Markets Higher on Better-than-Expected Data and a Pause in Rate Hikes

Chances of a U.S. recession continue to fade, and headline inflation should trend lower. The pace of Fed tightening has already slowed, and earnings estimates seem to have stabilized.

GENERAL MARKET ENVIRONMENT

Markets finished higher for the quarter on better-than-expected corporate earnings and economic data, waning inflation, and a pause in interest rate hikes. First-quarter earnings results topped forecasts helped by cost-cutting initiatives and improved operating efficiency. In addition, management outlooks included fewer references to sales and profitability headwinds. The unemployment rate remained low, consumer confidence improved substantially, GDP growth was revised higher, various housing statistics stabilized, and headline inflation trended lower. After hiking the benchmark rate by 25 basis points (bps) in May and softening the policy statement's rate guidance language, the U.S. Federal Reserve (Fed) left interest rates unchanged in June — the first time in 11 meetings — at a range of 5% to 5.25%. Chair Powell later remarked that further increases are likely necessary to bring inflation back to the Fed's 2% target. In response, odds of a quarter point rate hike at July's Federal Open Market Committee meeting rose, and U.S. Treasuries were pressured further.

EQUITIES MARKET ENVIRONMENT

> The S&P 500® Index returned 8.74% for the period. On a year-to-date basis, the Index returned 16.89%.

> Market leadership was narrow with mega-cap stocks outperforming the broad market. The 50 biggest stocks in the S&P 500 gained 13.19% versus 2.75% for the remaining 450 stocks.

> Most sectors finished higher. Technology, consumer discretionary and communications services sectors were the top performers while utilities, energy and consumer staples sectors were the bottom performers.

> The Russell 1000® Growth Index (12.81%) outperformed the Russell 1000® Value Index (4.07%), widening growth's year-to-date outperformance to nearly 24%.

> Equity volatility fell sharply, finishing below 14.

CONVERTIBLE SECURITIES MARKET ENVIRONMENT

> The ICE BofA US Convertible Index returned 4.63% for the period. On a year-to-date basis, the Index returned 8.55%.

> Convertible securities were positively impacted by rising stock prices and credit spread tightening.

> Nearly all sectors advanced in the period. Consumer discretionary, energy and technology sectors outperformed while utilities, consumer staples and industrials sector underperformed.

> Below-investment grade issues outperformed investment grade issues. Equity sensitive issues outperformed both yield alternative and total return (balanced) issues.

> New issuance increased quarter over quarter with 25 new deals pricing $14.3 billion in proceeds. The year's total stood at $27.3 billion.

HIGH-YIELD (HY) BOND MARKET ENVIRONMENT

> The ICE BofA US High Yield Index returned 1.63% for the period. On a year-to-date basis, the Index returned 5.41%.

> BB, B and CCC rated bonds returned 0.78%, 1.84% and 4.73%, respectively.

> Spreads tightened to 405 basis points (bp) from 458 bp, the average bond price rose less than a point to 88.71 and the market's yield increased modestly to 8.60%.

> All industries recorded gains for the period. Telecommunications, automotive, and travel sectors outperformed whereas cable, utilities, and food producers sectors underperformed.

> New issuance increased quarter over quarter with 73 issues priced, raising $55.1 billion in proceeds. The year's total stood at $95.6 billion.

> Trailing 12-month default rates rose but remained below the long-term average at 2.71% and 1.53% on a dollar- and issuer-weighted basis, respectively.

OUTLOOK

The likelihood of a U.S. recession in 2023 continues to fade, and headline inflation should trend lower. The pace of monetary policy tightening has already slowed, and corporate earnings estimates seem to have stabilized.

Steady employment and consumer spending, wage growth, excess savings, accumulated asset wealth, housing market improvement, and onshoring activity are potential economic

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Virtus Investment Partners is the manager for the Virtus Income and Growth Fund and Voya IM is the sub-advisor.

tailwinds. The lagged effects of monetary policy and quantitative tightening and the durability of household balance sheets to withstand higher interest rates are key risks to growth.

Inflation indicators, including consumer and business expectations, point to further cooling. Waning inflation and a currently restrictive monetary policy stance will likely influence the Fed to consider slowing the pace of interest rate hikes further or even ending their current campaign.

Corporate earnings estimates for 2023 and 2024 seem to have stabilized following better-than-expected first-quarter results and upward revisions to earnings and sales projections.

If the hiking cycle is nearing an end, it could be a positive development for stocks. Per Goldman Sachs, U.S. equities generally rallied in the months following the end of past Fed tightening cycles. In the three months following the peak Fed funds rate, the S&P 500 Index returned 8% (average), rising in five of six episodes. On a 12-month basis, the S&P 500 Index returned 19% (average), rising in five of six episodes.

U.S. convertible securities should continue to provide benefits to investors, including an attractive asymmetric return profile and lower interest rate sensitivity relative to core fixed income. After a challenging 2022, the universe's composition has shifted compared to the past decade. Today, many securities offer higher yields and most exhibit defensive characteristics given lower deltas and closer proximities to bond floors. This dynamic may allow for greater downside protection if equity volatility rises in 2023. If the prices of underlying stocks advance, convertible securities are positioned to participate in the upside. Higher financing costs will serve to benefit new issuance which could reach an upwardly revised $50-55 billion, according to market strategists.

U.S. high yield's risk and reward opportunity is compelling. Credit fundamental factors are healthy, near-term refinancing obligations remain low, and managements continue to prioritize debt reduction. Given these factors, defaults should remain well below historical cycle peaks. With the market trading at a deep discount to face value, high yield bonds offer very attractive total return potential. Notably, there are no instances of the asset class producing back-to-back negative annual returns[1] and forward 12- and 24-month return projections based on the current yield have been consistent with mid to high single digits.[2]

A covered call options strategy can benefit from elevated or rising equity volatility by collecting premiums that translate into attractive annualized yields.

Collectively, these three asset classes can provide a steady source of income and a compelling participate and protect return profile. Additionally, they serve as a diversification tool, historically offering outperformance relative to core fixed income in a rising interest rate environment.

[1]Source: ICE Data Services; data as of December 2022. [2]Source: JP Morgan; data as of October 2022.

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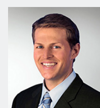
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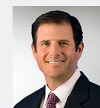
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