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Market Commentary
Did the Fed Read Our 2023 Outlook?

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Key Observations

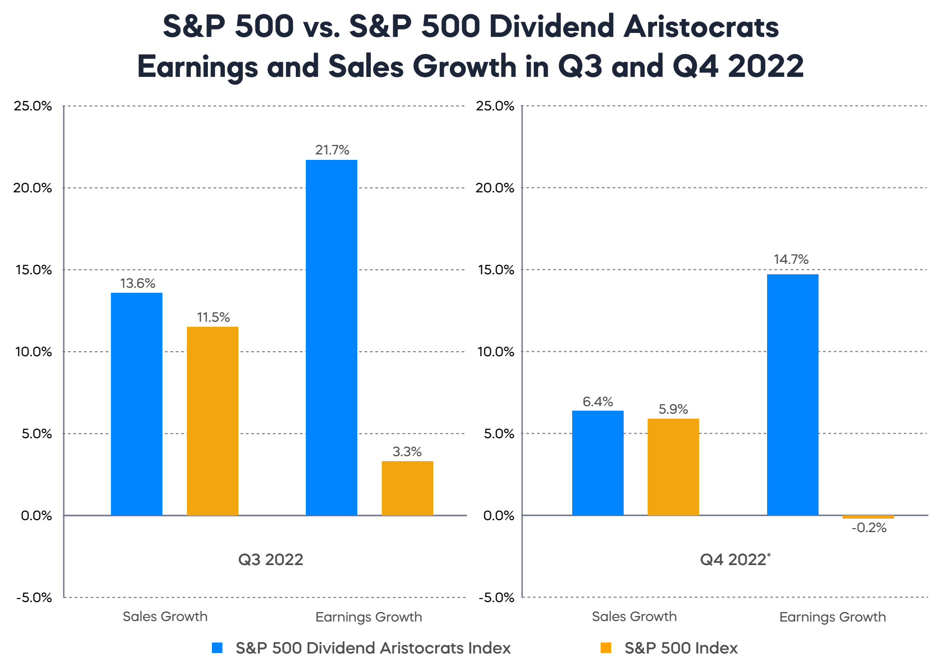
Did Federal Reserve Chair Powell read our “2023 Market Outlook: A Tale of Two Economies” last month? It was there we suggested that, since the manufacturing and goods side of the economy was not overheated, inflation could come down sufficiently without a significant rise in unemployment, and without a hard landing.

In his comments on February 1, following the announcement of the 25 bps hike in the Fed Funds rate, Chair Powell noted—using similar logic to our own—that he thinks the Fed can get inflation down to 2% “without a really significant downturn, or a really significant increase in unemployment.” Further emphasizing the potential for a soft landing, he commented “my base case is that there will be positive growth this year, albeit at a subdued pace.”

Powell also noted that inflation expectations have come in line, even in the near term. While he didn’t mention brevakeven inflation specifically, he may have had that measure in mind, as one-year breakeven inflation stands at 2.17% (Source: Bloomberg, 2/1/23).

Our webcast may not have prompted an equity market rally, but it seems Chair Powell’s comments may have. We caution against unbridled enthusiasm, however. Our base case is that the rally in longer-duration Treasurys may have run its course and that price-to-earnings (P/E) multiples, we think, are likely to remain stable in 2023. We also believe that earnings will be the driver of stock market performance. And while we could see 2% inflation sometime in 2024, lingering inflation in 2023 may continue to pressure margins.

Chart of the Month



Source: Bloomberg. Data as of 2/2/23, with 231 of 500 S&P 500 companies and 38 of 67 S&P 500 Dividend Aristocrats reporting Q4 earnings and sales data.

As we approach the half-way point of Q4 earnings reporting season, the S&P 500 has continued to exhibit a pattern of shrinking margins and little-to-no earnings growth. Meanwhile, the S&P 500 Dividend Aristocrats—companies in the S&P 500 that have increased their dividends for at least 25 years—have continued to expand margins and post significant earnings growth. Those were important drivers of S&P 500 Dividend Aristocrats outperformance relative to the S&P 500 in 2022, and could serve them well in 2023 too.

Performance Recap

Markets kicked off 2023 with a nearly across-the-board rally.

Source: Bloomberg. January returns 1/1/23–1/31/23. Past performance does not guarantee future results. Indexes are unmanaged, and one cannot invest directly in an index.

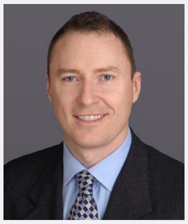
Economic Calendar

Here's a list of upcoming key economic releases, which can serve as a guide to potential market indicators.

Date Time	Event	Prior
02/10/2023 10:00	U. of Mich. Sentiment	64.9
02/10/2023 10:00	U. of Mich. 1 Yr Inflation	3.90%
02/10/2023 10:00	U. of Mich. 5-10 Yr Inflation	2.90%
02/14/2023 08:30	CPI MoM	-0.10%
02/14/2023 08:30	CPI Ex Food and Energy MoM	0.30%
02/14/2023 08:30	CPI YoY	6.50%
02/14/2023 08:30	CPI Ex Food and Energy YoY	5.70%
02/14/2023 08:30	Real Avg Hourly Earning YoY	-1.70%
02/14/2023 08:30	Real Avg Weekly Earnings YoY	-3.10%
02/15/2023 08:30	Retail Sales Advance MoM	-1.10%
02/15/2023 08:30	Retail Sales Ex Auto MoM	-1.10%
02/15/2023 09:15	Capacity Utilization	78.80%
02/16/2023 08:30	PPI Final Demand MoM	-0.50%
02/16/2023 08:30	PPI Ex Food and Energy MoM	0.10%
02/16/2023 08:30	PPI Final Demand YoY	6.20%
02/16/2023 08:30	PPI Ex Food and Energy YoY	5.50%
02/21/2023 10:00	Existing Home Sales	4.02m
02/21/2023 10:00	Existing Home Sales MoM	-1.50%
02/23/2023 08:30	GDP Annualized QoQ	2.90%
02/23/2023 08:30	Core PCE QoQ	3.90%
02/24/2023 08:30	PCE Deflator MoM	0.10%
02/24/2023 08:30	PCE Deflator YoY	5.00%
02/24/2023 08:30	PCE Core Deflator MoM	0.30%
02/24/2023 08:30	PCE Core Deflator YoY	4.40%
02/24/2023 10:00	New Home Sales	616k
02/24/2023 10:00	New Home Sales MoM	2.30%
02/24/2023 10:00	U. of Mich. Sentiment	—
02/24/2023 10:00	U. of Mich. 1 Yr Inflation	—
02/24/2023 10:00	U. of Mich. 5-10 Yr Inflation	—
02/27/2023 10:00	Pending Home Sales MoM	2.50%
02/27/2023 10:00	Pending Home Sales NSA YoY	-34.30%
02/28/2023 09:00	S&P CoreLogic CS 20-City MoM SA	-0.54%
02/28/2023 09:00	S&P CoreLogic CS 20-City YoY NSA	6.77%
02/28/2023 10:00	Conf. Board Consumer Confidence	107.1
03/01/2023 10:00	ISM Manufacturing	47.4
03/03/2023 10:00	ISM Services Index	—
03/10/2023 08:30	Change in Nonfarm Payrolls	—
03/10/2023 08:30	Unemployment Rate	—
03/10/2023 08:30	Average Hourly Earnings MoM	—
03/10/2023 08:30	Average Hourly Earnings YoY	—
03/10/2023 08:30	Labor Force Participation Rate	—

Source: Bloomberg, as of 2/1/23.

Equity Perspectives



By Kieran Kirwan, CAIA
Director,
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Another Head Fake?

The magnitude of January's equity rally seems to have caught investors off guard. The S&P 500 clearly had some momentum coming off its most recent low on October 12, however sentiment readings implied that few investors expected such a robust January effect.

Of course, actual results often differ from expectations. January produced strong returns across equity market segments, styles and sectors. Perhaps most interesting is that market leadership essentially reversed the patterns we saw in 2022. The Nasdaq-100 Index—one of 2022's worst performers with losses of 32.4%—led all major equity averages in January by posting returns of 10.7% (Source: Morningstar, as of 2/1/23). Consumer discretionary and communication services were the two worst performing sectors last year, but they were the two strongest performers in January. This all happened before the Fed's latest rate increase and less-hawkish tone.

The question on everyone's minds is whether the nascent rally has more legs, and if so, will it ultimately take us out of the bear market. Several major-market averages have shown signs of life and bullish trading patterns have emerged. But the S&P 500 rallied on at least three occasions in 2022 before flaming out and turning lower.

Which Way from Here?

The bullish narrative seems to have grown stronger during the first five weeks of 2023. Inflation has been retreating, the Fed's tightening appears to be nearing the end after its latest 25 basis point increase, and China is re-opening. Perhaps the Fed can slow inflation without breaking the economy. Even more, we're in a seasonally strong period for equity returns and in the third year of a presidential term—historically the best year. While that narrative is compelling, a prudent approach remains warranted.

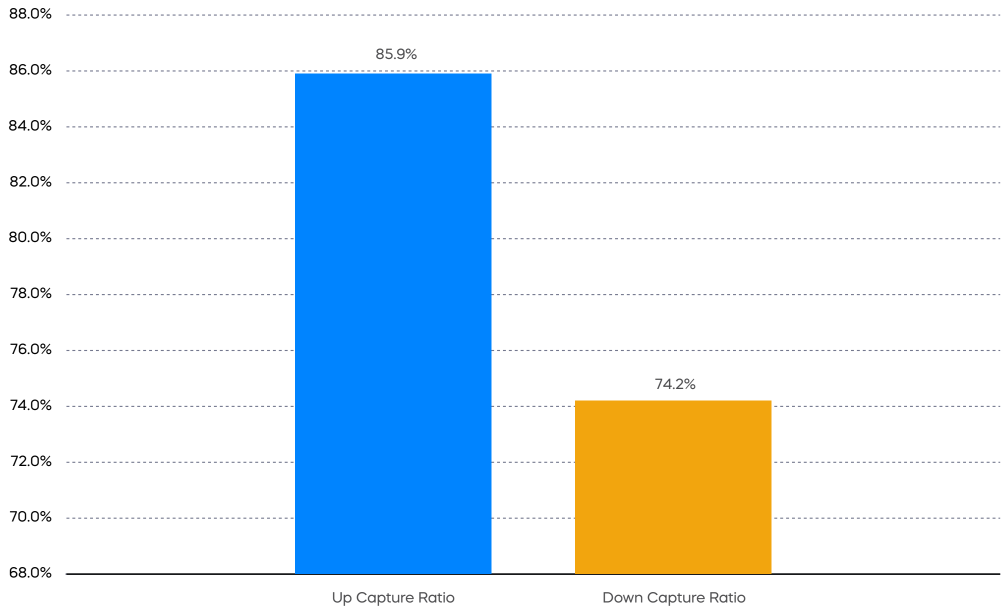
For one, several economic indicators have continued to weaken. According to the PMI data released by S&P Global in late January, the U.S. manufacturing sector continued to decline at the start of 2023. More broadly, several recession indicators are flashing red. The Conference Board's latest release of their leading economic index declined almost 4% over the latest six-month period. The yield curve also remains deeply inverted. With the S&P 500 trading at roughly its 10-year averages, valuations cannot be described as cheap. And on the question of corporate earnings—perhaps the biggest potential near-term mover of markets aside from the Fed—the picture remains clouded. As we said previously, early earnings reports for the S&P 500 during Q4 have shown modest growth. However, expectations are for a decline of near 5%, when all is said and done.

The point here is that asset allocators should remain vigilant and may want to focus on high-quality, all-weather strategies that can perform well under a variety of market conditions.

What to Do About Tech?

Technology investors have had a wild ride over the last several years. After leading the markets with strong returns from 2019 through 2021, the S&P Technology Select Sector Index declined over 27% in 2022. As the era of ultra-low interest rates continues to normalize, we've argued that investors should be more selective with their technology allocation. We believe that low-to-no profit tech at rich multiples are likely remain challenged. In contrast, more established technology names offer a desirable combination: profits and dividends.

All-Weather Growth Potential: Up/Down Capture of the S&P Technology Dividend Aristocrats Index vs. the Nasdaq-100 Index

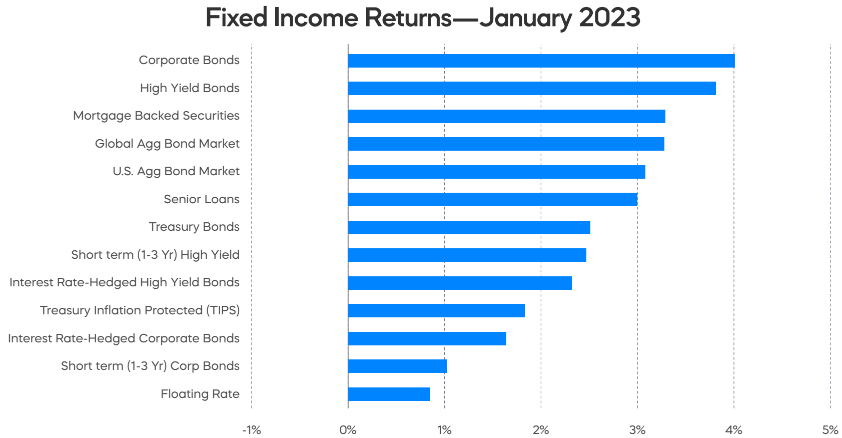


Source: Morningstar. Data from 12/1/2019–1/31/2023. Past performance does not guarantee future results. Indexes are unmanaged, and one cannot invest directly in an index. "Up capture ratio" measures the performance of a fund or index relative to a benchmark when that benchmark has risen. Likewise, "down capture ratio" measures performance during periods when the benchmark has declined. Ratios are calculated by dividing monthly returns for the fund's index by the monthly returns of the primary index during the stated time period and multiplying that factor by 100.

One potential solution to consider is a dividend growth focused approach like the S&P Technology Dividend Aristocrats. Like their peers from the well-known S&P 500 Dividend Aristocrats Index, the S&P Technology Dividend Aristocrats are high-quality stocks that have grown their dividends consecutively for an extended number of years. Relative to the Nasdaq-100 Index—a common proxy for growth and tech—they have delivered an attractive combination of upside and downside capture that may be just right for the times.

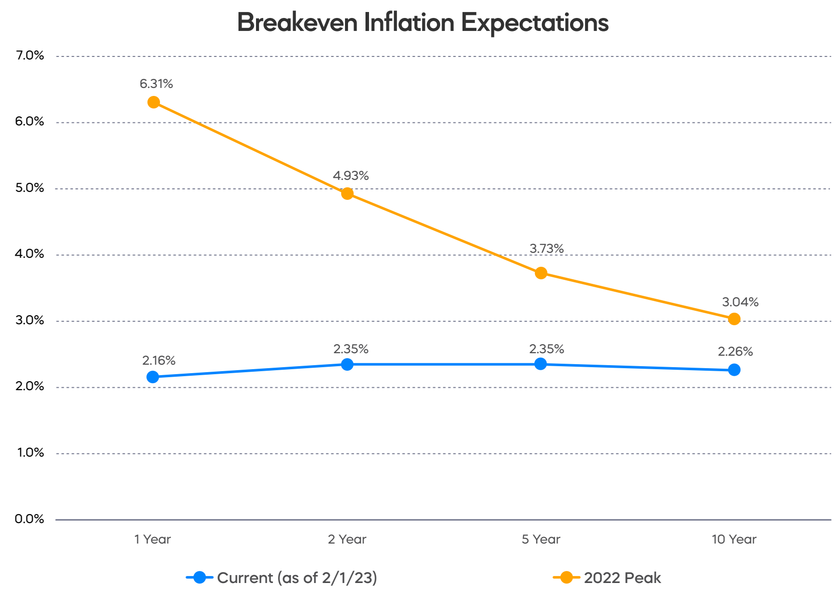
Fixed Income Perspectives

All fixed income segments were in the green for the month of January, as Treasury Yields fell and corporate bond spreads narrowed.



Source: Bloomberg, data from 1/1/23–1/31/23. Past performance does not guarantee future results. Indexes are unmanaged, and one cannot invest directly in an index.

The Federal Reserve increased its Fed Funds rate by 25 bps on February 1 and Chair Powell's comments were balanced, with perhaps a hint of dovishness. Importantly, he noted that inflation expectations, even relatively near term expectations, were well anchored.



Source: Bloomberg. Data as of 2/1/23.

The decrease in breakeven inflation, even just one year away, to near the Fed's 2% inflation target deserves a tentative victory lap. Chair Powell was careful to point out that if the current run-rate of inflation doesn't follow suit, those expectations could rise, but the path seems to be a solid one.

The Treasury yield curve now peaks just six months from now—roughly the market's assessment of a peak in Fed Funds. Holders of longer-duration Treasurys shouldn't get too excited about a Fed retreat just over the horizon. The recent rally in longer-duration Treasurys may have already run its course.

The long-term average real yield on the 10-Year U.S. Treasury is about 2%, now that Quantitative Tightening is well on its way to allowing longer-term Treasury yields to find their "natural" level. The simple of math of 2+2 (2% inflation plus 2% real yield) points to a 4% 10-Year Treasury yield. We saw a high of 4.22% last October, and the current rally has brought us to just below 3.5%. That may define the range for a while, leaving coupon clipping the most likely outcome for Treasury investors in 2023.

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Sources for data and statistics: Bloomberg, FactSet, Morningstar, and ProShares.

The different market segments represented in the performance recap charts use the following indexes: U.S. Large Cap: S&P 500 TR; U.S. Large Cap Growth: S&P 500 Growth TR; U.S. Large Cap Value: S&P 500 Value TR; U.S. Mid Cap: S&P Mid Cap TR; U.S. Small Cap: Russell 2000 TR; International Developed Stocks: MSCI Daily TR NET EAFE; Emerging Markets Stocks: MSCI Daily TR Net Emerging Markets; Global Infrastructure: Dow Jones Brookfield Global Infrastructure Composite; Commodities: Bloomberg Commodity TR; U.S. Bonds: Bloomberg U.S. Aggregate; U.S. High Yield: Bloomberg Corporate High Yield; International Developed Bonds: Bloomberg Global Agg ex-USD; Emerging Market Bonds: DBIQ Emerging Markets USD Liquid Balanced.

The S&P 500 is a benchmark index published by Standard & Poor's (S&P) representing 500 companies with large-cap market capitalizations. The S&P 500 Dividend Aristocrats Index targets companies that are currently members of the S&P 500 that have increased dividend payments each year for at least 25 years. The S&P Technology Dividend Aristocrats is a benchmark index published by Standard & Poor's (S&P) representing technology companies that have increased dividend payments each year for at least seven years. The Nasdaq-100 Index is a basket of the 100 largest, most actively traded U.S companies listed on the Nasdaq stock exchange. **THESE ENTITIES AND THEIR AFFILIATES MAKE NO WARRANTIES AND BEAR NO LIABILITY WITH RESPECT TO PROSHARES.**

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