HIGHLAND

Highland Associates

Multi-Asset Solutions
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Stocks: Small Caps Exhibiting Relative Strength; Investors Rotate Into Battered Banks and Energy While Tech Takes a Breather

Markets were able to sustain the prior week's advance in small-cap stocks as the Russell 2000 returned 1.92% while the S&P 500 posted a 0.41% gain, narrowing the year-to-date gap between the indices to 6%. Rotation into economically sensitive sectors on the week, along with a modest improvement in participation with more stocks trading above their 20-day moving average appears to be laying the groundwork for a more sustainable rally; however, domestic markets have come a long way in a brief time and a period of digestion would be welcomed in our view. Abroad, the international developed MSCI World ex US returned 0.98% on the week, whereas the MSCI Emerging Market Index generated a 1.89% gain with China and Brazil the most notable contributors. All told, we're more cautious on equities based on tighter liquidity conditions, bond market positioning, and seasonality concerns each working against equities, although peak pessimism may be behind us, in our view it's far too early to go all in on the next bull market.

Small-Caps Surge With Financials And Energy Taking The Leadership Baton:

Perhaps upstaged by the controversial shift in the professional golf world, Saudi Arabia enacted production cuts independent of OPEC last weekend that, coupled with underweight exposure, led energy to be the top performing sector on the week. Despite the expected reduction in global oil supply, WTI was down 2.19% continuing the prior week's downturn. This shift is likely to put modest upward pressure on prices at the pump with strong demand present during the heavy summer driving season. Financials also played a key role in lifting the small-cap Russell 2000 on the week, with well received bond sales on Monday and Wednesday leading to improved risk appetite and investor sentiment. While it is unlikely that bank stocks get back to 52-week highs in short-order given the regulatory and macro backdrop, valuations nearing 10-year lows, and strong dividend yields are enticing to long-term investors. Another appealing attribute in financials is the opportunity for defensive equity performance in a risk-off environment as the sector would benefit from lower short-term rates.

Nasdaq Rally Takes a Breather in the Face of Higher Yields:

After one of the best starts to the calendar year through May since 2000, the Nasdaq Composite continued its meteoric rise albeit at a slower pace last week gaining just 0.15%. The Nasdaq struggled early last week as higher long-term rates that weigh on the discounted cash-flow projections used to price growth stocks with lower current cashflows. Artificial intelligence, or AI stocks also came up for air after an extreme run-up that was overdue for some profit taking, and sideways short- term price action. from here would improve the sustainability of outperformance from our perspective. Tech stocks rose on Thursday as initial jobless claims for the week ended June 3rd came in higher than expected, reaching levels last seen in October of 2021, opening the door for a less hawkish Fed that would, in theory, boost the sector. Trading around recent movements in technology may seem like an intriguing strategy, but we'd prefer neutral exposure or smaller rebalancing moves to wholesale allocation shifts considering the significant upside in recent returns and downside to current valuations should the global economy weaken and/or global central banks tighten policy further.

Bonds: Short-Term Bond Yields Rise Despite Weaker Jobs Data; Reserve Bank of Australia and Bank of Canada Resume Rate Hikes; Increasing Chatter That The FOMC May Not Be Done:

Long-term Treasury yields picked up where they left off last week, ticking higher early on, topping 3.8% on the 10-year bond mid-week before retreating slightly after noisy US jobless claims spiked to 261K, well above the forecasted 235K. While the inconsistencies in the data collection give us pause, a modest softening labor market is evident and complicates matters for the Fed as the committee appears to be less convinced than markets on the direction of consumer prices. Interest rates grinding higher had a negative impact on duration- sensitive sectors, with the Bloomberg Aggregate Bond Index closing lower by 0.15% and the Bloomberg Investment Grade Corporate Index ending the week with a 0.31% loss. High yield bonds with a shorter duration advanced as income powered returns with the Bloomberg High Yield Bond Index up 0.31% for the week. Bond markets are in for a tumultuous month, as tighter spreads and higher Treasury issuance create an environment ripe for volatility that may invite opportunities to rebalance, capturing higher yields in the process.

Surprise Hikes Abroad Demonstrate That A Pause Is Just That, With Cuts Not Guaranteed to Follow:

Two G10 central banks caught markets off guard last week by re-engaging and raising policy rates further after taking a hiatus from hiking. The Bank of Canada raised its policy rate from 4.5% to 4.75%, but more important than the hike is the lengthy pause that could be a sign of things to come for the Fed, should it skip a hike this week. The Reserve Bank of Australia (RBA) also hiked rates by a quarter-point, though the RBA had already ended its brief pause in March before inflation reaccelerated. The actions of other developed central banks shouldn't be considered a projection as to what FOMC policy might have in store, but the willingness to pause, then continue with minimal backlash leaves the door open for a similar course of action. Immediately after initial claims for unemployment insurance surprised to the upside, rumblings began circulating that the impending FOMC pause could mark the end of the hiking cycle, but that thought process is putting the cart before the horse based on limited data. The Fed has erred on the side of overcommunication at every turn during this cycle and considering the market's aversion to surprises, we'd expect even the FOMC's 'pause and go' playbook to be more transparent.

Emerging Market Bonds Gaining Ground Amid Weaker Dollar And Falling Inflation:

Recent U.S. dollar weakness has reignited interest in emerging market debt with the Bloomberg Emerging Market Index returning 0.52% since June began. The greenback has weakened in each of the past two weeks, as U.S. economic concerns persisted with weaker PMI data on Monday followed by higher jobless claims data on Thursday, coupled with futures priced for slower monetary policy expectations. Emerging markets have also shown pockets of improvement in their respective fights with inflation, namely in Mexico where core inflation is trending lower, and in Chile where recent month-over-month readings were far better than expectations. After the pummeling last year that negatively impacted debt issued by emerging economies, a weakening dollar and less aggressive Fed could boost EM bonds in a meaningful way. However, debt concerns remain prevalent in select countries, specifically China, with another potential rate cut on the horizon as the country's latest 0.2% inflation reading suggests a cooler economy with lower investment rates and weaker economic activity.

What We're Watching:

- U.S. Consumer Price Index (CPI) for May is released Tuesday and the headline reading is expected to rise 0.2% month over month and 4.1% year over year, which would be a welcome deceleration from 0.40% and 4.9% in April. Core CPI, which excludes food and energy, is expected to rise 0.4% month over month and 5.2% year over year.
- The Federal Open Market Committee (FOMC) concludes its two-day meeting on Wednesday and is widely expected to pause, or perhaps more accurately, skip a rate hike at this meeting, although the likelihood of a quarter-point rate hike in July has been rising.
- U.S. retail sales for May is released Thursday and are expected to fall 0.15% month over month after a 0.4% rise in April versus March.
- The University of Michigan Consumer Sentiment index for June is released Friday and is expected to improve month over month to 60.3 from 59.2 in May.
- The Eurozone Consumer Price Index for May is released Friday and is expected to be flat month over month after a 0.6% jump in April versus March. However, Eurozone CPI is expected to have rise 6.1% year over year in May, in-line with the year over year reading from April.

	Price/Yield	Total Return (%)					
	6/9/2023	1 Week Ago	1 Month Ago	Year to Date	1 Year	3 Years	5 Years
Dow Jones Industrial Average	33944.8	0.36	1.29	3.29	7.26	9.69	8.32
S&P 500	4306.21	0.41	4.58	13.26	8.83	12	10.99
NASDAQ	13326.27	0.15	9.01	28.16	13.85	10.92	12.63
Russell 2000 Index	1875.72	1.92	6.81	7.25	2.33	8.71	3.52
MSCI World ex US	301.52	0.98	-0.24	8.69	4.72	6.48	3.16
MSCI EM	1002.33	1.89	2.33	5.89	-2.97	2.54	0.24
Bloomberg US Aggregate	4.71	-0.15	-0.85	1.65	-1.5	-3.76	0.86
Bloomberg Global Aggregate	3.74	-0.02	-1.46	1.3	-2.46	-4.86	-1.06
Bloomberg US Corporate	5.49	-0.31	-0.58	2.03	-0.87	-3.38	1.64
Bloomberg 10-Year Muni	3.57	0.1	-0.78	2.02	1.36	-0.54	1.76
Bloomberg High Yield	8.57	0.31	0.8	4.31	2.91	2.24	3.2
				Price/Yield			
	6/9/2023	1 Week Ago	1 Month Ago	12/31/2022	1 Year Ago	3 Years Ago	5 Years Ago
SOFR (yield)	5.05	5.07	5.06	4.3	0.75	0.08	1.69
30 Year Mortgage (average rate)	7.06	6.99	6.91	6.66	5.58	3.49	4.46
2 Year Treasury (yield)	4.6	4.5	4.02	4.43	2.81	0.2	2.5
10 Year Treasury (yield)	3.78	3.69	3.52	3.87	3.04	0.83	2.95
30 Year Treasury (yield)	3.92	3.89	3.84	3.96	3.16	1.58	3.09
WTI Crude (closing price)	70.17	71.74	73.71	80.26	121.51	38.94	65.74
Brent Crude (closing price)	74.79	76.13	77.44	85.91	123.07	41.18	76.46
Gold (NYM $/oz)	1962.2	1952.4	2042.9	1826.2	1848.8	1714.7	1298.1

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

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