ARE WE THERE YET?

Many of you are probably just returning home from what we hope was a relaxing Spring Break vacation. Perhaps you went snow skiing or drove to the beach in the family station wagon. Whether traveling by land or air, you most likely had to drown out the sound of your children, repetitively asking and eager with anticipation, "are we there yet"? While we are less eager for what is approaching on the horizon, we do find ourselves asking the very same question about the so-called recession, whose arrival (like many airlines these days) seems to be TBD. While market pundits debate the outcome of a hard or soft landing, it appears that the economy is experiencing a type of "ground effect" and may be inclined to simply traverse an extended glideslope versus an emergency landing.

Despite Chairman Powell's consistent rate hikes and hawkish rhetoric, the economy keeps coasting along, albeit with tempered enthusiasm. Data is pointing to a slowdown; however, we are not quite at stall speed. Inflation numbers are dropping (February PCE dropped to 5.0% from 5.3%), producer prices are falling, manufacturing and construction is contracting (ISM remains below 50) and retail sales are all in the negative. Nonetheless, the job market remains robust despite major layoffs in the tech sector that constantly occupy the headlines. Not even a good old-fashion run on the banks seemed to rattle the economy thanks to the swift and orderly action of the Fed to backstop both insured and uninsured deposits. Nevertheless, this shocking ordeal did ruffle some feathers and sent the 10-year Treasury back down to 3.4%, further inverting the already upside-down yield curve (the 2-10 Treasury spread reached a high of 107 bps on March 8th).

While the banking system is much stronger than it was in 2008, there has been a change in oversight among large institutions considered systematically important and too big to fail, versus their smaller regional cousins. We do not believe this recent banking crisis is systematic, however, clearly there was mismanagement over the asset/liability mix and maturity, which is now being exposed by the Fed's aggressive rise in rates. An inverted yield curve is not an attractive business model for lending. Banks cannot make money by paying higher rates on short-term deposits and lending at lower long-term rates, and the longer this persists the less profitable banks will be. In addition, bank capital is taking a hit as we saw with Silicon Valley Bank (SVB), as higher rates push down the value of the bonds they hold. This was a real time stress test, and to put it simply, SVB failed as it was forced to sell securities at a loss to meet withdrawal requests (please see postmortem below in "The Anatomy of Bank Collapse").

This failure launched a crisis of confidence, but may also be just what the doctor ordered as far as the Fed is concerned. Not that they were hoping for a bank failure by any means, but this may speed up the process of tightening as banks have less incentive to lend the more inverted the curve becomes, thus further slowing economic activity. In turn, this will hopefully shorten the process and allow the Fed to take a pause on future rate hikes (although they were not willing to pause on another 25 bps in March…couldn't lose face!). It has been said that something needed to break in order for the Fed to pivot; and something has broken indeed.

In the meantime, they have their hands full restoring trust in regional banks such as First Republic, which got caught up in the SVB fallout. On March 16th, an announcement was made from a consortium of the 11 largest banking institutions, including JP Morgan, Bank of America, and Goldman Sachs, they would deposit $30 billion in unsecured deposits with First Republic to reflect their confidence in the bank and to help stabilize its liquidity in the aftermath of a volatile week.

It has been mentioned that some of these regional banks had similar looking depositors, however, isn't that what a community bank is? Their job is to bank their community. Regional banks are the George Bailey's of Bedford Falls and at their core they are the heartbeat of the local economy. Banks outside of the top 25, account for 67% of all commercial real estate loans, 70% of construction and development loans and 90% of loans secured by farmland. While maybe not "systematically important", they are financially important to small and medium sized business as well as households. Not only will this have a tightening effect on credit, talk of additional regulatory oversight could cause further economic contraction as smaller banks reduce risk and limit access to capital. We may not have hit the brakes on Main Street quite yet, but it sure looks like we are on final approach and the Captain is lowering the landing gear.

March certainly came in like a lion, but is certainly not leaving like a lamb. It seems "March Madness" is catching and the number of surprises that the markets had to consumer were impressive. Unfortunately, we don't believe the "madness" – in terms of stock market volatility is over, but will likely continue as Washington turns towards dealing with the deficit ceiling debate, amongst other "Stormy" headlines. Fasten your seatbelts, we might experience a bit of turbulence in the coming quarter.

Closing Thoughts

I would be remiss not to mention anything about Artificial Intelligence, given the abundance of news buzzing around about AI this year. Therefore, I asked Microsoft's ChatGPT, "when will the recession end", to which it responded:

"As an AI language model, I do not have access to up-to-date information on the global economic conditions or the timeline of the recession. However, it is important to note that predicting the end of a recession is difficult, as it is influenced by a variety of factors such as government policies, global events, and economic trends.

It is also important to note that a recession is typically defined as a period of economic decline lasting for two or more consecutive quarters. While there may be indicators that suggest that an economic recovery is underway, it is difficult to predict when the economy will return to pre-recession levels or when individuals and businesses will fully recover from the effects of the recession. <u>It is important to stay informed about economic developments and to consult with financial experts for personalized advice on how to navigate through challenging economic times."</u>

Regards,

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Equity Markets

U.S. stock indices posted positive returns in 1Q but it was not smooth sailing; strong returns in January were followed by negative results in February and mixed performance across sectors and styles in March. The S&P 500 Index rose 7.5% for the quarter and the tech-heavy Nasdaq 100 soared 20.8%. Within the S&P 500, Technology (+22%), Communication Services (+21%), and Consumer Discretionary (+16%) rose sharply while Financials (-6%), Energy (-5%), Health Care (-4%), and Utilities (-3%) fell. Growth stocks trounced value for the quarter (Russell 1000 Growth: +14.4%; Russell 1000 Value: +1.0%) due largely to the sharp outperformance of Technology relative to Financials. Technology comprises just over 40% of the Russell 1000 Growth Index versus Financials at just under 7%. Within the Russell 1000 Index, just five stocks: Apple (+27%), Meta (+76%), Microsoft (+21%), NVIDIA (+90%), and Tesla (+68%) accounted for 60% of the 1Q return and made up about 15% of the Index. Small value (Russell 2000 Value: -0.7%) was the one sector to post negative returns, hurt by its exposure to smaller banks. Banks comprise just under 20% of this Index and were down 17% for the quarter. Small cap stocks underperformed mid and large (Russell 2000: +2.7%; Russell MidCap: +4.1%; Russell 1000: +7.5%) across the style spectrum.

Global ex-U.S. markets also posted solid results. The MSCI ACWI ex USA Index gained 6.9% (Local: +6.2%). Results were mixed across developed markets but most delivered positive returns. Europe ex-U.K. (+12%) outperformed Japan (+6%), the U.K. (+6%), and Canada (+4%).

Emerging markets (MSCI Emerging Markets: +4.0%; Local: +3.8%) were mixed; India (-6%) and Brazil (-3%) weighed on broad market returns while China (+5%) and Korea (+10%) outperformed. Quarterly returns were positive across regions: Latin America (+3.9%), Emerging Europe (+1.5%), and Emerging Asia (+4.8%).

Fixed Income Markets

Following the worst year ever for core fixed income, the Bloomberg US Aggregate Bond Index rose 3.0% in 1Q. As with equities, it was a bumpy ride with solid returns in January and March sandwiching a negative February. The yield curve remained inverted as of quarter-end, by 58 bps for the 2-year/10-year and 116 bps for the 1-year/10-year. Historically, a yield curve inversion has been a good indicator of a coming recession. High yield (Bloomberg High Yield Index: +3.6%) performed well as defaults remained low, supply subdued, and equity markets climbed. Munis also had a good quarter. The Bloomberg Municipal Bond Index rose 2.8% and the ratio of AAA municipal yields to the 10-year U.S. Treasury fell to 65%, well below its 10-year average (88%).

While short-term rates were broadly higher, longer-term rates fell across developed markets in 1Q. The Bloomberg Global Aggregate ex USD Index rose 3.1% (hedged: +2.9%). Emerging markets debt indices were also up (JPM EMBI Global Diversified: +1.9% and the local currency JPM GBI-EM Global Diversified: + 5.2%). Emerging market currencies, broadly, did well vs. the U.S. dollar during the quarter.

Real Assets

Real assets were mixed in 1Q but generally underperformed global equities. Gold (S&P Gold Spot Price Index: +8.8%), REITs (MSCI US REIT: +2.7%), infrastructure (DJB Global Infrastructure: +2.5%), and TIPS (Bloomberg TIPS: +2.0%) all posted positive returns. The S&P GSCI Index fell 4.9% with oil down about 7%. WTI Crude closed the quarter at $74/barrel, just before OPEC announced its intention to cut production in May.

Returns for Various Periods - March 31, 2023

	Last Quarter	Year to Date	Last Year	**Last 3 Years**	Last 5 Years	Last 10 Years	**Last 15 Years**
MSCI:ACWI	7.31	7.31	(7.44)	**15.36**	6.93	8.06	**6.02**
Russell:3000 Index	7.18	7.18	(8.58)	**18.48**	10.45	11.73	**9.90**
Russell:3000 Growth Index	13.85	13.85	(10.88)	**18.23**	13.02	14.16	**11.88**
Russell:3000 Value Index	0.91	0.91	(6.35)	**18.12**	7.30	8.99	**7.66**
MegaCap							
Russell:Top 50	12.92	12.92	(9.84)	**18.93**	13.20	13.10	**10.33**
Russell:Top 200	8.67	8.67	(8.27)	**18.36**	11.92	12.77	**10.21**
Russell:Top 200 Growth	15.60	15.60	(11.44)	**19.31**	14.79	15.61	**12.70**
Russell:Top 200 Value	0.85	0.85	(4.16)	**16.59**	7.96	9.30	**7.30**
Large Cap							
S&P:500	7.50	7.50	(7.73)	**18.60**	11.19	12.24	**10.06**
Russell:1000 Index	7.46	7.46	(8.39)	**18.55**	10.87	12.01	**10.02**
Russell:1000 Growth	14.37	14.37	(10.90)	**18.58**	13.66	14.59	**12.11**
Russell:1000 Value	1.01	1.01	(5.91)	**17.93**	7.50	9.13	**7.68**
MidCap							
S&P:400 Mid Cap	3.81	3.81	(5.12)	**22.10**	7.67	9.80	**9.82**
Russell:Midcap Index	4.06	4.06	(8.78)	**19.20**	8.05	10.05	**9.49**
Russell:Midcap Growth	9.14	9.14	(8.52)	**15.20**	9.07	11.17	**10.10**
Russell:Midcap Value	1.32	1.32	(9.22)	**20.69**	6.54	8.80	**8.71**
Small Cap							
S&P:600 Small Cap	2.57	2.57	(8.82)	**21.71**	6.30	9.87	**9.64**
Russell:2000 Index	2.74	2.74	(11.61)	**17.51**	4.71	8.04	**8.10**
Russell:2000 Growth	6.07	6.07	(10.60)	**13.36**	4.26	8.49	**8.67**
Russell:2000 Value	(0.66)	(0.66)	(12.96)	**21.01**	4.55	7.22	**7.24**
Russell:Microcap	(2.83)	(2.83)	(17.93)	**17.19**	2.96	7.27	**7.07**
Non-US Equity							
MSCI:ACWI xUS	6.87	6.87	(5.07)	**11.80**	2.47	4.17	**2.62**
MSCI:EAFE	8.47	8.47	(1.38)	**12.99**	3.52	5.00	**3.00**
MSCI:EAFE Growth	11.09	11.09	(2.79)	**10.95**	4.88	6.01	**3.92**
MSCI:EAFE Value	5.93	5.93	(0.31)	**14.58**	1.75	3.75	**1.90**
MSCI:EAFE Small	4.92	4.92	(9.83)	**12.07**	0.87	5.86	**4.58**
MSCI:EM	3.96	3.96	(10.70)	**7.83**	(0.91)	2.00	**1.69**
Fixed Income							
Blmbg:Aggregate	2.96	2.96	(4.78)	**(2.77)**	0.91	1.36	**2.71**
Blmbg:TIPS	3.34	3.34	(6.06)	**1.75**	2.94	1.49	**2.93**
Blmbg:Long Gov/Credit	5.76	5.76	(13.40)	**(6.33)**	0.63	2.35	**4.69**
Blmbg:Long Credit A	5.16	5.16	(12.06)	**(4.28)**	0.59	2.62	**4.86**
Blmbg:HY Corp Cash Pay	3.58	3.58	(3.29)	**5.94**	3.23	4.11	**6.57**
Blmbg:Muni 1-10 Yr	2.00	2.00	1.91	**0.75**	1.92	1.85	**2.86**
Blmbg:Glb Agg xUSD	3.06	3.06	(10.72)	**(4.13)**	(3.17)	(0.99)	**0.15**
Blmbg:Glb Agg xUSD Hdg	2.86	2.86	(3.27)	**(1.82)**	0.90	2.28	**3.06**
JPM:EMBI Plus	1.87	1.87	(8.42)	**(4.94)**	(3.12)	0.17	**3.20**
Other Assets							
Blmbg:Commodity TR Idx	(5.36)	(5.36)	(12.49)	**20.82**	5.36	(1.72)	**(3.55)**
S&P GSCI	(4.94)	(4.94)	(10.04)	**30.53**	4.93	(3.84)	**(5.85)**
S&P:Gold Spot Price Ix	8.76	8.76	1.65	**7.55**	8.40	2.21	**5.25**
FTSE:NAREIT Equity Index	2.68	2.68	(19.22)	**12.08**	6.02	5.97	**6.26**
Alerian:MLP Index	4.09	4.09	14.70	**47.08**	7.42	0.57	**6.21**

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