First Quarter Market Review and Comment
April 2023

Updated Market Performance

Returns	1st Quarter 2023	One Year	Annualized 3 Year	Annualized 5 Year	Annualized 10 Year
S&P 500	**7.50%**	**-7.73%**	**18.60%**	**11.19%**	**12.24%**
DJIA	**0.93%**	**-1.98%**	**17.31%**	**9.01%**	**11.15%**

Performance: January reversed December's losses, returning 6.28%. February changed the trend and gave back some of January's gains, decreasing -2.44%. March returns drifted upwards following January's momentum returning 3.67%. This left us with a 1st quarter 2023 total return of 7.50%.

After the 4th quarter 2022 posted a gain of 7.56%, the 1st quarter 2023 started off strong after a negative December. We ended the positive mainly attributed to January's gains leaving us with a return of 7.50%. The Dow Jones Industrial Average (DJIA) underperformed the SP500, posting a 0.93% gain over the same period. For the previous twelve months the SP500 has returned -7.73%, underperforming the DJIA which returned -1.98% over the same period. The annualized three-year returns for the SP500 were 18.66%, the DJIA three-year returns trailed the average increasing 17.31%. Over the last five years the annualized returns are right around historical norms (around 10.13%), with the SP500 returning 11.19% and the DJIA posting 9.01%. The ten-year annualized numbers are running above long-term averages (around 10.13%), with the S&P500 returning 12.24% versus the DJIA which turned in 11.15%.

Breaking down the returns for Q1 2023, we note that there were three outperforming sectors and eight underperformers. **The best sectors were Information Technology (21.82%), Communication Services (20.50%), and Consumer Discretionary (16.13%)**. **The underperformers during the quarter were Financials (-5.56%), Energy (-4.67%) and Healthcare (-4.31%).** The best sectors over the last twelve months were Energy (9.10%), Consumer Staples (-1.40%), and Industrials (-1.59%). Following behind were Real Estate (-22.37%), Consumer Discretionary (-20.42%), and Communication Services (-18.53%).

Economy: Growth in the economy increased in 2022 by 2.1% compared to an increase of 5.9% in 2021. 2022 began the deceleration in growth leaving us with growth below historical trends (Historical growth is ~3.13%). Expectations are that this year we will continue to see slow growth. Inflation is still running above historical averages although it has been slowly easing. The Fed has been aggressively tightening monetary policy to get inflation under control. Normally when the federal reserve tightens monetary policy and raises short term rates, they usually end up hindering growth and causing the economy to go into a recession. Recession risks are currently high. We had a technical recession in the first half of 2022 which is defined as two negative quarters of GDP. We think a more meaningful recession will occur sometime in 2023 or 2024 although at the current moment the recession looks to be shallow and short.

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The third estimate of 4th quarter 2022 Gross Domestic Product (GDP) is 2.6% according to the report released at the end of March by the Bureau of Economic Analysis (BEA). The latest estimate suggests that overall economic growth in the 4th quarter decreased 1.2% from the 3rd quarter 2022 third estimate of 3.8%. GDP for 2022 came in at 2.1% compared to 5.7% in 2021, -3.5% in 2020, 2.2% in 2019, 2.9% in 2018 and 2.2% in 2017. Currently Trading Economics estimate (Forecast of U.S. GDP Growth) has forecasted 2023 Q1 GDP growth at 2.90%. The Federal Reserve Board of Atlanta's GDPNow is forecasting 1st quarter GDP at 2.2%, which is below the consensus estimate of ~2.9%. By comparison, China says their GDP was flat at 0.0% in the 4th quarter of 2022. Decreasing from 3rd quarter 2022 reading of 3.9%. China's 2022 GDP was 2.9%, 8.1% in 2021, 2.3% in 2020, 6.1% in 2019, 6.6% in 2018 and 6.8% in 2017. Growth rates for the European Union (EU) and the Euro Area were -0.1% and 0.0% respectively in the 4th quarter 2022. For 2022, GDP grew 1.7% for the EU and 1.8% for the Euro Area. For 2021, GDP grew 5.3% for the EU and 5.3 for the Euro Area. For 2020, GDP fell -6.1% for the EU and -6.37% for the Euro Area. For 2019, GDP rose 1.5% for the EU and 1.2% for the Euro Area. This is down from the 1.9% growth achieved by the EU and the 1.8% achieved by the Euro Area in 2018. GDP Growth forecasts for the end of the 1st QTR 2023 are -0.20% for the EU and -0.20% for the Euro Area.

Unemployment is continuing to trend below historical norms (~5.76%). Even with increased layoffs in the headlines, unemployment remains resilient. According to the Bureau of Labor Statistics, March unemployment remained little changed at 3.5% from February. Unemployment for 2022 came in at 3.65% which is 1.71% below 2021's rate of 5.36%. Unemployment was 8.11% and 3.67% in 2020 and 2019 respectively. The number of unemployed was essentially unchanged at 5.8 million in March. The labor force participation rate continued to trend up in March rising to 62.6%. Employment continued to trend up in leisure and hospitality, government, professional and business services, and health care.

Inflation increased 5.00% in March continuing to run above the average trend. After averaging 7.67% in the 4th quarter 2022, inflation as measured by the Consumer Price Index (CPI) decreased to an average of 5.8% for the 1st Quarter 2023. The average rate of inflation for 2022 was 8.01% and was above average by historical standards (~2.59% over last 30 years and 3.27% from 1914-2023). The energy index decreased -6.4% for the 12 months ending in March, and the food index increased 8.5% over the last year.

Consumption is an important driver of the economy as it represented 67.9% of 4th quarter 2022 nominal GDP. The U.S. Census Bureau announced in March that retail sales for February 2023 were down -0.4% from January and were up 5.4% above February 2022. Food services and drinking places were up 15.3 percent from February 2022, while general merchandise stores were up 10.5 percent over the same period.

The manufacturing economy contracted in March. Economic activity in the manufacturing sector contracted for the month of March, with the overall economy contracting for the 5th consecutive month. This follows a 28-month period of expansion. The Purchasing Managers Index (PMI®) registered 46.3; a decrease of -1.4 from February's reading of 47.7. Of the five subindices that directly factor into the Manufacturing PMI®, none were in growth territory. This month, the PMI® registered its lowest reading since May 2020's reading of 43.5. Of the six biggest manufacturing industries, two Petroleum & Coal Products and Machinery registered growth in March. The Production Index logged a fourth month in contraction territory. None of the 10 subindices were positive for the period. A reading above 50 indicates that the manufacturing sector is generally expanding; below 50 indicates that it is generally contracting. Based on historical relationships between PMI and GDP, a PMI of 46.3 corresponds to a -0.9% decrease in real gross domestic profit (GDP) on an annualized basis.

Home prices continued to decrease in January. However, mortgage rates above their recent lows should increase supply in turn continuing to lower prices. According to the S&P Case-Shiller Home Price Indices home prices in January rose 3.8% over the last 12 months, which is down 1.8% from the previous month's 5.6%. Miami, Tampa, and Atlanta had the largest year over year increases with 13.8% for Miami, followed by 10.5% for Tampa, and 8.4% for Atlanta. According to the National Association of Realtors, the year-over-year change in existing home sales was –16.0% in February for Single family homes between $250,000-$500,000. Housing supply continued to remain tight in February with 2.9 months of supply.

Markets: The markets have continued to trade in a range after hitting an all-time high on the S&P 500 January 3rd, 2022, at 4,796.5. We went from being in a Bull market to being in a Bear market back in January of 2022. At this time, the market continues to be driven by hawkish monetary policy, inflation, recession fears, decreasing corporate earnings, Geopolitical risks, current banking situation, and the looming debt ceiling fight we will have in late summer/early fall of this year.

What will move the markets moving forward:

- **Earnings: Earnings growth for the SP500 is expected to decrease -6.8% for the 1st quarter 2023. For Q1 2023, the estimated earnings decline for the S&P 500 is -6.8%. If -6.8% is the actual decline for the quarter, it will mark the largest earnings decline reported by the index since Q2 2020 (-31.8%).** Looking at future quarters, analysts project earnings growth for the 2nd QTR 2023 to be -4.6%, 2.1% for the 3rd QTR 2023 and 9.0% for the 4th QTR 2023.
- **Valuations: Valuations came down meaningfully last year.** The current 12-month forward Price to Earnings is 17.8 (21.4 on January 3rd, 2022). The 20 Year average P/E is 15.5, which is 2.3 below our current levels. There is some room for more contraction without meaningful growth.
- **Monetary Policy/Interest Rates: Short Term Interest Rates are continuing to increase and are right at historical averages. The average effective Fed Funds rate since July 1954 is 4.60%. The average over the last 10 years is 0.88%.** The Federal Reserve raised the federal funds rate by.25% to a range between 4.50%-4.75% in its latest meeting in February and is expected to raise rates by at least .25% in May. The Fed will continue reducing its holdings of Treasury securities, agency debt, and agency mortgage-backed securities, as described in the Plans for Reducing the Size of the Federal Reserve's Balance Sheet. The Committee is strongly committed to returning inflation to its 2 percent objective. The spread between the 2-year and 10-year Treasury yields is -0.60%; as short-term rates have risen faster than long-term rates amid expectations for Fed monetary policy tightening. The yield curve is currently inverted (2-year yield is higher than the 10-year yield) and financial conditions are tightening. **Seven of the last Eight recessions have occurred during a rising interest rate environment when short term rates were higher than long term rates (Inverted Yield Curve), which leads to our ongoing concern of the Fed raising rates too fast. It is not if, but when.**
- **Inflation: Inflation has continued to remain elevated, however we are continuing to see signs of inflation easing.** The only silver lining is that Social Security was increased by 8.7% in 2023. Inflation is easing albeit slowly. Currently, the Fed has committed to increasing interest rates and decreasing their balance sheet to continue to fight inflation. This comes at a time when growth is slowing. If growth slows too much and inflation stays elevated/high, we may end up with stagflation.
- **Russia-Ukraine Conflict and other Geopolitical risks: The current conflict is continuing to weaken the European economy more than the US economy, with some speculation of a**

recession in some countries (especially Germany). We are currently feeling the impact through higher oil and commodity prices. At this time, it is hard to determine the total impact this conflict will have on the US. US-China relations remain tense.

- **The current banking situation:** The banking events were swift and severe: Silicon Valley Bank and Signature have both been taken over by the Fed and placed into FDIC receivership. Washington needs to come up with a new and improved cure. Banking issues, at this point in time, do not appear to be systemic, but continued withdrawals may lead to more failures. The two "issues" were separate. Silicon Valley Bank seems to be a traditional risk/maturity issue, which appeared to be a management failure and now also appears to be a regulatory one. Signature appears to be a portfolio issue. Without personal reduction of the event and damage that has taken place, the market is in opposition and deems this event as less critical. The market continues to maintain its past focal points on consumer spending, inflation, the Fed, and profits. This is not the 2008-2009 banking crisis and the market impact going forward at this point is expected to be tighter loan requirements, new regulations for regionals, lower margins for all deposit-related issues and an increased chance of a recession. The Fed stepped in and prevented contagion. They created the Bank Term Funding Program (BTFP) allowing banks to exchange treasury and other assets and receive full face value for 1 year. They have also accelerated their review of large bank balance sheets.
- **Debt Ceiling:** In the United States, the debt ceiling is a limit on how much national debt that Congress lets the Treasury Department incur. Although it does not authorize new spending, it does give greater power to Treasury over financing what Congress has approved. Congress has increased the debt ceiling 78 times since 1960. If the United States does not raise the debt ceiling, the government will begin defaulting on its debts starting sometime between early July and early September.

Forecast:

We think the biggest threats to the stock market are interest rates continuing to increase accompanied by elevated inflation, the Fed tightening monetary policy, and economic contraction. We think the SP500 will end Q2 2023 between 3900 and 4100. At this juncture, we venture a guess that stocks will end the year somewhere between 2% and 5% for the year.

For the next six to twelve months, the Federal Funds rate will most likely increase from its current range of 4.50%-4.75% to 5.00-5.25%. **The 10-year Treasury, which is currently priced at ~3.43% should remain in a range between 3.30%-3.60% through the end of the 2nd quarter.**

As always, we appreciate your continuing confidence in our firm. Please let us know if you have questions.

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