

ECONOMIC & MARKET INSIGHTS

An Executive Summary for First Quarter 2023

The first quarter of 2023 saw strong gains for stocks and bonds. Investor sentiment was fickle during the quarter as optimism over the resiliency of the U.S. economy was tempered by concerns that tighter financial conditions could hinder economic growth. In early March, the failure of two U.S. banks and the collapse of Credit Suisse, one of Europe's largest and oldest banks, led to a pullback, but the stock market rebounded following aggressive government intervention. The bond markets have been less optimistic about the potential threats to the U.S. economy. The U.S. Treasury yield curve remained sharply inverted, a recessionary signal that suggests investors believe the economy will weaken. Falling bond yields and an attractive level of current income boosted fixed income returns. The retreat in energy prices was a drag on both commodity and stock prices in the sector.

In the U.S., equity sector performance was mixed. U.S. large cap stocks, particularly in the technology and consumer communications sectors, were once again dominant despite mixed earnings results. On the other hand, sectors with weak earnings growth expectations, notably energy, and health care, declined. Financials, hard hit by the banking crisis, lost 10% during March resulting in a loss for the quarter. The outperformance of European equity markets, which began last October, continued into the new year as fears of an energy crisis in Europe abated and business activity picked up. Emerging markets lagged developed markets in response to tensions between the U.S. and China.

Recent economic data has been unexpectedly robust. U.S. GDP growth in the fourth quarter of last year was an annualized 2.9%. The consumer has remained resilient, supported by a solid labor market, but the personal savings rate has declined sharply, and credit balances are rising. Recent jobs data has been more robust than expected although job openings have declined, and wage gains are slowing. Inflation remains much higher than the Federal Reserve would like, however it is trending downward. One area that has demonstrated weakness is housing where a recent uptick in mortgage rates is squeezing affordability into the important spring selling season. The dearth of homes for sale will limit transaction volume. The two failed U.S. banks, Silicon Valley Bank and Signature Bank, were vulnerable due to poor risk management and concentrated exposure to speculative investments. Overall U.S. banks are well capitalized with sufficient liquidity, but the risk of financial instability has triggered a contraction in lending activity which likely will lead to a drop in business and consumer confidence.

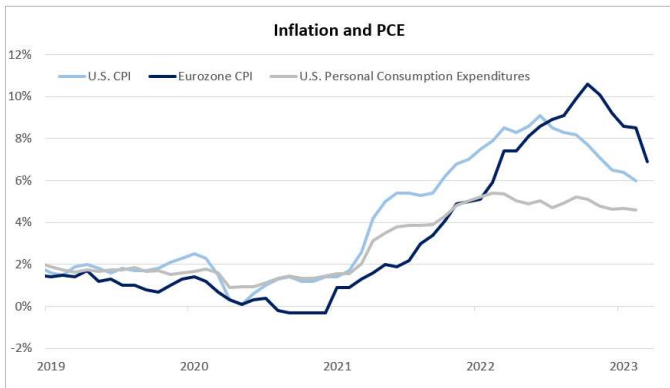
U.S. equity valuations are elevated for this late stage in the economic cycle when valuation levels typically approach lower points. The concentration of the U.S. stock market in the technology sector and the recent surge in stock prices are also concerning. International equity indexes are more diversified with more favorable valuations and have the potential for currency support if the U.S. dollar continues to trend downward. With taxable bonds yielding 4.4% at quarter-end and municipals yielding 3.3% (tax equivalent yield of 5.5% based on the maximum federal tax rate), high quality public fixed income is for the first time in many years a reliable source of income. The risks from higher interest rates and a potential economic slowdown do not appear to be fully reflected in the bond prices of more vulnerable borrowers. Tighter financial conditions and geopolitical threats are likely to keep market volatility elevated. Investors would be well-served to position portfolios based on a forward view of asset class returns and risks.

Economic Insights

Global growth has been more durable than anticipated so far in 2023 but more cracks are emerging. Notably, the U.S. banking sector was jolted when Silicon Valley Bank (SVB) swiftly collapsed in March. The demise of SVB was the second-largest banking failure in U.S. history, only behind Washington Mutual during the depths of the 2008 Financial Crisis. At the same time, the unemployment rate has risen from its post-pandemic low but remains at a historically low level. The resiliency of the labor market has been positive for growth, yet it could push central banks to maintain hawkish policy stances for longer than market participants expect.

Inflation metrics have fallen but are still above target levels. PCE, an important indicator for the Fed, fell to 4.6% in February. This figure was below consensus expectations but still well above the Fed's 2% target. The inflation narrative has become more nuanced as time has progressed and COVID-related disruptions have fallen off. Falling energy prices have helped lower the headline number but core inflation, which excludes more volatile categories, has stayed elevated. In particular, shelter and services (reflection of higher wages) show few signs of falling extensively in the near term and present an ongoing challenge for the Fed.

Still elevated inflation has placed global central banks in a challenging spot. Higher policy rates are starting to have implications for the broad economy, most notably inciting a banking crisis. At the same time, growth has yet to weaken to a point where it fully counteracts inflationary forces. Higher policy rates can also only do so much in eroding demand while offering some stimulatory side effects, such as higher interest rates for deposits and fixed income assets. While there will be outlier readings, inflation will likely stabilize in the coming months or year but might settle at a structurally higher rate than investors were accustomed to during the last cycle.



Bureau of Labor Statistics

Inflation has moderated from record highs from in 2022 but continues to be well above target levels. Lower energy prices have helped bring down headline inflation figures, but shelter and wages have yet to fully show signs of falling.



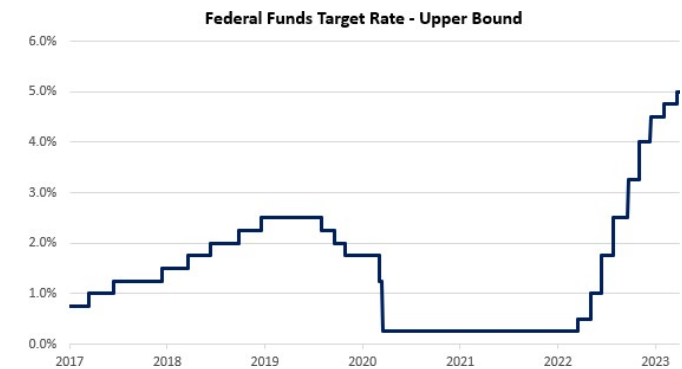
Institute for Supply Management

While the manufacturing indicator has been in contraction territory (below 50) since late 2022, the services (non-manufacturing) indicator has also slowed in recent months and is hovering around 50, the level dividing expansion and contraction territory.



Bloomberg

The U.S. dollar continued its downward trend during the quarter, dragged lower by the banking crisis and a quick reset in rate hike expectations from the Fed. Despite recent weakness and declines from post-COVID highs, it remains well above pre-COVID levels, reflecting higher relative interest rates.



Bloomberg

Encouraging labor market data initially had futures markets predicting a 50-basis point rate hike at the March FOMC meeting. A rapidly unfolding banking crisis quickly revised expectations for a 0 or 25-basis point raise. Ultimately, another 25-basis point hike was levied with less certainty around even one more hike at the next meeting in May.

Equity Markets

Equity markets had a positive start to 2023, although volatility remained elevated. 2023 kicked off with a broad rally through the end of January. Much of these gains were then given back in February following stronger than expected economic data (good news is bad news) and the anticipation of even more hawkish Fed action. Volatility carried over into March after the collapse of Silicon Valley Bank brought stocks down further while disproportionately weighing on the financial sector. Once the level of contagion was more fully understood and the fallout took some pressure off the Fed, stocks rallied to close out the quarter.

Within U.S. markets, growth stocks made a swift recovery over Q1, outpacing value shares as measured by respective Russell indexes. Growth's strong performance was supported by the technology and communication services sectors which quickly shifted messaging to show investors that they could demonstrate efficiency around costs to help preserve margins and cash flow during a time of slowing revenue growth. More richly valued portions of the market also benefitted from lower interest rates across much of the curve, which offered some support to falling valuations. Value-oriented sectors, such as energy and financials, which fared the best in 2022 struggled out of the gate in 2023. Both sectors also had idiosyncratic headwinds in the form of declining commodity prices or a banking crisis (SVB, etc.), respectively. Small caps also lagged due to lower concentrations in the sectors that have done the best so far this year (IT, communication services, etc.). International stocks were positive for the quarter, with developed markets leading the way. A falling dollar has turned from a headwind to a tailwind for U.S. investors in international equities. U.S. market valuations are near historical averages, but earnings appear vulnerable to slowing revenue growth and susceptible profit margins. International markets have more compelling valuations but could present more uncertainty. In many cases, the path forward remains unusually hazy and supports maintaining balance in equity portfolios with prudence applied to any outsized allocations.



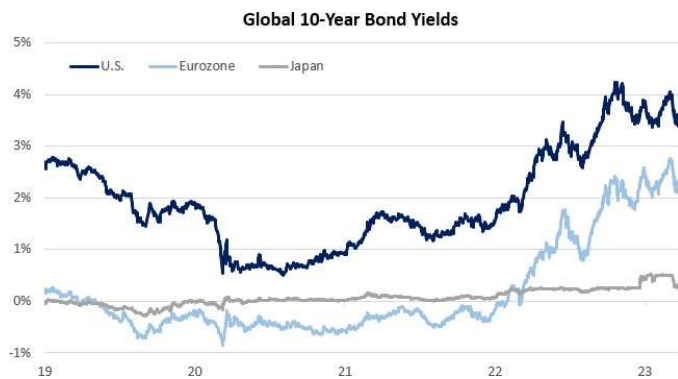
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Negative equity market performance over 2022 brought valuations lower across the board. While U.S. equities are near historical averages, many international markets are closer to the lower end of recent ranges. Notably, much of the gains so far this year have reflected higher valuations over a rise in earnings.

Fixed Income and Alternatives

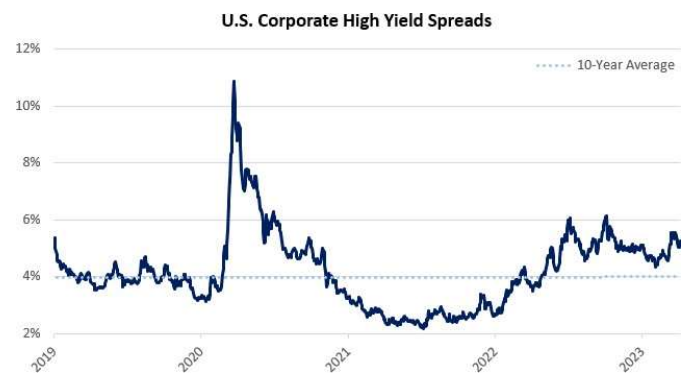
All major fixed income sectors were positive for the quarter. Although unexpectedly robust inflation data initially pushed bond yields higher, the banking crisis and concerns over financial stability caused yields to retreat, favoring long-duration assets and generating price gains for the quarter. Corporate credit, particularly high yield bonds, and bank loans outperformed, despite a pullback in liquidity. Limited credit exposure was a positive for municipal bonds which benefited from their defensive posture as bond market volatility picked up. Credit spreads generally widened, except for corporate high yield, reflecting heightened economic and liquidity risks. Non-agency commercial mortgage-backed securities were hampered by concerns over the declining office sector and saw the largest increase in spreads.

The turmoil in the banking industry had broad repercussions for the fixed income markets. While expectations for equity volatility remained modest, implied government bond volatility rose. Bond yields fell, sometimes dramatically, as was the case for the 2-year Treasury. Market expectations for central bank policy also shifted. The futures market, which once forecasted additional rate hikes leading to a terminal policy rate of 5.5%, now expects the Fed will cut rates by year-end, soon followed by the ECB and BOE. The unwinding of the Silicon Valley Bank and Signature Bank portfolios, which primarily consist of residential and commercial mortgages, also rattled markets, and caused spreads in these sectors to widen. The FDIC, which oversees the failed banks, has promised to gradually dispose of the assets to minimize market impact.



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Global bond yields declined across most developed nations as the banking crisis unfolded. Inflation levels remained elevated and the Fed and the ECB both chose to move ahead with policy rate hikes in March which impacted short-term yields.



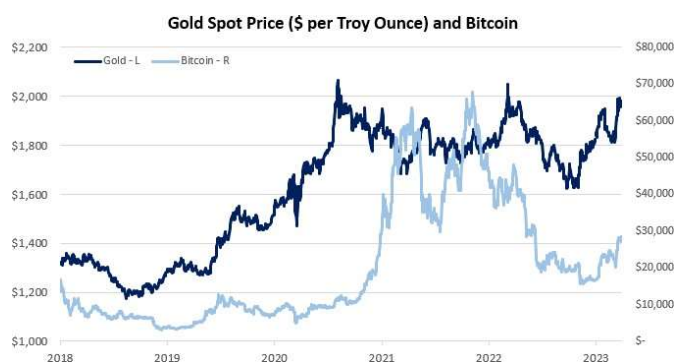
Bloomberg

Credit spreads moved higher across most bond sectors, but corporate high yield bond spreads declined slightly during the quarter. Although default rates remain low, the risk of a recession and tighter liquidity suggest credit spreads have room to increase.

Coming out of a robust 2022 for many real asset categories, 2023 has so far been more mixed. Many energy-oriented commodities have declined reflecting more uncertain forward demand and the potential for a recession. Prices have remained volatile and recently recovered ground after a surprise production cut by OPEC+ of 2 million barrels per day. After reaching decade plus highs last year, an unseasonably warm winter paired with conservation efforts contributed to a collapse in the futures price from close to \$10 per million Btu to \$2 per million Btu. Despite the rapid fall in price, homeowners are unlikely to see too much relief in their gas bills as elevated volatility in spot prices and whipsawing supply and demand dynamics still places upward pressures on utilities' cost structures.

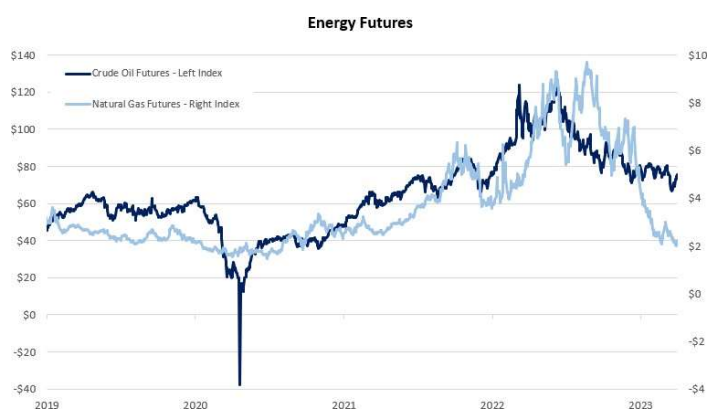
Gold was next to flat last year when CPI averaged close to 8% likely due to a strong dollar and higher yields elsewhere. Both factors have alleviated to a degree converting headwinds into tailwinds for the prominent store of value. In the digital world, Bitcoin's wild ride continued but took a more positive turn. Although the use cases are still being proven out, shaken confidence after the recent banking crisis seems to have offered some support. Other cryptocurrencies, such as Ethereum, have also recovered from lost ground but often to a lesser degree than the more ubiquitous Bitcoin.

The public real estate market has continued to evolve in a post-COVID world. After a swift recovery earlier in the pandemic, many public REITs' performance faltered during 2022 resulting in many securities trading at discounts to net asset values (NAVs). Picking up in 2023, REITs with most of their exposure to the more in-demand sectors, including residential and industrial, have continued to hold up well and trade at more expensive cap rates. Lodging and resort focused securities have also maintained their impressive recovery following a roaring back in travel and leisure demand. Office securities have shown little signs of relief reflecting the large levels of uncertainty in future demand.



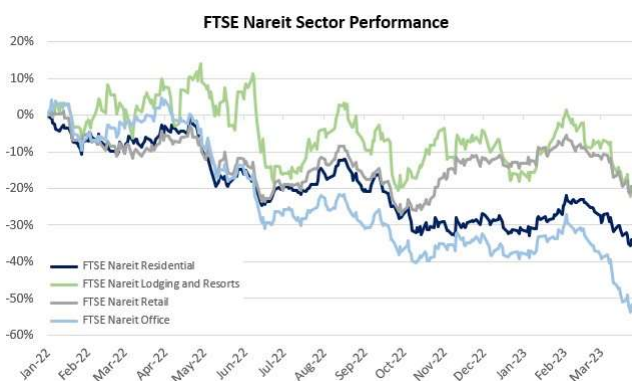
Bloomberg

Gold and Bitcoin have once again followed every different paths this year, although they are trending in a similar direction. Fear and volatility in the traditional banking system following the collapse of SVB, Credit Suisse, etc., has been supportive for both assets.



Bloomberg

Swinging supply/demand dynamics paired with an energy transition has kept volatility elevated. Natural gas futures rose to the highest level since the depths of the 2008 financial crisis before retracting back to 2020 lows. Oil briefly eclipsed \$120 per barrel last year but has settled closer to the \$80 per barrel level.



National Association of Real Estate Investment Trusts

After coming under pressure last year, many areas of the public REIT market have recovered some lost ground over the first quarter. The office sector was an exception as valuations continued to fall and vacancies stayed elevated. Distress is also starting to spread as debt refinancings come due and rates have reset substantially higher.

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