INVESTMENT OUTLOOK

A PEAPACK PRIVATE WEALTH MANAGEMENT PUBLICATION

FIRST QUARTER 2023: MARCH MADNESS, APRIL ADJUSTMENT?

Don't it always seem to go,
that you don't know what you've got till it's gone
-Joni Mitchell

Across the country, our calendars are dotted with national holidays that excuse workers from work and schoolchildren from school. President's Day, Memorial Day, Independence Day, Labor Day, and so on throughout the year. Some are somber, some are joyous, as they commemorate or acknowledge or celebrate something significant.

These 10 or so days off are well known to all of us. It's perhaps less well known, however, that we are, in fact, a nation of holidays. There are an extraordinary number of issues and items we celebrate—so many, that it's easy to miss some of them.

You may have been aware, or heard, that March 8th was International Women's Day. But in the first quarter did you celebrate January 2nd—National Introvert Day (by yourself, surely)? And I hope you didn't miss March 24th—National Cocktail Day, the intent of which is to not only celebrate the "ginormous variety of cocktails," but also encourage people to create their own concoctions. (Only one day? Really?) You may not be looking forward in September to National Psychotherapy Day. (Again, only one day? Who's your therapist?) But what kind of ogre wouldn't want to celebrate February 17th, National Random Act of Kindness Day? And are you daring enough to honor National Nude Day appropriately, with an air bath?

Of course, some matters are worthy of more than one day's recognition. In April, we celebrate National Week of Conversation. And Tom Lehrer sang, irreverently, about National Brotherhood Week. Black History deservedly gets a whole month's recognition, every February.

It feels like a while, however, since financial markets were in a holiday mood. Indeed, the quarter ended on a rather sobering note, as an old chestnut, National Bank Vulnerability Awareness Month, was reinstated. And widely publicized. The failures of Silicon Valley Bank in California and Signature Bank in New York brought eerie echoes of the Global Financial Crisis, reminding us of the adage that history doesn't repeat but it rhymes.

EQUANIMITY IN THE FACE OF INSOLVENCY

What, me worry?
-Alfred E. Neuman

You might not know, from market returns in the first quarter, that investors had to stare down distress in the financial sector. Indeed, equity markets were stoically unmoved by the *sturm und drang* in bankland. All asset classes save commodities posted healthy low- to mid-single-digit positive returns, in a sharp reversal from the year-ago quarter in which only commodities appreciated.

Asset Class	Index	1st Quarter Returns
US Large Cap Stocks	S&P 500 Total Return	7.5%
US Small-Mid Cap Stocks	Russell 2500	3.4%
International Developed Markets Stocks	MSCI EAFE	6.9%
Emerging Markets Stocks	MSCI EM	4.0%
Real Estate Securities	MSCI US Real Estate	2.7%
Commodities	Bloomberg Commodities Futures	-5.4%
Bonds	Bloomberg Barclays US Aggregate	3.0%
Cash	FTSE USBIG 1 Month Treasury Bill	1.1%

SOURCES: THE WALL STREET JOURNAL, STANDARDANDPOORS.COM, FTSE, MSCI, BLOOMBERG

For many, it was a peculiar quarter, a return to the pre-2022 market environment in which growth stocks out-performed value stocks, large cap stocks out-performed small cap stocks, and US stocks out-performed foreign stocks. Technology and communications services stocks out-performed. Bitcoin topped all traditional asset classes, up 70%, and meme stocks AMC and Gamestop rose 23% and 25%, respectively.

Back to the future, too, in the bond market, where rates fell and bond prices rose, despite additional rate increases from the Fed. And, once again, lower quality bonds out-performed higher quality bonds.

CELEBRATING, AND RUING, FULL EMPLOYMENT

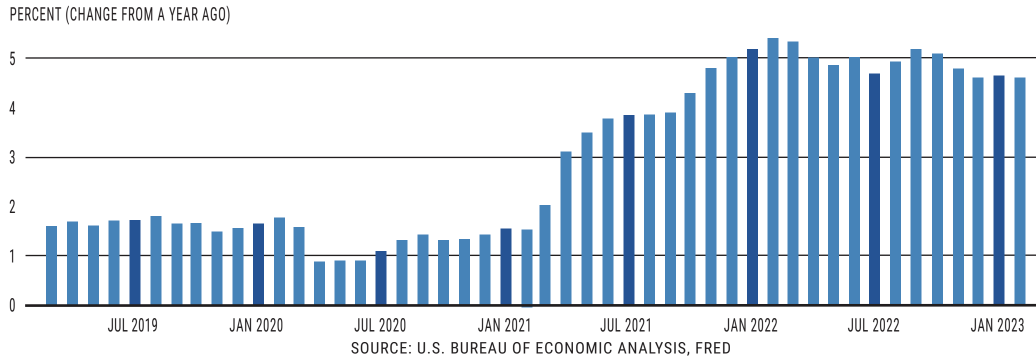
Sometimes I wonder if I'm
ever gonna make it home again
It's so far and out of sight.
-Carole King

Many of the earliest holidays were religious in nature, and more specifically in Christian faiths were saints' days. You can catch them all on All Saints Day (November 1st), but each one has a unique character. So, for instance, June 21st is the Feast of St. Aloysius Gonzaga (yep, that's where the name for the March Madness team comes from), who was canonized after he died caring for plague victims.

Chair Powell and his colleagues at the Fed have been ministering to an economy plagued by persistent high inflation. Their prescription of higher interest rates has alleviated some of the biggest strains from inflation, but the medication has proven to be only partially successful, so far, and has brought on nontrivial side effects.

The most widely cited inflation data point is the monthly Consumer Price Index (CPI). The CPI peaked at 9.1% in June 2021. As of February 2023, it had fallen to a still-lofty 6.0%. (For those who will celebrate National Chocolate Chip Cookie Day on August 4th, this toothsome indulgence will cost 23% more than a year ago.)

Core PCE: Inflation is Stubbornly Sticky



Using the Fed's preferred inflation gauge, Personal Consumption Expenditures excluding food and energy, inflation has fallen about 1% to 4.6%. That's a far cry from the sub-2% readings prior to the pandemic, and explains the persistent message from the Fed that its work is not done yet. The Fed's price stability mandate is, indeed, far and out of sight.

The Fed raised rates aggressively, beginning in March 2022, in the aggregate by 4.75%. So why haven't higher rates had a greater disinflationary impact? For one, interest rate policy is a proverbial blunt tool which operates with famously long and variable lags. For another, persistent labor shortages have sustained upward pressure on wages. With the unemployment rate at 3.6% in February, 10.8 million unfilled jobs, and so-called 'labor hoarding,' improvements in goods inflation and supply chains are being overshadowed by higher labor costs.

A fully employed labor force may also explain why economic momentum hasn't slowed significantly, yet. GDP growth came in at 2.6% for the fourth quarter last year, down from 3.2% in the third quarter. The Atlanta Fed's GDPNow model estimates that GDP advanced 2.5% in the just-ended first quarter.

There are sectors that evidence some economic weakening, particularly in interest sensitive areas like housing and auto sales. Credit card data suggest that lower income consumers are reining in spending. Manufacturing data are soft, and small business confidence is down. Consumer confidence, too, is at somewhat depressed levels—perhaps we should accelerate the October arrival of National Depression and Mental Health Screening Month.

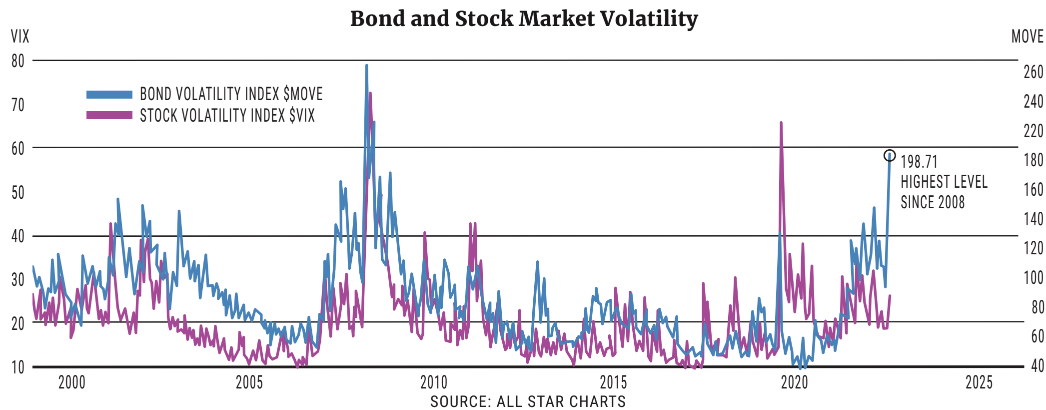
REMEMBER WHEN BONDS WERE BORING?

It just goes to show you, it's always something—if it's not one thing, it's another.
-Gilda Radner

Bond market participants have been through the wringer this year. In January, bonds returned +3.1%; in February, -2.6%; in March, +2.4%. All in, the bond market returned 2.5% for the quarter, but it was a roller coaster ride to get there. Looking at fluctuations in the bond market from another perspective, the 10-Year US Treasury yield ranged from as low at 3.30% to as high as 4.05% during the quarter, ending at 3.54%.

We reference the 10-Year US Treasury yield for a number of reasons: mortgage rates are priced off of it, it provides information regarding investors' longer-term inflation expectations, and it is less affected by short-term Federal Reserve monetary policy. By contrast, the 2-Year US Treasury instrument is more closely tied to investors' expectations of Fed policy. In the first quarter, the 2-Year US Treasury yield ranged widely, from a high of 5.07% to a low of 3.78%, as investors debated the path of Fed funds rates.

If it's been too rough a ride, maybe you can chill by looking forward to World Meditation Day (May 21st).



As the chart shows, the only greater period of volatility for bonds in the past 20 years was during the global financial crisis. Further, the volatility in bond markets has exceeded the volatility in stock markets.

How to understand such volatility? The future direction of the economy is always, inherently, uncertain, but there are periods in which the degree of uncertainty is elevated. During such times, investors hang on—and react to—every data point as it is announced, assessing and reassessing their positions. Data that suggested economic strength caused yields to rise and bond prices to fall, as investors feared a more aggressive Fed becoming more restrictive. Data that suggested economic softening cheered investors, who are hoping for lower interest rates. Ping, pong, push, pull, yin, yang, all quarter long.

Equity markets mimicked the bond market, rising, falling, and rising in the three months comprising the first quarter. They moved solidly into the green in March, as weakness among the banks generated a narrative that the Fed was nearly done with interest rate increases and would turn its attention from inflation to stabilization.

To a not insubstantial degree, markets in recent years have been driven by policymakers, not fundamentals. Interest rates, the size of the Fed's balance sheet, and fiscal spending, among other issues, have influenced stock and bond prices. That's a less healthy market environment, and a less predictable one. And, perhaps, one more prone to policy mistakes.

ON THE EVE OF INTERNATIONAL FACT-CHECKING DAY

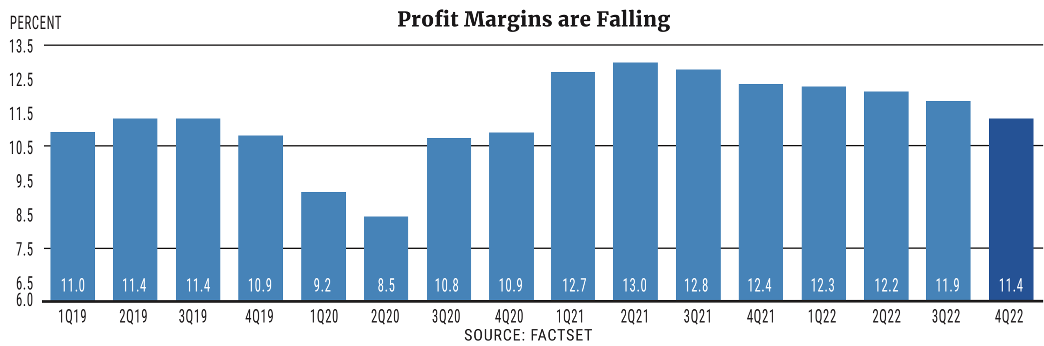
You go back to fundamentals when things start to go awry.
-Bill Cowher

Some day, hopefully soon, fundamentals will be in the ascendancy again. When? Hard to say, but optimistically let's declare 2024 "Fundamentals Matter Year."

So, what are the fundamentals? Let's look at some facts.

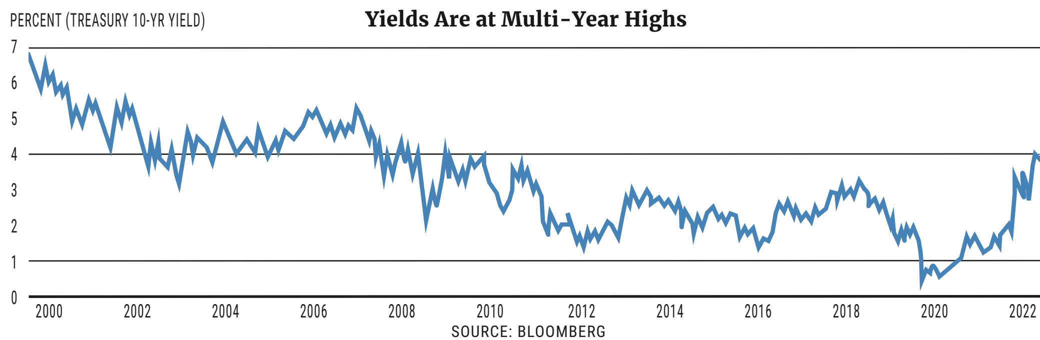
On the economy, it's a growth slowdown, perhaps a growth recession. While the Fed may be most of the way through interest rate increases, their cumulative effect will be manifested in coming months, and that suggests economic deceleration. The recent scare in the banking sector may be past its peak, but lending standards, which have been tightening for the past six months, are likely to become tighter still. As credit becomes more expensive and more scarce, further economic slow-walking should be anticipated.

In the stock market, last year's multiple compression story has given way to this year's tepid earnings story. The 3.2% earnings drop in the fourth quarter is expected to be followed by a 4.6% earnings drop for the just completed first quarter. At the same time, according to FactSet the price/earnings ratio for the S&P 500 is about 17.8 times, higher than the start of the year (16.7 times) and the 25-year historic average (16.8 times). So US large cap stocks are not on sale.



As the chart indicates, profit margins for companies in the S&P 500 have fallen for six consecutive quarters. Companies experienced healthy revenue growth in the fourth quarter, up 5.3%, as prices were increased. However, costs rose faster than sales, thus resulting in lower profit margins and earnings declines.

In the bond market, while yields are off recent peaks, they remain elevated in comparison with the last 15 years.



Of course, these higher yields are available in large part because of higher inflation.

What are the facts for the beleaguered banking industry? Regulations were loosened for all but the largest banks in 2019. Supervision of these institutions has fallen short of the mark. Managements at the failed banks took out-sized and unhedged risks. Fed monetary policy—rapid rate increases—have had the unintended consequence of trimming—and in some case slashing—the value of banks' bond portfolios. A concentration in the deposit base contributed to a run on Silicon Valley Bank.

Anxious investors are worried that there may be more bad news to come for the banks. After all, it seems not unlikely that other financial institutions could be caught with under-hedged long bond portfolios that are meaningfully under water. Upcoming quarterly earnings reports could be revealing, in terms of deposit inflows and outflows. Still, while there may be additional idiosyncratic situations that require shoring up, there does not appear to be a more widespread systemic crisis in the banking sector.

BANKING ON QUALITY

Safety isn't expensive, it's priceless.
-Unknown

So, there is still some fear in markets. After all, National Tarantula Appreciation Day (August 8th) approaches. And if you're already a bit nervous, maybe you didn't participate in Caffeine Awareness Month this past March.

In times of financial market stress, it's natural to try to immunize a portfolio. After all, 2023 International Infection Prevention Week is coming this fall, October 15-21, 2023. While complete immunization against price declines is not possible, protecting assets from excess risk is best done by focusing on quality.

In fixed income, we continue to favor both short- and intermediate-term investment grade bonds. Short rates are attractive in absolute terms, and intermediate-term bonds provide some protection against potentially lower interest rates in the next couple of years. While spreads have widened somewhat, purchasing higher quality bonds seems prudent in the face of the likely economic slowdown.

For US large cap stocks, prospective economic weakness increases the comparative appeal of equities that earn high returns on invested capital, generate high recurring cash flow, evidence consistent earnings, and feature conservative balance sheets. Among other risk assets, international and US small cap equities sport more attractive valuations.

Gloom and doom is so 2022. As investors anticipate the end of interest rate increases, optimism—John Maynard Keynes' "animal spirits"—may lift equity prices. After all, 2023 is the Year of the Rabbit. The rabbit is a symbol of longevity, peace and prosperity, and astrologers predict this will be a year of hope. And, at the end of the day, long-term investors are inherently hopeful.

WRITTEN ON APRIL FOOLS' DAY, 2023

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