Multi-Asset Solutions
Weekly Commentary
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Highland Associates

Stocks: Better Overall Market Tone, But Low-Volatility Could Prove Misleading; Emerging Markets Lead As China Bounces, U.S. Dollar Fails

While domestic large-cap and small-cap stocks turned out modest gains over the balance of last week, participation in those gains was more broad-based than what we have witnessed in recent months, an encouraging sign. The S&P 500 ended the week higher by 1.9% and closed at a year-to-date high to boot, while small caps turned surpassed large caps posting a 3.3% return, now higher by 5.2% year to-date. We have been focused on 4,200 as a key line in the sand for the S&P 500 as rallies have been capped by round-number resistance there on at least three prior occasions this calendar year. While the index did close above the 4,200-level last Friday, but bulls may want to hold off on their victory lap for now. Breadth, while improved, remains too narrow for our liking, and we are concerned that the S&P 500's uptrend amid subdued volatility may have attracted investors hiding out in cash back into the fray at the wrong time and just before a pullback of consequence materializes.

Japan Driving Developed Markets Abroad As Euro Area Indices Lose Momentum:

Japan's economy and Japanese equities have languished for the past three-plus decades. With this backdrop, U.S. based investors have understandably had few reasons to deploy capital into the country, but the Nikkei 225 has staged an impressive rally since the end of September that has taken the index to a level last seen in 1990 and has garnered the attention and capital of investors such as Warren Buffett along the way. In contrast to euro area and U.K. equities which have lost momentum of late due to lackluster economic data, Japanese equities have continued to stair-step higher on the heels of continued strength in the manufacturing sector. The Nikkei 225 index rose 7% in May alone benefitting from a stronger dollar. Japan accounts for over 22% of the MSCI EAFE index and is the largest individual country weight, but if the euro area economy deteriorates as we expect over coming quarters, it will be challenging for strength out of Japan to offset broad-based weakness in the euro area and U.K. We remain underweight developed market stocks abroad due to cyclical and structural headwinds facing the euro area, specifically.

Will The Bounce In Emerging Markets Have Staying Power?

MSCI Emerging Markets (EM) index caught a bid last week and ended higher by 1.3% on the back of a 2.8% bounce out of the MSCI China index. It's a minor miracle that the EM index has been able to eke out a 3.9% year-to-date gain given that the MSCI China index is lower by 4.6% over the same time frame, but strength out of Mexico, South Korea, and Taiwan has so far been enough to prevent a deeper drawdown in the broader emerging markets index. While China's economic recovery from COVID lockdowns has left much to be desired, last week there were some signs of life out of beleaguered Chinese internet and technology related names. The KraneShares CSI China Internet ETF (KWEB) which holds names such as Alibaba, Baidu, and Tencent, among others, jumped 7.32% over the balance of the week, although that ETF remains lower by 10.7% year-to-date even after last week's rally. We expect China's government to step up its efforts to stimulate economic growth over coming quarters, which could provide a tailwind for the MSCI EM index and is one reason we remain neutral on the asset class at present despite underwhelming absolute and relative performance over the past year.

Bonds: Investors Turn Attention To Treasury Issuance, FOMC Meeting With Debt Ceiling Concerns In The Rearview; International Inflation Moderating For Now:

Over the extended weekend a break-through in debt ceiling negotiations stirred optimism leading to intra-week gains that unraveled by Friday as the Aggregate Bond Index posted a 0.96% gain on the week. Fixed income returns were clustered with high yield corporates and long-term treasuries within a basis point at 1.15% and 1.16% respectively. Resolution on the debt ceiling opens the floodgates to an impending wave of government bond issuance at the front-end of the curve as the Treasury aims to refill their cash reserves to the tune of $450B in June after finishing May on fumes. The spike in short-term issuance is worth scrutiny as it syphons liquidity from the broader financial system, combined with already bleak seasonal summer liquidity, inviting lingering volatility. Less liquidity in the near-term reinforces our conservative view on credit rather than stretching for yield, especially when widely held default expectations remain optimistically below long-term averages.

Markets Recalibrating for Fed Pause, Though 'Skip' Appears More Accurate:

After a brief distraction via the debt ceiling, all eyes returned to the Fed as speculation around the June meeting shifted mid-week with FOMC voting member President Harker voicing approval to 'at least skip' raising the policy rate. Guidance here coupled with Fed Speak from other governors mostly aligned or left the door open for a June pause, while building in maneuverability for the meeting after. The tone from Fed officials moved the market as implied probability of a hike fell from 58% to 24% on Thursday effectively putting off the next hike, although Friday's run-away jobs report led the odds slightly higher. The jump in payrolls data, with nonfarm employment rising by 339,000 jobs over the consensus 195,000, was dampened by weak survey response numbers and countered by a higher than anticipated unemployment rate of 3.7% alongside lower weekly hours worked. This likely does little to deter the Fed from skipping, but investors won't get confirmation on the FOMC's direct view of the data until after the next meeting with the press blackout beginning over the weekend. Conflicting labor signals have become increasingly common as slowing labor trends continue with further weakening to an unemployment rate closer to 4% on the Fed's roadmap.

Inflation Cools Across The Pond, But One Month Doesn't Make A Trend:

Inflation in the Eurozone cooled more than expected in May with the headline Consumer Price Index (CPI) rising 6.1% year over year, less than the 6.3% estimate and well below the 7.0% reading from April. Core CPI rose 5.3% year over year, also below the 5.5% estimate and the 5.6% reading from April. Inflation falling across the Eurozone will be viewed by central bankers as a most welcome sight, but it's just one month, and the European Central Bank (ECB) will want to see a multi-month trend materialize before signaling a pause in its policy tightening efforts. Both the ECB and Bank of England (BoE) appear poised to hike key policy rates further later this month, but with inflation readings trending lower and economic data out of the Eurozone and U.K. showing signs of softening over the past month, long-term sovereign bond yields may continue to move lower and pull yields on long dated U.S. Treasuries along for the ride, boosting total return for investors in long duration bonds. A duration profile in-line with that of the Bloomberg Aggregate Bond index remains our preferred positioning as we see Treasury yields remaining range-bound over the near-term, but ultimately with a downward bias into year-end.

What We're Watching:

- Manufacturing orders out of Germany for April are released Tuesday and are expected to rise 1.5% month over month after a -10.7% reading in March relative to February. German industrial production for April is released Wednesday and is expected to rise 0.2% month over month after falling 3.4% in March relative to February. These datapoints are worth watching as a gauge on demand out of the U.S. and China for goods manufactured in the Eurozone.
- Eurozone retail sales for April are released Tuesday and are expected to rise 0.2% month over month after falling 1.2% in March relative to February.
- China releases export and import data for May on Wednesday. Exports are expected to have risen 2.0% year over year in May, a sharp drop from 8.5% in April, while imports are expected to have fallen 8.0% year over year during the month, down modestly from a -7.9% reading in April. These metrics are two indicators worth monitoring to gauge how China's economic recovery from COVID lockdowns is progressing.
- Initial jobless claims in the U.S. for the week ended June 3 are released Thursday.

* 3- and 5-Year Returns Annualized							
	Price/Yield	Total Return (%)					
	6/2/2023	1 Week Ago	1 Month Ago	Year to Date	1 Year	3 Years	5 Years
Dow Jones Industrial Average	33684.34	2.17	0.6	2.92	3.8	11.72	8.69
S&P 500	4281.87	1.88	4.17	12.8	4.29	13.37	11.19
NASDAQ	13280.87	2.07	9.75	27.97	8.49	12.19	12.76
Russell 2000 Index	1797.33	3.31	5.89	5.22	-2.05	10.23	3.39
MSCI World ex US	298.74	1.08	-0.02	7.63	2.41	7.66	3.04
MSCI EM	984.36	1.26	1.33	3.92	-4.22	3.38	-0.25
Bloomberg US Aggregate	4.65	0.96	-1.35	1.8	-2.19	-3.73	0.86
Bloomberg Global Aggregate	3.69	1.15	-1.61	1.32	-3.82	-4.67	-1.07
Bloomberg US Corporate	5.4	1.06	-1.27	2.34	-1.57	-3.05	1.66
Bloomberg 10-Year Muni	3.58	0.9	-0.53	1.92	0.69	-0.53	1.74
Bloomberg High Yield	8.54	1.15	0.29	3.99	0.92	2.85	3.23
			Price / Yield				
	5/19/2023	1 Week Ago	1 Month Ago	12/31/2022	1 Year Ago	3 Years Ago	5 Years Ago
SOFR (yield)	5.07	5.06	4.81	4.3	0.79	0.07	1.81
30 Year Mortgage (average rate)	6.99	7.19	6.83	6.66	5.39	3.45	4.41
2 Year Treasury (yield)	4.48	4.56	3.96	4.43	2.63	0.16	2.47
10 Year Treasury (yield)	3.69	3.8	3.42	3.87	2.91	0.69	2.9
30 Year Treasury (yield)	3.88	3.96	3.71	3.96	3.07	1.49	3.05
WTI Crude (closing price)	71.74	72.67	71.66	80.26	116.87	36.81	65.81
Brent Crude (closing price)	76.13	76.95	75.32	85.91	117.61	39.57	76.79
Gold (NYM $/oz)	1952.4	1944.3	2023.3	1826.2	1866.5	1725.2	1294.8

Source: Bloomberg (3- and 5-Year Returns Annualized)

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