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MARKET OVERVIEW Q1 2023

Projections and outlook

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Blackshield Capital

April, 2023

Market Outlook Q1 2023 - projections and outlook

Executive Summary

The first quarter of 2023 was marked by a series of events that will definitely go down in the financial history books. Sometimes decades pass in a matter of weeks, and the past few months serve as evidence of such possibilities.

First of all, it is worth noting the second and third largest bank failures in history, which did not prevent the Fed from continuing to raise interest rates in an attempt to curb the inflation problem. At the same time, the government program to support the banking sector has raised a number of doubts as to whether the liquidity cuts will last or whether a new phase of QE will begin.

Another dramatic story unfolded in Europe, where the 166-year-old history of Credit Suisse came to an end with its purchase by UBS, backed by the Swiss government. This led to a 50% plunge in CS shares over a single weekend and subsequently angered hybrid debt holders.
Investors had a tough time, as markets were filled with risk and short-term fluctuations caused by the divergence between expectation and reality.

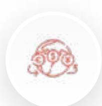
Since the late 1800s, there have been 30 recessions in the U.S. and 16 pronounced extended bear markets during recessions officially verified by the NBER (National Bureau of Economic Research).

In practice, under similar conditions, the optimal strategy for stock markets was first to take a defensive position relative to the market as the yield curve normalized, then to lock in profits as credit conditions tightened, accumulating cache to form positions on market reversals. An alternative position-fixing solution could be low-risk bonds, whose revaluation due to rising interest rates is close to the minimum.

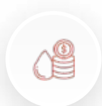
In this context, we recommend strategically:

Stocks
- non-cyclical sectors of the economy
- companies with a low debt burden and stable cash flow

Fixed Income
- corporate bonds with high credit ratings
- US Treasuries
- TIPS, Money Market



Global Markets
- Europe: non-cyclical economic sectors, energy sector
- China: consumer discretionary, consumer staples, industrial and technology sectors



Commodities
- gold, silver, industrial metals

Highlights and strategic discussion points for the second quarter of 2023 and beyond:

- Inflation is quite likely to remain well above the 2% FED target
- For now, the labor market is still extremely resilient, but any signs of fragility and rising unemployment will cause a negative ripple effect on the stock market
- The turmoil caused by the banking crisis revealed vulnerabilities in the financial system and showed that the cumulative effect of the economic slowdown in 2022 is reflected in different sectors and industries, and there is a significant time lag between stock market dynamics and economic phenomena
- Interest rates may peak sooner than expected as central banks are forced to balance inflation against indicators of growth and financial stability risks
- Tightening credit conditions seem likely to continue this trend, putting additional strain on the corporate sector

Market opportunities:

- Equity markets still contain more unrealized risks than bond markets
- Here and now is a good time to lock in peak bond yields over the next 1-2 years as the market starts to price interest rate cuts
- The dollar is unlikely to renew its peak value in the near future, creating additional opportunities for the growth of commodity assets, especially gold

In the second quarter of 2023, we expect:

- Further recession development, is set to weigh on the economy and GDP
- Possible first manifestations of a worsening labor market
- Falling profits of cyclical sectors compared to 2022

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STRATEGY

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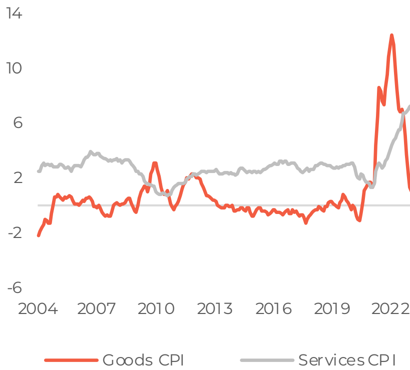
Strategy

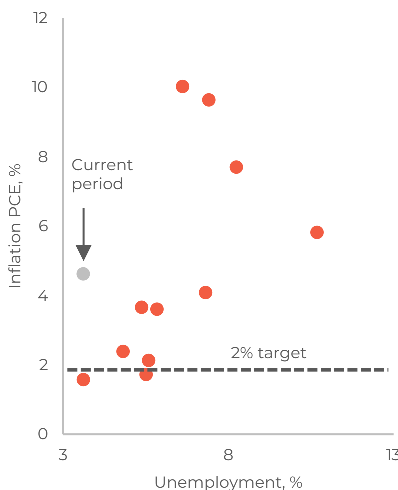
S&P 500 sector dynamics for Q1 2023

Sector	Dynamics for Q1 2023
Informational Technology	21.49%
Communication Services	20.18%
Consumer Discretionary	15.76%
Materials	3.75%
Real Estate	1.04%
Consumer Staples	0.16%
Utilities	-4.04%
Health Care	-4.72%
Energy	-5.57%
Financials	-6.05%

US CPI, %



Unemployment and inflation, during periods of Fed rate cuts



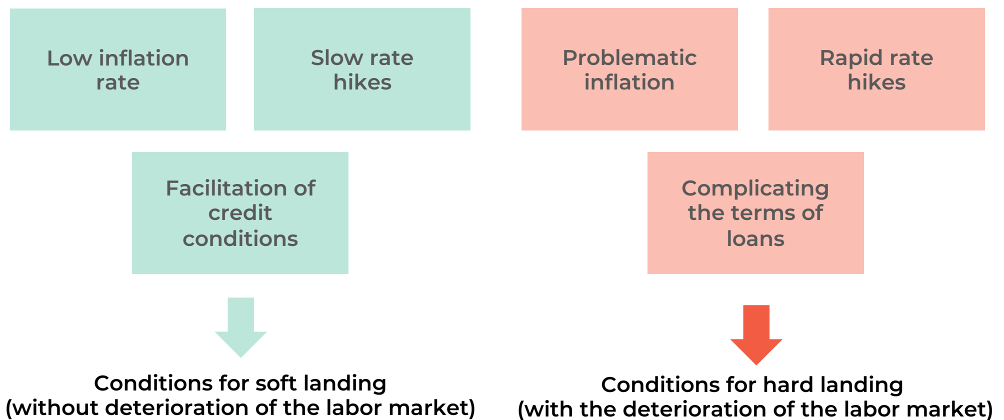
The S&P500 index started the year with a solid 7% gain in the first quarter, with the information technology sector leading the way and the healthcare sector lagging behind. Adjusting for earnings growth and inflation, the stock market is close to 2019 levels.

The stress in the banking sector has reminded us of the impact of monetary tightening. Going forward, we believe that investor attention will increasingly shift from the risks of rising interest rates to the risks of a recession. This should be a catalyst for a shift in the market leadership of risk-on sectors, with less risky sectors continuing to grow, which we expect to see over the next few quarters.

One of the main drivers of inflation in the post-COVID period was the disruption of the supply chain of goods, and analyzing a number of relevant indicators, we can clearly see that this problem is currently being resolved.
This has a strong impact on the prices of durable goods, which is subsequently reflected in inventories and changes the pricing strategy of goods. However, it has no effect on reducing inflation in the services sector, which depends more on the unemployment rate, which is close to historic lows. As for interest rate policy, the Fed has cut rates several times in the past despite high inflation, but the unemployment rate was higher (or inflation was below the 2019 target), so there is no perfect historical pattern for the current situation.

In the dilemma between "soft landing" and "hard landing", there is a growing debate in the media about "no landing" per se - when the Fed will raise rates enough to curb inflation, but not let the economy fall into recession. In reality, the economy usually gravitates towards one of these two scenarios and rarely lands in the middle. And in the real world, the turning point in the business cycle is driven by a reversal in the housing market, and the extent to which it lands depends on how much the labor market has deteriorated. But no matter what scenario is realized, the market always thinks there will be a "soft landing" and shows optimism, conditional on temporary asset growth.

Scenarios for economic development



Essentially, this divides investors into two categories, each of which is right in its own way - you can take an active stance, reacting to micro drivers of growth or decline to try to time the short term, or take a strategic stance and try not to revisit decisions made too often.

Strategy

Liquidity problems at U.S. banks - Silicon Valley Bank, Silvergate Capital, First Republic Bank, and Credit Suisse of Switzerland – resulted in one of the largest one-day falls of the banks in history.

The recent banking crisis has raised many questions about which next sector may be most vulnerable and crumble.

It is worth noting that small and medium-sized banks, vulnerable to deposit outflows, hold about $2.3 trillion in commercial real estate debt, nearly 80% of all mortgages.

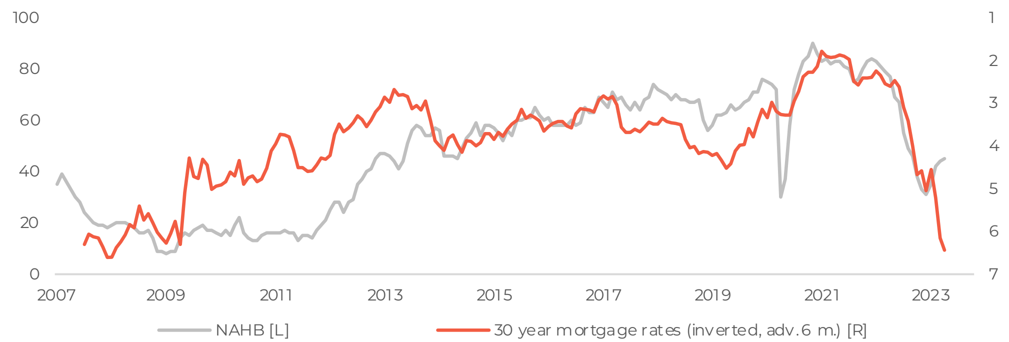
Of course, not all commercial real estate is the same - the Commercial Real Estate market is extremely segmented - from healthcare and industrial to apartment buildings and offices, each with different demand and profitability factors.

But in fact, the decline in the value of commercial loans at this stage is only a "paper loss" for banks, and these losses can remain unrealized either until prices normalize, or until the liquidation of positions in portfolios.

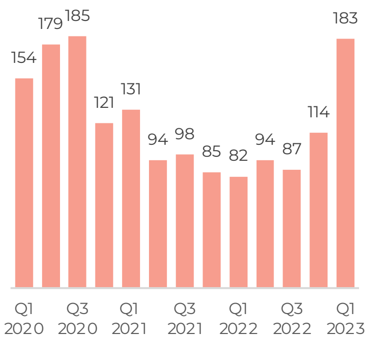
Given the sensitivity of the real estate market to rising interest rates, the risks in this sector may be realized.

In any case, the commercial real estate market, and especially the home construction segment, is in the risk zone. The housing market lags somewhat behind the rising mortgage rate, but inevitably follows it:

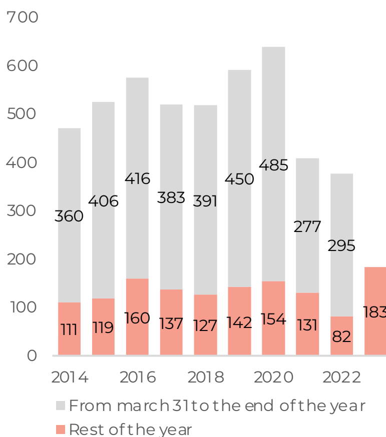
Correlation between real estate index and 30-year mortgage rates



Bankruptcy filings, USA

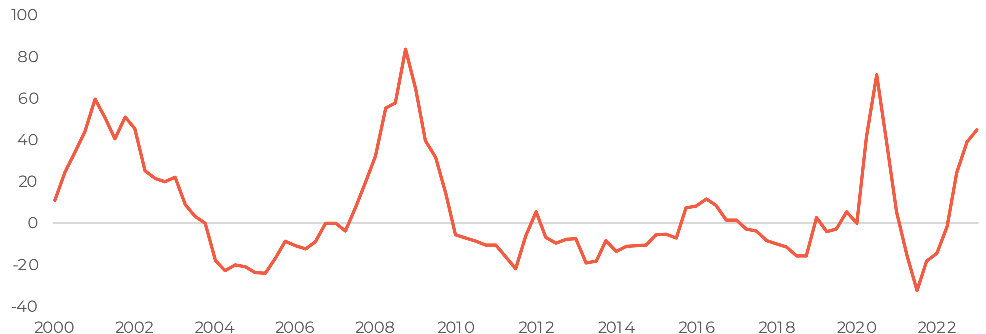


Bankruptcy filings, USA



It is worth noting separately how the tightening of bank lending affects firms. On average, there is a lag of around half a year before the corporate debt is translated into an increase in the number of defaults against a background of rising borrowing costs. This, in turn, is reflected in the corporate bond market by the need to raise coupons on new issues.

Share of banks tightening standards for lending



The default rate for Q1 2023 is higher than in the last 10 years.

The main difference between similar historical situations and the current one is that we are already formally in a recession, and the average market return at the time the terminal rate is reached is not relevant. It all depends on the context of labor market variables and how much corporate profits will fall.

Low risk premium - has a negative impact on the stock market because the reward for taking on the risks of a particular asset is less attractive.

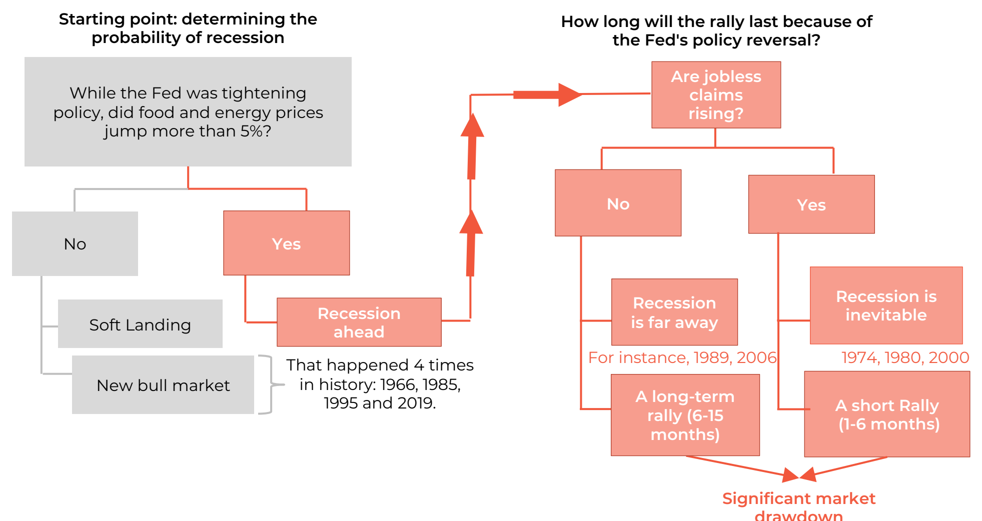
Strategy

Comparable to late 2022, the broad equity market offers less risk reward than debt.
This brings us back to the thesis that in a recession only a certain category of stocks can grow in an unbalanced market.
This is particularly true for companies that are able to refinance themselves out of cash flow and whose debt burden is not excessive.

Given the current inflation situation, the next logical question is how much further the Fed can raise rates without hurting the labor market.

The balance of probabilities suggests that the largest declines in business margins, employment and profits will occur in the coming quarters. There is no clear probability of serious banking problems, although the number of late payments will increase.
On the positive side, foreign demand for goods and services remains strong and the increase in the real yield on money market instruments (yield minus inflation) has led to a significant inflow of assets into this type of debt.

Basically, the core of our assumptions lies in the logic shown in the chart below, while the first step - inflation above 5% - has already passed. The next step will depend on the depth of the deterioration in the labor market.



In a soft landing scenario, the S&P 500 could close at 4,000 by the end of the year; in a hard landing, the target could be 3,200.

Strategy

The central bank acknowledges the possibility of a recession. Most recessions follow a "gradual, then sudden" scenario. At the last Fed meeting, committee members came to a consensus that the economy will go into a "mild recession" this year. That's more of a statement of fact than a forecast, though.

Inflation is likely to fall by the end of the year, even if unemployment remains low. The stock market remains optimistic against this backdrop, but this in no way rules out a recession.

The Fed is very likely to maintain its strategy of delaying interest rate cuts - the market is mostly evaluating cuts within an overly optimistic timeframe. This is the major divergence between possible reality and market expectations.

On top of that, manufacturing activity in the U.S. and European economies is shrinking, while the service sector remains resilient. This, in turn, is encouraging central banks to keep interest rates high for a while longer. At the same time, credit risks are on the rise: problems in the banking sector have made it difficult for businesses to borrow, and shrinking demand is squeezing business margins and causing a new wave of layoffs in the corporate sector (jobless claims rose by 40,000 last month).

Commodities

Gold/silver as an alternative to the dollar. The U.S. dollar may keep growing in the next quarter amid declining manufacturing activity and reduced demand for risky assets, as it was a year ago. At the same time, there are no long-term growth prospects for the dollar in the current environment. Against this background, gold/silver look promising, that can be a safe haven for investors in turbulent times.

Europe & China

The pace of Europe's economic slowdown depends on China's growth. In China, the overall recovery and credit growth is in line with the plan, declared by the political party, albeit with less optimism from investors, as expected. This is true for most emerging markets dependent on China, and it does have a major impact on the growth recovery in Europe.

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