ECONOMIC & INVESTMENT PERSPECTIVES

APRIL: MARGINAL GAINS FOR STOCKS & BONDS
ECONOMIC GROWTH & INFLATION UPDATE

Figure 1: 4/30/2023 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	0.6%	3.8%	-0.3%	-4.2%	7.3%
Investment Grade Corp Bonds	LQD	0.6%	5.3%	1.1%	-5.0%	11.7%
U.S. Treasury Bonds	GOVT	0.4%	3.7%	-1.0%	-3.9%	5.9%
U.S. 20+ YR Treasuries	TLT	0.3%	7.7%	-8.5%	-12.0%	15.9%
Muni Bonds	MUB	-0.2%	2.3%	2.9%	-1.4%	5.9%
US High Yield	HYG	0.2%	3.9%	1.3%	-6.0%	7.0%
Non-US Corp Bonds	IBND	1.7%	5.0%	-0.7%	-3.6%	19.8%
Emerging Markets Bond LC	EMLC	0.6%	5.7%	5.3%	-2.6%	12.3%
Global Equity						
ACWI Global Equity	ACWI	1.6%	9.1%	2.7%	-2.5%	22.3%
ACWI Global Equity ex US	ACWX	1.9%	9.2%	4.5%	-1.1%	28.0%
International Developed	EFA	2.9%	12.2%	10.1%	-0.3%	34.8%
Emerging Markets	EEM	-0.8%	3.2%	-5.5%	-9.5%	16.9%
Global Equity by Region						
United States	VTI	1.1%	8.3%	1.4%	-5.0%	18.0%
Europe	IEUR	4.2%	14.9%	12.5%	-0.5%	41.6%
Asia ex-Japan	AAXJ	-1.7%	3.0%	-4.4%	-8.7%	22.7%
China	MCHI	-4.3%	0.5%	-3.5%	-16.4%	36.3%
Japan	BBJP	0.4%	8.2%	5.7%	-0.8%	21.9%
Latin America	ILF	3.0%	7.4%	6.2%	-15.1%	18.5%
US Equity						
US S&P 500	IVV	1.6%	9.2%	2.7%	-3.8%	19.5%
NASDAQ 100 QQQ	QQQ	0.5%	21.3%	3.8%	-3.5%	26.9%
US Large Growth	IWF	1.0%	15.5%	2.2%	-4.6%	22.2%
US Large Value	IWD	1.6%	2.5%	1.1%	-4.7%	15.3%
US Eqwt S&P 500	RSP	0.4%	3.3%	0.3%	-6.8%	16.2%
US Mid Cap	IJH	-0.8%	3.0%	1.3%	-9.1%	14.2%
US Small Cap	VTWO	-1.8%	0.9%	-3.7%	-13.1%	7.8%

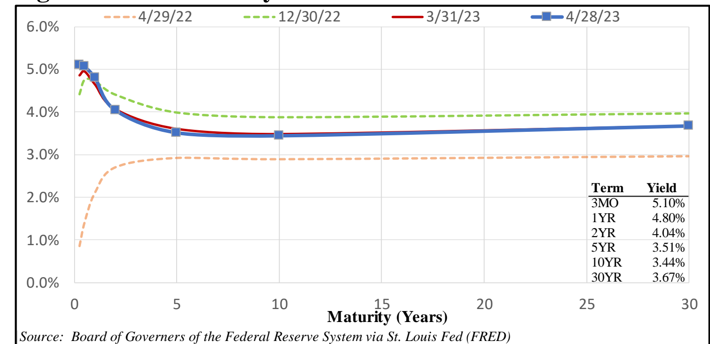
Despite lingering concerns about the stability of the banking system, the path of economic growth, inflation and interest rates, stocks and bonds stabilized in April. Quarterly earnings reports have been solid so far, powering an equity surge in the final days to log marginally positive returns for the month. Performance highlights for the month and year-to-date (YTD) are below.

- Bonds: Bonds rose in April as interest rates stabilized. The US Aggregate (AGG) index gained 0.6% (+3.8% YTD) with marginal gains for Treasuries, investment grade corporate and high yield issues. Non-US bonds in developed and emerging markets continued to out-perform in April and YTD due to narrowing credit spreads and strengthening currencies.
- Global equity (ACWI): +1.6% in April (+9.1% YTD).
- US Equity: The broad market (VTI) gained 1.1% (+8.3% YTD), and the S&P 500 (IVV) was up 1.6% (+9.2% YTD). Returns were slightly positive across economic sectors except utilities. Large stocks continued to out-perform smaller stocks, powered by mega-cap tech and e-commerce names, while small cap stocks (VTWO) were down 1.8% (+0.9% YTD).
- Non-US Equity: Developed markets (EFA) rose 2.9% in April (+12.2% YTD), led by a continued surge in Europe (IEUR +4.2% in April, +14.9% YTD) amid easing energy and economic concerns despite on-going war in Ukraine. Emerging markets (EEM) fell 0.8% (+3.2% YTD), led lower by China (MCHI), which fell 4.3% but remains 36% above 52-week lows as their economy reopens from harsh Covid restrictions.

Interest Rates and the Economy

The yield curve (Figure 2) plots the yields (Y-axis) for various maturities (X-axis) of U.S. Treasuries. After several months of volatility, interest rates were remarkably stable in April, finishing the month roughly unchanged. The market expects that the Fed is very close to the end of their rate-hike cycle. The Fed Funds target is now 4.75-5.00%, with some probability of one more 0.25%. The yield curve remains inverted (short-term rates > long-term yields), which has historically been a recession warning. The 10-year US Treasury now yields 3.44%.

Figure 2: US Treasury Yield Curve

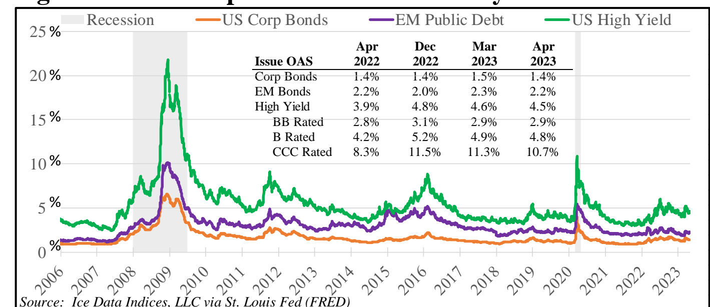


Source: Board of Governers of the Federal Reserve System via St. Louis Fed (FRED)

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 April, despite lingering stress in the banking system.

- Investment grade corporate bond spreads are historically low, narrowing to +1.4% in April, unchanged versus a year ago.
- High yield (non-investment grade) spreads narrowed to +4.5% this month but are wider than year-ago spreads of +3.9%. The riskiest bonds (rated CCC & below) narrowed to +10.7% over Treasuries but are well above the +8.3% spreads a year ago.
- Emerging market spreads narrowed to +2.2% but have been stable over the past year. Emerging market credit has out-performed US bonds in 2023 as the US dollar has weakened.

Figure 3: Credit Spreads vs. U.S. Treasury Yields

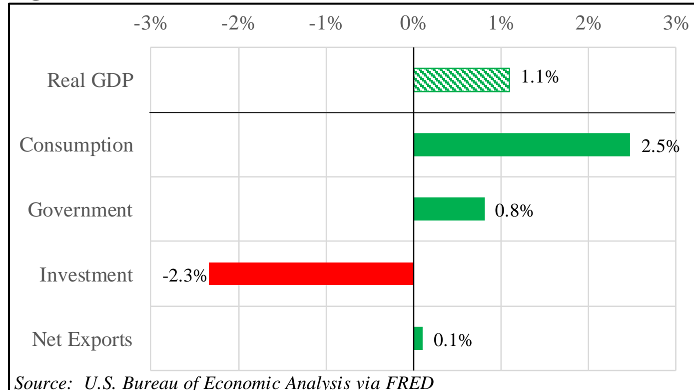


Source: Ice Data Indices, LLC via St. Louis Fed (FRED)

Growth & Inflation

The Bureau of Economic Analysis (BEA) reported that U.S. real GDP grew at an annualized rate of 1.1% in the first quarter. (Note: Real GDP stands for Gross Domestic Product, the value of all final goods and services produced in the U.S., adjusted for inflation.) After uneven but positive real growth of +2.1% in 2022, the economy has slowed under the weight of tighter financial conditions as the Fed raises rates to tame inflation. An analysis of the four primary sub-components of GDP during the quarter is instructive. As illustrated in Figure 4, consumer spending remains robust, but businesses have reduced spending.

Figure 4: U.S. Real GDP Growth Contribution

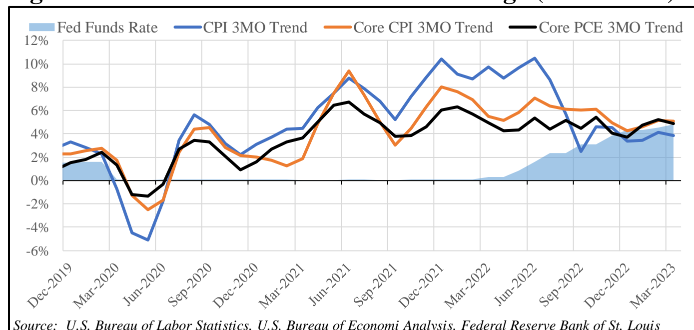


Source: U.S. Bureau of Economic Analysis via FRED

- **Personal Consumption:** 68% of the U.S. economy is powered by the expenditures of individual consumers. Healthy consumer spending continues to drive positive real growth.
- **Government expenditures:** 18% of GDP is driven by direct consumption of goods and services by federal, state and local governments, which had a positive impact on overall growth.
- **Private Investment:** 17% of the economic output comes from business spending and investment activity, including construction, equipment, manufacturing and inventories. Q1 real growth was negatively impacted by an inventory drawdown as businesses reduced spending and production in anticipation of a slowing economy and tighter financial conditions.
- **Net Exports:** A trade deficit (the net value of U.S. exports minus imports) subtracts from economic growth, but a slightly smaller trade deficit contributed positively to Q1 real growth.

It is worth noting that annualized nominal GDP growth (not adjusted for inflation) in Q1 was actually +5.1%, implying an inflation impact of roughly -4.0%, which is somewhat lower than the latest Consumer Price Index (CPI) reading of +5.0% for March versus a year ago. Inflation appears to be coming down, evidenced by the most recent inflation trends illustrated in Figure 5.

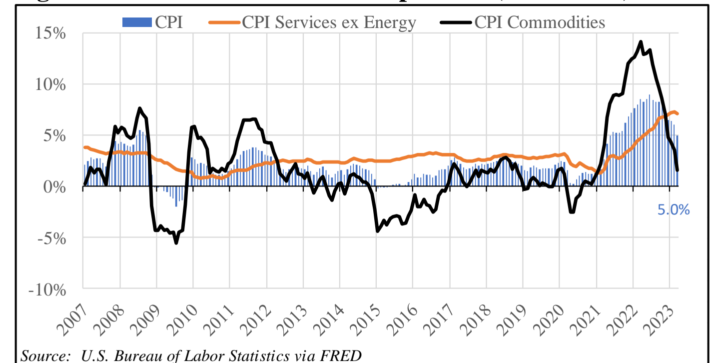
Figure 5: Inflation Trend – 3-Month Average (annualized)



Source: U.S. Bureau of Labor Statistics, U.S. Bureau of Economi Analysis, Federal Reserve Bank of St. Louis

Inflation has come down as Covid-era supply chain disruptions abated, energy prices declined and aggressive monetary policy tightening by the Fed (and global central banks) began to impact financial conditions. Recent inflation appears to be hovering around 4%. It is noteworthy that the cumulative Fed rate hikes have resulted in positive real interest rates (greater than inflation) for the first time in years, but inflation remains well above the Fed's 2% target. Figure 6 breaks CPI inflation down into major sub-components: commodities (raw materials: oil, gas, materials, agriculture, etc.) and non-energy services (housing, medical, transportation excluding gas, education, travel, leisure, etc.).

Figure 6: U.S. Inflation Sub-Components (Year/Year)



Source: U.S. Bureau of Labor Statistics via FRED

After initially driving inflation higher, commodity prices have declined. The sustained rise in the services component is the Fed's primary concern; it comprises more than half of the CPI calculation, and services inflation tends to be sticky while commodity prices are volatile. The largest sub-component of services is shelter (housing) with year-over-year price increases of +8.2% as of March; however, actual data suggests that the CPI survey methodology may be over-estimating shelter inflation (Figure 7).

Figure 7: Year/Year Rent Growth Metrics

Source: Starwood Capital, CoStar, REIS, U.S. Bureau of Labor Statistics

Bottom Line

The Fed is likely near the end of the current rate-hiking cycle as the economy slows and inflation comes down under the weight of tightening financial conditions (higher interest rates, decreasing money supply, stress in the banking system). Stable interest rates and solid corporate earnings reports calmed markets in April, but headwinds remain, including the possibility of further bank failures (First Republic), contentious debt ceiling negotiations, and the risk of recession. An inverted yield curve has historically been a reliable recession predictor, signaling that the Fed will have to cut rates as the economy falters. Because market volatility is likely to return, diversification is critical, with lower exposure to equities in favor of bonds, cash and non-dollar assets.

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