INVESTMENT STRATEGY UPDATE

MARKET REPORT
APRIL 2023

BAD NEWS IS GOOD NEWS FOR MARKETS

The first quarter of 2023 was positive for markets with favorable movement in all the major indices, offering a welcome relief after broadly negative returns in 2022. The rally persisted despite an abundance of concerns. Higher than anticipated inflation data prompted the Federal Reserve (Fed) to signal a "higher for longer" interest rate policy. In March, the banking crisis that took down Silicon Valley Bank created additional turmoil for markets. In the end, bad news was good news, and markets responded positively to the prospect that the economy may weaken enough from the combination of already higher rates and more restrictive lending to allow the Fed to ease rates sooner.

The biggest loser in 2022, the NASDAQ, was the top performer of this quarter with a gain of 16.77%. Growth stocks in general outperformed value stocks by a wide margin, with small companies also outperforming large value names. Although they lagged developed international stocks, emerging markets also posted decent results, with the MSCI Emerging Markets Index up 3.96% for the quarter.

In the US, the economy has continued to deliver mixed signals. Interest rate sensitive areas, such as housing, have slowed along with demand for goods. But a strong labor market and high demand for services have kept the economy from falling into a recession, while contributing to stubbornly high inflation. It takes time for the full effects of Fed policy to materialize, so it remains unclear what the final outcome of this rate hike cycle will be and whether a recession will unfold.

As we look ahead, there are still many issues simmering that could cause markets to relinquish some of their recent gains. In addition to inflation and potential Fed action, the list of concerns includes the unresolved US debt ceiling issue, the ongoing war with Ukraine, and a potential flaring of the US trade conflict with China. The recovery feels tenuous at this point, and we remain committed to a slightly more defensive positioning for the near term.

Index	*2023 (through 3/31)*
S&P 500	+7.5
DJIA	+.9
MSCI EAFE	+8.4
BC US Aggr. Bond	+2.9
Dow Jones Relative Risk Benchmarks	
Conservative	+2.8
Moderate	+4.4
Aggressive	+5.7

OUR VIEW

FIXED INCOME:
Although it appears the Fed may be pausing its rate hikes soon, we feel rate cuts are unlikely until next year. While the probability seems to be falling, if inflation data stays hot, there remains a chance that rates still may go higher than expected. We feel bonds are attractive overall at this point, offering decent yields along with good return potential, particularly if the economy softens. We are in favor of a diversified mix of bonds and alternatives to balance the risk of rates moving higher with overall encouraging bond return potential in a slowing economy.

US EQUITY:
The S&P 500 remains 14% below its previous high, after being down as much as 25% in October of 2022, and is now trading at around 18 times earnings. Earnings estimates are still reflecting an optimistic economic outcome, and it is unclear whether this will play out. If earnings fall as is normal in a recession, there would likely be another repricing for stocks as a result. We are still in favor of a more defensive positioning in stocks, with a bias toward large, quality companies and a slight preference for value.

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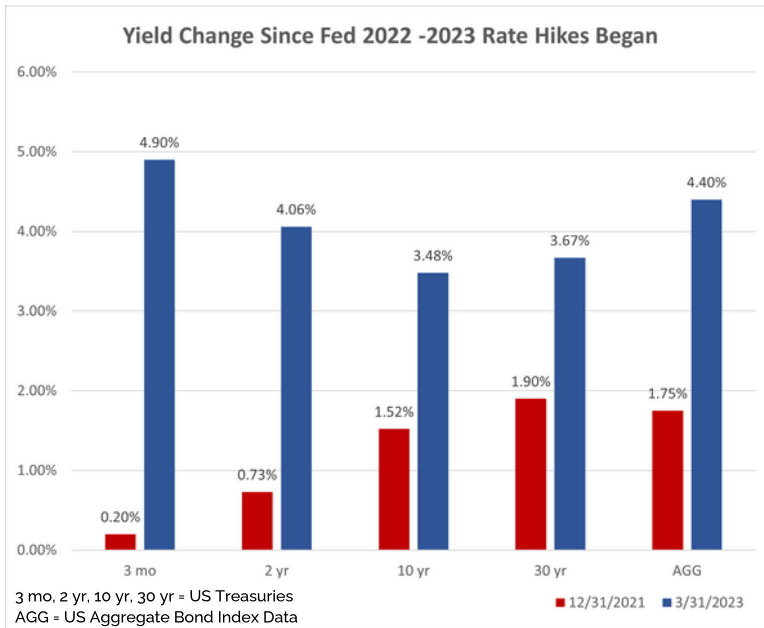
INTERNATIONAL EQUITY:

A major energy crisis, and subsequent economic catastrophe, did not unfold in Europe over the winter as many had feared last fall, causing developed international stocks to outperform the US. The decline in the US dollar also helped foreign market returns. Emerging markets have yet to show the major economic boom many had predicted with China's COVID reopening. A growing trade conflict between the US and China likely further hampered economic activity, leaving emerging markets mid-pack for returns. We like the long-term prospects for international equities, but feel caution is prudent in the near-term due to the slowing global economy, war in Ukraine, and potential for a US/China trade conflict to escalate.

THE RETURN OF FIXED INCOME

Fixed income returns have been underwhelming over the past decade, as the Fed has held interest rates low to keep the economy humming. Borrowers benefitted from low interest rates, while savers were penalized with little to no return on safer investments. Returns for fixed income lagged inflation and grossly underperformed equities during this period, and cash returns were essentially nothing. Investors were forced to take more risk to get returns.



Source: J.P. Morgan, Guide to Markets, Mar 31, 2023

That dynamic has shifted as the Fed raised interest rates 9 times since March of 2022, increasing the Fed Funds rate by 4.75% over the 12-month period. This caused a very painful repricing of bonds in 2022, and bonds posted their worst year ever by a wide margin. However, yields on fixed income have risen since the beginning of this rate cycle (see chart to the left).

With today's higher yields and the Fed likely approaching the end of the rate hiking cycle, fixed income is offering investors a much more attractive return opportunity. Many cash alternatives such as certificates of deposit, US Treasury bills, and money market funds are now offering yields above 4% annualized.

The landscape for fixed income has changed dramatically and continues to be volatile. For the time being, fixed income investors can find decent returns, and it is our hope that when the Fed cuts rates again in the future, they will not have to go all the way back to zero!

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