April 2023

Economic Update

A Review of First Quarter 2023

There is an old Wall Street cliché that markets “climb a wall of worry.” There is certainly plenty to worry about in the world today. War in Ukraine continues unabated. While inflation likely peaked in June of last year, it remains stubbornly high at 6% year-over-year as of February per the Bureau of Labor Statistics. The Fed has continued to raise rates, including the most recent hike in March, which puts the current Fed rate range at 4.75 to 5.00%. This, in turn, has recently put significant pressure on the global banking industry.

Yet, despite these concerns, markets throughout the world had a strong first quarter to start the year. In the U.S., the S&P 500 was up over 7% for the first three months of the year, while the tech-heavy NASDAQ rebounded more than 16%. Both Tesla and Meta Platforms, for example, are each up more than 60% so far during 2023.

U.S. Economy

On March 10, Silicon Valley Bank became the biggest bank failure in the United States since the global financial crisis. It was a stunning reminder that, despite centuries of banking history to learn from and numerous attempts at regulation, our financial system is still subject to classic bank runs any time that depositors lose confidence in a bank’s financial stability.

In the case of Silicon Valley Bank, bank executives were caught by a combination of having a concentrated set of sophisticated depositors coupled with extremely poor risk management practices that did not take that into account. The bank had invested depositors’ money in longer duration government bonds. While not at any real risk of default, those investments were no longer worth what they paid for them as a result of interest rates having risen since the time of their original purchase. When their venture capital-backed customers became aware of these losses, they pulled out their money quickly.

Note that a bank’s primary business is taking customer deposits and attempting to loan out that money at a higher rate than they credit their depositors. So, while Silicon Valley Bank had unique issues, markets immediately seem to have realized that other banks could also be facing similar trouble as well. A couple of days after the Silicon Valley failure, Signature Bank also failed and there was an announcement made that First Republic Bank had needed to be propped up as well. Shortly thereafter, the then growing banking crisis seems to have finally been averted when the Fed announced additional lending available to troubled banks and also that all depositor money would be guaranteed, including amounts over the $250,000 limit explicitly covered by the FDIC.

The recent interest rate movements at the root of our banking troubles are likely to have larger reverifications for our broader economy as well. At this point, it is uncertain whether or not the Fed will raise another twenty-five basis points at their next opportunity on May 3. The Fed has stated that it expects a raise on that date and then no further change for the rest of the year. The Globex treasury

futures market, on the other hand, expects no additional raise in May, followed by fifty basis points worth of cuts between now and year end. Near-term market performance will depend, in large part, as to which one of those two predictions is more accurate.

While we are not in a recession now, there are signs that there might be one on the horizon. Businesses are pessimistic. The March Manufacturing PMI registered 46.3, which is a drop from the 47.7 reading taken in February. Readings below 50.0 represent a suggestion of future economic contraction. The Manufacturing PMI is now at its lowest reading since May 2020.

Consumers have also turned pessimistic with the first decline in the University of Michigan Consumer Sentiment reading since November of last year. The latest reading for March was 62.0. This reading is down from January and February, but is also higher than nine of the 12 months in 2022, including nine of the last 10. While generally not explicitly concerned about our banking system, the consumers surveyed did increasingly expect recession when compared to the prior survey results.

These fears have not yet materialized in the jobs data, however. Per the Bureau of Labor Statistics, the U.S. economy added 472,000 net jobs during January, 326,000 in February and 236,000 in March. They also reported that the total number of unemployed persons is now 5.8 million and the unemployment rate is 3.5%.

International Economy

Global banks have been under similar stress as compared to their U.S. counterparts. Approximately one week after the U.S. depositor backstop announced by the Fed, Switzerland's biggest bank, UBS, announced the purchase of its ailing rival Credit Suisse. In an extraordinary measure, the Swiss government changed Swiss law so that shareholders would not need to approve the acquisition, which wiped out existing Credit Suisse shareholders.

Echoing the U.S. Fed, Christine Lagarde, President of the European Central Bank, has indicated that the ECB also stands ready to help banks maintain enough cash to fund their operations if needed.

Surprisingly, the European economy has held up well given its challenges going into this past winter. Previous fears concerning a natural gas shortage never materialized as both consumer and business resilience aided by a mild winter helped drive a sharp fall in gas consumption.

Eurostat estimates that European Union GDP was flat for the fourth quarter, but still up more than 3% for the year as a whole. They are expecting slight GDP growth during the first quarter of 2023 as well. Labor markets are also performing strongly, with EU unemployment down to an all-time low of 6.0% as of February.

Markets

Developed equity markets had a strong first quarter. U.S. large-cap equities, as represented by the S&P 500 Index, gained 7.50% during the quarter. Developed international equity markets, as represented by

the MSCI EAFE Index, fared even better. That index was up 8.47% for the quarter. Similarly, the Wilshire REIT Index gained 3.25% during the first three months of the year.

Bond indexes were positive as well. Longer-term interest rates, which heavily influence bond prices, continued to moderate during the quarter as it had for the three months prior to that. The Barclays U.S. Aggregate Bond Index and the Barclays Global Aggregate Bond Index earned 2.96% and 2.90% respectively during the last three months. The Barclays U.S. Inflation-Linked Bond Index posted comparable results, gaining 3.34% for the quarter.

The MSCI Emerging Markets Index trailed developed markets, but still finished the quarter up 3.96% overall. Commodities, however, were one of the few asset classes to post negative results. The Dow Jones UBS Commodity Index lost 5.36% for the first three months of the year.

Through March 31, 2023

% Return

	Quarter-to-Date	Year-to-Date	1-Year	3-Year	5-Year
T-Bills	1.16	1.16	3.17	1.12	1.46
Bloomberg US Agg Bond Index	2.96	2.96	-4.78	-2.77	0.91
Bloomberg Global Agg Bond Index	2.90	2.90	-3.86	-2.13	0.95
Bloomberg US Infl Linked Bond Index	3.34	3.34	-6.06	1.75	2.94
S&P 500 Index	7.50	7.50	-7.73	18.60	11.19
MSCI EAFE Index	8.47	8.47	-1.38	12.99	3.52
MSCI Emerging Markets Index	3.96	3.96	-10.70	7.83	-0.91
Bloomberg Commodity Index	-5.36	-5.36	-12.49	20.82	5.36
Wilshire REIT Index	3.25	3.25	-21.33	11.03	5.66

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Outlook

Have we started a new bull market or do the strong returns of the past few months just represent a bear market rally? Stock markets saw a significant rebound during the first quarter as investors are becoming increasingly confident that inflation is now behind us, and the current Fed-tightening cycle is at or near its end.

However, note that markets have consistently been ahead of the Fed during this entire bear market, so although it is quite possible that the investors are correct this time, it is also possible that the Fed continues to provide periodic negative surprises over the next few quarters and the current market volatility continues. Still, regardless of near-term forecasts, we continue to recommend a diversified portfolio containing a reasonable amount of equity exposure for any investor with a long enough time horizon.

Bloomberg US Aggregate Bond Index: The Aggregate Bond Index is a broad-based benchmark that measures the investment grade, dollar-denominated, fixed-rate taxable-bond market, including Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS and CMBS. The Aggregate rolls up into other Bloomberg flagship indices such as the multi-currency Global Aggregate Index and the Universal Index, which includes high-yield and emerging markets debt. The Aggregate Index was created in 1986, with index history backfilled to Jan. 1, 1976.

Bloomberg Global Aggregate Bond Index: The Global Aggregate Index provides a broad-based measure of the global investment grade fixed-rate debt markets. The Global Aggregate Index contains three major components: the Aggregate (USD 300mn), the Pan-European Aggregate (EUR 300mn) and the Asian-Pacific Aggregate Index (JPY 35bn). In addition to securities from these three benchmarks (94.0% of the overall Global Aggregate market value as of Dec. 31, 2010), the Global Aggregate Index includes Global Treasury, Eurodollar (USD 300mn), Euro-Yen (JPY 25bn), Canadian (USD 300mn equivalent) and Investment Grade 144A (USD 300mn) index-eligible securities not already in the three regional aggregate indices. The Global Aggregate Index family includes a wide range of standard and customized sub-indices by liquidity constraint, sector, quality and maturity. A component of the Multiverse Index, the Global Aggregate Index was created in 1999, with index history backfilled to Jan. 1, 1990.

Bloomberg Global Inflation-Linked Index: The Global Inflation-Linked Index (Series-L) includes securities that offer the potential for protection against inflation as their cash flows are linked to an underlying inflation index. All securities included in the index have to be issued by an investment-grade-rated sovereign in its local currency. The list of eligible currencies is the same set of currencies eligible for inclusion in the Global Aggregate Index. The Global Inflation-Linked Index (Series-L) represents a stand-alone multi-currency index exposed to the real yield curve for each relevant currency. As such, the index does not contribute to the Global Aggregate Index. The Global Inflation-Linked Index (Series-L) was created on Oct. 31, 1997.

S&P 500® Index: A market capitalization-weighted index of 500 widely held stocks often used as a proxy for the stock market. It measures the movement of the largest issues. Standard & Poor's chooses the member companies for the 500 based on market size, liquidity and industry group representation. Included are the stocks of industrial, financial, utility and transportation companies. Since mid-1989, this composition has been more flexible and the number of issues in each sector has varied. The returns presented for the S&P 500 are total returns, including the reinvestment of dividends each month.

MSCI EAFE Index: The MSCI EAFE® Index (Europe, Australasia, Far East) is a free float-adjusted market capitalization index that is designed to measure developed-market equity performance, excluding the U.S. and Canada. As of April 2002, the MSCI EAFE Index consisted of the following 21 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland and the United Kingdom.

MSCI Emerging Markets Index: The MSCI EMF (Emerging Markets Free) Index is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets. As of April 2002, the MSCI EMF Index consisted of the following 26 emerging-market country indices: Argentina, Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Jordan, Korea, Malaysia, Mexico, Morocco, Pakistan, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, Turkey and Venezuela.

Bloomberg Commodity Index: Bloomberg Commodity Index℠ and Bloomberg Commodity Index Total Return℠ the DJ-UBSCI℠ family includes both the BSCI℠, which is calculated on an excess-return basis, and the BSCITR℠, a total return index based on the BSCI℠. The former reflects the return of underlying commodity futures price movements only, while the latter reflects the return on fully collateralized positions in the underlying commodity futures.

Wilshire US REIT Index: Introduced in 1991, the Wilshire REIT index is intended as a broad measure of the performance of publicly traded real estate equity securities. The index is market-capitalization weighted of publicly traded real estate securities, such as Real Estate Investment Trusts (REIT), Real Estate Operating Companies (REOC) and partnerships. The index is composed of companies whose charters are the equity ownership and operation of commercial real estate.

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