Market Review & Outlook

April 2023

The bulls wrested control of markets during the first quarter of the new year, a welcome reprieve for weary investors battered by steep losses in both stocks and bonds during 2022. So far, the first three months of 2023 have rewarded patience, as the S&P 500 managed a healthy 7.5% gain, while the Nasdaq soared an impressive 17%, its best quarter since the 2nd quarter of 2020 and one of its 10 best since 1985. The Dow Jones Industrial Average eked out a 0.93% gain, lagging the other senior indexes as its more cyclical and value-oriented constituents underperformed the broad market. After the worst year in bond market history, money flowed into the fixed income market, with the broad US benchmark index rising almost 3% and the 20-Year Treasury bond climbing 7.5%. For a more detailed look at how various asset classes performed in recent periods, please refer to the table above.

Index	March 2023	1st Qtr. (YTD) Perfomance	One Year performance	Description (what the index is comprised of)
S&P 500	3.67%	7.50%	-7.73%	Large Cap US Stocks
DJ Industrial Average	2.08%	0.93%	-1.98%	Large Cap US Stocks
Nasdaq Composite	6.78%	17.05%	-13.28%	Large & Mid Cap US Tech Stocks
Russell 1000 Growth	6.84%	14.37%	-10.90%	Large Cap US Growth Stocks
Russell 1000 Value	-0.46%	1.01%	-5.91%	Large Cap US Value Stocks
Russell 2000 Growth	-2.47%	6.07%	-10.60%	Small Cap US Growth Stocks
Russell 2000 Value	-7.17%	-0.66%	-12.96%	Small Cap US Value Stocks
MSCI EAFE	2.48%	8.47%	-1.38%	Foreign Developed Market Stocks
MSCI EM	3.03%	3.96%	-10.70%	Emerging Markets Stocks
Credit Suisse High Yield	1.34%	3.90%	-3.02%	US High Yield Bonds
Bloomberg US Aggregate Bond Index	2.54%	2.96%	-4.78%	US Treasuries, mortgage-backed, investment grade corporate bonds

That stocks were able to rally so strongly in the face of a weakening economic and earnings backdrop, as well as continuing Fed rate hikes is impressive, but also concerning given how narrowly focused much of the advance was. Indeed, 7 stocks – Apple, Microsoft, Nvidia, Amazon, Apple, Tesla, Google, and Meta (Facebook) accounted for 90% of the S&P 500's 1st quarter return. This was more surprising given estimates (based on company guidance) that technology earnings will decline 14.4% in Q1 of 2023 vs. a year ago. Meanwhile, ever since Silicon Valley and Signature Banks imploded, the banking sector has not recovered, as the SPDR® S&P Regional Banking ETF (KRE) and Financial Select Sector SPDR® ETF (XLF) sit near the same levels they did weeks ago when fears of a banking contagion were widespread. This, despite the Fed's implicit pledge to backstop the banking sector in the event of further "systemic" events.

How is the recession watch going? For months, the pronouncements from various pundits and Wall Street firms have varied wildly, from some believing the US will be able to avoid a recession altogether, to those who believe we have been in an "everything bubble" for years and that considerable weakness lies ahead for both the economy and stock market. A review of some key data points might help us better assess the reality of the situation.

First, the conference board's index of leading economic indicators has declined for 11 consecutive months through February, something that historically has only happened when the economy was either in a recession or on the precipice of one. In addition, the ISM Manufacturing Survey for March came in at 46.3 vs. 47.5 expected and now has fallen below 50 (i.e., a contractionary level) for five consecutive months, another tell-tale sign of building recessionary pressures. Moreover, given that consumer spending is the lifeblood of the US economy – accounting for 70% of GDP – the fact that retail sales have been declining or flat

for months when adjusted for inflation cannot be a good sign. Further evidence consumers are being squeezed was revealed in the updated credit card data for the 4th quarter, which shows credit card balances grew at the fastest pace in at least 20 years, with the cost of that revolving credit continuing to reach multi-decade highs. Finally, the Bloomberg recession-odds model pegs the likelihood at 100% for a recession to commence within 6 months.

We also must account for what the Fed has done over the past 13 months to combat inflation, beginning with its first interest rate hike in March of last year. After once again lowering short-term interest rates to zero to ease financial conditions during the COVID pandemic, the Fed was perhaps slow to recognize the inflation threat and was forced to raise rates all the way up to nearly 5% in the space of 12 months, the fastest pace of interest rate hikes in our central bank's history. At the same time, parts of the yield curve in the US and elsewhere began to invert roughly 12-13 months ago. The curve remains solidly inverted and was recently inverted to an extent not seen since the early 1980s when then Fed-chair Paul Volcker was fighting the high inflation of a previous era.

A yield curve inversion happens when the yields on shorter-dated bonds rise above the yields on longer-dated bonds, a phenomenon that has occurred prior to every previous recession. Looking at past business cycles, 12 months after a yield curve inversion is on average about when things in the economy begin to "break," like the banking failures that already happened last month. Fed officials have been quick to assure the public the banking issues are contained, but we saw similar proclamations from the Fed in previous cycles, such as during the runup to the 2008-2009 financial crisis.

One important difference during this business cycle compared to the past is the COVID pandemic. COVID-related shutdowns were a catastrophe for the US economy, and the policy measures taken to ease the pain of the shutdowns were unprecedented. $5 trillion in stimulus money was printed, resulting in the money supply growing by 40% during 2020-2021. This is likely the best explanation for why inflation began to move up during 2021. However, the money supply began to contract near the end of 2021 and has been showing year over year declines since the beginning of this year. We have data going back to 1960 and during that entire time, the money supply has never contracted on a year over year basis, so again, an unprecedented development that results in tighter financial conditions in the broader economy. Even ignoring the contraction of the money supply, 100% of the time in the past, the economy has tipped into recession when the Fed hiked rates into an inverted yield curve.

Our views have not changed over the last several quarters, and we view the recent rally with caution. Bulls continue to point to strong labor market data to bolster their narrative, but the unemployment rate is a classic lagging indicator, and we fear a recession cannot be avoided. The market is pricing in one more 0.25% rate hike by the Fed in May, and then rate cuts by the end of the year, though Fed chair Powell has balked at that suggestion, especially if inflation remains sticky. It is true that inflation has moderated in recent months, but services inflation remains stubbornly high, more than twice as high as the Fed's target rate.

If you are a long-term investor, you can (and should) ignore much of the day-to-day market gyrations as well as the financial media, who often serve as cheerleaders for whatever the fad of the day is. Of course, this assumes you have a well-grounded investment plan. On the other hand, economic growth is slowing, speculation is still rampant among retail investors, valuations are still rich, earnings estimates have only marginally declined from all-time highs, and the Fed is still in tightening mode. So, if you are near retirement or have other short-term considerations, we believe staying defensive and cautious is prudent given the uncertain economic and investment landscape which lies ahead.

If you have a general administrative question about your account, please contact our customer service at 800-535-4253 option 1. If you would like to set up an investment consultation, please contact our customer service line or send us an email at advisors@wespac.net. We would be happy to schedule a call or Zoom meeting to discuss your portfolio.