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NCM Monthly Commentary for February 2023

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A Strong Start to the New Year:

After a challenging year in 2022, global stock markets were strong out of the gate. In the United States, the S&P 500 was up 6.2% while the Nasdaq added 10.7% during the month of January. Over in Europe, the Euro Stoxx 600 index gained 6.7% during the month of January while one of Japan's leading indices, the Nikkei 225, was up 4.7%. The gains for all 3 markets continued into February although a portion of these gains were reversed as markets have pulled back towards the end of the month.

One of the key questions on the minds of investors is whether the strong start to the year will be sustained and whether global equity markets have begun a new bull market. Of course the answer to this question will only be known with the benefit of hindsight. The answer is not clear cut as there are many conflicting signals in the economy which are providing lots of fodder for both the bulls and the bears. The debate for the last few months has been whether the economy is headed for a soft or a hard landing. Given the recent wave of positive economic data, some market pundits are now saying that there will be no landing at all.

The bulls are pointing to an unemployment rate of 3.4%, stronger than expected retail sales in January, and a booming services sector. When the Bureau of Labor Statistics gave its update in January, it reported that the U.S. unemployment rate fell to 3.4%. Not only was this figure below consensus at 3.6%, but it also was the lowest unemployment rate in the United States in more than 50 years. For the month of January, the Commerce Department reported that U.S. retail sales rose by 3%, which was well above the consensus estimate of 1.9%. It's safe to say that consumers are still spending. Another data point during the month of January came from The Institute for Supply Management, which reported that the ISM Services PMI increased to 55.2. The index had fallen to 49.2 in December, which is below the threshold level of 50 which signals contraction in the economy. The rebound in U.S. services during the month of January should be viewed very favourably given that services make up more than 75% of the U.S. economy.

The bears will argue that unemployment is a lagging indicator, that consumers are simply running down the last of their excess COVID savings, and that 1 good month of data for the ISM Services data is not enough to say that we are out of the woods. The bears would also point to January's inflation data, which was hotter than expected. The consumer price index (CPI), which measures a broad basket of common goods and services, rose 0.5% in January and an annualized rate of 6.4%. Both of these figures were ahead of consensus estimates of 0.4% and 6.2% respectively. Excluding food and energy, the core CPI increased 0.4% monthly and 5.6% from a year ago, which were above consensus figures of 0.3% and 5.5%.

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So bringing it all together, there are many good arguments from both the bulls and the bears as to why the economy may or may not go into a recession this year. Nobody knows for certain and we will only find out with the benefit of hindsight. I don't have a strong opinion on the outcome of the recession debate. I believe there is a decent chance that a recession might be avoided but if a recession does materialize, I believe it will be a milder garden variety type recession. Global banks have robust levels of capital so a repeat of the 2008-09 Financial Crisis seems highly unlikely. Meanwhile, corporates and consumers are less exposed to credit risk and leverage risk than they have been historically. In the United States, debt servicing ratios are near multi-decade lows and 90% of U.S. mortgages are fixed, far below levels seen during previous tightening cycles. Similar to consumers, U.S. corporates have shifted to fixed rate debt. Today over 75% of S&P 500 debt is long-term fixed versus 40% back in 2007. For all these reasons, I believe that any recession that unfolds should be a shallow one as opposed to a deep, prolonged downturn. While the recession debate between the bulls and bears continues, I am comforted by the fact that the companies I own across the portfolios are well positioned for any environment that unfolds in the months ahead.

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