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First Quarter Investment Market Review, April 2023

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Stocks surged to start the new year. Sectors that were battered the most in 2022 led the early 2023 market rally. S&P 500 index performance was driven by a very narrow concentration of a few economic sectors. A broadly diversified portfolio of high quality securities remains a proven long-term wealth generation and risk-mitigating strategy, while chasing sector or individual stock performance inevitably backfires.

Growth stocks handily outperformed value stocks during the first quarter, recouping some of the losses realized last year. The tech-heavy NASDAQ posted its best January return since 2001 and was up 17% for the quarter. The technology and communications services sectors, which comprise 34% of the S&P 500 index, were both up over 20% in the first quarter, while the utilities, healthcare, energy, and financial sectors all declined more than 3%. The S&P 500 is up 84% since the index reached a pandemic-era low on March 23, 2020**.**

It is often said that the Fed raises rates until something breaks, and in that vein, the first cracks emerged in the form of regional bank failures. Unlike the exotic debt instruments that were the undoing of several companies during the financial crisis in 2008, the banks that failed in March held "safe" government bonds. However, as interest rates rose, the value of the bonds they held declined in value and, as skittish depositors rushed to withdraw their cash, the banks were rendered insolvent.

Regulators stepped in to shore up confidence in the banking system and prevent the panic from spreading. The measures included guaranteeing all deposits at the failed banks since each had a large portion of deposits that exceeded the Federal Deposit Insurance Corporation (FDIC) limits of $250,000. The Federal Reserve also created a new lending program that allows banks to borrow funds to meet customer withdrawals without the need to sell securities that have declined in value. While the measures appear to have worked for now, the regional banking sector remains beaten down as investors assess which firm may be the next casualty of a bank run.

The Fed raised rates by a quarter point at both of their meetings this quarter. The most recent increase marked the ninth consecutive increase since they began their campaign to extinguish inflation last year and put the federal funds rate at its highest level since 2007. The March meeting was held amidst the turmoil in the banking sector, causing investors to wonder whether the Fed would raise rates at all. That was a sharp reversal from just weeks earlier when investors expected that a half-point increase may be needed to contain persistent inflation. While the Fed did raise rates in March, they noted that stresses in the banking system would tighten financial conditions through more stringent lending standards and more expensive loans, which would have a similar impact as a rate increase. The lingering question is the extent and duration of the tighter financial conditions, a question that will be answered over the coming quarters.

Inflation has been cooling each month since reaching a peak last June but remains well above the Fed's target of 2%. The Fed softened its message to the market following the March meeting by indicating some additional increases may be needed rather than telegraphing ongoing increases as was previously

stated. The difference was subtle but enough for the market to adjust expectations to only one additional rate increase from the Fed. There continues to be a disconnect between what the Fed says is needed to contain inflation and where the market expects interest rates to be at year-end. While the Fed expects to hold rates steady following the next rate hike, investors expect rate cuts later in the year. Fed Chair Jerome Powell stressed that none of the committee members were contemplating rate cuts.

Analysts have been revising 2023 corporate earnings estimates lower over the past several quarters to account for softening economic conditions in the second half of the year. Earnings growth of just over 1% is now expected for this year before more robust growth returns in 2024. Falling earnings estimates and rising stock prices have pushed the valuation of the market, as measured by the price-to-earnings ratio (P/E), slightly above the long-term average.

Indexes of consumer confidence are often cited as contrarian indicators. History shows that the stock market generally performs better following troughs in sentiment (i.e., consumers are pessimistic about the future) compared to periods following peaks in sentiment (i.e., consumers are very optimistic about the future). Consumer sentiment has risen recently but remains quite low. While this potentially bodes well for stocks in the long run, enthusiasm must be tempered by current valuations, stresses in the banking sector, future Fed policy, and the forthcoming standoff over the debt ceiling in Washington. In addition, the next Presidential election cycle is effectively upon us, which historically generates much uncertainty about the future of the economy.

In fact, each issue above introduces uncertainty. As a rule, the stock market detests uncertainty and, in turn, volatility typically follows. On the heels of the initial COVID-19 shock wave in 2020, at the time combined with the impact of long-term excess stimulus resulting from long-running ultra-low interest rates, the stock market provided dramatically positive returns in 2020 and 2021. It is no surprise that the market suffered from some "mean reversion" in correcting. Combined with the current headwinds, volatility may continue near-term, but we expect certain truisms to benefit investors when the market solidifies and resumes its upward march, which it always does.

Over long enough periods of time, stock prices ultimately go where earnings go. The trend may not be in lock-step, but it is clear enough to be a reliable path to better understanding the methodical nature of the stock market. In challenging times, holding high quality stocks with a long-term record of growing earnings at a steady, consistent, and healthy pace should serve as an anchor to the wind. Said another way, we still view a well-diversified portfolio of stocks as the best vehicle to grow wealth over the long-term, for those able to withstand the volatility that is inherent in investing.

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