Insights: April 2023

Market Overview and Performance

If you read most of the major news publications or watch financial news, it will be quite apparent that the world is coming to an end in Global Financial Crisis style. Unfortunately, no one seems to have informed the investment markets about this. Stocks, bonds and Gold have all delivered positive returns in the first three months of this year and in fact, equities in particular have been rising since October 2022, up over +17%. Conflicting Bad News/Good News data continues to keep markets guessing, but for now, the trend is still "up" despite a myriad of headwinds. Private Equity manager, Hamilton Lane, recently articulated this dynamic. "Let me stack these rocks. Bank earnings better than expected. Inflation data coming in weaker than expected. Economic data is surprising to the upside. Credit spreads in an improving trend. The VIX traded at a 16 handle today. The S&P 500 just had its highest weekly close in SEVEN months and international markets are outperforming the U.S. Our stack of rocks still has plenty of headwinds but the longer it can stay put, the more time we have to get some mortar on it to keep that next bad bank executive, commercial RE loan default wave or geo-political event from pushing it over. There are still so many bears out there planning on a 20-30% pullback to save their 2023 forecast, but what if it never occurs?" Without question, there are very legitimate reasons to expect a slowdown in the economy in the coming months which will impact risk assets, however, the optimistic view seems to rarely be discussed. As macro strategy research firm Datatrek highlighted this week, "US equities seem to be ignoring the very real risk of recession, but that's because they see an economic contraction solving the Pandemic Era's three most intractable problems: declining labor force productivity, inflation, and aggressive Fed rate policy. Every recession since 1960 has caused all three issues to reverse course, and quickly. Recession is a "feature, not a bug". As always, thank you for reading our market Insights.

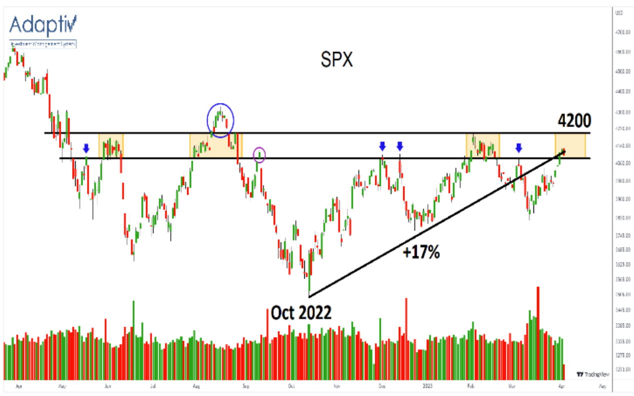
	Quarter to Date March 31	***Year to Date March 31***
Equity	***Total Return % (USD$)***	***Total Return %***
S&P 500 Index	7.50	**7.50**
Russell 2000 Index	2.74	2.74
MSCI EAFE Index	8.47	**8.47**
MSCI Emerging Markets Index	3.96	3.96
Fixed Income		
Barclay's U.S. Aggregate Bond Index	2.96	**2.96**
Barclay's U.S. Aggregate Credit Index	5.42	**5.42**
Barclay's U.S. Aggregate Corporate High Yield Index	3.57	**3.57**
Barclay's Municipal Bond Index	2.78	2.78
Macro Measures		
Gold	8.76	**8.76**
Crude Oil	-5.72	-5.72
CBOE Volatility Index	-13.71	**-13.71**
USD Dollar Index	-0.98	**-0.98**

Current Theme – Unexpected Banking Sector Stress Causes Concern but the Equity Market Remains Resilient While Inflation Fears Abate

Equities, Fixed Income and Gold All Start the Year with Gains as Many of the Headwinds in Place at the Start of the Year Have Altered Direction.

While the current environment "feels" challenged due to all the potentially impactful negative factors, the US equity market has proven very resilient. In fact, the S&P 500 has been trading sideways for much of the last 12 months and is within 1% of the April 2022 close.

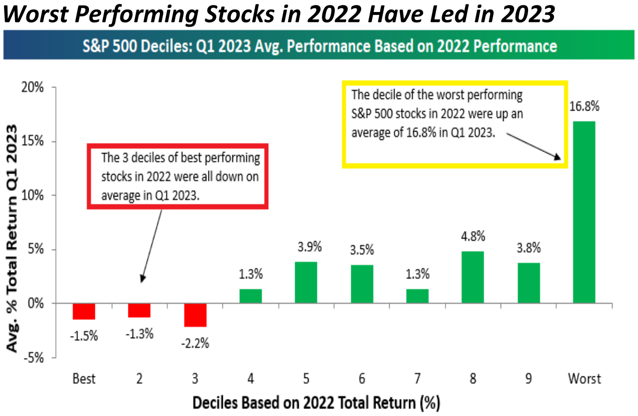
S&P 500 Testing Top of Range for Close to a Year Now



Source: Ian McMillan; Adaptive

Additionally, several attempts have been made by the Index to break out of the 3800 to 4200 range that has been in place for much of the past 12 months. This is evidence of underlying strength. So while it may appear like the market has been "treading water" without much progress, there have been notable changes occurring underneath the surface. As the chart below highlights, the bottom 10

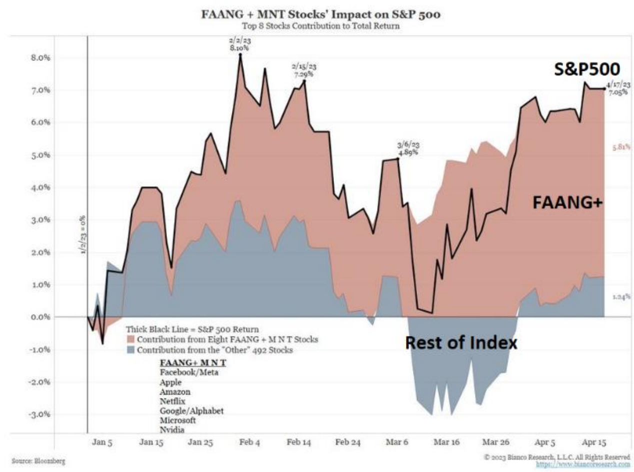
Worst Performing Stocks in 2022 Have Led in 2023



Source: Bespoke Investment Group

percent of the S&P 500 which fared the worst in 2022, has rallied the hardest thus far in 2023 with gains of over +16%. Conversely, the leading segments of the market in 2022 have lagged. The top three deciles from last year have declined between -1.5 to -2% in 2023.

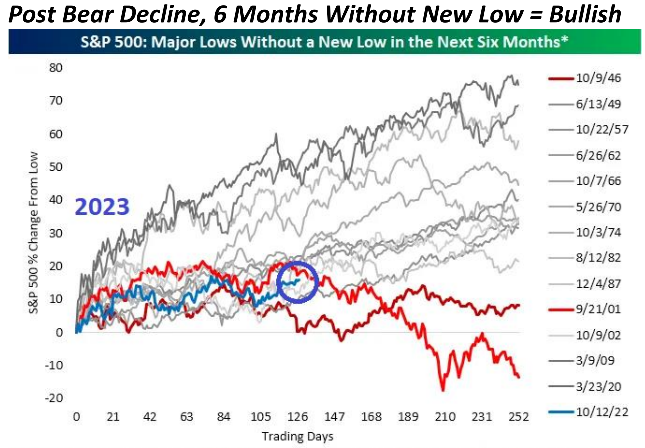
7 Big Tech Names Account for 6% of S&P 500's 7% Gain YTD



Source: Jim Bianco; Bloomberg

Intuitively, this makes sense, however the magnitude of the shift has proven to be notable. Large Technology names broadly declined by about -35% as a group last year. However, as one can see above, in 2023, seven large technology names have accounted for roughly 6% of the S&P 500's 7% return for the year. These gains have been enhanced by the fact that the fundamental earnings of these large tech companies have exceeded expectations even in the face of continually rising interest rates.

Post Bear Decline, 6 Months Without New Low = Bullish

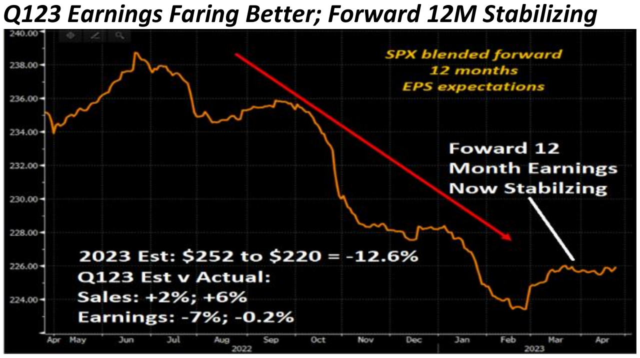


** Dates shown represent the low point of 20%+ declines from 52-week highs that did not see a new low for at least six months. Lines for each date show the % change in the 12 months following the low.*

Source: Bespoke Investment Group

Essentially, the market has returned to these companies as pillars of strength in turbulent times due to their high cashflow generative abilities. And as we mentioned, this trend has actually been in place since October of 2022. As the previous chart demonstrates, following a Bear market (-20% decline), a sustained path higher for stocks without making a new low over six months is typically constructive for stocks. 2001 proved to be the exception as the Federal Reserve pushed rates to 6.5% just as the Dot Com Bubble was bursting.

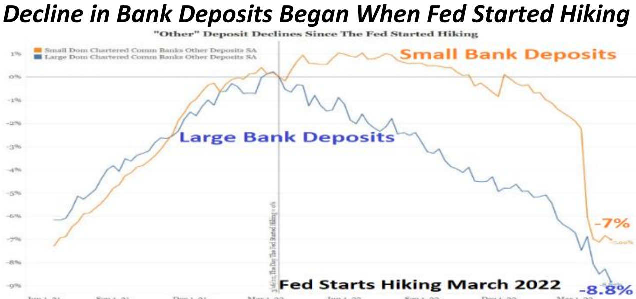
Q123 Earnings Faring Better; Forward 12M Stabilizing



Source: Macro Compass; Bloomberg

At the end of the day however, prices need to be supported by fundamentals. As we entered 2023, the consensus view was that earnings estimates were too high and needed to be revised lower. In fact, 2023 estimates have already fallen by -13% since June of 2022. As the chart above shows, reported results for Q1 have handily exceeded expectations with about 44% of companies in the Index reporting thus far. As a result, the forward 12-month measure has stabilized.

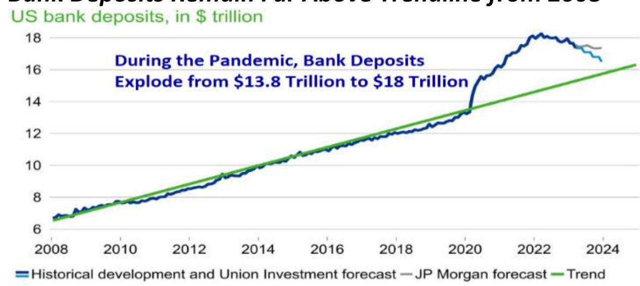
Decline in Bank Deposits Began When Fed Started Hiking



Source: Bianco Research; Bloomberg; The Federal Reserve H8 Report

This type of fundamental validating data is particularly important given the banking scare that occurred in March. While there were some idiosyncratic bank issues, broadly speaking, a decrease in bank deposits was at the heart of the matter. As the previous chart highlights, the decline in deposits actually began when the Fed started hiking rates in early 2022. This $221 billion drain as estimated by the Financial Times, has done little to dent the massive deposit built up since the Pandemic as seen below.

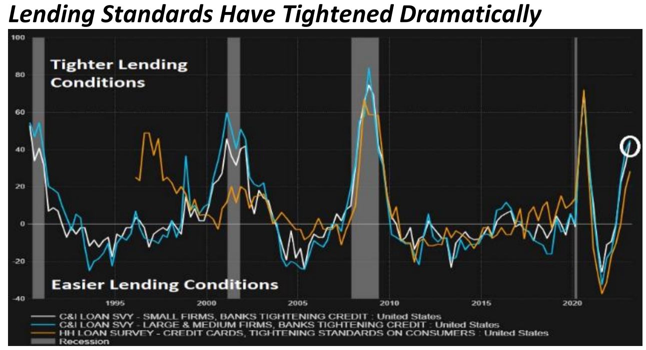
Bank Deposits Remain Far Above Trendline from 2008



Source: Macrobond

Specific bank issues began when select institutions had to sell longer dated Treasury positions at a loss to meet liquidity requests. Unlike 2008, no toxic assets were involved and no systematic leverage was present that could lead to market contagion. There will be consequences however. As seen below, lending standards have already increased markedly according to the Fed's Senior Loan Officer Survey.

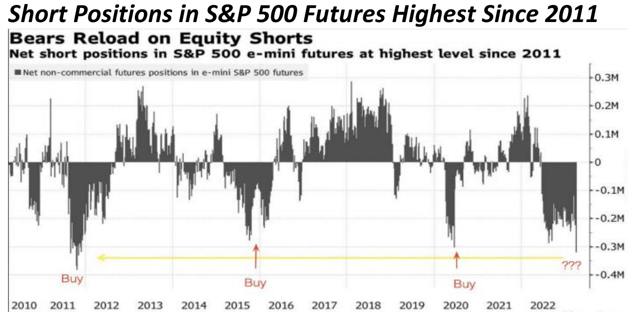
Lending Standards Have Tightened Dramatically



Source: Refinitiv; Arno Venter, Fed Senior Loan Officer Survey

During past episodes when banks reduced lending, a sharp slowdown in economic activity has logically followed. The Market is keenly aware of this and Index short positions are now at levels not seen since 2011.

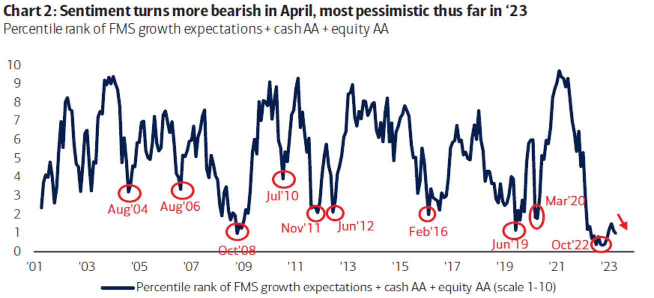
Short Positions in S&P 500 Futures Highest Since 2011



Source: Bloomberg; Ryan Detrick

Incidentally, these past spikes in short interest have proven to be good entry points. The market consensus is strongly tilted toward the other side of this view.

Investor Expectations for Growth Near 20 Year Lows



Source: BofA Global Fund Manager Survey

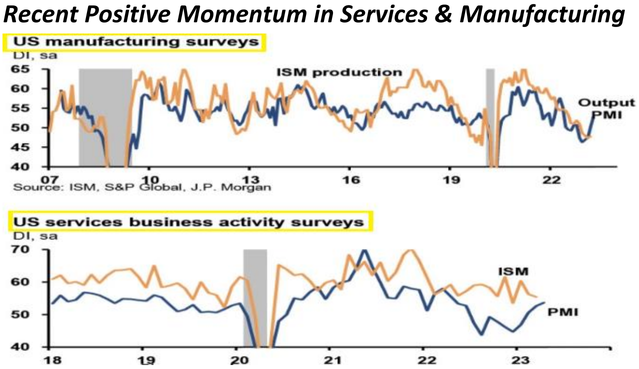
As seen above, expectations for future growth from participants in the BofA Global Fund Manager Survey are close to Global Financial Crisis lows. While likely an exaggerated response, growth concerns are not unmerited. Leading Economic Indicators which serve as a proxy for growth continue their downward trajectory into what has previously been recessionary territory.

Leading economic Indicators Continue to Deteriorate

Source: The Conference Board; Bureau of Economic Analysis

However, as we mentioned in our opening comments, conflicting data is readily available pointing to a potentially different outcome.

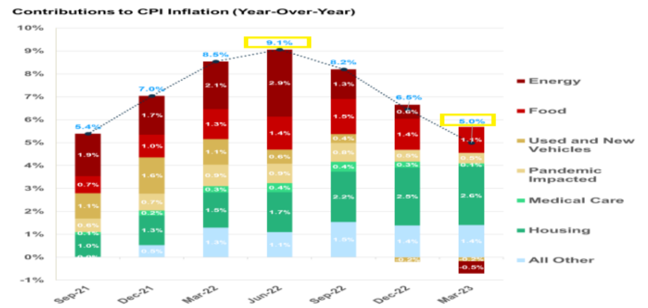
Recent Positive Momentum in Services & Manufacturing



Source: ISM; S&P Global; JP Morgan

Consider the previous chart which illustrates the fact that both the Manufacturing and Services components of the PMI survey are expanding. In the words of J.P. Morgan, "April PMI showed unexpected and broad-based improvement suggesting further positive momentum in the US economy. A more sustained pace of expansion; tighter monetary and credit conditions do not appear to be significantly slowing activity at this time".

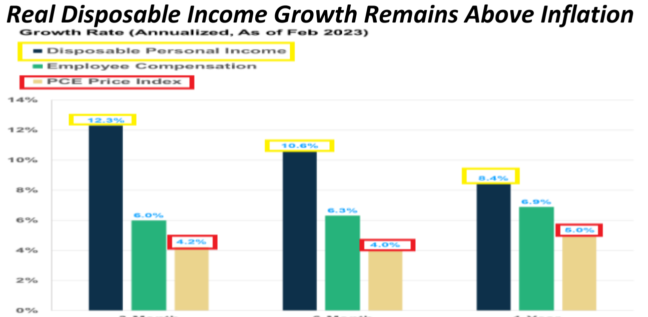
CPI Has Gone From 9.1% (June 2022) to 5.0% (Mar 2023)



Source: Carson Investment Research; BLS

Without a doubt a contraction in inflation will be a primary determinant of whether or not that assessment proves accurate. And for the time being, that appears to be the prevailing trend. As seen above, inflation as measured by CPI has gone from a peak of 9.1% year over year growth in June of 2022 down to the 5% level in March 2023.

Real Disposable Income Growth Remains Above Inflation



Source: Carson Investment Research; FRED

Regardless of the actual level of inflation, an important piece of the puzzle which is often overlooked is disposable income growth. This has a tremendous influence on whether or not consumers feel confident. As seen above, on a one-year basis, disposable personal income grew at 8.3% while inflation grew just 5%. The effects are compounded as inflation falls more rapidly while wages remain steady. On a 3-month basis, disposable incomes grew 12.3% while inflation rose by just 4.2%. Confirming data in the form of Q1

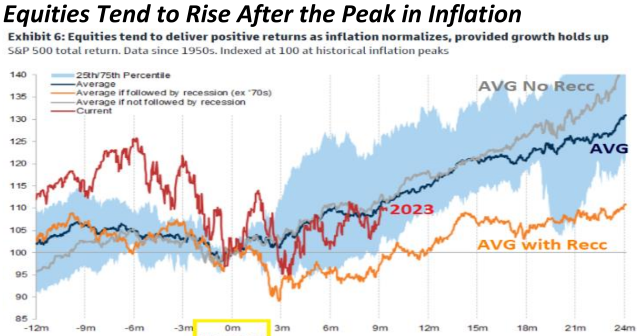
GDP was just released this week showing that consumer spending grew +3.7% on an annual basis suggesting that consumers are confident enough to spend rather than save. In fact, expectations for inflation in one year's time have fallen to 3.6% which would likely further embolden US consumers.

1 Year Inflation Expectations Have Declined to 3.6%

Source: Fundstrat; Bloomberg; Cleveland Fed

Rapidly falling inflation tends to be embraced by the markets as well for obvious reasons. As seen below, after a peak in inflation, equity markets historically rally over the next 24 months, even more so if no recession develops. If one assumes that June 2022 was the peak in inflation, 2023 is in line with the average.

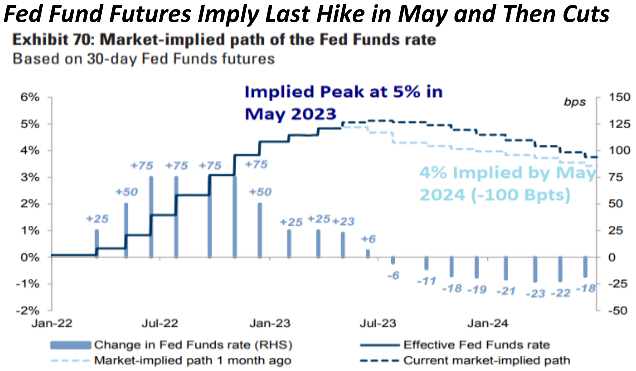
Equities Tend to Rise After the Peak in Inflation



Source: Goldman Sachs Global Investment Research

If inflation has indeed peaked, the Federal reserve is also likely to get less aggressive with rate policy.

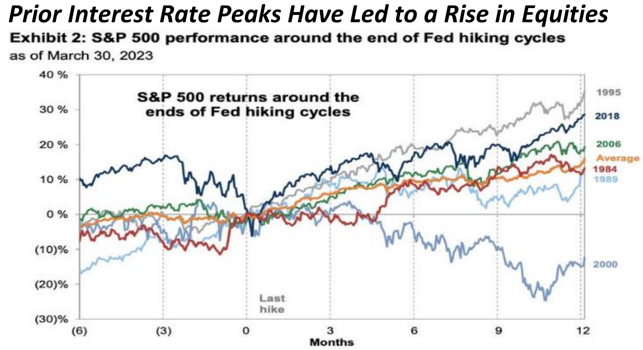
Fed Fund Futures Imply Last Hike in May and Then Cuts



Source: Goldman Sachs Global Investment Research; Haver Analytics

As seen in the previous chart, the market now anticipates just one more interest rate hike in May to 5% and then a pause before -100 basis of cuts take the rate back down to 4%. Part one and two of this narrative are for the most part widely accepted by market participants, but cuts by the end of the year are more controversial. If the Fed were to cut rates that substantially so quickly after the last hike, it would suggest that the economy has truly regressed into a dangerously contracting environment. Whether or not that proves to be the case, equities historically perform well after the end of a rate hiking cycles.

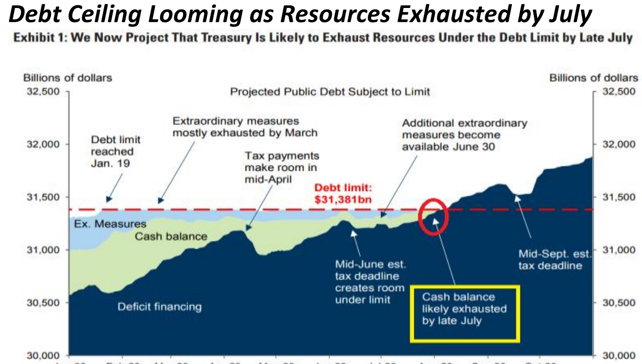
Prior Interest Rate Peaks Have Led to a Rise in Equities



Source: Goldman Sachs Global Investment Research; FRB

While it will take some time to gain any certainty around which path the economy is marching toward – a slowdown led by tightening lending conditions or a steady measured rise as the inflation and rate headwinds abate – one important factor that will become abundantly clear in the next few months is the debt ceiling. This is due to the fact that as per Goldman Sachs calculations, the Treasury will exhaust its spending resources by late July. As a reminder, the S&P 500 cascaded-17% lower during the 2011 political theatre debt spectacle, and unfortunately, it appears we are likely to see more of the same as the next few months unfold.

Debt Ceiling Looming as Resources Exhausted by July



Source: Goldman Sachs Global Investment Research; Treasury

Going Forward

It's hard to overstate how remarkably resilient markets have been. There are a litany of negative factors that one can legitimately point to as causes for concern, yet US equities climb higher seemingly every day, non-US equities even more so, both corporate bonds and treasuries are higher on the year, gold is up almost 10%, and credit spreads and volatility measures remain quite muted. If someone had told us that within the first quarter of the year, we would see bank failures in both the US and Europe seemingly out of the blue and that 2-year bond yields would collapse from 5% to 4% in two days, we would have positioned quite defensively – and many did (and remain so). However, as we discussed, there has been a shift in the challenges present heading into the year, namely, inflation and a relentless rise in interest rates. It is undoubtedly a conflicted environment. As Dan Suzuki, Chief Investment officer at Bernstein Advisors suggested, "There's a lot for both bulls and bears to hang their hats on right now; Bulls can point to pervasive bearish sentiment, last year's rerating, declining interest rates, the falling US dollar, lower gas prices, the China reopening, a resilient domestic economy and decent market momentum. On the other hand, bears can point to weakening overall growth, the earnings recession, tightening liquidity, as well as the stubbornly high concentration and valuations in growth stocks".

While we have benefitted from what we would judge to be a fully invested orientation since last October, the impact of the tightening lending environment cannot be dismissed. It is more likely than not that a slowdown in the economy will take place in the coming months particularly since it is small and mid-sized banks, those who need to shore up their loan portfolio and deposit bases the most, who provide funding to many of the small business across the US.

As a result, as equity markets approach the top of the 12-month range, we will be looking to reduce exposure. With the strong outperformance of large cap tech to start the year, some names provide areas to harvest gains, however, rebalancing opportunities exist across sectors as many defensive areas made strong gains in 2022. Given that small and mid-cap stocks companies generate almost all of the of their sales domestically, they are poised to benefit from an improving inflation and rate scenario. Valuations for both small and mid-cap stocks are very attractive when compared to their large cap counterparts and fund flows have therefore been attracted to these areas at the start of 2023. There has been a notable shift in asset flows since the banking issues developed in mid-March however, with many investors seeking the perceived safety of larger capitalized companies at the cost of small and mid-cap exposure.

Regions outside of the US which were challenged by a very strong US Dollar throughout 2022 have seen a change in the headwinds. Valuations outside of the US are very compelling on a historical basis after a difficult 2022. Additionally, the US Dollar appears to have peaked for the near term declining about -11% since September 2022. If that trend continues, along with the improving fundamental data we have seen globally, non-US markets could potentially do well in 2023 and in fact, are outperforming their US counterparts thus far in 2023.

Within fixed income, we continue to place our emphasis on shorter duration exposures and unconstrained strategies. We also continue to find opportunities within municipal bonds. More recently however, we have taken advantage of the climb in treasury yields to allocate a portion of our exposure into laddered short-term treasuries as a way to capture risk-free yield for fixed income portfolios. As rate increases by the Federal Reserve are projected to end, we would anticipate taking advantage of slightly longer duration exposure that stand to benefit from a more stabilized rate environment combined with falling inflation.

We believe that commodity exposure including both gold and non-precious metals (agriculture, industrial metals, energy) will continue to be additive due to the nature of the current supply constraints. Gold in particular has served its purpose as a diversifying asset quite well, returning +8% in Q1 of 2023.
Thank you for taking the time to read our thoughts on the markets and we look forward to speaking soon.