# First Quarter 2023 – Investment Commentary

Inflation remained front and center for much of the quarter and heading into March expectations were building that the Federal Reserve (Fed) was going to keep rates higher for longer due to stubbornly high inflation and a persistently tight labor market. This alone was enough to keep markets volatile, but things abruptly changed with the turmoil surrounding Silicon Valley Bank, which added another layer of uncertainty for investors.

Last quarter I wrote that the Fed was in the midst of a policy misstep for not allowing "some lag time for the rate hikes to take effect before pursuing additional rate hikes." There are some relevant market adages: "The Fed tightens until something breaks;" and "Only when the tide goes out do you discover who's been swimming naked." One only needs to look at a few examples in recent history to see how things have broken before during a hawkish Fed campaign.

- 1987 - "Black Monday" stock market crash
- 1994 - Orange County LA blew up due to its mortgage exposure
- 1998 - Long-Term Capital hedge fund collapsed due to leveraged exposure to Russian bonds
- 2007 - Bear Stearns hedge funds succumb to leveraged sub-prime mortgage lending pressures
- 2008 - Lehman Brothers folded and the Bernie Madoff Ponzi scheme was exposed

The Fed has indicated that the recent banking industry events will likely act as a de facto rate hike by tightening financial conditions for businesses and consumers and lowering overall demand in the economy and labor market. The Fed's latest U.S. economic projections for 2023 and 2024 reflect the expected weakness as both were lowered, from +0.5% to +0.4% for 2023, and from +1.6 to +1.2% for 2024.

This position by the Fed is a double-edged sword. If they are correct and the banking event does meaningfully impact economic growth, then we are likely to see a recession happen sooner than previously anticipated. If, on the other hand, the Fed is incorrect and the banking event is an isolated incident and passes without much impact, it runs the risk of falling further behind in their efforts to corral inflation which will likely lead to a continuation of rate hikes. I'm in the recession-sooner-than-anticipated camp, due to the expanding economic impact of aggressive rate hikes as well as reliable indicators such the inverted yield curve and the LEI survey.

The treasury yield curve has been a reliable harbinger of pending economic activity and for quite some time now the yield curve has been inverted. An inverted yield curve is when short-term yields are higher than long-term yields and this is important as an inverted yield curve has preceded the last eight recessions. It is highly likely this will again be the case, especially given higher uncertainty.

On March 14th, when the February CPI report was released, it reached its widest inversion spread in 42 years (-1.06) as inflation came in hotter than expected which also sent the two-year treasury to 5.06%, its highest level since June 2006. Two days later on March 16th the banking sector came under tremendous pressure with the turmoil surrounding Silicon Valley Bank and interest rates plummeted. A couple of weeks later at the end of the first quarter, the two-year treasury yield stood at 4.07% and the bond market began pricing in a near-term cap on rate hikes with subsequent rate cuts starting as early as July.

On March 22nd, the Fed concluded its policy making FOMC meeting raising the target rate +0.25% to 5.00%. At the post-meeting press conference, Fed Chair Powell communicated that the Fed is moving into wait and see mode on rate hikes to observe what affect banking events will have on credit conditions and economic demand. Additionally, the bond market is pricing consecutive rate cuts every meeting in the second half of this year while the Fed's projection shows rates being held steady for the year. When asked if the bond market is totally wrong Powell stated "participants expect relatively slow growth, a gradual rebalancing of supply and demand for the labor market, with inflation moving down gradually. In that most likely case, if that happens, participants don't see rate cuts this year. They just don't." So, from the Fed's perspective, the likelihood of a rate cut this year is low. This is rather perplexing especially given that they lowered their GDP forecasts for 2023 and 2024!

Once again, there is a disconnect between the Fed and the bond market. The bond market clearly thinks the economy is going to weaken as bond yields plummeted at the end of the quarter sending bond returns higher for the month and the quarter.

**Table 1 – Fixed Income Index Total Returns – as of March 31, 2023**

| Fixed Income | 1-Month | 3-Month | YTD | 1-Year | 3-Year | 5-Year | 10-Year |
|---|---|---|---|---|---|---|---|
| Bloomberg High Yield | 1.07 | 3.57 | 3.57 | -3.34 | 5.91 | 3.21 | 4.10 |
| Bloomberg Aggregate | 2.54 | 2.96 | 2.96 | -4.78 | -2.77 | 0.91 | 1.36 |
| Bloomberg Municipal | 2.22 | 2.78 | 2.78 | 0.26 | 0.35 | 2.03 | 2.38 |
| Barclays Michigan Muni | 2.10 | 2.63 | 2.63 | -0.48 | 0.13 | 2.10 | 2.53 |
| Bloomberg Inter Gov't/Credit | 2.30 | 2.33 | 2.33 | -1.66 | -1.28 | 1.40 | 1.32 |

The stock market is definitely expecting, more like hoping, that the Fed changes its monetary policy stance from hawkish (raising rates) to accommodative (lowering rates) in 2023. Despite slowing revenue and earnings growth, stock markets pushed higher for quarter with the tech heavy NASDAQ leading the pack at +17.1%. For the S&P 500, while it moved higher for the quarter at +7.5%, sector participation lacked depth of breadth as returns were concentrated in three sectors (Info Tech +21.8, Communication Services +20.5% and Consumer Discretionary +16.1%) while four sectors experienced negative returns for the quarter (Utilities -3.2%, Health Care -4.3%, Energy -4.7% and Financials -5.6%).  Depth of breadth is important as it indicates widespread economic strength.

**Table 2 – Equity Index Total Returns – as of March 31, 2023**

| Equity | 1-Month | 3-Month | YTD | 1-Year | 3-Year | 5-Year | 10-Year |
|---|---|---|---|---|---|---|---|
| NASDAQ | 6.78 | 17.05 | 17.05 | -13.28 | 17.56 | 12.60 | 15.30 |
| MSCI Developed | 2.48 | 8.47 | 8.47 | -1.38 | 12.99 | 3.52 | 5.00 |
| S&P 500 | 3.67 | 7.50 | 7.50 | -7.73 | 18.60 | 11.19 | 12.24 |
| MSCI Emerging | 3.03 | 3.96 | 3.96 | -10.70 | 7.83 | -0.91 | 2.00 |
| S&P 400 | -3.21 | 3.81 | 3.81 | -5.12 | 22.10 | 7.67 | 9.80 |
| Russell 2000 | -4.78 | 2.74 | 2.74 | -11.61 | 17.51 | 4.71 | 8.04 |
| Dow Jones Industrial | 2.08 | 0.93 | 0.93 | -1.98 | 17.31 | 9.01 | 11.15 |

Markets are going to remain volatile until it becomes clearer where inflation levels off and how the economy is going to respond to rate hikes and recent banking events. The good news is that inflation has been trending lower for many months and this trend should continue. It appears that most of the heavy lifting has been done and we are on the back nine (for you gophers) of rate hikes, that economic weakness has been expanding albeit slowly throughout the economy, and the banking sector event is looking more like an isolated incident. However, global geo-political tensions remain heightened and pose a serious event risk. For now, we remain neutral on stocks and bonds, favoring small and mid-cap stocks and a modest underweight on bond duration.

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Sources:  FactSet, The Federal Reserve

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