ECONOMIC & INVESTMENT PERSPECTIVES

MARCH: STOCK AND BOND MARKETS RALLY
VOLATILE INTEREST RATE EXPECTATIONS

Figure 1: 3/31/2023 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	2.6%	3.2%	-4.6%	-6.8%	6.9%
Investment Grade Corp Bonds	LQD	3.9%	4.7%	-6.3%	-9.8%	11.4%
U.S. Treasury Bonds	GOVT	2.9%	3.3%	-4.4%	-6.1%	5.6%
U.S. 20+ YR Treasuries	TLT	4.8%	7.4%	-17.4%	-20.0%	15.8%
Muni Bonds	MUB	2.4%	2.6%	0.5%	-1.7%	6.3%
US High Yield	HYG	2.0%	3.7%	-3.1%	-8.5%	7.3%
Non-US Corp Bonds	IBND	4.6%	3.3%	-9.8%	-10.4%	18.0%
Emerging Markets Bond LC	EMLC	3.8%	5.2%	-1.1%	-6.6%	12.8%
Global Equity						
ACWI Global Equity	ACWI	3.3%	7.4%	-7.1%	-10.1%	20.4%
ACWI Global Equity ex US	ACWX	3.1%	7.2%	-4.3%	-8.4%	25.7%
International Developed	EFA	3.1%	9.0%	-0.2%	-4.2%	31.0%
Emerging Markets	EEM	3.2%	4.1%	-10.5%	-15.6%	17.8%
Global Equity by Region						
United States	VTI	2.7%	7.2%	-8.8%	-11.6%	16.7%
Europe	IEUR	2.3%	10.3%	1.1%	-3.2%	35.9%
Asia ex-Japan	AAXJ	3.7%	4.8%	-8.0%	-12.8%	24.8%
China	MCHI	4.2%	5.0%	-3.7%	-12.6%	42.5%
Japan	BBJP	4.9%	7.8%	-3.2%	-6.0%	21.4%
Latin America	ILF	0.4%	4.3%	-11.4%	-23.6%	15.0%
US Equity						
US S&P 500	IVV	3.7%	7.4%	-7.9%	-10.6%	17.6%
NASDAQ 100 QQQ	QQQ	9.5%	20.7%	-10.8%	-13.1%	26.2%
US Large Growth	IWF	6.8%	14.3%	-11.2%	-13.7%	20.9%
US Large Value	IWD	-0.5%	0.9%	-6.2%	-10.3%	13.6%
US Eqwt S&P 500	RSP	-0.9%	2.9%	-6.6%	-9.9%	15.8%
US Mid Cap	IJH	-3.2%	3.8%	-5.1%	-8.3%	15.1%
US Small Cap	VTWO	-4.8%	2.8%	-11.6%	-14.7%	9.8%

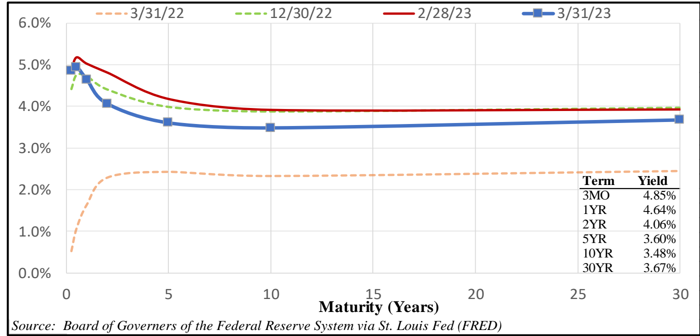
Volatility returned in March as high-profile bank failures roiled markets and led to a reassessment of expectations for future Federal Reserve (Fed) interest rate hikes. The decline in interest rates led to strong returns for bonds and growth stocks. Highlights for the month and first quarter (Q1) are summarized below.

- Bonds: US bonds rose in March as interest rates fell. The US Aggregate index gained 2.6% (AGG +3.2% Q1); long-term Treasuries were up 4.8% (TLT +7.4% Q1). Corporate bonds rose 3.9% (LQD +4.7% Q1), and high yield rose 2.0% (HYG +3.7% Q1). Non-US bonds were up 4.6% (IBND +3.3% Q1), while emerging market debt rose 3.8% (EMLC +5.2% Q1).
- Global equity (ACWI): +3.3% in March (+7.4% YTD).
- US Equity: The broad market gained 2.7% (VTI +7.2% Q1), and the S&P 500 was up 3.7% (IVV +7.4% Q1). Returns were concentrated in the large tech, communications and consumer discretionary sectors; the Nasdaq QQQ rose 9.5% in March (+20.7% Q1), while mid (IJH) and small stocks (VTWO) were down for the month and up only marginally in Q1. The financial sector (XLF) was down 9.6% in March and -5.5% in Q1.
- Non-US Equity: Developed markets (EFA) rose 3.1% in March and 9.0% in Q1, led by strong returns in Europe (IEUR), which rallied 35.9% off of 52-week lows as a mild winter eased energy and economic concerns in the region. Emerging markets (EEM) gained 3.2% in March and 4.1% in Q1 on gains in China (MCHI), which rallied 42.5% off of 52-week lows as their economy reopens in the wake of Covid shutdowns.

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 rates by 0.25% in March (Fed Funds target range now 4.75-5.00%), but yields declined amid concerns about the stability of the banking system. Investors believe that the rate-hike cycle is ending, and the inverted yield curve (short-term yields higher than long-term yields) suggests that the economy will weaken, forcing the Fed to cut rates this year. The 10-year Treasury now yields 3.48%.

Figure 2: US Treasury Yield Curve

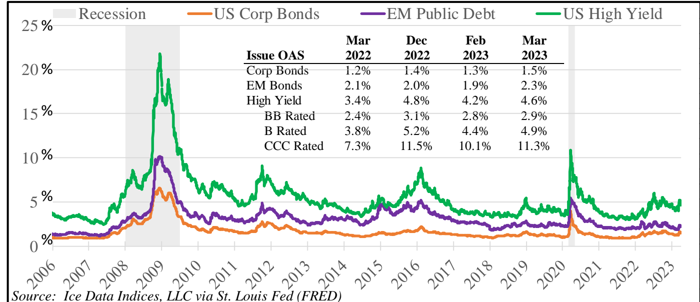


Source: Board of Governers of the Federal Reserve System via St. Louis Fed (FRED)

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 widened in March, reflecting the stress in the banking system.

- Investment grade corporate bond spreads remain historically low but rose to +1.5% in March versus +1.2% a year ago.
- High yield (non-investment grade) spreads widened to +4.6% this month, well above year-ago spreads of +3.4%. The riskiest bonds (rated CCC & below) widened to +11.3% over Treasuries and are significantly wider than a year ago.
- Emerging market spreads widened to +2.3% but have been relatively stable over the past year. Emerging market credit has out-performed US and developed market bonds in 2023 as EM currencies stabilized or appreciated versus the dollar and euro.

Figure 3: Credit Spreads vs. US Treasury Yields

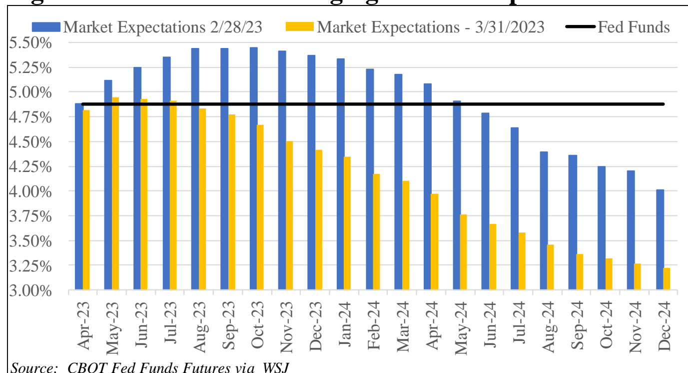


Source: Ice Data Indices, LLC via St. Louis Fed (FRED)

Volatile Interest Rate Expectations

Interest rate forecasts have been volatile so far in 2023. In last month's commentary, we noted that market expectations for further Fed rate hikes moved significantly higher in February after a series of stronger-than-expected economic data (strong employment, stubbornly high inflation, strong consumer spending, etc.). Exactly the opposite occurred in March as interest rate expectations moved sharply lower due to concerns regarding the stability of the banking system in the wake of several high-profile bank failures (notably SVB). Figure 4 illustrates the sharp move lower in interest rate expectations. (Note: Fed Funds futures trade via monthly contracts, providing a framework for illustrating market expectations for future Fed interest rates decisions.)

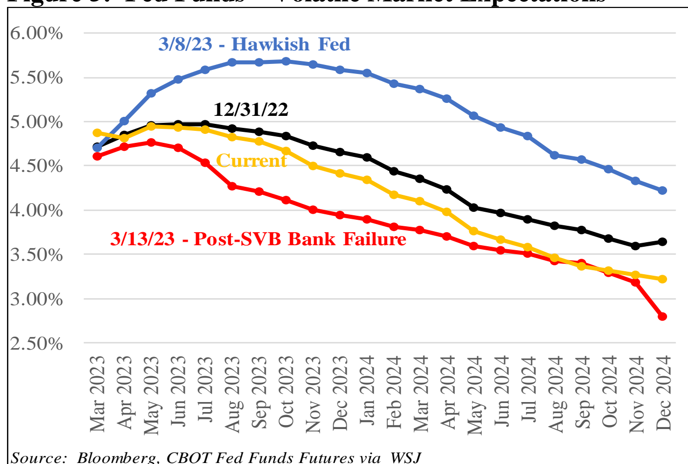
Figure 4: Fed Funds - Changing Market Expectations



Source: CBOT Fed Funds Futures via WSJ

A month ago, market expectations for further interest rate hikes were well above the current Fed Funds target (4.75-5.00% range), predicting at least two more 0.25% hikes. Today, the futures market predicts that the Fed is likely finished raising rates (small probability of one more hike) and that they will begin cutting interest rates in the second half of this year as the economy weakens (recession). The forecast for the 2023 year-end Fed Funds target rate declined from 5.4% to 4.4% during March, but this understates the intra-month volatility of those expectations. Figure 5 illustrates the volatility of interest rate expectations in 2023.

Figure 5: Fed Funds – Volatile Market Expectations

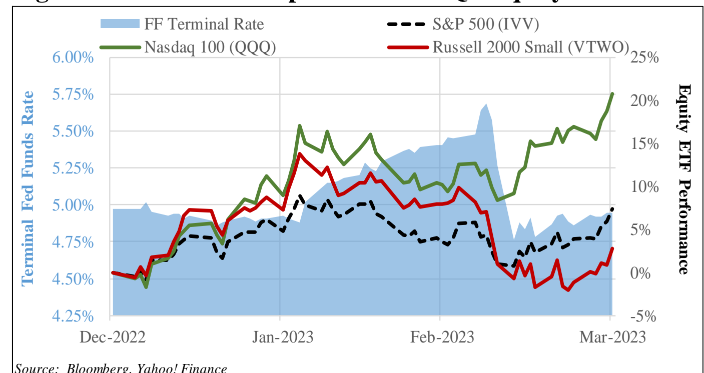


Source: Bloomberg, CBOT Fed Funds Futures via WSJ

- 12/31/22: Expectations were that the Fed would continue raising interest rates to a terminal (peak) rate of approximately 5%, with recession and rate cuts beginning by late 2023.
- 3/8/23: Forecasts for the terminal rate peaked at 5.7% in the wake of a hawkish speech by Fed Chair Powell. Recession and rate cut expectations were pushed into 2024.
- 3/13/23: Interest rate expectations plummeted after SVB and other bank failures; the terminal rate troughed at 4.8% on 3/13 with recession and rate cut expected by summer.
- Current: Rate forecasts moved somewhat higher after the Fed, FDIC and Treasury moved aggressively to stabilize the banking system and calm depositors. The first quarter ended with terminal Fed Funds rate expectations of 4.9% and recession and rate cuts predicted to begin in the second half of 2023.

The wild swings in bond yields and interest rate expectations have had a dramatic effect on stocks here in the US. Figure 6 illustrates the performance of the S&P 500 (IVV), Nasdaq 100 (QQQ) and small cap stocks (VTWO) against the backdrop of the changing interest rate expectations.

Figure 6: Fed Funds Expectations vs. Q1 Equity Returns



Source: Bloomberg, Yahoo! Finance

In general, stocks did well in January with stable interest rate expectations, then sold off in February and early March as strong economic data and hawkish Fed rhetoric drove rate expectations higher. Stocks moved sharply lower after SVB and other bank failures came to light but began to recover on 3/13 after the coordinated government action stemmed fears of another financial meltdown. If we just focus on the S&P 500, we would lose the nuance of the stock market dynamics during the first quarter. Large growth-oriented stocks (QQQ) exploded higher as interest rate expectations declined, a function of lower interest rates increasing the present value of the future earnings of growth-oriented technology and consumer stocks. By contrast, small caps (VTWO), which are more levered to the domestic economy and include larger exposures to regional banks, have not recovered.

Bottom Line

Market volatility is caused by changing economic data, expectations and forecasts. Over the past year, interest rates have risen steadily as the Fed seeks to tame inflation. This caused negative returns in 2022 for stocks and bonds, but prices rebounded late last year as investors anticipated the end of the Fed rate hike cycle. Stocks faltered anew in February and early March as continued economic strength implied more aggressive rate hikes than had been anticipated. Then something broke. The rapid increase in interest rates caused the market value of banks' bond reserve portfolios to decline, raising solvency questions and, ultimately, several bank failures. The coordinated response of the Fed, FDIC and Treasury seems to have calmed depositors' and investors' fears, at least for now. Ultra-large tech-oriented stocks and sectors resumed their leadership role as rate expectations declined, but the probability of recession has increased as financial conditions continue to tighten. Because markets are likely to remain volatile for the foreseeable future, diversification remains critical.

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