1st Quarter 2023 Review

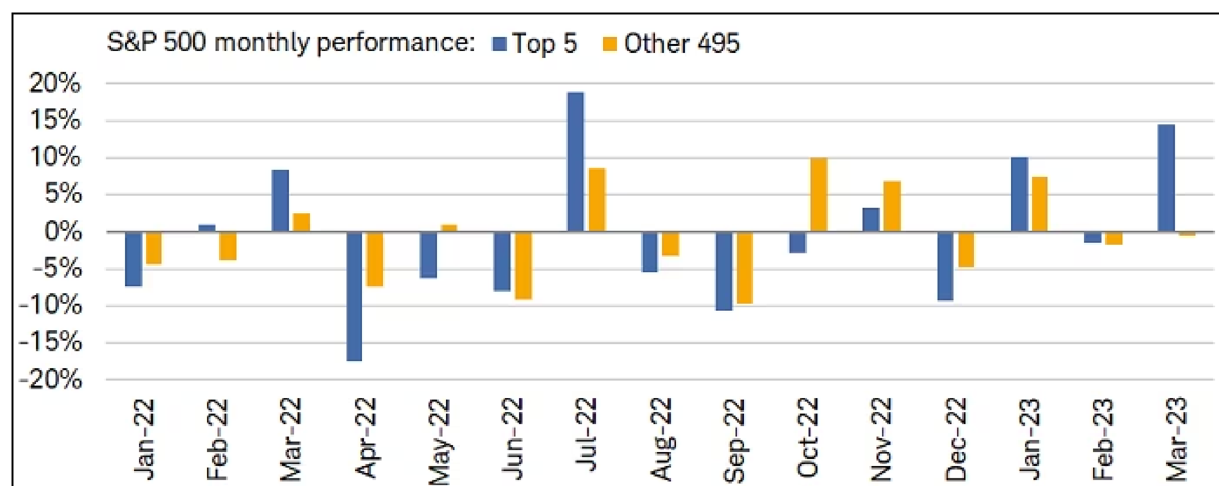
Resiliency and uncertainty are the best ways we can think of to sum up the first quarter of 2023. Markets displayed incredible resiliency in the face of multiple bank failures late in the quarter, while uncertainty surrounding the path of future Federal Reserve policies and their impact on the economy remains to be seen.

Coming into the year the dominate fear was that the U.S. economy was heading for an inevitable recession. It was all about whether the Federal Reserve could orchestrate a soft-landing (mild recession) or a hard landing (a more severe downturn). While the rate hikes that helped drive markets lower in 2022 continued into January, markets began pricing in the expectation that the Fed may be getting closer to a pause in policy rates in response to increased announcements of job cuts (particularly in the technology sector). This led to a rally in stock prices during January.

The mood did not last too long though as readings on inflation and the labor markets came in at strong enough levels to change the market narrative to one where maybe the Fed was not quite done with their inflation fight. A refocus on interest rates now being “higher for longer” led to a selloff in stocks by over 2.5% in February. Then we get to March where in a matter of days we have the 2nd and 3rd largest U.S. bank failures followed by a forced merger by the Swiss to take over the distressed bank, Credit Suisse. (We won’t rehash commentary on the bank failures here as we put out a note on March 13 that we’re happy to send you if you missed it.) With amazing resiliency, (with the exception of financial stocks) the markets rallied in March (S&P 500 up 3.7%) to cap off a volatile quarter for both stock and bond markets.

The quarterly returns for the major averages were: The Dow Jones Industrial Average rose 0.91%, the S&P 500 was up 7.46%, the Russell 2000 Small Cap Index rose 2.70%, the NASDAQ gained 16.7%. International equities were up for the quarter as well with emerging market stocks rising 4%, while the MSCI EAFE Developed International Index rose 8.9%. Bonds also regained some lost ground with the Aggregate Bond Index gaining 3.23% for the quarter as yields fell.

In a complete reversal from the prior quarter, the value versus growth leadership flipped. For the first quarter the Russell 1000 Growth Index gained 14%, while the Russell 1000 Value Index was up just fractionally. The shock from the bank failures seems to have reignited the momentum traders who are embracing the largest capitalized growth companies as well as the highest P/E ratio and highest price to sales companies again on the premise that rates will not be going any higher. This can be seen clearly in the data on market breadth and stock factor performance in the quarter. According to data from Bespoke Investment Group, the 50 stocks with the highest valuations in terms of P/E ratios at the start of the year gained 13% in the first quarter, while the 50 stocks with the lowest P/E ratios fell 2.5%. Further, while the March rally was super-charged by the largest capitalization stocks, small cap stocks were down over 5% and mid cap stocks were off by over 3%. In a healthy stock market, you expect to see an expansion in the breadth of stocks (the majority of stocks rising). We are not seeing this occur and in fact the exact opposite is happening, with only a handful of the largest stocks responsible for all of the year-to-date gains for the S&P 500. Here's a chart from Schwab's Liz Ann Sonders that shows the dominance of the five largest stocks in the S&P 500 and their average performance by month compared to all of the other 495 companies in the index.



Source: Charles Schwab, Bloomberg, as of 3/31/2023.

"Top 5" represent five largest stocks in the index by market capitalization in any given month. "Other 495" represent the rest of the index not included in the top five. **Past performance is no guarantee of future results.**

As we have seen many times in the past, this risk-on speculative activity in a narrow band of stocks can turn on and off like a switch. Much of this activity can be attributed to the fast-paced algorithmic trading that dominates today. (All the more reason to stay focused as a long-term investor.) All it would take to unwind the recent gains is another change in the narrative away from the embedded expectations for rate cuts

(remember, the strong rebound in growth stocks goes hand in hand with the lower bond yields of late). Towards the end of the quarter the NASDAQ was trading at a forward P/E ratio of 25 which is a large premium to the also higher than normal 18 x forward P/E ratio of the S&P 500.

The starting conditions from here for the broad S&P 500 Index point to lower than historical forward returns. This can be estimated based on the level of profit margins and the Price/Earnings multiple, which are both at elevated levels. Over the last 20 years the net profit margin for the S&P 500 has ranged between 7% and 13% (with 13% being the current level). The forward Price/Earnings multiple has been in a range from 13X to 20 x (with the current level being 18X).

There are better opportunities for long term investors outside of these areas of high starting valuations. Fortunately, our approach allows for stock selectivity and active management as opposed to just taking what the market offers. Our core stocks which are diversified across both sector and market capitalization trade at an average forward P/E ratio of 12 x. We feel this discount will be rewarded over time as these businesses are not priced for perfection in an extremely uncertain macro environment.

There is a great deal of macro uncertainty surrounding the end of this Fed-tightening cycle. Much of this is of the Fed's own creation by holding rates so low for so long and then ratcheting them up at the fastest rate since the early 1980's. There is a disconnect between what markets are pricing in for the final level of the Fed Funds rate versus what the Fed itself is saying. What is clear in their communications is that they are expecting a tightening of financial conditions in the U.S. – whether this comes from further increases in the interest rate that they control or is transmitted through the economy via tighter credit conditions, the end game they are targeting is slower growth and lower inflation. The extent and duration of the credit tightening that has begun as a result of the recent turmoil in the banking sector and its ultimate impact on growth, jobs and inflation is highly uncertain. Credit growth (particularly as it comes from small and regional banks) is a strong gear that turns within an economy to drive economic growth. That gear is slowing down after a long period of frictionless motion spurred on by the Fed's own policies. Just as interest rate hikes impact the economy with a lag, so will the tightening of credit.

We said last quarter that it would be quite a feat by the Fed to succeed in their desire to defeat inflation without causing some damage to the economy along the way. It now looks like some of that damage has been inflicted on the very banking system that they are charged with monitoring, as some banks were poorly positioned for the impact of higher rates on their balance sheets. While the immediate contagion risk to the banking sector appears to be contained, the fallout from the inevitable tightening of credit mentioned previously will need to be monitored for its impact on asset classes and individual company prospects.

It is reasonable to expect more volatility in both rates and stock markets as this unfolds in a probable "stair-step-like" fashion with both fits and starts. Interest rate volatility drives volatility across the asset class spectrum as their returns are compared to the risk-free rate of

Treasuries. We lean on active management in the bond portion of portfolios to allow managers to put on exposure across the duration or yield curve environment in response to the opportunity set they are given for their specific fund objectives. This is also true across the credit spectrum, allowing them to emphasize the highest quality credits when defensiveness is warranted, while allowing for the optionality to add lower investment grades when the opportunities are justified.

A higher volatility environment can lead to larger dispersion between leaders and laggards across sectors in both equities and credit. This type of environment has historically been a favorable backdrop for alternative investments such as long/short hedge funds and multi-strategy funds which are less reliant on the direction of the major indices. Other private markets may be poised to take advantage of any dislocations and opportunities that emerge from a backing off of credit extension by the regional banking sector. Some alternative investments in these areas and more do require an investor to accept less liquidity in order to get access to certain vehicles in these markets, and they can vary from quarterly liquidity to multi-year lock up periods. A matching up of risk tolerance and liquidity needs is required in the overall context of an investment strategy including traditional equities, bonds, and private investments.

We remain anchored to a prudent long-term investment strategy involving both diversification and valuation discipline all centered around a financial plan and investment policy designed to meet the long-range goals of you, our valued clients. We thank you for your trust and confidence.

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