VERED WEALTH MANAGEMENT (CANADA) COMPANY LIMITED

June 26th, 2023

Key Takeaways

The Fed's Tightening Cycle May Not Be Over

Earnings Trends Will Be Key To Watch For Equity Direction

Corporate Bond Yields Exceed S&P 500 Earnings Yields

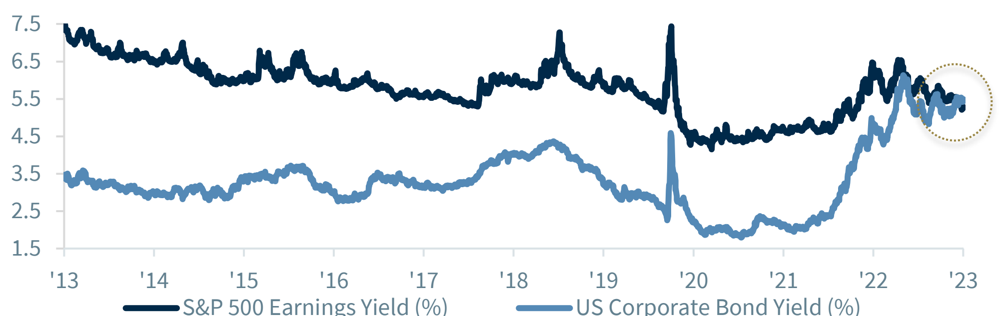
This past Wednesday marked the official start of summer! The summer solstice represents the best time of year—the maximum amount of daylight coupled with warm temperatures. In many ways it's the perfect season—school's out, family vacations, barbeques and beach trips! It sure is fun, that is, while it lasts. And speaking of the maximum sunlight, the sun has been shining on the S&P 500 the last several weeks as it sits just below our year-end target of 4,400. A better-than-expected Q1 earnings season, decelerating inflation, growing optimism about a soft, non-recessionary landing, the AI-powered tech rally, and the Fed nearing the end of its tightening cycle have been key drivers behind the recent upswing. However, with much of the good news now priced in, the equity market is in a more vulnerable spot, susceptible to disappointment. Below are some catalysts that we're watching to gauge the next direction for the markets:

- **The Sun May Not Have Set On The Fed's Tightening Cycle |** This week, the markets had a chance to hear directly from Fed Chair Powell and several other Fed officials after last week's hawkish shift in the dot plot. Powell maintained a hawkish tilt during his semi-annual update to Congress, reiterating the Fed still has more work to do to bring inflation down to the central bank's 2.0% target. There were mixed comments from other Fed officials, but one common thread emerged and that is, rate cuts are a long way off. Persistently high core inflation data (most recently at 5.3%) has unnerved Fed policymakers, but that is to be expected as they try to calibrate the right amount of restraint needed at this point in the cycle. With the economy still showing signs of resilience and core inflation sticky, it is not surprising the Fed wants to keep its options open for further rate hikes. That is why our economist is now calling for one additional rate hike, with the fed funds rate now expected to peak at a top rate of 5.50%. This, combined with the global flurry of interest rate increases from the UK, Swiss, Europe, Australia, Canada and Norway central banks, remains a key risk to further upside in the equity markets—particularly since central banks have a history of 'over' tightening.
- **Will Earnings Take Another Dip Or Will It Be Smooth Sailing? |** As we discussed in prior *Weekly Headings*, the earnings recession that plagued the market for much of the last year has shown signs of stabilizing. Turns out that analysts were way too pessimistic—just as we forecasted. The resilience of the economy, cost-cutting measures (i.e., layoffs) and disinflationary trends that boosted margins and growing enthusiasm around AI helped put a floor under the declining earnings trends. In fact, the S&P 500's forward earnings estimates bounced off their recent lows of $226 to ~$232 as the corporate profit outlook brightened.* This has contributed to the broader risk-on trend in the markets over the last few weeks, which admittedly, is likely stretched—at least in the near term. In a few weeks' time, we will flip the page to second-quarter earnings season and will monitor whether companies will be able to sustain these trends in the wake of more challenging consumer and economic headwinds. Early reporters have flagged weakening demand (FedEx), a difficult macro environment (Darden Restaurants) and lower tech spending (Accenture).
- **Recession Concerns Still Cast A Dark Cloud |** The debate about when the recession will begin, if one will begin at all, is likely to dominate news headlines until there is definitive evidence that the labor market is cracking. While there have been signs of cooling labor demand (i.e., rising trend of initial claims*, increased corporate lay-offs, fewer people voluntarily quitting their jobs, slowing demand for temporary workers, and a declining number of hours worked) the labor market remains strong by any historic standard. In fact, this is a key reason why our economist recently pushed out the likely beginning of recession from Q3 to Q4 2023. But as we have stated in the past, we remain skeptical that the recent strength can continue and believe that the payroll data may be overstating job growth—particularly given the noise between the establishment and household surveys. And we are expecting there to be a strong slowdown in job creation over the coming months. This, plus the ongoing deterioration in the Conference Board's leading economic indicators, which has fallen for fourteen consecutive months, suggests that a recession is more likely than not. With equity markets rallying on hopes of a soft landing, disappointing economic news could lead to a potential setback.
- **Hot Bond Yields Could Challenge Equity Flows |** After the massive reset in interest rates last year, bonds look increasingly attractive versus equities. With the recent rally in equity market, the S&P 500 earnings yield (the inverse of the price-earnings ratio) has fallen to 5.3%. Compare that to the 5.5% yield on the US corporate bond index or the 5.1% yield on cash instruments and suddenly stocks look a little less attractive on a relative basis. While equity flows have recently increased as investors chase the strong returns of the last few weeks, we suspect this dynamic could reverse, particularly if economic data disappoints.

CHART OF THE WEEK

Corporate Bond Yields Exceed S&P 500 Earnings Yield

Historically, the earnings yield on the S&P 500 exceeds corporate bond yields to compensate investors for the greater risk of investing in equities. Today, corporate yields are higher.



Source: FactSet

ECONOMY

- May saw the housing market stabilize further, with both Building Permits and Housing Starts increasing 5.2% and 21.7% month-over-month (MoM), respectively. Housing Starts recorded its highest MoM rate since October 2016.* This rebound may be challenged as the Federal Reserve (Fed) is expected to increase rates at least one more time—pushing mortgage rates higher.
- The Existing Home Sales showed that, although still fragile, the housing market has stabilized as higher interest rates have reduced the pool of buyers. However, the still low inventory of homes is keeping the existing home side of the housing market afloat.
- The Conference Board Leading Economic Index (LEI) fell for the fourteenth consecutive month in April, continuing to suggest that the US economy is bound to enter a recession in the near term.*
- **Focus of the Week:** Adding to this week's housing reports, next week will see more data points that will help gauge the housing market's health: FHFA and S&P/Case-Shiller Home Price Indices (Tue.) to help measure housing inflation and New (Tue.) and Pending (Thur.) Home Sales to help measure housing demand strength. In addition, the Fed's preferred inflation metric—Personal Consumption Expenditures (PCE)—will come out Friday, and we expect the year-over-year (YoY) growth rate to fall to 4.0%—its lowest in more than two years. Conversely, core PCE is likely to be more stubborn and remain at last month's level of 4.7% YoY.

June 26 – June 30

MON		WED	Wholesale Inventories	FRI	PCE Price Index Michigan Sentiment
TUE	FHFA & SP/C-S Home Prices New Home Sales Consumer Confidence	THU	Jobless Claims 1Q23 GDP (final estimate) Pending Home Sales	FUTURE EVENTS	7/3 Construction Spending 7/5 Durable Orders, FOMC Minutes 7/7 Employment Report

US EQUITY

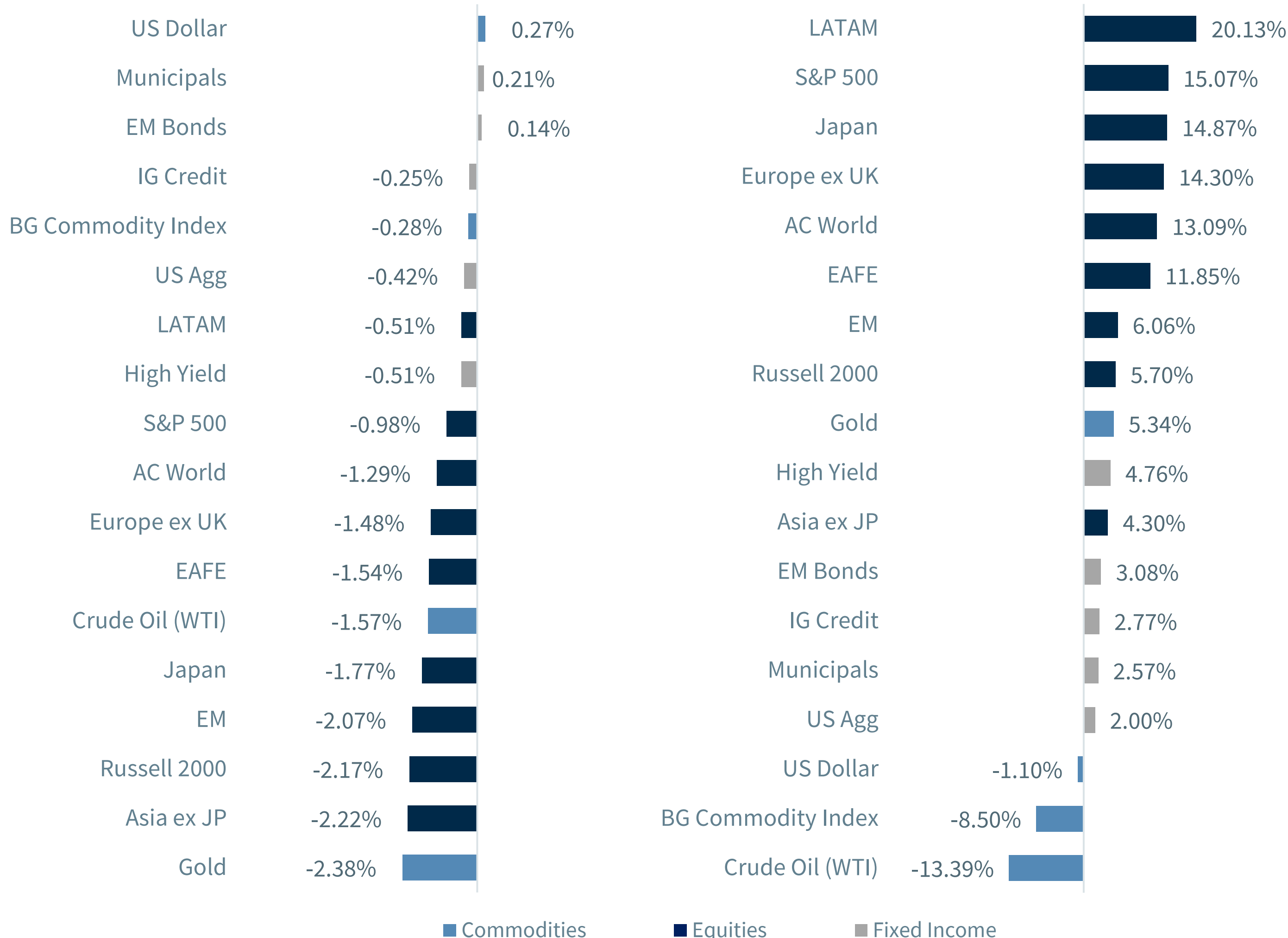
- After the third best start to a year (+14%) over the last 25 years, we expressed caution on the equity market last week as the S&P 500 rallied above our year-end target of 4,400. Technical indicators appear to be stretched with the S&P 500 rising into overbought territory (14-Day RSI>70) and the % of bullish investors in the AAII survey rising to the highest level since November 2021.*
- This week, the market took a bit of a technical breather, as the S&P 500 is on pace to post its first weekly decline in six weeks—ending the longest streak of consecutive weekly gains in nearly two years. The best performing sectors year-to-date were the laggards this week—as the Tech and Communication Services sectors saw some of the weakest performance.
- Despite our caution near term, we remain constructive on the equity market over the next 12 months (12-month S&P 500 price target: ~4,600) as easing inflation, the eventual end of the Fed tightening cycle and solid corporate fundamentals (elevated margins, still solid earnings) are supportive of the equity market longer term.
- **Focus of the week:** While the start of the 2Q23 earnings season is a few weeks away and will be the next big hurdle for the equity market, a small diversified group of early reporters this week gave a glimpse into the state of the economy: FedEx highlighted that cost cutting remains in focus and goods spending continues, KB Homes highlighted that housing activity is picking up, and Darden suggested inflationary pressures continue to decelerate as input and wage costs continued to ease.

FIXED INCOME

- The recent rise in bond yields and more hawkish shift from Fed officials has deepened the US yield curve inversion. The 2-year Treasury yield (4.72%) exceeds the 10-year yield (3.70%) by ~100 bps, its widest level since before the March banking crisis and its deepest inversion since 1981.* The market pays attention to this indicator as it has correctly predicted the last six recessions. Historically, a recession has occurred within eighteen months after the curve first inverts; this cycle's inversion began in April 2022 which places a recession starting by this October. With the Fed maintaining a hawkish bias, the yield curve is likely to invert further. Similar to the US, yield curves are inverted in a many countries, including Germany, the UK, Australia, Canada and Sweden.
- **Focus of the Week:** The bond markets, particularly those overseas, will need to recalibrate where they see interest rates peaking this tightening cycle as policymakers signal they still have more work to do to bring down inflation. The US bond market will have to absorb a ton of bond issuance next week. Next Friday's PCE report should provide further evidence of disinflation, which would be a positive signal to Fed policymakers.

POLITICS

- Secretary of State Anthony Blinken met with Chinese President Xi Jinping during his two-day visit to Beijing that concluded on Monday. The visit, previously unannounced reception by Xi, and overall positive takeaways from the trip confirm our outlook that we have likely passed the peak of US-China tensions and associated macro risk for the year. While no major policy developments were made, both sides affirmed mutual respect for the other's interests and communicated a desire to hold further talks, with Blinken stressing that "we both agree on the need to stabilize our relationship."
- Looking ahead, our outlook for the rest of the year is generally calm, with the Biden administration seeking to limit hawkish actions ahead of Biden and Xi's potential meeting in November—however, we will be monitoring the accelerating activity in Congress on key China policy issues as a potential source of tensions.



**Weekly performance calculated from Thursday close to Thursday close.

***Assumes all asset classes are priced in US dollars unless otherwise noted. Ranked in order of performances (best to worst).

Weekly Data**

Data as of June 22

US Equities

Index	Price	Weekly	MTD	YTD	1 Year	3 Year	5 Year	10 Year
S&P 500	4381.9	(1.0)	4.9	15.1	18.6	13.8	11.7	12.8
DJ Industrial Average	33946.7	(1.3)	3.2	2.4	11.4	9.3	6.7	8.7
NASDAQ Composite Index	13630.6	(1.1)	5.4	30.2	23.3	10.7	12.1	15.0
Russell 1000	4607.5	(1.1)	5.0	14.7	2.4	12.5	10.6	11.8
Russell 2000	4593.2	(2.2)	5.7	5.7	(4.7)	9.2	2.7	7.4
Russell Midcap	7283.2	(1.8)	5.3	5.9	(4.5)	10.2	6.9	9.3

Equity Sectors

Sector	Price	Weekly	MTD	YTD	1 Year	3 Year	5 Year	10 Year
Materials	506.0	(1.0)	7.6	4.4	10.1	15.0	8.9	9.8
Industrials	880.8	(1.0)	7.9	6.9	22.9	16.6	9.6	11.3
Comm Services	215.8	(1.5)	2.5	36.1	16.7	6.3	9.5	6.7
Utilities	335.6	(0.6)	2.5	(4.9)	2.8	8.0	8.9	9.8
Consumer Discretionary	1312.9	0.9	10.6	31.3	21.3	8.6	9.3	13.0
Consumer Staples	779.1	0.3	3.2	1.3	9.6	11.7	11.0	9.7
Health Care	1544.9	0.6	4.1	(1.7)	8.3	11.7	11.3	12.8
Information Technology	3031.5	(1.7)	4.7	40.3	38.0	19.5	20.9	21.6
Energy	599.9	(2.8)	2.6	(9.1)	11.5	32.1	6.0	4.0
Financials	547.4	(1.8)	4.1	(3.0)	7.3	13.8	6.3	10.0
Real Estate	227.2	(3.2)	1.3	(0.5)	(6.4)	4.6	5.9	7.7

Fixed Income

Index	Yield	Weekly	MTD	YTD	1 Year	3 Year	5 Year	10 Year
3-Months Treasury Bill (%)	5.2	0.1	0.3	2.2	3.6	1.3	1.5	0.9
2-Year Treasury (%)	4.8	(0.2)	(0.5)	0.7	(0.2)	(1.3)	0.8	0.6
10-Year Treasury (%)	3.8	(0.6)	(1.1)	1.8	(2.3)	(6.8)	0.4	0.9
Bloomberg US Corporate HY	8.9	(0.5)	1.1	4.8	7.2	2.4	3.1	4.4
Bloomberg US Aggregate	4.8	(0.4)	(0.4)	2.0	(0.2)	(3.9)	0.8	1.5
Bloomberg Municipals	--	0.2	0.9	2.6	4.0	(0.6)	1.8	2.7
Bloomberg IG Credit	5.5	(0.3)	(0.0)	2.8	1.5	(3.6)	1.8	2.6
Bloomberg EM Bonds	7.5	0.1	1.3	3.1	4.7	(2.8)	0.9	2.7

Commodities

Index	Price	Weekly	MTD	YTD	1 Year	3 Year	5 Year	10 Year
WTI Crude ($/bl)	69.5	(1.6)	2.1	(13.4)	(34.5)	19.8	0.3	(2.9)
Gold ($/Troy Oz)	1923.7	(2.4)	(2.9)	5.3	4.6	2.9	8.6	4.1
Bloomberg Commodity Index	103.2	(0.3)	5.4	(8.5)	(17.2)	16.8	3.4	(2.1)

Currencies

Currency	Price	Weekly	MTD	YTD	1 Year	3 Year	5 Year	10 Year
US Dollar Index	102.4	0.3	(1.9)	(1.1)	(1.7)	1.8	1.6	2.2
Euro	1.1	0.4	2.8	2.7	3.4	(0.9)	(1.2)	(1.8)
British Pound	1.3	(0.0)	2.8	5.9	3.5	0.8	(0.8)	(1.9)
Japanese Yen	142.8	(1.6)	(2.2)	(7.6)	(4.9)	(9.2)	(5.1)	(3.7)

International Equities

Index	Price	Weekly	MTD	YTD	1 Year	3 Year	5 Year	10 Year
MSCI AC World	676.2	(1.3)	4.8	13.1	16.5	10.9	8.2	9.3
MSCI EAFE	2127.4	(1.5)	4.3	11.8	18.9	9.0	4.6	6.0
MSCI Europe ex UK	2356.4	(1.5)	3.6	14.3	22.5	10.2	6.3	7.2
MSCI Japan	3560.7	(1.8)	5.6	14.9	21.4	5.9	3.5	5.9
MSCI EM	1001.1	(2.1)	4.8	6.1	4.3	2.9	1.2	3.9
MSCI Asia ex JP	639.0	(2.2)	3.9	4.3	2.1	1.9	1.0	5.3
MSCI LATAM	2469.1	(0.5)	13.2	20.1	29.3	15.6	5.8	2.2
Canada S&P/TSX Composite	14869.5	(2.2)	0.0	1.0	3.0	8.1	3.5	5.0

**Weekly performance calculated from Thursday close to Thursday close.

Disclaimer

1. The particulars contained herein were obtained from Raymond James we believe to be reliable but are not guaranteed by us and may be incomplete. The opinions expressed are based upon our analysis and interpretation of these particulars and are not to be construed as a solicitation or offer to buy or sell the securities mentioned herein.

2. The securities or sectors mentioned herein are not suitable for all investors and should not be considered advice. Please consult your investment advisor to verify whether this security or sector is suitable to you and to obtain the information, including the risk factor completely

3. Vered Wealth Management (Canada) Company Limited provides comprehensive investment services, including managed accounts and advisory services. We have access to a wide range of investment products, including mutual funds, stocks, fixed income products, various alternativeinvestment products and more. We offer registered and non-registered investment accounts, such as cash and margin accounts, corporate accounts, RRSPs & RRIFs, L/RAs & L/Fs, RESPs and TFSAs.

4. Vered Wealth Management (Canada) Company Limited is a member of the Investment Industry Regulatory Organization of Canada (IIROC) and is registered in BC and ON. Vered is a member of the Canadian Investor Protection Fund (CIPF).

5. The contents herein are not intended and shall not be construed as a solicitation of customers or business in any jurisdiction in which Vered is not registered as a dealer in securities.