Transcript: Q2 2023 Financial Markets Outlook

[Upbeat music]

[Dave Donabedian, Chief Investment Officer, CIBC Private Wealth U.S.]

>>Dave Donabedian:
Hello, and welcome to our quarterly financial markets review and outlook webinar. I'm Dave Donabedian, chief investment officer of CIBC Private Wealth Management in the US. I'm joined today by our head of fixed income, Gary Pzegeo, and senior equity trader, Rebecca Babin. Let's start with a look back at how markets fared in the first quarter.

[spreadsheet titled “A look back: Market scorecard” outlines first quarter returns as of March 31, 2023]

There was plenty of drama for sure, especially with all the banking sector concerns in March. But in the end, the quarter was a good one for equities and fixed income. As you see in the first column there, all positive numbers in the stock and bond categories. Commodities fell back as energy prices declined. If you look at the second column, the trailing 12-month period, it really tells a different story with negative returns across the board, owing to the bear market environment that existed last spring and summer.

And it's important to note in the last column, even with the 2022 bear market and the brief pandemic bear market in 2020, the S&P 500 has still earned a strong compound annual return north of 11% over the last five years. Let's look ahead now and start with a view on the economy.

[The words “U.S. Economy” sit on an American flag.]

We said at the beginning of the year that we were concerned about a recession in the second half of 2023, and we still are. Many leading indicators suggest a stumble ahead for the economy. We've seen an equity bear market, an inverted yield curve, aggressive monetary tightening, and a big drop in the index of leading economic indicators. While the job market has remained solid, other parts of the economy have begun to falter, things like the housing market, manufacturing, exports, and business investment. It may also be that the banking sector volatility, even though contained, could cause some further damage to the outlook. It's likely to slow investment commitments by some businesses and create a more cautious lending environment.

[Line graph titled “Growing headwinds for the economy”]

This slide shows the results of the Federal Reserve survey of bank senior loan officers. And it indicates that even before March's turbulence, banks were already adopting more conservative lending standards, with many more loan officers saying they were tightening standards as opposed to easing them. We do expect some good economic news. Headline inflation peaked back in June and is likely to continue to come down as the year progresses. We've already seen goods inflation fall. And when the reality of lower housing prices filters through the data, services inflation should fall in the months ahead as well. So really, all the things I've touched on, risk of recession, financial conditions, and inflation feed into the calculus for monetary policy.

[The words “Monetary Policy and the Bond Market” sit on a backdrop of the Federal Reserve building.]

So now to discuss the Fed's policy dilemma and the bond markets, let me turn it over to our head of fixed income, Gary Pzegeo.

[Gary Pzegeo, Head of Fixed Income, CIBC Private Wealth U.S.]

>>Gary Pzegeo
Thanks, Dave. When it comes to policy, this has been a cycle of extremes, and so it makes sense that we're moving on from the 40-year highs of inflation and rate hikes to a 40-year-high in what I'll call policy expectations reversal. On March 7th, Fed Chair Powell testified in front of Congress with a message that hinted at a faster pace of rate hikes in response to strong January and February data. At that time, Powell and

the Fed were leading markets to expect a peak rate approaching 6%. And on March 8th, the two-year treasury yield sat just below 5.1%.

Since then, we've seen the impact of banking sector concerns on the Fed and the markets.

[Line graph titled “Monetary policy”]

The two-year yield fell by over one and a quarter percentage points, including the largest one-day yield change in over 20 years. The market's expectation for future rate hikes turned into expectations for rate cuts, with the December 2023 futures contract falling toward 4%. And the Fed toned down their language in regards to fighting inflation. The inflation fight is not over. The Fed still thinks it may have to nudge rates a little higher. But the Fed now has the difficult task of assessing how much the banking concerns are restraining growth and if the lending restraint is enough to bring inflation down. In other words, to what extent will financial sector tightening replace monetary tightening?

We can see that trade-off in part by looking at how expensive it has become for banks to hold onto deposits and by how lenders react to the new funding environment.

[Line graph titled “Credit markets”]

So far, the short answer is more expensive and less credit availability. The early deposit outflows are already forcing a response from some financial institutions in the form of higher deposit rates and stricter lending conditions. Deposit rates typically lag Fed policy, moving up more slowly than other market rates like those for short-term treasury bills. This cycle is a little unusual in the speed and the magnitude of the Fed move. And that in combination with other unique factors around access to information and the ease of moving deposits make this difference between deposit rates and other yields more of a concern this time around. That concern runs across the capital structure. Riskier parts of lenders funding models like subordinated debt or contingent capital saw a spike in volatility and may not be economic sources of funds for some issuers.

A key question going forward and really in any episode of any market uncertainty is whether the issue is isolated or systemic. So far, we've seen unusually large outflows from smaller banks and greater usage of the Fed's various lending facilities. But both appear stable following a sharp increase in the first few days following the SVB and Credit Suisse takeovers. Regardless, more expensive capital, or just a more difficult environment for a deposit gathering, should have negative implications for lending activity and growth, and will likely force the Fed into an easier policy stance earlier than they have signaled.

[The word “Equities” sits on a moving backdrop of the stock exchange]

With that, let me pass it over to Rebecca Babin.

[Rebecca Babin, Senior Equity Trader, CIBC Private Wealth U.S.]

>>Rebecca Babin
Thanks, Gary. One may I look at the performance of US equities for the quarter and conclude it was uneventful. However, the headline numbers only tell part of the story. Under the surface, we saw a meaningful uptick in both volatility and sector dispersion, as the stress in the banking system reverberated through financial markets. The clear outperformance from a relative valley standpoint came from the technology sector, which rallied nearly back to its relative highs versus the S&P.

[Line graph titled “U.S. equities: Tech rally buoys overall equity market performance”]

The reason for the outperformance of technology comes from the view that some investors hold that technology is now a safe haven during times of financial stress, as well as the restored expectation that the Fed is going to cut rates in the second half of 2023. We'll delve into that further on the next slide.

[Line graph titled “U.S. equities: Stocks respond to Fed easing, but not right away”.}

The banking episode coupled with slowing economic conditions brought back expectation of a Fed rate cut in the second half of 2023. The equity market has interpreted this shift as an all clear signal. While a potential change in monetary policy is an important development for equity markets, a review of the last eight bear markets suggest it may not be an immediate elixir. Looking at the chart on this slide, which shows the percentage change in the S&P following the Fed's first rate cut and the time from the first rate cut to the market bottom, we can see that the market fell on seven of the eight instances. In 1974, 1987, and 2020, the market bottomed very shortly after the Fed's first cut, while it took much longer following the bear markets in 1981, 1989, 2001, and 2007. This, in conjunction with our estimates for corporate profits, suggests that the road ahead may continue to be bumpy, and caution is still warranted.

Incorporating our estimates, the S&P closed the first quarter with a forward P/E of nearly 20 times. To put this in context, the forward P/E historically has been around 16 times. The reason drop in bond yields admittedly does lift the fair market value for equities. However, we think a forward P/E of 20 is too optimistic given the amount of uncertainty in the coming months. Three factors are responsible for the deteriorating earnings expectations for US companies.

[The words “Moderating economic conditions” sit on a backdrop of a miscellaneous line graph]

First, moderating economic conditions is impacting revenue growth.

[The words “Costs remain above average and sticky” sit on a backdrop of a miscellaneous line graph]

Second, costs remain above average and sticky, not coming down as quickly as revenue growth is decelerating.

[The words “Pricing power has been eroded” sit on a backdrop of a miscellaneous line graph]

Third, pricing power has been eroded, as companies are not able to pass along their higher cost to customers. This has caused profit margins to come in below prior expectations.

[Line graph titled “U.S. equities: Earnings estimates under pressure”]

At the start of 2023, analysts were forecasting mid-single digit profits for the year. These estimates have been ratcheting lower and are currently just above breakeven compared to 2022, as shown on the slide in this chart.

It is our belief that earnings will turn modestly negative even if the US does not enter a recession. The resetting of earnings expectations is a necessary ingredient for the market bottoming process. This adjustment process will likely play out in the first half of 2023, and earnings estimates will ultimately adjust to a more appropriate level. At that juncture, the equity market can begin to look ahead for a positive inflection in profit estimates late this year and into 2024. We believe equities remain in the late stages of a bear market given the valuation concerns, earnings concerns, combined with overly optimistic expectations, we remain cautious in the short-term. However, on the silver lining side, the building blocks of a new bull market are likely to emerge in the second half of the year, and we have some things to look forward to.

>>Dave Donabedian:
Thanks, Rebecca. We've talked a lot so far about the stock and bond markets, but I wanted to take a couple of minutes to discuss alternative investments, and in particular, private equity.

[The words “Private markets” sit on a purple backdrop]

The valuation of private companies is impacted by what happens in the stock market, but with a lag. So it looks to us like it's a good time to be considering investing in private companies over the next couple of years, because valuations have started to and will probably continue to come down for a while. And like any investment, price matters. It's important to take note of the structural change in the life cycle of companies that has occurred in corporate America over the last couple of decades.

[Line graph titled “Private markets: Corporate life cycle: Most of the value accrues while in private hands”]

20 years ago, the typical private company went public with an IPO three years after formation. In more recent years, though, the time to going public is more like 10 years, so companies are staying private for longer.

And 80% of a company's total value creation for investors now happens while the company is private. The opportunity set in the private market is enormous. Of the 21,000 companies that produce more than a hundred million dollars in revenues, over 80% of them are privately held. Because of these trends and some other factors, private equity has outperformed the stock market over long periods of time. This slide shows the 10-year rolling annualized returns for private equity investments. That's the gray line versus the stock market, which is the red line. And over the last 35 years, private equity has earned a six percentage point annual premium over the stock market. But in investing, you don't get something for nothing. A big part of this return premium is due to the illiquid nature of private markets. When an investor commits to a private investment, they should assume that this is an eight to 10-year time horizon. It's not like the stock market where you can buy a stock today, and if you change your mind, sell it tomorrow.

But for investors with a growth objective and where a portion of their wealth can be dedicated to truly long-term investments, private equity is worthy of consideration. Again, we think the entry point is attractive as well because, during times of uncertainty, like now, the amount of capital invested in private markets tends to slow down. This reduces competition and bidding for acquiring companies, ultimately creating an opportunity to purchase strong businesses at advantageous prices. So let me conclude now with our takeaways on the outlook.

We expect a recession and the second half of the year. On a positive note, inflation should drop significantly as 2023 progresses. The Federal Reserve's path has changed and is now likely to provide some modest relief from tightening before year-end.

We foresee at most one small rate hike this spring and then the start of rate cuts in the second half of the year. We saw bond yields fall dramatically in March. They may have overshot a bit, so we could see in the near-term an upside bias to yields. But we believe that last October's high in yields where, for instance, the 10-year treasury got up to four and a quarter, that those yields will not be challenged. Equity markets have been quite resilient over the last six months. However, before we can be confident that the bear market is over, a valuation of reset in the context of weaker earnings needs to occur. And finally, on the policy front, Congress and the President will need to raise the debt ceiling at some point over the summer. It's not exactly clear how that's going to transpire, but we would just note that this has been a source of short-term market volatility in the past. And with that, I want to thank Rebecca and Gary. And a special thanks to all of you for taking the time to listen.

[Upbeat music]

[CIBC logo]

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[Screenshot of CIBC Private Wealth Management disclosure]