Highland Associates

Multi-Asset Solutions
Weekly Commentary
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Stocks: A Lift From Quarter-End Window Dressing And Some Short Covering; Breadth Encouraging With Small-Caps Keeping Pace.

Markets stateside were relatively calm into mid-week before window dressing kicked in and portfolio managers flocked to 1Q's winners as they desired to show current and prospective investors that they didn't miss the boat after a challenging year for performance in 2022. The S&P 500 ended the week higher by 3.5% on its way to a 7.9% quarterly gain, while the Russell 2000 small-cap index outperformed, rising 3.9% on the week, but still trailed the S&P 500 by 4.5% for the quarter. Mega-cap technology companies were the big winners during the quarter as Apple, Meta Platforms, Microsoft, and virtually any semiconductor stock remotely tied to mania surrounding Artificial Intelligence (AI) rallied, capping off a quarter in which the tech-heavy Nasdaq Composite gained just shy of 18% and outperformed the S&P 500 by 10%. Alongside the continuing rally in technology stocks, domestic indices were aided this week by modest short covering in beaten down industries as banks stabilized somewhat and real estate investment trusts (REITs) with commercial real estate exposure bounced after experiencing sizable drawdowns. Under the surface, S&P 500 breadth has improved with more stocks participating in the rally, and while small caps outperformed the S&P 500 last week, the magnitude of month-to-date Russell 2000 underperformance remains a worrisome market dynamic that needs to shirt in a more constructive way before we can fully buy-in and embrace last week's rally.

- Encouragingly, the S&P 500 closed above the index's 50-day moving average of 4,020 last week, and above the 4,040-4,050 zone that has presented a ceiling of resistance. 4,040 now becomes a potential floor of support worth monitoring, and after last Friday's close the S&P 500's February high of 4,150 could come into play in relatively short order. While we remain cautious on the outlook for earnings over the coming quarters and believe the S&P 500 is 'rich' as a result of this view, we must also incorporate the technical setup which at present paints a more constructive picture.
- Abroad, developed markets fared relatively well, with broad-based strength out of Europe notable despite substantial upward pressure on euro area sovereign bond yields over the balance of the week. The MSCI Emerging Markets (EMI) index lagged, rising just 1.9% last week with China again providing a lift amid the announcement that consumer discretionary/technology behemoth Alibaba would be splitting into six business units, a decision that generated a 14%-plus rally in the company's shares last Tuesday alone.
- Earnings season kicks off late next week with the consensus currently expecting S&P 500 quarterly earnings to fall 5.7% year over year in 1Q with estimates falling sharply since October. While wouldn't quibble much with the current 1Q estimate/outlook for S&P 500 profits, where we find ourselves in disagreement with the consensus comes

in the back-half of this year. While 2Q S&P 500 EPS are expected to fall 3% year over year, which also appears reasonable, the consensus calls for EPS to grow 2.9% year over year in 3Q and a whopping 9.9% in 4Q. Estimates for the back-half of '23 will likely be ratcheted lower, perhaps meaningfully, over the coming quarter(s) as expectations build for tighter lending standards and financial conditions, which will serve to stunt economic growth. Given our belief that the current full year 2023 S&P 500 EPS estimate of $219.99 remains subject to negative revision, the current forward S&P 500 price to earnings ratio of 18.3X appears loftier than meets the eye and provides little margin for error should a deeper economic contraction materialize in the back half of this year.

• After trading poorly over the first half of the month as economically sensitive commodities sold off due to economic growth fears, West Texas Intermediate (WTI) crude oil rallied over 12% from St. Patrick's Day through month-end to close at $75.67 per barrel. Over the weekend, OPEC announced a 1 million-plus barrel per day supply cut to be in effect through year-end 2023, sending WTI to $80 and Brent to $85 per barrel in early trading. OPEC's move will put upward pressure on prices of WTI and Brent crude, along with gasoline prices, leading up to the seasonally strong spring/summer driving season. OPEC's decision maybe in response to the Biden administration dragging its feet to refill the Strategic Petroleum Reserve (SPR), or it could be a sign that OPEC+ sees waning demand for crude oil in the offing due to a global economic slowdown of some magnitude, or a combination of both factors. The decision throws another monkey wrench into the FOMC's decision making framework when it meets in early May as a spike in oil prices is simply another variable largely out of the Committee's control that is preventing inflationary pressures from subsiding as quickly as desired.

Bonds: Waning Liquidity Fears, Weak Auction Results Force Treasury Yields Higher; Market Slowly Moving Toward Fed.

Treasury yields ended the week higher as liquidity concerns surrounding the banking space subsided, reflecting a 'crisis averted' sentiment, and market participants began to back away from expectations of aggressive cuts to the Fed funds rate over the balance of this year. The 2-year Treasury yield ended the week at 4.06%, a 30-basis point upward move on the week as Fed funds futures backed out over 25 basis points of rate cuts over coming quarters. However, additional upward pressure on short-term yields may be in the cards over the near-term given the magnitude of the disconnect that exists between what the FOMC expects it will do and what the market anticipates it will need do to ensure financial stability. In early March, as banking sector liquidity fears arose, market participants expected the Fed to respond by cutting the Fed funds rate aggressively over the balance of this year to ensure the financial system continued to function as desired. After the March FOMC meeting, Chair Jerome Powell stated that the Committee didn't anticipate cutting the Fed funds rate in 2023, and at the same time Fed funds futures were pricing in four quarter-point cuts prior to the year-end. A disconnect between the market and the Fed remains as April begins, but as liquidity concerns have waned over recent weeks, the market has moved closer to the FOMC; however, interest rate volatility is likely to remain elevated until the two get on the same page, or at least the same chapter.

- A series of Treasury auctions garnered our attention last week for what they could potentially signal regarding risk appetite and demand for Treasuries from abroad. On balance, the auctions were poorly received, with high yields at auction for both the 2- and 5-year well above the current market rate for each tenor. $42B of 2-year notes were auctioned on Monday with a high yield of 3.95%, above the 3.875% prevailing market rate, and $43B of 5-year notes followed on Tuesday with a high yield of 3.665%, again above the 3.625% current market rate. Most notably, the dealer community was forced to take down 23% of the 2-year auction versus the 'normal' 12%-13%, likely indicative of investors believing that yields on Treasuries on the short end of the yield curve are likely to move higher as the market ultimately moves closest to the Fed's expectations for no rate cuts in '23. We agree with this assessment.
- We often focus on the relationship between small-cap stocks and high yield corporate bonds as a true representation of investor risk appetite and as a gauge of the trend in economic growth expectations. By these gauges, the outlook for the U.S. economy appears less constructive than the 7.5% quarterly gain in the S&P 500 might indicate. The Russell 2000 small-cap index rose 2.7% during the quarter after losing 4.7% during March, and while the Bloomberg U.S. High Yield index rose a respectable 3.5% during the quarter, it returned just 1% during March and meaningfully lagged the Bloomberg Corporate index. Small-caps and high yield bond aren't yet painting a dire picture of the outlook for economic growth, but one of cautious optimism, and are worth monitoring over coming months for signs of economic deterioration.

What We're Watching:

- The Job Openings and Labor Turnover Survey (JOLTS) for February is released Tuesday and is expected to show 10.45 million jobs were open during the month, down from 10.842 million in January.
- Markit U.S. Purchasing Managers Index (PMI) for March is released Wednesday on the heels of a 53.3 reading in February. A reading above 50 indicates economic expansion, below 50, contraction.
- The Nonfarm Payrolls Report for March is released Friday and is expected to show 240k jobs were created during the month, down from 311k in February. Average hourly earnings are expected to rise 0.3% month over month, above the 0.2% increase in February, and the unemployment rate is expected to remain static month over month at 3.6%.

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