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First Quarter 2023 Market Commentary

Following a terrible 2022, both stock and bond markets produced positive returns during the first quarter of 2023. After appreciating by 1% during the final six months of 2022, global stocks continued to recover, returning 7.2% for the quarter ended March 31. Bonds enjoyed declining interest rates which helped produce a 3.2% return over the same period. Returns listed here are VT (Vanguard Total World Stock ETF), AGG (iShares Core US Aggregate Bond ETF).

The portion of the bear market described as Phase 1 in our last letter made itself known again in March. That phase relates to problems cropping up because of the rapid rise in short-term rates orchestrated by the central banks. The failure of Silicon Valley Bank and other entities was commented on in our recent market note. With no more bank failures it would seem that the banks have weathered this deposit crisis from a solvency point of view so far.

But there are important shifts occurring within the banking system. A significant amount of deposits have moved across banks within the system and also have left the banking system for money market funds. Much of our lending in this country is granted by banks and a stable and predictable deposit base helps support stable and predictable lending activity. The deposit base of banks has been anything but stable. One indication of this instability is the difference in deposit rates being offered. Recently, some of our country's largest banks were offering deposit interest rates of 0.05%. At the same time, two large local banks were offering deposit interest rates of 100 times that or 5%. That is a bit of a gap and shows how much some banks are trying to maintain or grow their deposit bases in light of current events.

The impact of this will be lower bank profitability and lower amounts of lending. A change in lending will have an impact on economic growth. The KRE ETF (regional bank ETF) is still down 16% this year and has not recovered at all since these problems surfaced last month. We will have to wait and see whether the challenges facing banks result in an additional pressure point on economic growth.

The Conference Board Leading Economic Index fell in February of 2023 for the eleventh straight month, and the rate of decline increased over the last 6 months from August 2022 to February 2023 compared to the previous six months. The LEI is a composite that looks at credit measures, manufacturing, labor, homebuilding, unemployment, consumer expectations, capital expenditures and bond and stock market conditions. It has now moved sustainably below the threshold that has indicated recessions in the past.

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The gains in the market this year are narrow, focused on one sector which seems to suggest that the market is not quite convinced we are out of the woods yet. Without the Information Technology sector the YTD return for the S&P500 falls from 7% to 2.7%. Also, during the bank crisis in March the S&P500 index fell reducing its YTD gains back to around 0%. While the S&P500 has gained since then, both Mid-Cap and Small-Cap indices have not recovered from their levels reached around the Silicon Valley Bank failure news.

On the bright side, while earnings expectations continue to decline for 2023, they still reflect a level 11% higher than last year. That means that consensus earnings expectations do not seem to include a recession for 2023. If we do experience one, the timing and duration of any recession will affect the possibility of positive equity returns in 2023.

The key to maintaining positive equity returns will be earnings growth. As stated last quarter, corporate earnings fall in recessions and markets fall in the beginning when the timing for the 'bottom' or worst of news is uncertain. Equity markets will then begin to recover before the economy does, as they anticipate the recovery in earnings. With the recent change in the lives of banks and bankers, and how these changes can affect lending (oxygen for economic growth), we suspect that we have not seen the 'all clear' signal to convince us we will avoid a recession.

As always, we are happy to discuss any specifics with you.

Regards,

Peter B. Harre, CFA