Q1

2023

Market Commentary

Financial asset performance was strong in Q1, though it might not have felt like it.

1Q 2023 Market Commentary

LEEWARD FINANCIAL PARTNERS

Good riddance 2022, hello 2023

In the wake of a historically challenging year for financial assets, the first quarter of 2023 brought a much-needed reprieve as markets stabilized and both stocks and bonds both notched positive returns. Encouragingly, up and to the right remained the story for both stocks and bonds in April, which we'll outline in more detail in the next few paragraphs.

The U.S. equity market stormed out of the gate in January; the S&P 500 Index returned 6.3%, and smaller companies (Russell 2000 Index +9.8%) outperformed as valuations recovered from oversold levels and optimism built around the prospects for upward revisions to company earnings estimates. Tech companies (NASDAQ +10.7%) were the biggest beneficiaries of the rally, though they had been beaten down the hardest last year.

In February, equity markets took a step back as inflation data came in hotter than analysts anticipated, and Fed Chairman Powell noted that "a couple" more small rate increases may be needed. Prior to the Fed decision in February, the consensus was that the final rate increase would come at the March meeting. The change in language from the Fed Chair increased market expectations for the terminal interest rate, at the expense of equity and bond markets.

Equity performance in March was a sector story, exacerbated by the blowups of several smaller regional banks. On one hand, declining interest rates and a more cautious risk sentiment supported strong returns for the tech, communication services, consumer staples, and utilities sectors. On the other hand, the financials sector (-13.7%) and more economically sensitive sectors took it on the chin. Given the higher weight of the technology companies in the United States market, the net return of the market was positive, and those investors who held limited exposure to banks performed quite well.

In April, volatility in the market fell to the lowest level in over a year as investors developed confidence that the hiccups in the banking sector in March were indeed just hiccups. The S&P 500 Index returned another 1.6% on the back of stronger-than-expected tech earnings, and bonds delivered small gains as long-term interest rates remained relatively stable.

While the first four months of the year brought strong returns, those returns were accompanied by a fair amount of volatility, especially in March, which dampened sentiment and left many investors with a bad taste in their mouth. Through the rest of this

piece, we will address the sources of this indigestion. But before we do that, let's first set the table with an update on the economic landscape.

Recession?

One quarter of the way through 2023, the health of the economy remains a hotly contested debate.

Those feeling more pessimistic about the economic outlook will point to inflation (+6.0% year-over-year) which remains substantially higher than the Fed's target (2.0%). They will point to the contraction we're seeing in the manufacturing sector of the economy. They will point to issues within the banking sector and the simultaneous slowdown in business lending, as well as the impact of higher mortgage rates on homebuilding. Finally, they will express their concerns around the debt ceiling and geopolitics.

Those pitching a brighter outlook will highlight the fact that the economy has still grown around a 3% annualized pace over the last two quarters and that the services sector of the economy is expanding. They will highlight that despite a setback in March, consumer sentiment actually improved in the first quarter. They will say that pending home sales have ticked up, indicating an improvement in the liquidity of the housing market. They will call attention to the fact that nearly every gauge of the labor market remains historically strong. They will rest their case by commenting that the banking turmoil has contributed to lower oil prices, and that it may convince the Fed to stop tightening soon and might prod Congress and the Administration into a less-eventful raising of the debt ceiling.

Both arguments can be made in good faith. Given the complexity of the environment we find ourselves in today, a balanced view of the economy is warranted. The Atlanta Fed is projecting that GDP growth in the first quarter will remain about where it has been at the last few quarters – around 3%. That number is higher than we were expecting, and we wouldn't be surprised to see growth slow through the rest of the year, with the economy potentially falling into a mild recession by the end of the year.

Though the consensus is that the economy will grow around 3% in Q1, the economy is not the market, and the outlook for corporate earnings is decidedly worse. As of mid-March, analysts are expecting the S&P 500 Index to post an earnings decline of -6.1% in the first quarter. If earnings actually decline by that number, it would mark the largest quarterly earnings decline since Q2 2020, the low point of the pandemic. Revenues, however, are expected to grow about 2% in nominal terms, supported by higher prices, with profit margins holding steady around 11%. Interestingly, while the view remains that the economy will be stronger in the first half of the year and weaker in the second half, the opposite is expected for corporate earnings. Current projections show earnings declining -6.1% in Q1 and -3.8% in Q2, and then growing 2.9% in Q3 and 9.7% in Q4.

Of course, these numbers are a moving target and

historically, earnings growth has come in 3-4% higher than the aggregate estimate going into earnings season. From an investor's perspective, if earnings grow as expected over the next year and valuations remain stable, the S&P 500 Index would increase in price by 19.0% over the next 12 months, from around 3900 to around 4630. Now we'll step away from hypothetical performance and recap actual performance over the last quarter.

Markets were better than they felt

After the strong start in January, market performance was solid over the quarter, with stocks and bonds both managing to deliver positive returns. Large-cap U.S. equities (S&P 500 Index) returned 3.4%, bolstered by mega-cap tech (NASDAQ 100 +15.3%), while small-cap companies underperformed (Russell 2000 Index -0.2%). International developed equities (think Europe and Japan) slightly outpaced U.S. equities (MSCI EAFE +5.5%) supported by a weakening U.S. dollar, relative to the Euro and British Pound particularly.

Emerging market equities (MSCI EM Index +2.9%) were buoyed by the strong performance of Mexico (+18.0%), and South Korea (+6.3%). China (+3.9%) remains the story within the emerging markets, and volatility remains the story in China. Across the globe, measures of implied volatility moved higher as investors braced for any potential fallout related to the banking issues and the international central bank crusade to contain inflation.

The bond market was quite choppy over the quarter as investors attempted to game out how the Fed was digesting incoming economic data, and whether the Fed would be willing to keep hiking interest rates as planned, given the new developments relating to the regional bank issues. The 10-year Treasury yield advanced from 3.40% to 4.07% in February following the Fed Chairman's comment that "a few" more rate hikes would be warranted, and then proceeded to fall back down to about 3.40% by the end of March as investors rotated back into bonds to seek refuge in a more uncertain environment. By quarter-end, rates were slightly lower than where they were at the beginning of the year, meaning bonds generated a small amount of price appreciation on top of the yield they are currently providing.

High-quality corporate bonds (+3.1%), Treasury bonds (+2.8%), municipal bonds (+2.0%) all posted solid returns, but riskier corporate bonds (+0.8%) started to show some signs of stress toward the end of the quarter.

Oil prices fell about 9% to $73/barrel and natural gas prices dropped nearly 55%, both contributing to deceleration on the inflation front. Gold (+8.1%) closed in on the $2,000/oz level as investors flocked to safe haven assets in March and real interest rates declined.

Canary, or nothing scary?

The collapse of Silicon Valley Bank and Signature Bank sent bank shares tumbling in March as investors feared potential aftershocks and further contagion. We've already distributed a note on this crisis, but to summarize, the autopsies of these banks concluded that the failures were a result of:

Poor internal risk controls. Banks need to match the duration of their liabilities with the duration of their assets to limit interest rate risk. This is basic blocking and tackling, and both banks failed spectacularly on this front.

A misjudgment by the banks on the diversity of their depositor base. When all your clients are taking money from the same few venture capital funds and they are all in the same WhatsApp chats, the correlation of your depositors is very high, which increases the risk of deposit flight in a bank run scenario. In other words, the risk management teams should have viewed their depositor base as a small number of conglomerates, rather than 10,000 depositors with $10,000,000 each.

The decline in loan demand in 2022 encouraged regional banks to invest in longer-term bonds, which fall in value the most when interest rates increase quickly.

Outdated regulations. Since the securities these banks were buying with their deposits were U.S. Treasury bonds, by rule, they did not need to build additional buffer capital to offset the additional interest rate risk being taken. If the banks had bought an equivalent amount of risk in corporate bonds, they would have had to fortify their balance sheets further.

Fortunately for the markets, the Federal Reserve, FDIC, and Treasury Department acted quickly to restore confidence in the banking system, and set up a new funding facility called Bank Term Funding Program to provide liquidity for depositories. We cover this in more detail in our Regional Bank Weakness piece which was released in mid-March. The most important point is that we don't believe Silicon Valley Bank and Signature Bank are canaries in the coal mine. While it appears that First Republic Bank will need to be acquired, bank failures happen. In fact, there have been 563 bank failures in the United States since 2001, and 216 since 2011. It is possible that other banks' balance sheets are coming under pressure due to the rising rate environment, but the big players have far more diversified businesses, and are subject to much more stringent regulations. We had very limited exposure to the Financials sector prior to the blowups, and we expect to keep it that way for the foreseeable future.

How much is too much debt?

The debate around the US debt ceiling is back again. While we believe Congress will eventually increase the debt ceiling, as it has in every past episode, we expect the process to be especially messy this year.

What is the debt ceiling? The debt ceiling is a legal rule that requires Congress to authorize the Treasury to borrow money. The debt ceiling is not fiscal policy and has nothing to do with government spending plans. Instead, the debt ceiling is simply a process where Congress votes to authorize already approved spending. This is a vote to pay the bills, just like paying a credit card.

The ceiling was bumped up three times under the previous Presidential administration without incident. We anticipate the debt ceiling vote to be more contentious this time around, however, because control of Congress is split, and the House may try to extract spending cuts from the Presidential administration.

Could the debt ceiling rule cause the US government to default on its debt?

Technically, if the debt ceiling is not adjusted by a drop-dead date, the US government would be in default on its debt. This date occurs when the government's spending ability is exhausted. It's impossible to predict this date too far ahead of time. The exact timing will depend on government revenues. We believe Congress won't get serious about addressing the issue until the third quarter when most economists believe we will reach the drop-dead date.

The last time the debt ceiling adjustment was contentious was in 2011. This time around, negotiations will be even messier. Some in Congress seem willing to risk default in order to win spending cuts. This is a minority view, but the narrow Republican majority in the House of Representatives means minority views carry significant power.

To cut or not to cut

The Federal Reserve raised interest rates by a quarter of a percentage point in both February and in March, bringing the quarterly increase to 0.50% and leaving short-term interest rates around 5%. The current rate hike cycle, which started last March, has been unprecedented in terms of both the pace of the hikes, and the overall magnitude of the increase in interest rates.

The questions remain:

1. When will the rate hikes stop?
2. When/will the Fed start cutting interest rates?

Over the last year, the stickiness of inflation has prevented policymakers at the Federal Reserve from softening their tone regarding inflation because the Fed is dead-set on retaining its credibility. When they say inflation is their biggest concern, they are going to commit to keeping policy tight (interest rates high) until they see lots of evidence that inflation is moving lower for good. As a result of inflation not falling as quickly as many had hoped, and the Fed not softening its stance, the expected date at which we'll see a Fed pivot (switching from raising to lowering rates) continues to be pushed out. As we write this

commentary in late-April, the current expectation is that the Fed will deliver a final 0.25% interest rate hike on May 3rd, leave rates unchanged for a few months, and then start cutting interest rates around September, with rates falling from around 5.00-5.25% in September 2023 to around 3.00% by September 2024.

Given the underlying inflation data and the slight cooling in the economy, it is likely that the last increase in interest rates will come in May. However, there is a risk that once we have our last rate hike, interest rates will plateau, and remain elevated longer than expected.

Many professional investors appear to be on the same page. Hedge funds managers, for example, have established a significant negative position against Treasury rates, meaning they expect interest rates to go up over the next month. Given this positioning in the market, we could see the road for bonds getting bumpier through summer, so we're avoiding significant additional exposure to that space until the path forward clarifies itself.

Portfolio positioning

In the first quarter, we increased client exposure to fixed-income (bond ETF) positions. Historically we have been underweight fixed-income due to low yields and unfavorable risk-adjusted returns. This situation changed in 2022 due to the aggressive rate hike cycle of the Fed. Entering 2023, bonds appear attractive relative to historical levels. We have increased our duration (interest rate exposure) by buying longer-term bond ETFs and by increasing the overall weighting of fixed-income positions in portfolios. For clients with significant bond exposure in taxable accounts, we have focused on municipal bonds, which provide tax-free income. Once we get clarity on the direction of interest rates over the summer, we expect to add to our positions.

In stocks, we have maintained conservative sector allocations with higher weights in consumer staples and healthcare. In March, we began to adjust this positioning. So far, we have started to increase our technology exposure. We anticipate continuing this shift in the second quarter, adding to faster growth sectors such as consumer discretionary and communication services. We also see tactical trading opportunities for client portfolios with energy exposure.

Small-capitalization stocks have been disappointing over the last two months due to financing concerns and banking restrictions. This headwind will continue for smaller companies in the near term. We are actively looking for alternatives for clients with higher risk tolerances that hold significant levels of small capitalization companies.

Looking around the corner

Throughout the summer, we expect markets to be relatively flat. The Fed is getting what it wants. Jobless

claims are on the rise, and inflation is waning. April's economic data has clearly slowed despite a decent monthly jobs report last month. Earnings season is underway, and so far, the numbers have come in better than feared. Of course, earning estimates have come down significantly from the highs of last year. Still, earnings beats are sharply outpacing misses, and forward guidance has been in line.

Volatility is on the decline post the regional banking drama in late March. There is still uncertainty in the Financial Services space, and it is an area where we are limiting our exposure. One ripple effect of the regional bank saga is more limited funding options for small-cap and start-up companies. The tighter access to capital in this area will limit upside and IPO opportunities for small and private companies for now.

Both commercial real estate and residential real estate look challenged for the time being. There are long-term secular trends (limited supply, under-building) in the residential real estate market that should help limit the downside for house prices. Price support for commercial real estate remains less clear. Politics may impact markets around the debt ceiling in the third quarter, but we do not see the 2024 Presidential cycle having a material impact on markets this year. Geopolitical tensions remain a risk, although the Ukraine crisis has not been a major market driver for quite some time now.

Final Thoughts

The market bottoming process can be bumpy. After realizing new lows in June and September of last year, both 4Q22 and 1Q23 market returns are positive. Still, the positive six-month returns do not feel great because most portfolios have yet to recoup their 2022 losses. Fortunately, the trend is moving in the right direction. Markets are off to a strong start in 2023. We expect momentum to pick up throughout the year as rate expectations become more certain and near-term risks resolve themselves.

Thank you for your business and partnership.

Sincerely,

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