Investment Commentary

Quarterly Overview

In quite an eventful start to the year, stocks started off on a positive note. The largest companies in the US (S&P 500) were up over 7.5% for the first three months of the year with technology companies (Nasdaq 100) leading the way up over 20.8% on a total return basis. Foreign stocks as measured by the MSCI EAFE Index outperformed the S&P 500 on a total return basis, rising 8.6%.

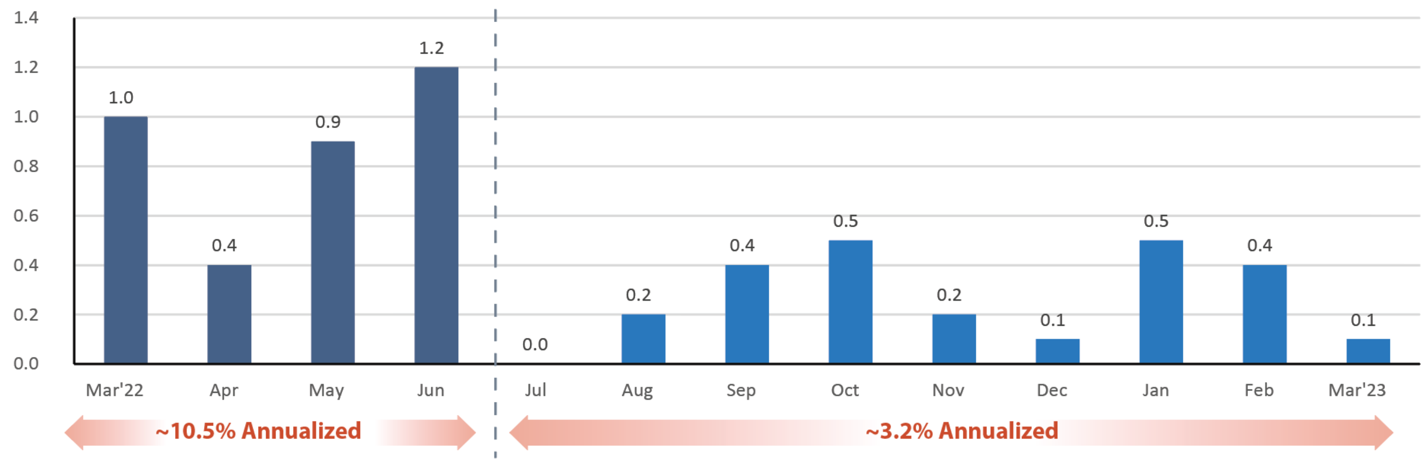
Interestingly, the underperformers of 2022 became the outperformers in the first quarter. The performance of the non-profitable tech areas, like the infamous ARK Innovation ETF (ARKK), exceeded that of the cash flow kings and dividend payers as renewed optimism for a soft landing and declining inflation expectations took hold and investors felt confident after growth in the fourth quarter of 2022 was robust.

Employment continues to be a difficult situation to manage with unemployment hovering near a historic low of 3.5%. Jobless claims have begun to tick up recently, and a more concerning small business survey has shown that hiring intentions are continuing to slow rapidly which tend to lead rises in unemployment by four to six months.

The quarter ended with a series of banks running into liquidity issues and ultimately being placed into a receivership by the FDIC. This led to a flurry of concern and folks clamoring for US Treasuries and protection in lieu of the $250k max insured in bank accounts – a wise move in our eyes and something we had been preaching for months (see "**No Man's Land**" *Feb 9* and "**Market Volatility and Silicon Valley Bank**" *Mar 10*). The Treasury and Fed instilled confidence in consumers by offering backstops on savings above the FDIC limits but not bailing out the banks themselves. While there is lingering concern over some of the "super regional" banks like Silicon Valley, the true aftermath of these bank failures is yet to be seen.

Inflation started the quarter with a couple of hotter-than-expected reports in January and February, but the March report (released April 12th) showed inflation dropping back to 5.6% for the trailing 12-months, levels not seen since 2021. This latest report may give the Fed room or reason to pause with regard to future rate hikes. There will be one more inflation report prior to the next Fed meeting, and we are hesitant to believe they will raise rates above where the level of inflation should be (e.g. if inflation is 5% and the Fed raises rates to 5.00-5.25%).

A Brief Check on Inflation

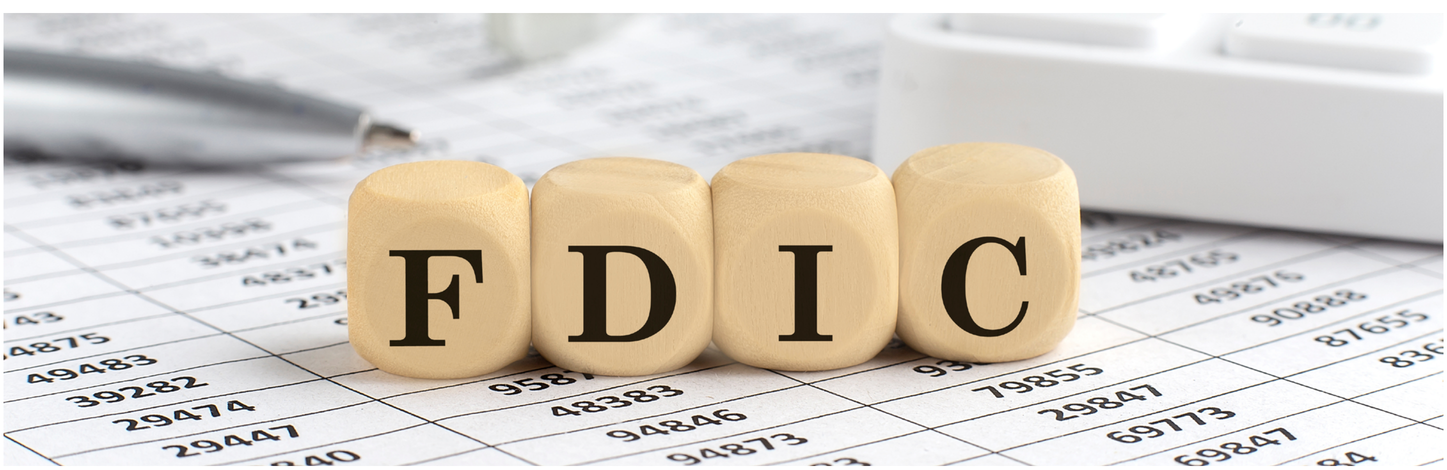


Source: Bureau of Labor Statistics

What's more important in our eyes is the trend. Since the summer, when rate hikes really began to take effect, inflation has moderated considerably. This could coincide with a switch in consumer spending habits from goods to services or this could coincide with easing of supply chains - possibly both. Whatever the case, we think the Fed will quickly shift its attention to the labor market and a pause would make a lot of sense to us. There are clear consequences from the swift and severe rate increases, which we will dive into in a moment. With inflation trending in the right direction, and a weakening labor market, there would be cause for concern that additional rate hikes could tip the economy into a recession.

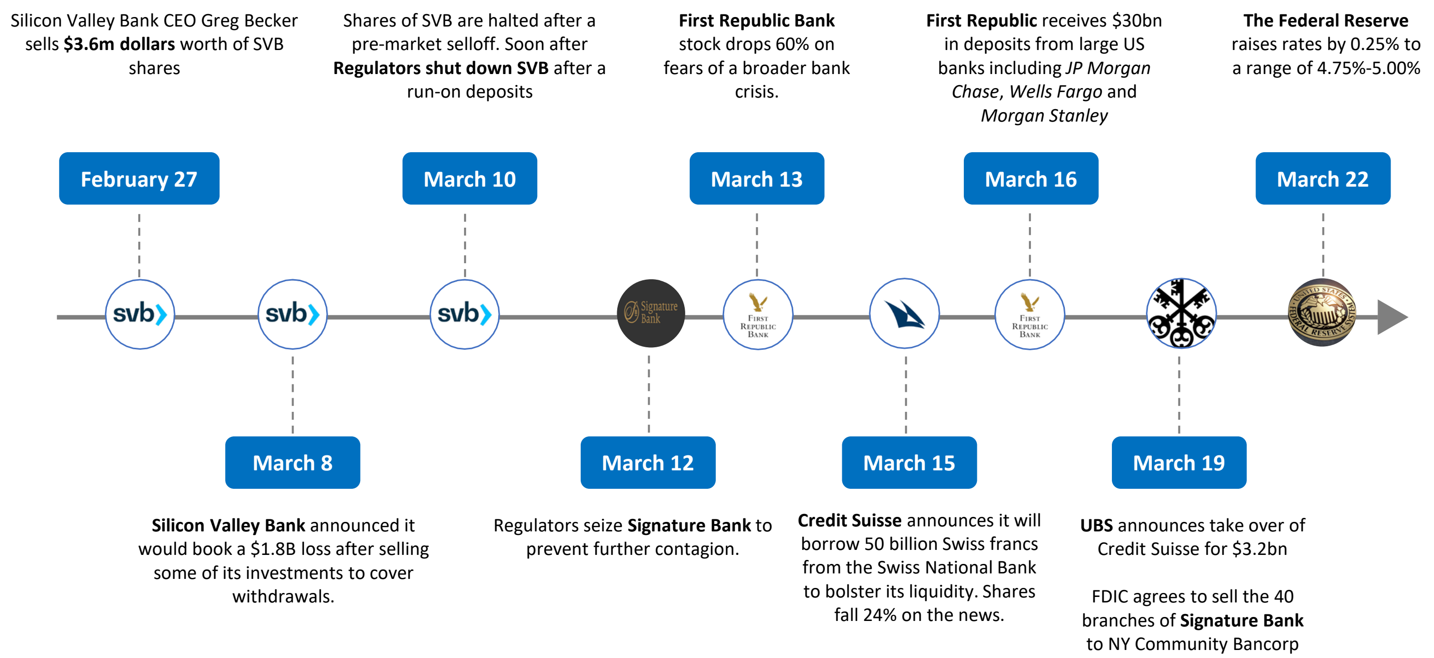
Banking Crisis

With so much focus on inflation, the Fed lost sight of what unintended consequences their rate hikes might have had on the other important areas of the economy. The quarter ended with a bang when a series of events led to Silicon Valley Bank – a top 20 bank by deposits in the country – going under and depositors being made whole on their uninsured deposits. Next came Signature, Credit Suisse, and nervousness about many other smaller banks like First Republic Bank. We explained the "how" and "why" this happened and discussed some of the "how was this was not caught" talk in the hyperlinked articles* if you would like to read them again, but today the focus will be on what is next.



*https://www.withumwealth.com/special-update-market-volatility-and-silicon-valley-bank/
https://www.withumwealth.com/withum-wealth-minute-should-the-fed-have-seen-this-coming/

Recent Banking Crisis: A Timeline of Events



Source: Withum Wealth Management

The fact of the matter is that this is going to impact bank lending moving forward. The Fed Chair, Jerome Powell, noted this during his last press conference, alluding to tightness in the credit markets coming from sources other than rate hikes. They are likely seeing the availability of money dry up and that is not a good thing. If the banks are losing cash deposits to US Treasuries their net interest margin is also shrinking. In general terms, the Net Interest Margin is how banks make money; they keep the spread between their lending mortgages at higher rates while paying out interest deposits at lower rates.

Additional tightening in credit markets due to this banking crisis could be the straw that breaks the economy's back.

Economic Implications and Forward Outlook

Several leading economic indicators have been pointing towards contraction for some time now and with less lending, which could further impede an already slowing economy. If the economy slows, what might that look like? Manufacturing tends to be one of the first areas that shows weakness. Eventually lending becomes harder and harder to obtain and business slows. Once businesses revenues start to fall, they must cut costs and employees are let go.

From a valuation standpoint, we look at markets as expensive or cheap relative to history. Typically, when valuations are too rich, there are better times to invest and when valuations are cheap, you should put money to work in stocks. At this moment, if earnings are going to decline in a recessionary environment, then valuations may be too expensive. Earnings are projected at $210 for the S&P 500 in 2023 which, for an index hovering around 4,100 as of this writing, results in a 19.5x P/E multiple. Historically, markets bottom around 15-16x earnings so maybe there is still room to fall if both earnings decline more than expected, and investors lose confidence and are not willing to pay such a high multiple.

However, we reached a 16x earnings multiple in September of 2022. At that point, the market was around

27% from the highs which is in line with bear market bottoms. The problem is that the market has never bottomed before a recession has started. It is possible we do not have a recession or, if there is ever a time to say, “this time is different”, maybe it is now.

Regardless of what the future holds, recession or not, lower markets or not, what is most important is understanding the companies we invest in on behalf of client portfolios. Sticking to profitable companies with consistent cash flows in predictable lines of business is something that has steered us well through the last 15 months of volatility and should continue to do so.

As always, if you would like to discuss ways to earn more yield on your excess cash, want to review your financial plans, or simply want to discuss an update for your portfolios, we are available for you.

Thank you and enjoy the spring and beginning of summer.

For Additional Market Insight and Analysis, Join Our Quarterly Economic Webinar

Withum Wealth Management presents its quarterly near-term and long-term economic outlook during this webinar on Tuesday, April 25th at 2PM.

Q&A Session will be hosted at the end of the presentation. For more information or to register for the event, click the image above or visit us at withumwealth.com/events.

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Need More Information? Please do not hesitate to contact a member of the Withum Wealth Management team with any questions or concerns:

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