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1Q 2023 Commentary

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EQUITIES

Stock indices had mixed returns in the 1st quarter as growth stocks staged a strong rally despite bank failures and multiple Federal Reserve rate hikes.

Growth outperformed value in the quarter.

Quarterly Returns: As can be seen from ***Table 1*** (see below), growth stocks, particularly large cap, led the market. Value stocks were generally flat. Most bank stocks declined after the bank failures, which weighed on value index returns. The S&P 500 gained 7.5%. The five largest stocks in the S&P 500 were up 33% on average, bouncing back after suffering large losses in 2022. Developed international stocks were up 8.5%, while emerging market stocks were up about 3.5%.[1] Gold rallied over 9% while Bitcoin soared 73%. Hedge funds had mixed results, with long short equity funds generally outperforming credit funds.

Table 1 – US Equity Returns[2]

1Q 2023	Value	Core	Growth
Large Cap	1.0%	7.5%	14.4%
Mid Cap	1.3%	4.1%	9.1%
Small Cap	(0.7%)	2.7%	6.1%

FIXED INCOME

Bonds, particularly Treasuries, rallied after Silicon Valley Bank and Signature Bank were seized.

Bonds had positive returns as investors fled to safety.

Quarterly Returns: Bonds had positive returns in the quarter as yields fell, though some financial bonds were down in value. Treasuries maturing beyond one year rallied as investors fled to safety after the bank failures and priced in the possibility of slower economic growth and/or lower inflation. Treasury yields declined more than corporate and municipal bond yields. Short term Treasury yields (less than one year) were higher after two Federal Reserve rate increases, but portfolio performance was driven by the Treasury yield declines highlighted in blue in ***Table 2*** below.

[1] Developed international = MSCI EAFE Index; emerging markets = MSCI Emerging Market Index; source: FactSet.

[2] Large cap growth = Russell 1000 Growth Index; Large cap core = S&P 500; Large cap value = Russell 1000 Value Index; Mid cap growth = Russell Mid Cap Growth Index; Mid Cap Core = Russell Mid Cap Index; Mid cap value = Russell Mid Cap Value Index; Small cap growth = Russell 2000 Growth Index; Small cap core = Russell 2000 Index; Small cap growth = Russell 2000 Value Index; source: FactSet.

*Table 2 – Treasury Yields**

Maturity	9/30/22	12/31/22	3/31/2023	1Q23 Yield Change
3 Month	3.23%	4.41%	4.75%	**+0.34%**
2 Year	4.20%	4.42%	4.07%	**(0.35%)**
5 Year	4.04%	4.00%	3.61%	**(0.39%)**
10 Year	3.80%	3.88%	3.50%	**(0.38%)**
30 Year	3.76%	3.97%	3.69%	**(0.28%)**

**Source: FactSet*

Inflation

Inflation is still elevated, though more timely data suggests some improvement.

Inflation remains high. The most recent Consumer Price Index (CPI) increased 6.0% over the last 12 months. Housing continues to be a key driver, with the shelter component up 8.1%, [3] despite more timely reports from the National Association of Realtors that the US median home price fell for the first time in 11 years.[4] Other components of the CPI are still much higher than a year ago, such as food (+9.5%) and airline fares (+26.5%), while energy (+5.2%), new cars (+5.8%) and other goods price increases have decelerated. Overall, higher prices continue to pressure consumers, particularly those who have not benefited from the large run up in asset prices in recent years.

ECONOMIC AND MARKET ENVIRONMENTS

The Fed continues to tighten despite bank failures.

The Federal Reserve (the Fed) continued to tighten financial conditions. The Fed Funds rate was increased twice in the quarter, with the second increase after the bank failures in early March. The Fed also continued "quantitative tightening" throughout the quarter, selling off or not reinvesting another $121 billion of Treasury notes.[5] The yield curve continued to be inverted, though not to the extent it had been at year end. The Fed believes that slower economic growth is key to bringing inflation down to their 2% target. Something always cracks when the Fed raises interest rates, and the stresses caused by higher interest rates are now visible on bank balance sheets. Banks have large Treasury portfolios with sizable unrealized losses despite the recent decline in interest rates. They will most likely rein in lending, which historically has led to slower growth or a recession.

The US banking system is stronger than 2008, but we are not out of the woods yet.

Bank Failures: The failures of Silicon Valley Bank and Signature Bank in early March impacted the fixed income markets more than stocks. As noted in our intra-quarter letter on March 13 (found here), both banks were unusual in how they were funded. It is too soon to tell if there will be lasting effects from the bankruptcies, but we do not believe there is systemic risk in the financial system like 2008. Banks have much more capital and fewer loans relative to deposits, making them better able to withstand loan losses should they occur. The short-term effects of the bankruptcies were significant flows of cash from small and regional banks to the largest banks and into money market funds. Though the situation appears to have stabilized, banks with outsized exposure to commercial real estate could still struggle or fail, and it seems reasonable to assume financial institutions with particularly

[3] BLS - https://www.bls.gov/opub/ted/2023/consumer-price-index-up-0-4-percent-over-the-month-6-0-percent-over-the-year-in-february-2023.htm

[4] Home prices fell 0.2% from the previous year to $363,000 - https://www.nar.realtor/newsroom/existing-home-sales-surged-14-5-in-february-ending-12-month-streak-of-declines

[5] Source: Federal Reserve and PSG; the Fed owned $4.7 trillion of Treasury Notes and Bonds as of 12/28/2022.

large unrealized losses from Treasuries (sited above) could see funding costs rise to unsustainable levels. The banking crisis may not be over.

Recession Or Not?: An ongoing debate since the Fed began raising interest rates has been whether such increases would lead to a "soft landing" or a recession. Based on the data currently available, it would appear a recession of some type is likely. Consider the following:

There are many signals a recession is inevitable…

- The US Leading Economic Indicators have fallen for 11 straight months. Over the last 60 years this has always led to a recession.
- Inflation remains high, which hurts consumer spending.
- The yield curve has been inverted since July 2022, often a recessionary signal.
- Global money supply is falling, which often precedes slower growth.
- Banks, particularly smaller/medium sized ones, will likely cut back on lending which should slow economic growth.
- US corporate bankruptcies in January/February were the highest since 2011.
- US default later this year remains a possibility (even for a short period).

… but there are powerful offsets, such as a strong labor market.

On the other hand, there are the following mitigating factors:

- The job market has remained very strong and wages are growing at a healthy clip.
- There still seems to be labor shortages in certain industries causing employers to be hesitant to lay people off.
- This year saw a large cost of living increase (+8.7%) for Social Security recipients.
- Since WWII, a recession has never started while real interest rates were below inflation,[6] which is currently the case.
- Personal savings remain relatively high, and can earn more interest income with short-term interest rates at attractive levels.

While we do not have a crystal ball, and calling the timing of a recession is difficult at best, it seems the weight of economic factors are tilted in that direction.

Earnings growth has slowed considerably.

Impact on the Equity Market: The decline in longer term interest rates, despite the Fed raising rates this quarter, seemed to fuel the rally in growth stocks. Market participants are pricing in a pause and eventual rate cuts by the Fed by year end.

While interest rates are an important factor for stock prices, earnings expectations are the key. As of the end of March, S&P 500 earnings were only expected to grow 1.5% in 2023. Company revenues have been increasing, but higher costs have eaten into margins, which is a trend expected to continue the next few quarters. Stocks in the value indices, particularly energy and financials companies, have seen earnings expectations deteriorate, while growth-oriented communication services[7] and technology companies' earnings expectations have improved. We suspect tighter lending conditions will make earnings growth more difficult in the near term, and would not be surprised if 2023 earnings ended up being below 2022 levels.

[6] Real interest rates are defined as Treasury yields minus inflation (CPI).

[7] Communication services has companies like Google, Meta (Facebook), Netflix, and Activision Blizzard.

CONCLUSIONS

Tighter lending standards make us cautious, but we are not reducing positions.

Stocks: Despite the short-term headwinds for corporate earnings, high quality companies with strong financial statements continue to deserve an outsized allocation in most portfolios. We have written about market timing in the past, and while we have recently been reluctant to add new funds to the stock market, we are also not reducing stock allocations because of short-term concerns. The managers we utilize all purchase higher quality companies, so we expect their companies to weather a slowdown or recession better than others. Earnings growth should rebound as economic conditions improve, and historically markets have sniffed out the bottom before all the evidence of such a turn can be gathered.

Bonds remain attractive.

Bonds: Individual bond yields continue to be attractive. Bonds now provide decent income with relative stability and remain an important component of many diversified portfolios. Longer term yields may have peaked, but having a portion of a bond portfolio delivering predictable income over 5-10 years will likely provide a better return than just holding short term bonds or money market funds. That said, money market funds yield more than 4%, and we recommend clients with large bank balances protect and grow their "safe" cash assets by taking advantage of the protection Schwab offers with the higher yields we can earn.

Bank troubles could lead to opportunities in private credit.

Private Investments: Slower economic growth and tighter lending standards should provide increased opportunities for both distressed private credit funds and private lending funds. Banks are likely to pull back, giving lending funds the ability to dictate more favorable terms, such as higher interest rates and tight covenants. Distressed investing tends to be cyclical, and we are likely entering a positive part of the cycle for them.

DISCLOSURE