Commentary

# Quarterly Market Update: Second Quarter 2023

## Executive Summary

**THE FOLLOWING IS AN EXECUTIVE SUMMARY FOR THE "QUARTERLY MARKET UPDATE: SECOND QUARTER 2023" REPORT BY FIDELITY'S ASSET ALLOCATION RESEARCH TEAM**

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### Market Summary: Asset Markets Rose amid 2023's Bumpy Start

Financial markets digested multiple crosscurrents during Q1, including stress in the U.S. and European banking systems, signs of persistent core inflation pressures, falling energy prices, and a solid upswing in Chinese economic data. With major central banks still tightening monetary policy, macroeconomic and policy uncertainty could remain high and warrant a degree of caution, along with ample portfolio diversification.

**Market Overview:** Asset prices fluctuated considerably in this environment but ended up posting their second consecutive quarter of widespread gains. A decline in U.S. Treasury yields helped boost both fixed income and equity returns, with gold, non-U.S. developed-market equities, and large cap growth stocks leading the way. Longer maturity bond categories posted the best fixed income gains, while commodity prices fell.

The markets still appeared overly sanguine about how quickly and painlessly the U.S. Federal Reserve could pivot to easing monetary policy. Combined with slower liquidity growth, persistent inflation risk, and tentative growth momentum, monetary policy uncertainty raised the odds that market volatility could remain elevated. Some of these challenging dynamics have been priced into markets in the form of more attractive valuations, particularly in fixed income and non-U.S. equities.

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**A View of Volatility:** Bond volatility underpinned market gyrations during the quarter. The MOVE Index, a measure of volatility in Treasury markets, spiked to its highest level on record outside the global financial crisis period of 2008–2009. Banking sector turmoil and dramatic fluctuations in investor views of the outlook for inflation and monetary policy contributed to the volatility.

In contrast, measures of equity-market volatility, such as the VIX Index, remained relatively range-bound. We believe the evolution of these trends defines the 2023 outlook, and valuation opportunities may appear within a still-volatile backdrop.

## Economy/Macro Backdrop: Many Late-Cycle Economic Pressures Persist

We believe the U.S. is in the late-cycle expansion phase, with a significant likelihood that recessionary pressures may increase in 2023.

**Inflation:** U.S. consumer inflation rates continued to slow after reaching a multi-decade peak of 9.1% last year. Many inflation pressures that tend to be more transitory, such as supply-chain disruptions, continued to fade.

However, categories where price increases tended to be more reliant on demand-side factors accounted for the bulk of the inflation drivers. If tight labor markets continue to boost unit labor costs, inflation in services sectors may linger for longer than investors expect.

We believe the moderating trend will continue in 2023, but it may be difficult to return to the stable, low-inflation environment of the past two decades.

**Yield Curve:** Our preferred yield curve—the 10-year less 3-month Treasury yield—experienced its greatest inversion since 1981, as the Fed hiked short-term rates and longer-term rates fell due to growth concerns. Historically, the yield curve has been a reliable leading indicator of economic weakness, inverting before the last 8 recessions. The timing of recession after curve inversions ranges between 4 and 21 months, historically.

**Late-Cycle Trends:** Reflecting a typical late cycle, the earnings outlook deteriorated during Q1, with investors expecting slower sales growth and negative earnings growth for calendar-year 2023.

Also typical of a late cycle, in the latter half of 2022, U.S. banks tightened lending standards across multiple loan categories. The banking stress experienced during Q1 2023, highlighted by the failure of two regional banks, could generate even greater caution and lead to further credit tightening. Compared with large banks, smaller regional banks average more exposure to commercial real estate loans.

**Global View:** Global manufacturing activity in the U.S. and other developed markets (DM) continued to decelerate in Q1. DM bullwhips—new orders minus existing inventories—remained negative, typically a signal of more slowing ahead. However, industrial activity remained mildly expansionary in emerging-market (EM) countries, providing an asynchronous boost to a global manufacturing cycle that slowed significantly over the past year.

Many global economies faced headwinds related to inflationary pressures and tightening monetary and financial conditions. However, the global cycle has become less synchronized, with China accelerating amid a post-COVID reopening and Europe stabilizing amid falling energy prices.

Central banks tightened policies to address rising inflation over the past year at varying speeds and magnitudes. Many EMs appeared nearer the end of their hiking cycles, while persistent pressures in many DM countries kept policy rates below trailing inflation rates. EM consumers remained particularly exposed to volatility in food and energy prices.

## Asset Markets: Most Asset Categories Rose for Q1

A rally in information technology and communications services sectors powered U.S. growth stocks in the first quarter. All fixed-income categories finished in positive territory as yields dropped for the quarter. Financial stocks and commodities lagged amid concerns about banking stress and commodity demand. Most categories remained in negative territory on a one-year basis.

Valuations moved higher for U.S. and non-U.S. developed markets as stocks rallied during Q1. The trailing, one-year price-to-earnings (PE) ratios for non-U.S. stocks (DMs and EMs combined) remained below their long-term averages, while the U.S. finished roughly in line with its long-term average.

**Corporate Earnings:** Global earnings growth continued to slow in Q1, coming back to earth after a decade-high spike during the 2021 profit recovery associated with economic reopening. EM earnings, which were in contraction the last two quarters, declined slightly but may be bottoming as China's economy reopens. Global earnings growth expectations for the next 12 months are relatively muted.

**Currencies:** On a cyclical basis, weaker U.S. growth trends relative to the rest of world implied a more favorable medium-term outlook for non-U.S. currencies. On a long-term basis, non-U.S. currencies appeared undervalued relative to the dollar. Historically, extreme financial turbulence or a severe global recession boosted the dollar, but we generally expect non-U.S. currencies could provide upside and portfolio diversification benefits.

**U.S. Treasuries:** Treasury yields dropped and credit spreads widened across most fixed income categories during Q1, at least in part due to banking-sector turmoil. Most major bond categories' yields and spreads finished roughly at or above their averages over the past two decades. After many years of extremely low bond yields and tight credit spreads, fixed income assets offered relatively better income opportunities with more attractive valuations as of the end of the quarter.

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*Fidelity Thought Leadership Vice President Mike Tarsala provided editorial direction for this article.*



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In general, the bond market is volatile, and fixed income securities carry interest rate risk. (As interest rates rise, bond prices usually fall, and vice versa. This effect is usually more pronounced for longer-term securities.)

Fixed income securities carry inflation, credit, and default risks for both issuers and counterparties.

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