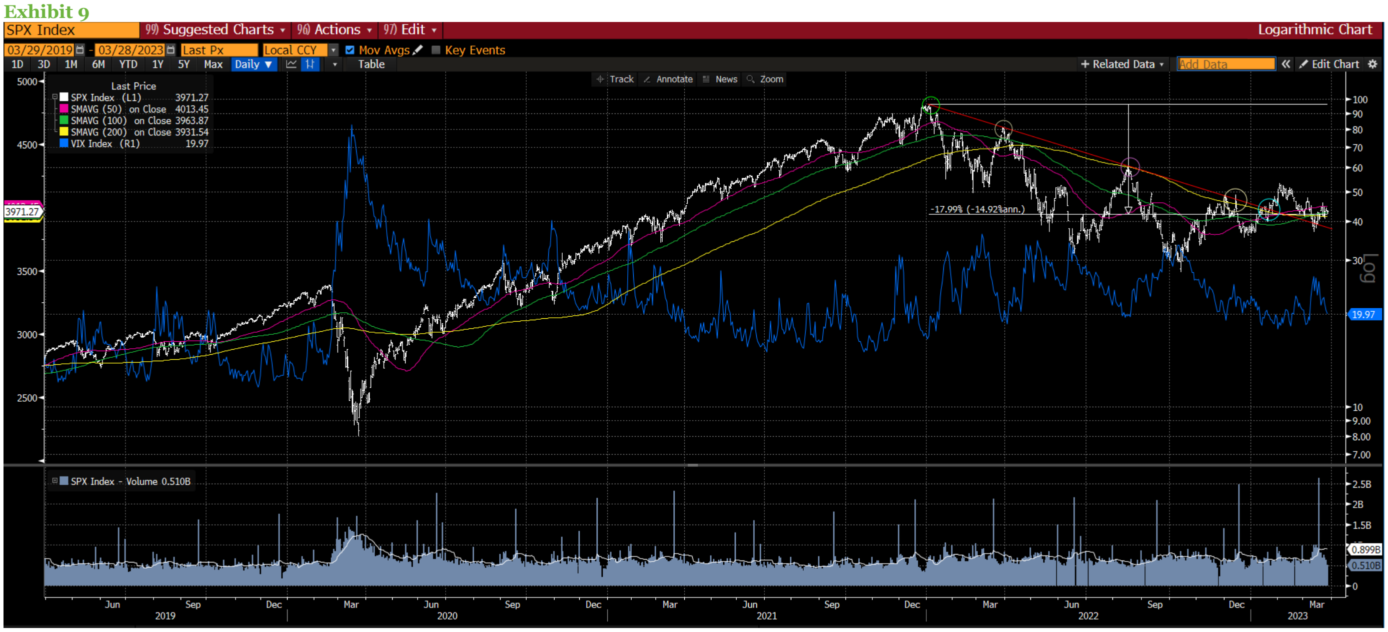
Exhibit 8

Source: Bloomberg/PMI

A look at the chart technicals for the S&P 500 Index shows that a "bullish" signal was generated when the Index broke through both the 200-day moving average and the downward resistance trendline which held on 4 previous occasions since the Index peaked on 1/4/22. However, for this "bullish" signal to remain intact, it is important that the Index now holds above the 200-day moving average. While the recent upward moves in the Index have been encouraging, it is important to note that we still do not have an "all-clear" signal. The Index has been trading in a narrow range between 3800 to 4170 with volatility (as measured by the VIX) trading back down to pre-Silicon Valley Bank crisis.

With the Index still down -17.99% (at the time of writing) from its peak (up 12.6% from the 3,577.03 Oct 12th low), it is still officially in correction territory (from its 2022 highs) and not far off from -20% which defines a bear market. In addition, market breadth is still weak with only 45.91% of S&P Index members trading above the 200-day moving average.

Exhibit 9



Source: Bloomberg/PMI

The NDX Index (Nasdaq 100), entered a technical “bull” market on 3/29/23. The Index closed up 20.3% from its 2022 low in December. As a reminder big-tech was one of the first sectors to sell off back in 2021 as the market discounted the Fed will be embarking on a rate hike cycle.

Source: Bloomberg

With the market and economy giving off conflicting signals, is the outlook for equities **half-empty or half-full**?

PMI is of the opinion that while volatility remains a concern, as this part of the business cycle plays out, the outlook for the market can be considered as half-full. While the odds of a recession occurring towards the latter half of the year is high, it will most likely be a mild one. Risks to this would be a broader spillover of the regional banking crisis. While bonds yields have retrenched, further moves to the downside as well as Fed rate cuts anticipated in the second half of the year should provide some support to stocks as recession gives way to a new business cycle. PMI