Quarterly Newsletter

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Market Overview

All major stock indices experienced first quarter gains even as a regional banking crisis ensued and geopolitical tensions rose. The annual percent change in the Consumer Price Index (CPI) continued to decline, contributing to bullish sentiment for growth stocks as investors anticipated the end of the rate hiking cycle. The Nasdaq[1] led 1st quarter stock returns finishing up 17.05%, with the S&P 500 Index[2] and the Dow Jones Industrial Average[3] ahead by 7.5%, and 0.93%, respectively.

In the first quarter of 2023, Technology was the top performing sector rising 21.8% followed by Communication Services increasing by 20.5%, and Consumer Discretionary by 16.1%. These sectors were the worst performers in 2022.

The Federal Reserve ("the Fed") continued to hike interest rates in the first quarter with increases in February by 25bps and by 25bps in March. These moves brought the Federal funds rate range to 4.75% to 5.00%. The market expects the Fed will continue to lift interest rates by another 25bps in May and then pause to assess economic and inflation conditions before cutting rates near the end of the year. While there has been a notable softening in manufacturing and declines in real consumer spending, labor market conditions have remained resilient. However, the growing list of layoffs in technology may extend to additional sectors, as the lagged effects of tighter Fed policy become more pervasive. Tighter bank credit conditions and deposit losses have contributed to a regional banking crisis and to a bank run. It is expected that these events will temper the Fed's hawkish policy and lead to a pause mentioned earlier. By the second half of the year, economic growth and inflation conditions should moderate enough to induce a decline in the Federal funds rate.

Ten-year Treasury bond yields fell 50 basis points (1/2%) during the first quarter as the bond market expected the Fed's tough policy to push the economy into recession. But the decline in bond yields supported higher stock prices as equities became more competitive, especially those low dividend paying technology stocks. While equities turned to the upside, investors continued to exert a cautious tone as volatility continued to swing wildly.

International and emerging markets were positive for the first quarter of the year as the falling US dollar bolstered returns.

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U.S. Equity Returns Table Source: Tamarac			U.S. Treasury Yield Table Source: Treasury				Other Indices Table Source: Morningstar		
Index	Q1 2023 Returns	2023 Returns		03/2023	03/2022	03/2021		Q1 2023 Returns	2023 Returns
Dow Jones	0.93%	0.93%	3 month	4.68%	0.51%	0.03%	Gold (GLD)	8.01%	8.01%
S&P 500	7.50%	7.50%	2 year	4.06%	2.28%	0.16%	Brent Oil (BNO)	-6.01%	-6.01%
NASDAQ	17.05%	17.05%	5 year	3.60%	2.42%	0.92%	U.S. Dollar Index (UUP)	0.25%	0.25%
Russell 2000	2.74%	2.74%	10 year	3.48%	2.32%	1.74%	Int'l Equity Markets (EFA)	8.96%	8.96%
MSCI World	6.52%	6.52%	30 year	3.67%	2.44%	2.41%	Emerging Equity Markets (EEM)	4.12%	4.12%

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The Tech Stock Surge, Fed Policy, and the Imminence of Recession

Stocks rose sharply across the board in the first quarter. While the S&P 500 gained 7.5%, led largely by the 21.8% gain in large cap technology stocks, large cap value stocks were ahead by only 0.65%, and small cap value advanced 2.65%.[4] This was a significant mean reversion as value stocks handily outperformed growth in 2022.

This performance disparity may have a lot to say about the imminence of recession and by implication for the trajectory of monetary policy. Equity sector leadership on a year-to-date basis is clearly not consistent with the start of a recession where the technology and consumer cyclical sectors are typically the worst performers. Healthcare and consumer defensive sectors usually outperform entering a recession, but they lagged badly in the first quarter.

There may be an added reason for this performance divergence, and that is the aftermath of the collapse of Silicon Valley Bank, the follow-on demise of the crypto-centered Signature Bank, and a run on First Republic Bank. These events accelerated the deposit outflows from small and mid-sized banks already underway and raised the expectation of a liquidity and credit crunch. Why would large cap technology stocks benefit from this?

The intervention by the Fed, Treasury Department and FDIC to backstop the deposit drains had the immediate effect of changing market perceptions of the Fed's inflation-fighting monetary policy. Bond yields collapsed along the yield curve. And growth stock prices are heavily influenced by interest rates, which are used to present value their long-expected stream of future profits. A lower repricing of interest rates has a magnified positive effect on large cap technology valuations and stock prices.

But there is a bottom-up clue about the imminence of recession and that is what Corporate America is saying. According to FactSet, the number of S&P companies citing "recession" in their quarterly conference calls peaked at 241 in the second quarter of 2022, declining to 148 at the end of last quarter.[5] While still elevated, citing's have declined by 40%, suggesting an ongoing rise in upcoming business prospects, especially in cyclical businesses.

Market attention is now turning to Q2 2023 earnings. It is notable that earnings have declined on a quarter-to-quarter basis through this past quarter — for six consecutive quarters! Some of that has been the result of supply-induced profit margin compression, but fading demand has also occurred. How much more "earnings discounting" is left in stock prices? If consensus analyst earnings expectations for this year are anywhere near right (admittedly a big "if"), quarterly earnings momentum should be sharply positive starting in Q2.

None of this suggests a recession is not on the horizon. There are traditional cyclical indicators such as the inverted yield curve, declining leading economic indicators, and steeply negative monetary growth that suggest a recession may be on the way. But the timing and amplitude based on real time market signals are likely to be further off and more shallow than current bearish estimates. A lot will depend on the path of Federal Reserve policy and continued resiliency of corporate earnings.

It is becoming clearer that the fragility of the financial system has been exacerbated by the recklessness of an historic rising interest rate trajectory. Overlooked was the increasing risk of bank deposit outflows fed by the massive interest rate spread between money market yields and deposit rates. But the outcome, ironically, favors further financial asset appreciation as the Fed will be nearly finished raising rates with a newfound concern with financial stability and aided by the coming sharp decline in inflation. Better than expected earnings and a recession-lite landing may provide the platform for a continuation of the longer term equities uptrend that began in 2013.

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Disclosures

Sources:

1. The Nasdaq Composite is a stock market index that includes almost all stocks listed on the Nasdaq stock market and is heavily weighted towards companies in the information technology sector.
2. The S&P 500 Index is designed to be a leading indicator of U.S. equities and is commonly used as a proxy for the U.S. stock market.
3. The Dow Jones Industrial Average (DJIA), or simply the Dow, is a stock market index of 30 prominent companies listed on stocks exchanges in the U.S.
4. Morningstar,Inc. https://www.morningstar.com/etfs/arcx/spy/performance
5. FactSet. https://insight.factset.com/are-fewer-sp-500-companies-concerned-about-a-recession

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