Q1 2023 Review and Update

If one simply looked at the beginning of the year level of the stock market index (S&P 500)) and at the level of interest rates (2-year maturity and 10-year maturity U.S. Treasury Notes), and compared them with their respective levels at the end of the quarter, one might be forgiven for thinking it a rather benign first quarter of the year.

	12/31/2022	3/31/2023	Change
S&P 500	3839.50	4109.31	+269.81
U.S 2-Yr Note Yield	4.43%	4.03%	-43 basis points
U.S. 10-Yr Note Yield	3.88%	3.47%	-41 basis points

The S&P 500 rallied for a gain of some 7.5%, while both 10-year and 2-year Note yields dropped nearly one-half of one percent (40 basis points).[i]

WOW! Did you miss a few things!

In the Rearview Mirror

January was encouraging as a rebound in the beaten down Technology, Real Estate and Communications sectors led the market to a 5.5% gain in January, with bonds rallying alongside. In a widely anticipated, if not telegraphed move, the Federal Reserve increased the short-term rates 0.25% at the conclusion of their meeting on February 1st, followed by a 0.50% hike by the Bank of England the next day. The following day, February 3rd, the U.S. non-farm payrolls report (a key metric of employment in the Fed's gauge of inflation potential) came in much, much higher than forecast, spooking the market on the notion that the Fed would need to continue increasing rates and perhaps revert to the quicker, 50 basis point pace that it had initially taken in order to slow the inflationary pressures in the economy. As if on cue, on the last Friday of February, the January Personal Consumption Expenditures Index, one of the Fed's preferred gauges of inflation, surprised to the upside, coming in at an annualized rate of 5.4%!

Translating to concerns over higher interest rates, the 10-year Note yield spiked to 4.07% as shorter-term rates moved higher in tandem. At the same time in early March, tensions mounted with the shooting down of a Chinese High-Altitude Balloon that had transgressed U.S. airspace and we noted the one-year anniversary of Russia's invasion of Ukraine. Corporate earnings forecasts were being revised lower, based on the forecast for continued higher interest rates and the downward revisions to Q4 2022 GDP, substantiating a slowing economic outlook, thereby casting doubt on corporate profitability for 2023. Fed Chairman Powell's Humphrey Hawkins Testimony to Congress on March 7th, reinforced the need to remain vigilant suggesting a higher rate by the end of the tightening cycle and a potentially faster pace. 2-year Notes closed the day over 5% with 10-year Notes touching 4.0%.

Three days later, Silicon Valley Bank was declared insolvent and closed by regulators launching a wave of financial contagion impacting virtually every financial institution and regional banks in particular. A "flight-to-safety" ensued, putting in at least an intermediate climax two weeks later as Deutsche Bank came under close scrutiny by investors, driving 10-year Note yields to 3.37% and 2-year Notes to 3.77%.

The important take-away here is that 2-year maturity U.S Treasuries, normally a rather subdued maturity along the yield curve, traded in an extraordinarily wide 128 basis point range adding to the volatility inherent in uncertain times. 10-year notes also experienced an expanded trading range over the quarter of 71 basis points.

Fed Chair Powell has repeatedly maintained that the Fed is "data dependent" in determining their course of action. Throughout Q1, economic data has indicated a slowing economy in the manufacturing sector and, more recently, some slowing in the services sector which benefitted later in the cycle from the Covid recovery. Inflation appears to be receding somewhat, especially as higher readings from 2022 roll off the 12-month count. One of Fed's preferred gauges of inflation, the Core Personal Consumption Expenditures Index, has fallen from an annualized rate of 5.0% at the beginning of the year to 4.6% as of the most recent report.

The labor force remains tight, with unemployment and Non-Farm Payrolls remaining strong, yet average hourly earnings growth is modest relative to inflation.

Coming into the year, the consensus was for energy to remain in favor (lack of prior investment is stifling our ability to meet demand globally); industrials and basic materials would benefit from large infrastructure spending and initiatives to re-shore manufacturing facilities and infrastructure; and technology would remain under pressure from higher interest rates. Historically, the conventional place to ride out a storm in the equity markets has been utilities consumer durables and healthcare.

In a bizarre twist, the technology and communication services sectors each have rallied over 20% for the quarter, while energy, financials, healthcare and utilities were each down between -3.24% and -5.5%! Growth outperformed Value and Large-Cap stocks outperformed small- and mid-cap stocks.

In my opinion, these are knee-jerk reactions. Moreover, many attractive stocks (and ETFs for that matter) are being drubbed ("throwing the baby out with the bathwater", as the old saying goes.)

Flies in the Ointment

1. The Fed is intensely focused on the labor force as a potential source of inflationary pressures, given the historically low unemployment rate and relatively high number of job openings. As we wrote last month, there are secular changes underway in the labor force, including the issues of improving productivity, which typically entail a technology solution. (Think of Deere which is the leader in autonomous farming.)

2. The level of interest rates, which the Fed has the ability to control, may not be the correct metric by which to measure financial constraint in light of today's circumstances.
    a. We learned how quickly social media can exert a powerful force on financial institutions. Silicon Valley Bank has become the posterchild for a 21st century bank run. What had previously taken weeks or months to develop manifested in less than 72 hours!

b. SVB's collapse sparked a whiff of contagion as investors maniacally sold off regional bank stocks fearing their deposit bases were eroding, potentially leading to a liquidity crisis.
c. Concern over bank stability (which is way over done) has led to disintermediation – investors are moving money out of banks and into Treasury bills at higher yields than they can achieve with a bank deposit.
d. The net effect of this will be more stringent credit criteria to qualify for loans and more discerning loan officers, compounded by higher interest rates. This is what is meant by "tighter credit" conditions.
e. As Chairman Powell stated, the banking episode and resulting effects may have supplanted at least one rate hike by the Fed.

3. As noted last month, the unseasonably warm weather through the winter greatly distorted the Bureau of Labor Statistics "seasonal adjustments", potentially suggesting the labor market (if not the economy) is actually weaker than the reports would indicate.

4. The Russia-Ukraine conflict is far from resolved and China could well seize on that distraction to advance its intentions toward Taiwan.

Through the Windshield

The magnitude and severity of higher interest rates and less readily available financing for projects (think commercial real estate) will take time to course through the economy. OPEC +'s recent decision to trim output will elevate crude oil prices and contribute to inflation in the near term; however, strategically, this suggests the members are expecting slower economic growth in the future and less demand for crude oil. This is something to watch!

Tactically, as has been maintained for some time, seeking stocks with the following characteristics is preferred in this type of market:

- Strong financial condition, solid balance sheet, relatively low financial leverage, that generate strong cashflow, and the pricing power to pass through increased costs through to their customers.

- dividend payers with a history of increasing dividends

- Strong market position within their sectors

- Stocks and sectors that are likely beneficiaries of the secular trends we discussed last month, repeated below for your benefit.

Overall, geo-political circumstances remain sufficiently uncertain to prevent a high degree of confidence as to market direction over the next 6-9 months. The market can be subject to sharp fluctuations as sentiment ebbs and flows or exogenous shocks manifest (such as the failure of Silicon Valley Bank today). That said, we expect major secular themes to present attractive investment opportunities for the longer run. The United States boasts considerable advantages in many sectors and industries that are critical to the world economy. Specifically:

- *The United States is the largest producer of fossil fuel in the world.*
- *Despite the desirability of shifting to renewable energy, adequate infrastructure is not in place as yet.*
- *Demand for electricity continues to grow, dramatically outpacing dwindling capacity.*[ii]
- *The United States remains at the forefront of technological development even as manufacturing has been outsourced to Asia.*[iii]
- *The recent swell of Artificial Intelligence interest depends heavily on integrated chips with spectacular processing power. Sensors to convert analog signals to digital are essential.*
- *Chip content and electrical components in automobiles are only increasing with the shift to EVs and autonomous driving.*
- *The Inflation Reduction Act of 2022 is the third piece of legislation passed since late 2021 that seeks to improve US economic competitiveness, innovation, and industrial productivity through the investment of billions of dollars in infrastructure and technology innovation.*
- *This bodes well for machinery and industrial companies and those engaged in basic materials as well as semiconductor design.*
- *As geo-political tensions remain high, the U.S. dominates the global defense industry.*
- *The United States remains the largest global producer of corn and is second only to Brazil in the production of soybeans.*

All the best,

Jim

James W. Graves
Managing Director

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[i] Data sourced from First Trust Advisors, L.P Monthly Commentary

[ii] PJM Interconnection, a regional wholesale electric transmission organization serving 13 states and Washington, D.C, reported its region could be left without enough electricity to meet demand in as soon as 5 years as a result of the conversion from fossil fuel to renewable resources. Yardeni Research, *Weekly Briefing,* March 3, 2023

[iii] For an in depth understanding of the Semiconductor industry's history, see Chip War by Chris Miller, Scribner, 2002.