First Quarter 2023 – Wealth Management Insights

Economic Overview

Steve Scranton, CFA, SVP, Chief Investment Officer and Economist

Economic growth in the 1st quarter showed evidence of the economy slowing from its 4th quarter 2022 pace. Economic growth in the 4th quarter — as measured by Gross Domestic Product — rose at a 2.6% annualized rate. Current estimates for 1st quarter GDP growth from economists surveyed by Bloomberg is for 1.6% growth.

Consumers

Consumers remain under financial stress but continue to spend. For the consumer, their "core inflation" rates differ significantly from the inflation index the Federal Reserve monitors. The Federal Reserve's "core" inflation rate is currently at a 4.4% year-over-year rate. The following are the year-over-year rates for items that most consumers would consider as their core expenses. Data is from the Consumer Price Index components as of 2/28/23.

- Food: +9.5%, Rent: +8.0%, Childcare: +5.7% and Energy:
  - Electricity: +12.9%, Natural Gas: +13.3%, Diesel: +9.2% and Gasoline: -2.0%

Businesses

Business activity continued to slow in the 1st quarter. The housing and construction industries continue to suffer some of the biggest negative impacts from the rising interest rate environment and a lack of qualified help.

- Construction spending
  - Construction spending is in a clear downtrend on year-over-year basis.
  - Construction spending has fallen from an 11.7% growth rate in February 2022 to a 5.2% rate in February 2023.
- Housing
  - Housing starts fell from a 24.3% annual growth rate in February of 2022 to a negative 18.4% pace as of February 2023.
- Manufacturing
  - Most of the major manufacturing indices showed declines through February and most of the regional Federal Reserve manufacturing activity indices also showed declines.

Government

Government spending looks to have made a slightly positive contribution to 1st quarter economic growth. There are still stimulus funds being distributed, including funds from the infrastructure bill as well as funds still available for rental assistance.

Summary

Similar to the 4th quarter of 2022, the 1st quarter of 2023 started on relatively solid footing. As the quarter wore on, the impact from continued interest rate increases and elevated inflation started to take its toll. The quarter ended with a banking scare that was quickly addressed by the Federal Reserve, FDIC and US Treasury. The event has most likely made credit conditions become more restrictive as financial institutions take a cautious approach, while consumers and businesses may also become more cautious as people wait to see if the closure of the three banks was an isolated event.

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Strategy Review

Derrick Wilson, CIMA®, VP, Portfolio Manager

A wild ride would best describe what the markets and investors experienced over the past three months. Following one of the toughest years on record, both equities and fixed income bounced back providing positive returns in the 1st quarter to start this year. Actions by the Federal Reserve and other global central banks remained pivotal as the fight over inflation continued.

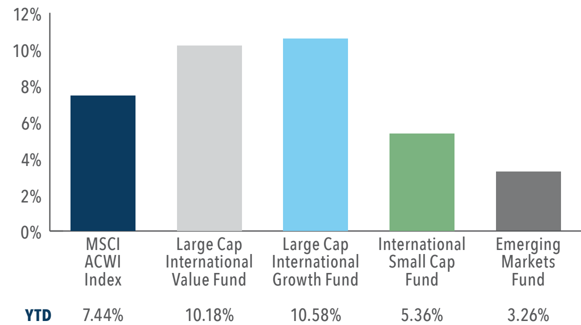
Compounding on monetary policy, market participants had to navigate the rippling effects of the FTX crypto debacle and then the downfall of Silicon Valley Bank and its concentrated relationships of tech start-ups. European banks felt pressures as well and culminated with the government-supported acquisition of Credit Suisse by UBS. Getting further from the onset of these incidents, they appear to be much more isolated than systemic in nature.

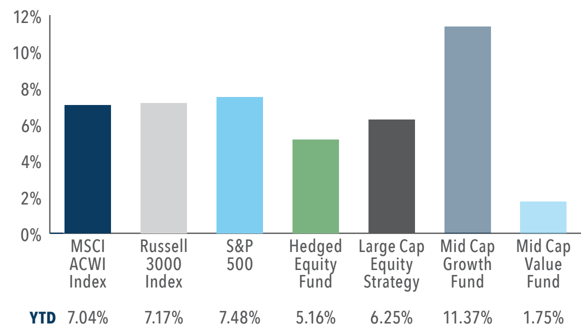
Global equities finished the quarter over 7% higher. US equities, measured by the S&P 500, just barely outpaced international equities. Within international equities, developed markets (+8.6%) outperformed domestic markets (+7.5%) while emerging markets (+4%) was the laggard. A softening US dollar continued to help to support foreign market returns.

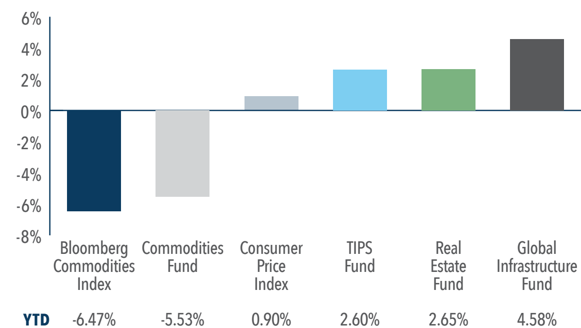
Fixed income saw extreme rate volatility in the last few weeks of the quarter, stemming from the banking situation and the markets' forecast for lower rates by year-end as recession still looms on the horizon. Riskier credits led gains with high yield outperforming shorter-maturity investment grade government and corporate bonds. Emerging market bonds saw positive returns as well, but less than domestic. Overall, higher coupons will help to support total returns.

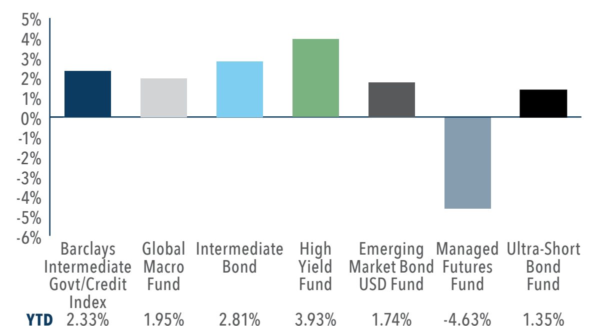
Outside of traditional asset classes, alternatives remained varied. Easing prices saw the broad basket mix of commodities lower by over 5% for the quarter. Trend-following managed futures strategies also saw declines to the same level as various markets traded with much choppier action. Global infrastructure continued to perform well, posting gains over another quarter, as did the global macro strategy.

As we entered this year, expectations for markets were higher given lower starting points and the rising rate cycle coming closer to an end. We saw this take shape, but not without some notable market events. Volatility has since subsided and, barring any new surprises, the wait goes on to see how much further central banks move rates — which could ultimately push economies into recession.









Domestic Equities

Gayle Sprute, VP, Senior Portfolio Manager

After a tumultuous 2022, domestic stocks posted welcome gains during the first quarter of 2023. Positive returns came despite bouts of uncertainty. Focus on the Federal Reserve's (Fed) commitment to increasing interest rates to fight inflation was a pervasive narrative. As the year got underway in January, speculation rose that inflation might start peaking and that it could influence the Fed to slow its path of aggressive rate increases — even though Fed members maintained the message of "higher-for-longer." Nevertheless, "hopium" surged and a "risk on" mentality fueled a rotation into cyclicals, growth and lower quality stocks that had been the bottom performers in 2022.

Enthusiasm evaporated in February and stocks tumbled as the Fed took the wind out of "hopium's" sails. The "higher for longer" interest rate message was resolute amidst the central bank's focus on inflation pressures and a still-tight labor market (with ongoing resolve to break the back of wage inflation). As hope waned, the market unwound expectations for a pause and started to price in a higher peak in interest rates than previously hoped (over 5% and perhaps even approaching 6%). Concern also rose about possible lagged effects on the economy that could occur due to the Fed's aggressive rate campaign.

March brought an unexpected event — turmoil in the banking industry. Institution-specific issues led to the closing of three regional banks (Silicon Valley Bank Financial Group (SIVB), Signature Bank (SBNY), and Silvergate Capital (SI)), a forced takeover of Credit Suisse (CS) and pressure on Deutsche Bank (DB) shares amidst concern about its stability. Government actions to provide liquidity backstops were important in bolstering psychology. Occurrences at these banks have been worrisome but we view the events as specific to each bank's risk-oriented management decisions — and not indicative of systemic issues at this time.

The banking industry events acted to effectively tighten financial conditions. The Fed's moderate rate increase in March highlighted an effort to balance tightening credit (as a result of these events) with continued inflation challenges. Investor concerns eased toward the end of the quarter, allowing for a rally that brought the quarter to a close on an upbeat note.

Fixed Income

Brian Brill, CFA, VP, Senior Portfolio Manager

The relentless rise in interest rates by the Federal Reserve (Fed) continued in the 1st quarter, but the motto, "They will keep increasing rates until something breaks" may have come true as questions about the strength of the banking system became front page news.

Yields experienced extreme bouts of volatility multiple times in the 1st quarter. At first, weak economic data in January led investors to believe that the economy was slowing fast. Quickly, the market started to price in rate cuts starting as early as mid-year. Yields whipsawed higher, though, as the data improved. The rebound in yields was so great that expectations went from rate cuts to more rate increases.

This was all just a prelude to the final three weeks of the quarter. The canary in the coal mine proved to be Silicon Valley Bank.

The rapid rate increases throughout last year, and the revised expectations for more, decreased the value of many US banks' investment portfolios that are invested in US Treasuries and mortgage-backed securities. At the same time, the rapid rate increases increased the yields of money market mutual funds that made it very tempting for bank depositors to withdraw their money and move it to those funds. As banks lost deposits, they went from a position of having excess levels of regulatory deposits to needing to borrow to satisfy those requirements. Unfortunately, what they could borrow was based on the value of those investment portfolios that were showing losses.

Silicon Valley Bank, the 16th largest bank in the US, ran into an old-fashioned bank run but this time the speed was hours/days as modern banking allows withdrawals to happen at the click of a computer button.

Investors were spooked as two other banks faced the same problems. Yields cratered as those investors sought the safety of US Treasury securities.

The banking fears have subsided as the Fed instituted measures to provide liquidity, but the result will be tighter lending terms for many businesses which will decrease economic activity. As a result, expectations are back to rate decreases later this year.

International

Matt Clarke, CIMA®, VP, Senior Client Portfolio Manager

The 1st quarter of the year was eventful, to say the least. Optimism about China's economic reopening helped carry momentum for the global equity markets well into the month of January. In February, nagging concerns about the persistence of inflation and the potential of higher interest rates forced the markets to give back some of those gains. By March, the global markets experienced additional volatility due to short-lived stress in the banking sector (multiple bank failures), but ultimately found footing following a swift and coordinated response to contain the crisis. In the end, international equities managed to finish the quarter in positive territory.

Similar to the final quarter of 2022, **developed international outpaced emerging markets as well as the S&P 500.** Strength out of the European Union helped to fuel those returns with Germany, France, and Spain each contributing over 12%. The MSCI EAFE (developed international), finished the quarter higher by 8.65%, ahead of the S&P 500 at 7.48%. **Momentum in the emerging markets space slowed later in the quarter** due to rising geopolitical tensions between the US and China as well as overall concerns about the banking sector. By the quarter's end, the MSCI Emerging Markets Index closed higher by only 3.97%. Global bonds had something of a wild ride as well – and for many of the same reasons. Similar to stocks, bonds managed to finish higher with the Bloomberg Global Aggregate (measure of global investment grade debt) at 3.01%.

While global inflation showed signs of slowing, it was clearly still very much in focus and **central banks continued to tighten in an effort to tame it.** Over the 1st quarter, both the European Central Bank (ECB) and the Bank of England (BoE) hiked rates twice, bringing their main policy rates to 3.50% and 4.25% respectively, just behind the US at 5.00%. At the same time, the Bank of Canada (BoC) hiked rates once bringing their main policy rate to 4.50%, before providing guidance that they intend to hold their rate where it is for the foreseeable future.

As we consider the 2nd quarter, we will continue to closely monitor global inflation, central bank policy as well as rising geopolitical tensions and make adjustments to our strategy as necessary. As always, we will remain disciplined in our approach with a focus on the long term, while looking to the benefits of diversification, active management, and strategic allocation.

Additional and expanded information to this newsletter discussion may be obtained by contacting your Relationship Manager. We will be happy to expand our discussion with you to meet your individual requirements as a client of Wealth Management & Advisory Services.

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