ECONOMIC & INVESTMENT PERSPECTIVES

FEBRUARY: STOCK AND BOND MARKETS FALL

Figure 1: 2/28/2023 Returns (source: Bloomberg)
Conditional formatting: green (high) to red (low) for each time period

Bonds	ETF	Month	YTD	1YR	vs. 52-wk High	vs. 52-wk Low
US Aggregate Fixed Income	AGG	-2.7%	0.6%	-9.7%	-12.5%	4.4%
Investment Grade Corp Bonds	LQD	-4.2%	0.8%	-12.3%	-15.8%	7.6%
U.S. Treasury Bonds	GOVT	-2.3%	0.3%	-10.1%	-12.4%	2.8%
U.S. 20+ YR Treasuries	TLT	-4.9%	2.4%	-25.5%	-28.5%	10.7%
Muni Bonds	MUB	-2.3%	0.1%	-4.4%	-6.7%	4.0%
High Yield	HYG	-1.9%	1.7%	-6.2%	-11.1%	5.9%
Non-US Corp Bonds	IBND	-4.5%	-1.3%	-16.4%	-17.1%	13.0%
Emerging Markets Bond LC	EMLC	-2.9%	1.3%	-5.0%	-11.5%	9.2%
Global Equity						
ACWI Global Equity	ACWI	-3.3%	3.9%	-8.3%	-13.5%	16.5%
United States	VTI	-2.4%	4.4%	-8.3%	-14.5%	14.1%
International Developed	EFA	-3.1%	5.7%	-2.8%	-8.0%	27.0%
Emerging Markets	EEM	-7.6%	0.9%	-16.2%	-18.4%	14.2%
Global Equity by Region						
United States	VTI	-2.4%	4.4%	-8.3%	-14.5%	14.1%
Europe	IEUR	-1.5%	7.8%	-0.8%	-6.4%	32.9%
Asia ex-Japan	AAXJ	-7.7%	1.0%	-15.3%	-16.9%	20.4%
China	MCHI	-10.7%	0.8%	-16.6%	-19.0%	36.7%
Japan	BBJP	-4.5%	2.8%	-9.8%	-11.7%	15.8%
Latin America	ILF	-6.7%	3.8%	-0.4%	-23.9%	14.6%
US Equity						
US S&P 500	IVV	-2.5%	3.6%	-7.8%	-14.2%	13.9%
NASDAQ 100 QQQ	QQQ	-0.4%	10.2%	-14.7%	-21.0%	15.5%
US Large Growth	IWF	-1.2%	7.0%	-13.5%	-19.8%	13.5%
US Large Value	IWD	-3.5%	1.4%	-3.0%	-9.3%	14.7%
US Eqwt S&P 500	RSP	-3.4%	3.8%	-3.2%	-9.1%	17.4%
US Mid Cap	IJH	-1.9%	7.2%	-0.7%	-6.3%	19.4%
US Small Cap	VTWO	-1.7%	7.9%	-5.9%	-11.3%	15.7%

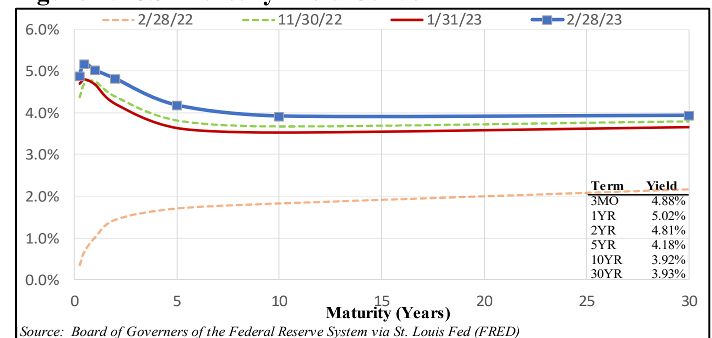
Markets retreated in February, giving back some of January's gains as strong economic data (employment, consumer spending) and persistent inflation increased expectations for more Fed rate hikes. Market highlights for the month are summarized below.

- Bonds: US bonds fell in January as interest rates rose. The US Aggregate index (AGG) lost 2.7%; long-term Treasuries (TLT) were down 4.9% but are still up 2.4% YTD. Corporate bonds (LQD) fell 4.2%, and high yield lost 1.9% amid stable credit spreads. Non-US bonds (IBND) were down 4.5% as the dollar strengthened, while emerging market debt (EMLC) fell 2.9%.
- Global equity (ACWI): -3.3% in February (+3.9% YTD).
- US Equity: The broad market (VTI) fell 2.4% this month (+4.4% YTD). The S&P 500 (IVV) was down 2.5% (+3.6% YTD), while small stocks (VTWO) lost 1.7% (+7.9% YTD). Growth stocks (QQQ and IWF) and sectors (consumer discretionary, communications, tech) have fared well as solid earnings offset the impact of rising interest rates. Defensive sectors (utilities, health care, staples) have under-performed YTD.
- Non-US Equity: Developed markets (EFA) fell 3.1% this month (+5.7% YTD), and emerging markets (EEM) lost 7.6% (+0.9% YTD). European stocks continue to perform surprisingly well (+7.8% YTD) as currencies stabilized. China equities (MCHI) have been more volatile, down 10.7% this month (still +0.8% YTD) and 36.7% above 52-week lows as their economy reopens amid heightened geopolitical tensions.

Interest Rates and the Economy

The yield curve (Figure 2) plots the yields (Y-axis) for various maturities (X-axis) of US Treasuries. The Fed raised the Fed Funds target rate by 0.25% in early February (now 4.50-4.75% range). The inverted yield curve (short-term yields higher than long-term yields) signals that investors believe the Fed will raise rates above 5% (at least two more 0.25% hikes) but will eventually cut rates as the economy weakens, potentially entering recession in the next year. The 10-year Treasury now yields 3.92%.

Figure 2: US Treasury Yield Curve

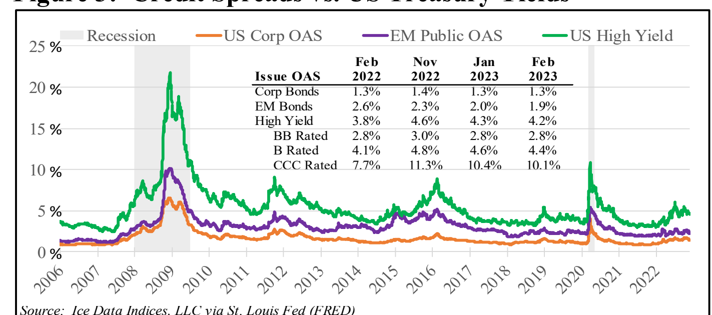


Source: Board of Governers of the Federal Reserve System via St. Louis Fed (FRED)

For bonds other than US Treasuries, we track the option-adjusted spread (OAS) between yields and Treasuries of comparable maturities (Figure 3). Low or narrowing spreads signal optimism, while high or rising spreads signal fear. Spreads narrowed slightly in February despite the negative tone in global markets.

- Investment grade corporate bond spreads have been relatively stable over the past year and were steady this month at +1.3%.
- High yield (non-investment grade) spreads narrowed to +4.2% this month, still above year-ago spreads of +3.8%. The riskiest bonds (rated CCC & below) now yield +10.1% over Treasuries, narrowing in recent months but still wider than a year ago.
- Emerging market bond spreads have narrowed steadily over the past year, now +1.9% over Treasuries. Emerging market credit has out-performed US bonds as those spreads have declined and EM currencies stabilized versus the dollar.

Figure 3: Credit Spreads vs. US Treasury Yields



Source: Ice Data Indices, LLC via St. Louis Fed (FRED)

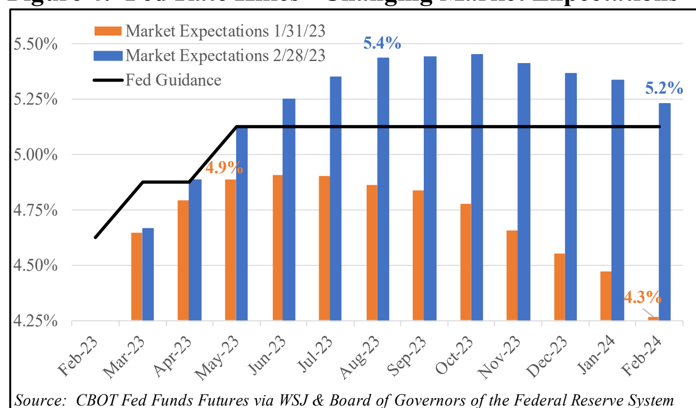
Rising Interest Rate Expectations

After rebounding strongly since October lows, stocks and bonds weakened in February as recent data continued to indicate economic strength, implying that the Fed will need to tighten monetary policy further (raise interest rates) in order to tame inflation.

- The Fed raised interest rates by 0.25% in February (to a range of 4.50-4.75%) signaling “a couple more hike rates” and the need to maintain higher rates for an “extended period”.
- Strong job market: January payrolls increased by 517,000 jobs, much stronger than expected, and the unemployment rate is now 3.4%, the lowest since 1969. Where are the layoffs?
- Stubborn inflation: Headline CPI came in at +6.4% year-over-year for January, while core CPI (which excludes volatile food and energy) remains elevated at +5.6%; the Fed’s preferred inflation metric (Core Personal Consumption Expenditures) is +4.7% for the past twelve months, well above their 2% target.
- Strong consumer spending: Retail sales rebounded strongly in January (+3% for the month) after weakening late in 2022.

Market expectations for further interest rate hikes moved significantly higher in February as illustrated in Figure 4.

Figure 4: Fed Rate Hikes - Changing Market Expectations

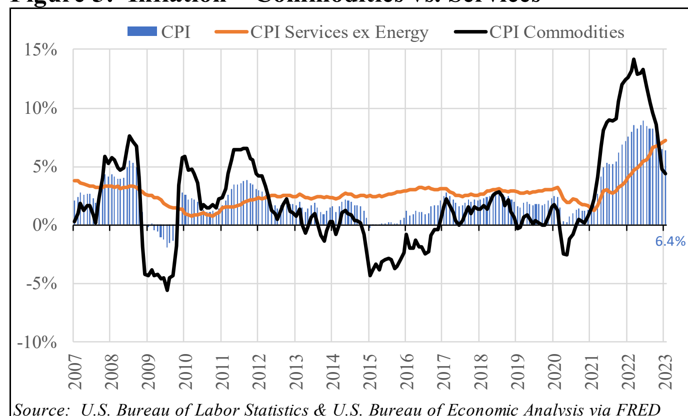


Source: CBOT Fed Funds Futures via WSJ & Board of Governors of the Federal Reserve System

A month ago, market expectations for further interest rate hikes were below the guidance offered by the Fed itself. While the Fed has indicated that they anticipate two more hikes of 0.25% (to a range of 5.00-5.25%), then maintain and adjust based on incoming data, the Fed Funds futures market was more sanguine, indicating a terminal target rate below 5%. In the wake of the strong data referenced above, investors now anticipate at least three more 0.25% hikes by summer and have pushed recession concerns (and rate cut forecasts) months or quarters into the future. A month ago, the futures market was forecasting that rate cuts would begin in Q3, and the Fed Funds target rate would be about 0.50% below current levels a year from now. Today, traders are forecasting the first rate cut to occur in Q4, with interest rates staying above 5% for at least the next 12 months.

The Fed’s inflation fight is not done. Figure 5 breaks CPI down into sub-components: commodities (oil, gas, materials, agriculture, etc.) and non-energy services (housing, medical, education, insurance, travel and leisure, etc.). Commodities spiked as the global economy recovered from the pandemic (exacerbated by Russia’s invasion of Ukraine), but commodity prices are volatile; their impact on inflation has diminished notably in recent months. By contrast, services inflation tends to be “sticky” (less volatile), and it accounts for more than half of the CPI calculation. The sustained rise in the services component of inflation is the Fed’s primary concern. Services inflation remains elevated, but monetary policy takes months to actually impact economic behavior.

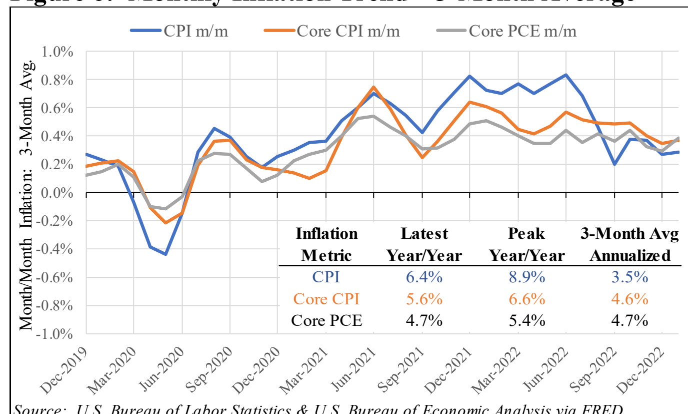
Figure 5: Inflation – Commodities vs. Services



Source: U.S. Bureau of Labor Statistics & U.S. Bureau of Economic Analysis via FRED

The good news is that overall inflationary pressures have eased somewhat in recent months. Figure 6 plots the rolling three-month average of the monthly inflation data for CPI, core CPI (excluding food and energy) and the Fed’s favorite, core PCE.

Figure 6: Monthly Inflation Trend – 3-Month Average



Inflation Metric	Latest Year/Year	Peak Year/Year	3-Month Avg Annualized
CPI	6.4%	8.9%	3.5%
Core CPI	5.6%	6.6%	4.6%
Core PCE	4.7%	5.4%	4.7%

Source: U.S. Bureau of Labor Statistics & U.S. Bureau of Economic Analysis via FRED

- Headline CPI peaked at +8.9% (year/year) in June, 2022 but has slowed to +6.4%. Over the last three months, inflation has declined further to an annualized rate of +3.5%.
- Core CPI (ex-food & energy) peaked at +6.6% (year/year) in September but has eased to +5.6%. Recent data suggests that core inflation has slowed further to a +4.6% annualized rate.
- Core Personal Consumption Expenditures (PCE), which peaked at +5.4% (year/year), has eased somewhat to +4.7% but remains well above the Fed’s target of 2% per annum.

Bottom Line

Market volatility is caused by changing data, expectations and forecasts. Over the past year, stock and bond markets have been weak as investors digested the new reality of higher interest rates after more than a decade of historically accommodative monetary policy (near zero interest rates). Markets rebounded strongly off of October lows as investors speculated (or hoped) that the Fed was near the end of the current rate hike cycle, but more recent data suggests that the inflation fight is not yet done. February’s selloff was driven by strong economic data, but good economic news is bad news for the markets at present because it implies more rate hikes to come and that interest rates will remain elevated for longer period. Because markets are likely to remain volatile for the foreseeable future, diversification remains critical.

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