Market Perspective from the Investment Advisory Group

Even if Fed tightening is nearing an end, we stay defensive as economic risks grow

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Keith Lerner, CFA, CMT
Co-Chief Investment Officer
Chief Market Strategist

Highlights

- Relative to the news flow and erratic swings, the overall market has been fairly resilient, at least at the headline level.
- Recent events appear to have pulled forward the end of the Federal Reserve's (Fed) tightening cycle.
- Although a Fed pause or pivot could trigger a short-term rally, we don't see this as a cure-all, especially if the economy falls into recession later this year.
- The Fed's reaction function to current events will likely be less aggressive in providing monetary support relative to past periods given the conundrum of still-elevated inflation.
- We stay defensive with a fixed income tilt relative to equities, a focus on high quality bonds, a slight cash overweight, and a bias for U.S. large caps within equities.

What happened

After three recent bank failures in the U.S., Swiss regulators pushed UBS to buy Credit Suisse (CS) over the weekend. CS, whose stock had already fallen 80% over the past two years, even before the recent financial strains, was considered one of the weaker global links. A sharp increase in customer outflows last week increased the urgency of a deal.

Our take

The overall market has been fairly resilient over the past week, relative to the news flow and erratic swings. The S&P 500 bottomed just above the key support level at 3800 on Monday and actually gained 1.4% last week.

Data source: Truist IAG, Haver performance does not guarantee future results

Much of the market's resilience can be attributed to the strength in the technology and communciatons sectors, which gained more than 5% last week, alongside consumer discretionary, which rose 2%. These strong moves paired with postive returns in less economically-sensitive sectors, such as consumer staples, more than than offset the 6% decline in the financials sector (11% decline in banks) and 7% decline in the energy sector.

Past performance does not guarantee future results
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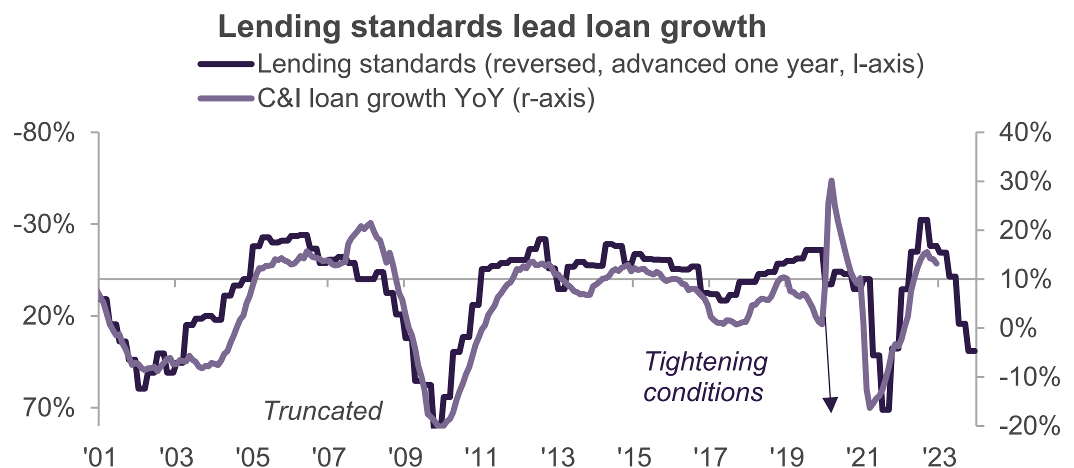
Staying defensive

Despite the market's recent resilience, we are sticking with a defensive posture given:

- Equities continue to trade near average valuation levels, which we view as unwarranted given above-average macro risks.
- Although the recent actions of the U.S. and overseas regulators have reduced some of the systemic risk in the financial system, we anticipate economic growth to slow as the rate hikes of the past year still filter through the system, and we see further downside to earnings.
- Bank lending trends (chart below), which had already become tighter, are likely to become even more restrictive following recent events, including for smaller banks where regulations and funding costs are likely to rise.

  This is important. Smaller banks (less than $250 billion in assets) are estimated to hold close to 50% of U.S. bank deposits and account for half or more of commercial and industrial lending as well as mortgage and commercial real estate loans, according to BCA Research.
- The Fed's reaction function to current events will likely be less aggressive in providing monetary support than in financial challenges of the past generation given the conundrum of still-elevated inflation and the scar tissue left behind from waiting too long to hike rates.



Data source: Truist IAG, Haver

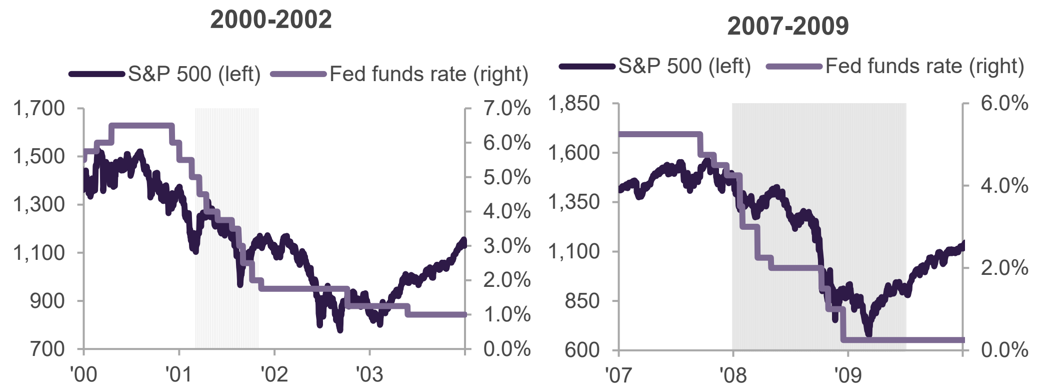
To be fair, there have been some positive market offsets. Less than two weeks ago, the main challenge for the stock market was higher rates. Well, the 10-year U.S. Treasury yield is down about 60 basis points from early March, and the 1-year U.S Treasury yield is down to 4.2% from 5.3% a little over a week ago.

Indeed, recent events appear to have pulled forward the end of the Fed tightening cycle. The market is starting to price in multiple Fed rate cuts in the second half of this year.

Although a Fed pause or pivot could trigger a short-term rally, we don't see this as a cure-all over the intermediate term, especially if the economy falls into recession later this year, as is our current *House View.*

- Stocks did rally strongly following the mid-cycle economic slowdown in 1995 as well as after Fed Chairman Powell's pivot in 2019. These cycles were not followed by recession.
- However, one only needs to look back to 2000 or 2008 to see that a shift in Fed policy alone is not always enough to stop an economy on a downward trajectory or start a new bull market. Stocks and rates fell together for much of these cycles.

Stocks declined alongside Fed rate cuts in the 2000 and 2007 cycles



Data source: Truist IAG, FactSet, Haver. Past performance does not guarantee future results. Gray bar = recession

Importantly, since WWII, stocks have never bottomed before a recession started. To be fair and *to keep an open mind*, the 25% peak-to-trough decline in 2022 was in line with the median market decline during recessions, and Fed forward guidance likely accelerates historical trends. Still, even if stocks don't make new lows, the upside also appears to be capped given current full valuations and earnings risks.

Stocks have never bottomed before a recession even started

Recession begins	Recession ends	Recession duration	# of months S&P 500 bottomed after recession started
Nov-48	Oct-49	11	7
Jul-53	May-54	10	2
Aug-57	Apr-58	8	2
Apr-60	Feb-61	10	6
Dec-69	Nov-70	11	5
Nov-73	Mar-75	16	10
Jan-80	Jul-80	6	2
Jul-81	Nov-82	16	13
Jul-90	Mar-91	8	2
Mar-01	Nov-01	8	6
Dec-07	Jun-09	18	14
Feb-20	Apr-20	2	1
Average		**10**	**6**

Data source: Truist IAG, FactSet, Haver. Past performance does not guarantee future results.

Bottom line

Stocks have been relatively resilient in the face of many obstacles. Investors are now hoping for a shift in Fed policy to trigger a risk-on rally. While this is plausible, our view is the equity risk/reward over the intermediate term remains less favorable given heightened macro risks and far from compelling valuations.

Therefore, we stay defensive. We maintain an overweight to fixed income relative to equities, with a focus on high quality bonds. We keep a slight overweight to cash. Within equities, we maintain our long-standing U.S. and large cap bias, which tends to outperform global markets during periods of financial strains and economic slowdowns.

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