

## April 17, 2023 – Investment Commentary

### Follow the Money

After several large U.S. banks reported earnings last Friday, there was an air of relief around the markets. The CBOE Volatility Index (VIX), the so-called fear gauge, closed last week at its lowest level since early January 2022. The MOVE Index, which tracks Treasury market volatility, had also fallen below where it was before Silicon Valley Bank collapsed last month. Stocks were higher last week for the fourth week of the last five (S&P 500 +0.8%). The week featured somewhat better inflation news, weaker retail sales, and continued concerns of an economic slowdown/recession. The best performers were financials (+2.9%) and energy (+2.5%); the worst performers were REITs (-1.5%) and utilities (-1.3%). Over the last 11 months, the S&P 500 has been trading on either side of 4,000 level. In Q1 2023, Apple, Microsoft, and Nvidia contributed over 50% of the S&P 500 appreciation. The top 10 largest stocks accounted for more than 95% of the total appreciation.

We believe earnings announcements by JPMorgan Chase, Wells Fargo, Citigroup, and PNC Financial Services aren't sufficient information to confidently declare an end to bank stress. We believe the more appropriate focus should be on the regional and small bank announcements in the week ahead. After all, that's where the deposit stress and commercial real estate concentration is most acute. In addition, First Republic and PacWest Bancorp report next week. The Investment Office is focused on the financial health of those regional lenders with special attention to changes in deposit outflows, increases in provisions for loan losses, potential losses on held-to-maturity securities and guidance. The Federal Reserve's latest "beige book" survey of economic conditions Wednesday will be another indicator of the impact. Confidence in the banking sector will be a critical link to the chain of a sustainable bull market rally.

### What We Believe

Economic Slowdown Remains Are Base Case. The yield curve has been inverted since late 2022, and inverted yield curves have been a strong predictor of recessions over the last 50 years. In addition, housing and manufacturing data are also slowing, two other strong recession indicators.

Skeptical of approximately 100bps Fed cut in 2023. In the wake of recent bank failures, the Fed Fund futures market is anticipating the Fed will pivot to rate cuts before the year is out. We think Fed Chair Jerome Powell remains focused on tackling evidence of inflation. If the bank crisis spreads, then the Fed will be in a tough position. However, absent a systemic crisis, the Investment Office does not see the central bank cutting rates before declaring victory over inflation.

Sticky Inflation. The headline CPI inflation rate fell from 6.0% year on year February to 5.0% in March. However, the core inflation edged up from 5.5% to 5.6%. The good news is that inflation continues to fall, but the bad news is the level is well above the Fed target of 2% with increasing energy prices more recently.

Earnings Recession. Most data points to narrower margins and lower profits year over year due to a global slowdown, higher interest rates, tighter credit and a tight labor market with limited productivity enhancements.

Cautious Outlook Influences Our Portfolio Positioning. Because we believe we face an economic and earnings slowdown, we are focused on high-quality equities and fixed income. In our view, earnings expectations for U.S. equities are too optimistic, given the anticipated slowdown. All of this is complicated by our belief in more regulation of small- and mid-sized regional banks where banks will limit credit further in anticipation of higher liquidity and capital requirements.

## Disclosures

Investment Commentary Sources: Bloomberg and <https://www.federalreserve.gov/newsevents/pressreleases/monetary20230312b.htm>

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