



Global Economic and Markets Review

March 31, 2023

Although we work through financial markets, our goal is to help Main Street, not Wall Street.
– Janet Yellen

Relief from last year's equity market downdraft arrived in the first quarter. After a weak economic conclusion to 2022, first quarter economic activity positively surprised and investors responded by buying stocks, especially those in the technology-heavy Nasdaq index, which suffered the most last year.

<u>Equity Indices:</u>	<u>3/31/23</u>	<u>Qtr Return</u>
S&P 500 Index	4,109	7.5%
Nasdaq Composite Index	12,222	17.0%
Russell 2000 Index	1,802	2.7%
MSCI EAFE Index*	2,093	8.6%
MSCI Emerging Markets Index	1,005	4.0%
<i>*Europe, Australasia, Far East</i>		

A rebound in consumer demand provided the counter argument to an imminent recession. The consumer continues to draw support from a labor market that, though showing signs of moving towards a healthy balance, still heavily favors employees and represents the Federal Reserve's most significant obstacle to returning inflation to its 2% target. Three high-profile bank failures during the quarter shook investor confidence, but their effects were largely contained to the financial services sector and the U.S. Treasury market, where interest rate volatility was extremely high.

The first quarter's economic data and strong equity market returns notwithstanding, we continue to see the economic and financial market risks as skewed to the downside. The Federal Reserve's previous rate increases are only starting to take effect, businesses and consumers are becoming increasingly cautious, and the ripple effects of three small, but highly publicized bank failures will exert additional downward pressure on the U.S. economy over the remainder of this year and into the first half of 2024. We still see a moderate recession as the most likely scenario starting in the second half of the year.

Bond investors appear to agree, based on their expectation that the Federal Reserve, after raising rates one more time in May, will reverse course and begin lowering rates as early as October, presumably in an effort to provide monetary support to what would be a rapidly faltering economy. Equity investors on the other hand, appear to expect only a pause, not a contraction, judging by earnings estimates for this year and next.

Which is why we still expect stocks to succumb to another bout of weakness this year. With strong first quarter performance, valuations are somewhat richer, which could make the weakness slightly more pronounced. We may be wrong, Wall Street is not Main Street, but Main Street drives the economy, which ultimately dictates the direction for Wall Street.

The Global Economy

Strength in the U.S. economy, falling natural gas prices in Europe, and post-covid reopening in China helped boost global economic activity during the first quarter. However, the pace of growth towards the end of the quarter was lackluster. Russia's war of aggression is partly to blame, but as in the U.S., inflation has eroded a portion of the global consumer's strength.

<u>Foreign Currency:</u>	3/31/23	Qtr Change*
European Euro	1.08	-1.2%
British Pound	1.23	-2.0%
Canadian Dollar	1.35	-0.2%
Japanese Yen	132.78	1.3%
Chinese Yuan	6.87	-0.4%

** US Dollar performance versus the Foreign Currency*

This is a particular concern for Asian economies, which, as net goods exporters, exhibit heightened exposure to global consumer and industrial activity. For those more closely tied to China's consumer economy, the consumer demand snap-back following the termination of its zero-covid policy partially offset export weakness to other countries. But China's benefit to its Asian neighbors is likely to prove ephemeral; China itself relies on exports to Europe and the U.S., which, given economic and geopolitical friction, are susceptible to weakness. So, although first quarter growth was decent, the outlook for Asian economies, especially those with large goods exporting sectors, is less so.

In Europe, a warm winter and energy conservation efforts have produced historically high natural gas inventories going into the spring and summer, averting a worst-case scenario for heating and electricity prices, and for the economy. Consumers, therefore, are in better condition than feared last fall, and improving sentiment indicators demonstrate rising confidence. The services sector is growing nicely, but the manufacturing sector is sliding deeper into contraction. Inflation is still a major issue, forcing the European Central Bank (ECB) to raise rates at least one more time this year. Like Asia, economic activity during the first quarter was positive, but the path forward will be challenging.

In the U.S., a weak conclusion to 2022 produced a stronger than expected rebound in the first quarter of 2023, powered by a recovery in consumer spending, a function of ongoing strength in the labor market, which, by all measures, remains unbalanced and inflationary. Through March, the unemployment rate was 3.5%, rivaling the best pre-covid levels on record. Businesses hired an average of 345,000 employees during the first quarter and still want to hire 9.9 million employees, compared to the 5.8 million of total unemployed. High profile layoff announcements in the Technology sector only free technically skilled employees to serve in other industries, which are ravenous for technology talent. As such, filings for unemployment benefits remain historically low, an indication that businesses are reluctant to dismiss employees they worked so hard to recruit, even if they must agree to more generous compensation packages to keep them.

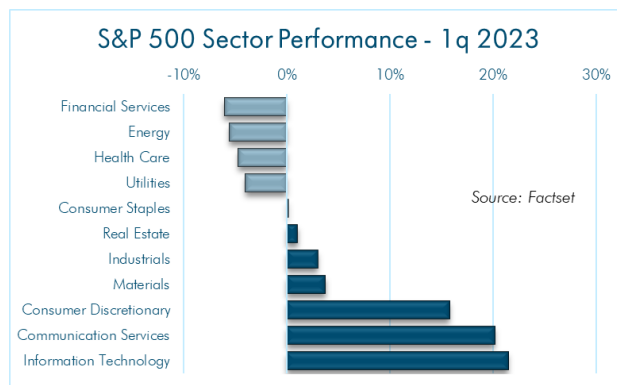
Employee negotiating power translated into consumers' ability to simultaneously maintain their spending levels and save more. Personal Consumption Expenditures during January and February grew faster on a seasonally-adjusted basis than the holiday shopping season of October through December, even if consumer spending patterns noticeably shifted towards essential items. The personal savings rate ticked up to 4.6%, below the long-term average of 7%, but higher than the 2% - 3% range of 2022.

With that said, economic data late in the quarter suggest last year’s Federal Reserve rate actions are starting to take effect, but unevenly. In the more interest-rate sensitive sectors of the economy such as real estate (where development, construction, and transactions are often financed) and manufacturing (where capital investments and inventory accumulation are often financed), activity has either plummeted (real estate), or fallen into a degree of contraction typically associated with a broad economic recession (manufacturing). On the other hand, less interest-rate sensitive sectors, such as services, show only minor effects from the Federal Reserve’s actions last year.

This is most notable in the labor market. Small businesses, which are predominantly services-oriented, and therefore, less interest-rate sensitive, represent the vast majority of posted job openings, and as such, currently contribute the most to labor market imbalances. Their relatively low sensitivity to interest rates explains why the Federal Reserve’s efforts have yet to materially affect the labor market or labor-driven inflation in the services sector. It also explains why the Federal Reserve raised rates in March, despite some conjecture that three high profile bank failures would dissuade them from doing so.

Equities

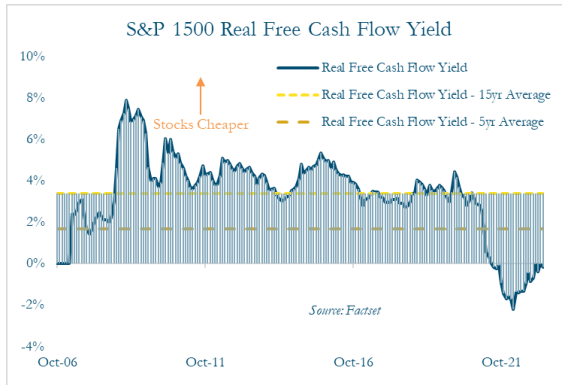
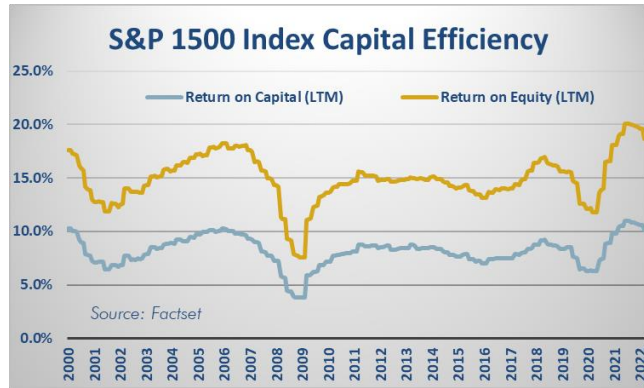
Against the positive economic backdrop, U.S. equities overall performed well, but three sectors drove the gains. Information Technology and Communication Services (which includes the social and streaming media universes) benefitted from anticipation that the Federal Reserve is nearing the conclusion of its rate-rising cycle, but our sources also indicate that an important driver of IT and CS stock price performance related to short-covering by investors, which does not necessarily imply the future path will be higher.



The Financial Services sector trailed after Silvergate, Silicon Valley Bank, and Signature Bank of New York all collapsed in the same week, igniting a deposit flight from other small banks around the country. Silvergate and Signature Bank were cryptocurrency lenders, while Silicon Valley Bank lent to venture capital investors and their companies.

The positive performance overall belies a modest underlying deterioration in the expectations investors have for company results in 2023. On January 1, investors expected companies to deliver 4% earnings growth on 2% sales growth for 2023. Today, investors expect no earnings growth on 2% sales growth in 2023, presumably due to a continued contraction in profit margins, and expect nearly 5% sales growth and nearly 13% earnings growth in 2024.

When we step back to consider those expectations in light of our economic outlook, we find them unrealistic. Both Return on Equity and Return on Capital far exceed the historical corporate average. If the U.S. and global economies are headed into a recession, even a moderate one, capital efficiency and profit margins are likely to fall enough to make this year's and next year's earnings estimates unachievable.

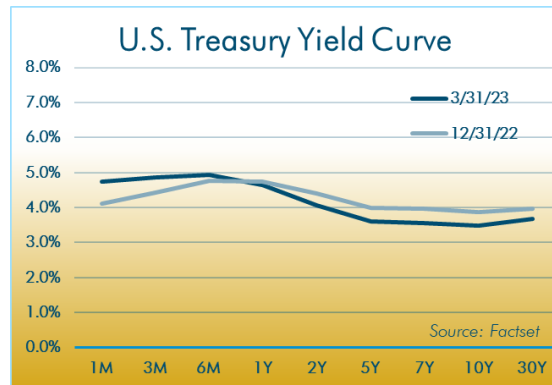


Which is why we see stocks, already expensive compared to their own historical levels, even more expensive than investors realize. A return to historical levels relative to other asset classes, such as U.S. Treasuries, would imply a decline in valuations of somewhere between 20% and 40%. Granted, if Free Cash Flow is growing, then the ultimate decline in stock prices would be smaller. Nevertheless, we continue to be cautious about U.S. equities overall, concerned that investor

expectations are unrealistic, contain more risk to the downside than upside, and that valuations don't adequately incorporate these risks.

Fixed Income

Three bank failures in four days created breathtaking volatility in the U.S. Treasury market for about two weeks, but investors' nerves calmed prior to quarter end. Yields on bonds maturing beyond 1 year fell during the quarter, reflecting fixed income investor expectations for slower economic growth and lower inflation.



Yields on corporate bonds, however, rose during the quarter, regardless of credit quality, reflecting concerns about profit margins and cash flow. Even so, interest rate differentials between corporate bonds and U.S. Treasuries are historically low, a reasonable situation given the general health of corporate balance sheets.

Commodities

Within the commodities complex, Natural Gas stands out, a victim of both rising supply, as U.S. oil producers extract more oil and with it, natural gas, and lower than expected export demand, due to Europe's warm winter. After the quarter ended, OPEC+ agreed to additional voluntary production cuts that may push the price of oil higher over the course of the year, an unwelcome development for central banks trying to tame inflation.

Commodities:	3/31/23	Qtr
		Change
Gold	\$ 1,969	8.2%
Crude Oil	\$ 75.67	-5.6%
Natural Gas	\$ 2.22	-50.5%
Gasoline	\$ 2.75	-0.9%
Copper	\$ 8,935	6.5%
Wheat	\$ 6.92	-12.6%

Conclusion

Although the first quarter delivered a number of positive surprises, our outlook for the rest of the year is largely unchanged. If anything, shocks within the banking industry raise our confidence that by the end of the year, the U.S., and with it, the global economy, will have entered a modest recession. Not because three bank failures in March portend a wave of bank failures on a scale that threatens the economy. These banks were poorly run and two of them took speculative risks in cryptocurrencies without adequate risk controls. There may be more crypto-related banking failures, but we would categorize such a scenario as "addition by subtraction"; the capital tied up in them is best-served redeployed, and important lessons in speculation would (hopefully) be learned. Joseph Schumpeter's observation about the benefits of creative destruction pertain here.

Rather, we think the bank failures apply another negative pressure point to an influential aspect of the U.S. economy, namely, bank lending standards. Banks were already starting to tighten lending standards but the possibility of emotional depositors pulling funds from stable banks will accelerate small banks' efforts to reduce lending risks. Because small businesses, and in particular, real estate, depend heavily on small bank loans, financing conditions will get increasingly difficult as the year progresses. Capital necessary for expansion and investment will become progressively hard to obtain, roughly coinciding with when the Federal Reserve's aggressive rate actions from last year will crest.

We do not see either monetary support or fiscal support as helpful. Monetary, because it acts with a lag and will be too little, too late to avert a recession, and fiscal, because governments are focused on repairing the covid-induced fiscal damage of the last two years.

Hence, our unenthusiastic outlook for Main Street, which, when coupled with our belief that investor expectations are unrealistically optimistic and equity valuations are deceptively high, produce our cynical outlook for Wall Street in the near term.

On the other hand, because we expect only a moderate recession and a moderate correction in equities to precede it, each lasting a few quarters, our medium-term outlook is quite constructive. We believe that 2023 will present an attractive buying opportunity for patient investors, and that just as Wall Street will follow Main Street into a downturn, Wall Street will follow Main Street into the next expansion.