Asset Strategy Consultants

MARKET REVIEW

First Quarter 2023

We are pleased to present *Market Review*, featuring a discussion of the Capital Markets during the First Quarter 2023 and a summary of historical performance for the major asset style passive indices for the period ending March 31, 2023. We hope you find the information useful and helpful in your investment considerations.

We welcome your comments.

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ASSET STRATEGY CONSULTANTS

Founded in 1991, Asset Strategy Consultants provides investment consulting services to institutional clients representing $6.9 billion under advisement. Asset Strategy Consultants is headquartered in Baltimore, with a consulting office in Harrisburg, PA.

A Hiccup... or a Belch?

THE MACROECONOMIC ENVIRONMENT

The Fed encountered a hiccup, or perhaps more of a belch, on its path to combat inflation. Nine consecutive rate hikes, the most rapid in its history, took the Fed Funds rate from roughly 0% to 5% in one year's time. While higher rates are a welcome outcome for fixed income investors (on a going-forward basis), they have had deleterious effects on the longer-term balance sheet holdings of some banks.

In March, word of losses at a few banks sparked fears for depositors and led to a bank run that resulted in regulators seizing regional lenders Silicon Valley Bank and Signature Bank. The U.S. Treasury, Federal Reserve, and Federal Deposit Insurance Corporation quickly stepped in and announced measures to provide additional liquidity to banks that needed it and further guaranteed depositors would have access to funds (beyond the $250,000 insured amount) at both banks. A third regional lender, First Republic, also came under significant pressure and a group of larger banks came together in a spirit of unity to provide liquidity.

As of quarter-end, nerves around the health of the U.S. banking system were frayed but fears of contagion were largely allayed. That said, the full impact of the "hiccup" is unknown as lending conditions are expected to tighten and will likely have an adverse effect on businesses and consumers. Despite these events, views are generally that large banks in the U.S. are in reasonably good shape and that this is not a repeat of 2008. However, it is reasonable to expect consolidation among smaller banks and/or increased regulatory scrutiny as these banks are not subject to the same level of regulation as their larger counterparts. While not in the same category, banking woes were on display outside the U.S. and exemplified by the Swiss government's carefully orchestrated purchase of 170-year-old Credit Suisse, one of the "global systematically important banks," by UBS.

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Bond markets swiftly reacted to the banking turmoil in the U.S., with the two-year U.S. Treasury Note yield dropping about 100 bps in three business days, the most since the stock market crash in 1987. Its yield was 5.1% on March 8, and dropped to 4.0% by March 13 before closing the quarter at 4.1%. The S&P 500 Index was down about 3.4% over the same period but climbed nearly 7% into quarter-end.

While returns were positive for both stocks and bonds in 1Q23, there was significant intra-quarter volatility in both markets. It was most pronounced within fixed income, partly due to the hiccup mentioned above. The ICE BofA MOVE Index (commonly used to assess volatility in the U.S. Treasury market) spiked to levels not seen since 2008. The VIX, a popular measure of volatility in stock markets, was elevated but not to the same degree. Notably, stock and bond markets are painting two different pictures. The inverted U.S. Treasury yield curve suggests that bond market investors are expecting both rate cuts and a slowdown while stock markets do not appear to be priced for an economic downturn.

Growth is expected to slow; the questions are how much, for how long, and, more importantly, what the impact on inflation will be.

The Fed's 25 bps hike in March was seen as a "dovish" hike reflecting the uncertainty around the degree to which tighter lending conditions for consumers and businesses could lead to slower growth. This hike brought the Fed Funds rate to 4.75% - 5.0% with a unanimous vote. The last time that the Fed Funds rate was at this level was the fall of 2007. Notably, Chairman Jerome Powell softened language around the potential for future rate hikes, raising the possibility that the Fed may take a pause to assess the fallout from the stress seen in small/mid-sized banks. That said, the Fed's median expectation for the Fed Funds rate at year-end remains 5.1%, while market expectations are lower. As of quarter-end, futures markets were pricing in rate cuts of 50-75 bps before year-end.

Growth is expected to slow; the questions are how much, for how long, and, more importantly, what the impact on inflation will be. The U.S. economy grew 2.6% in 4Q, down slightly from the initial estimate of 2.9%. As of quarter-end, the Atlanta Fed's GDPNow forecast for 1Q GDP growth was 2.5%. Fed projections released at its March meeting show a 0.4% GDP real growth rate for the full year, implying a sharp slowdown in future quarters from the likely 1Q print. The Congressional Budget Office (CBO) projects a similar paltry 0.1% rate for the full year. The Fed expects inflation to fall; the median expectation for the Core PCE Index is 2.6% in 2024 and 2.1% in 2025. Markets also expect inflation to trend lower; the five-year breakeven spread (the difference in yields between five-year U.S. Treasuries and five-year U.S. Treasury Inflation Protected Securities) was 2.4% as of quarter-end.

While inflation has moderated, it remained well above the Fed's 2% target. The CPI rose 6.0% in February (year-over-year) but this was the least since September 2021. Ex-food and energy, the Index climbed 5.5% over the past 12 months, also the least since fall of 2021. The Fed's favored measure (Core PCE) was up 4.6% for the same period, down just a tad from 4.7% in January. Much of the inflation has come from the services sector as consumers have been spending money saved during the pandemic. February service sector inflation was 7.6%, the highest since 1982, and it accounts for about 60% of the broad index. Shelter costs, which comprise a significant part of the CPI, were up 8.1%.

The labor market continued to show resilience despite large layoffs in the tech sector. Unemployment was 3.6%, not far from the February 54-year low of 3.4%. Employers added 311,000 jobs in February, well above expectations though less than the massive 504,000 gain in January. The Fed expects unemployment to climb; the median projection is 4.5% in 2023 and 4.6% in 2024 and 2025. Over the past 12 months, average hourly earnings grew 4.6%, but the February increase was the smallest in one year.

The World Bank estimates that global growth will slow to 1.7% for 2023, about half of the rate expected just six months ago and the third weakest in nearly 30 years. The outlook is driven largely by the global effort to tame inflation through higher policy rates and the potential for negative shocks. That said, so far economies have weathered the impact of higher rates reasonably well, outside of the recent hiccups in the banking sector, but inflation remains elevated around the globe.

In Europe, a warm winter helped to avoid the potentially devastating impact of higher energy prices, but inflation remains stubbornly high. According to Eurostat, inflation in the euro zone was 8.5% (year-over-year) and the estimate for March is 6.9%. The decline reflects a drop in energy inflation from 13.7% in February to -0.9% in March (both year-over-year). In March, the European Central Bank raised its benchmark deposit rate 50 bps, bringing it to 3.0%. The U.K. central bank has raised rates 11 times since December 2021, with a 25 bps increase in March bringing its rate to 4.25%. Inflation in the country surged 10.4% in February (year-over-year). Even Japan has experienced inflation, though modest in comparison. Japan's annual inflation rate fell to 3.3% in February, down from a 41-year high of 4.3%. Core inflation was up 3.1%, above the Bank of Japan's 2% target for the 11th consecutive month.

China is recovering and benefiting from the end of its "zero-COVID" policy in December 2022. The International Monetary Fund projects that China's economy will expand 5.2% in 2023, one of the world's few growth engines this year and, importantly, contributing roughly one-third of global growth. However, challenges remain in the beleaguered property sector and over longer periods in China's slowing population growth and declining productivity. ■

GLOBAL EQUITIES

U.S. stock indices posted positive returns in 1Q but it was not smooth sailing; strong returns in January were followed by negative results in February and mixed performance across sectors and styles in March. The S&P 500 Index rose 7.5% for the quarter and the tech-heavy Nasdaq 100 soared 20.8%. Within the S&P 500, Technology (+22%), Communication Services (+21%), and Consumer Discretionary (+16%) rose sharply while Financials (-6%), Energy (-5%), Health Care (-4%), and Utilities (-3%) fell. Growth stocks trounced value for the quarter (Russell 1000 Growth: +14.4%; Russell 1000 Value: +1.0%) due largely to the sharp outperformance of Technology relative to Financials. Technology comprises just over 40% of the Russell 1000 Growth Index versus Financials at just under 7%. Within the Russell 1000 Index, just five stocks: Apple (+27%), Meta (+76%), Microsoft (+21%), NVIDIA (+90%), and Tesla (+68%) accounted for 60% of the 1Q return and made up about 15% of the Index. Small value (Russell 2000 Value: -0.7%) was the one sector to post negative returns, hurt by its exposure to smaller banks. Banks comprise just under 20% of this Index and were down 17% for the quarter. Small cap stocks underperformed mid and large (Russell 2000: +2.7%; Russell MidCap: +4.1%; Russell 1000: +7.5%) across the style spectrum.

Global ex-U.S. markets also posted solid results. The MSCI ACWI ex USA Index gained 6.9% (Local: +6.2%). Results were mixed across developed markets but most delivered positive returns. Europe ex-U.K. (+12%) outperformed Japan (+6%), the U.K. (+6%), and Canada (+4%).

Emerging markets (MSCI Emerging Markets: +4.0%; Local: +3.8%) were mixed; India (-6%) and Brazil (-3%) weighed on broad market returns while China (+5%) and Korea (+10%) outperformed. Quarterly returns were positive across regions: Latin America (+3.9%), Emerging Europe (+1.5%), and Emerging Asia (+4.8%). ■

GLOBAL FIXED INCOME

Following the worst year ever for core fixed income, the Bloomberg US Aggregate Bond Index rose 3.0% in 1Q. As with equities, it was a bumpy ride with solid returns in January and March sandwiching a negative February. The yield curve remained inverted as of quarter-end, by 58 bps for the 2-year/10-year and 116 bps for the 1-year/10-year. Historically, a yield curve inversion has been a good indicator of a coming recession. High yield (Bloomberg High Yield Index: +3.6%) performed well as defaults remained low, supply subdued, and equity markets climbed. Munis also had a good quarter. The Bloomberg Municipal Bond Index rose 2.8% and the ratio of AAA municipal yields to the 10-year U.S. Treasury fell to 65%, well below its 10-year average (88%).

While short-term rates were broadly higher, longer-term rates fell across developed markets in 1Q. The

Bloomberg Global Aggregate ex USD Index rose 3.1% (hedged: +2.9%). Emerging markets debt indices were also up (JPM EMBI Global Diversified: +1.9% and the local currency JPM GBI-EM Global Diversified: + 5.2%). Emerging market currencies, broadly, did well vs. the U.S. dollar during the quarter. ■

REAL ASSETS

Real assets were mixed in 1Q but generally underperformed global equities. Gold (S&P Gold Spot Price Index: +8.8%), REITs (MSCI US REIT: +2.7%), infrastructure (DJB Global Infrastructure: +2.5%), and TIPS (Bloomberg TIPS: +2.0%) all posted positive returns. The S&P GSCI Index fell 4.9% with oil down about 7%. WTI Crude closed the quarter at $74/barrel, just before OPEC announced its intention to cut production in May. ■

CLOSING THOUGHTS

After a grim 2022, stock and bond markets provided a reasonable start to the year despite the unforeseen swoon in the banking sector that muddies the picture going forward as it relates to both the impact of tighter lending conditions for businesses and consumers and the Fed's next moves. Perhaps not surprising, equity and fixed income markets appear to differ in their views, with equity investors being more sanguine/optimistic than bond investors. Thus far, the economy appears to have weathered the most rapid Fed rate hikes in history with only a hiccup, but it remains to be seen if deeper and more profound effects will be revealed. At the very least, the Fed has been forced to add a third consideration to its twin mandates of managing inflation and employment—financial stability. Further, geopolitical tensions, weakness in Europe, a continuing war in Ukraine, and a looming debt ceiling provide additional fodder for an uncertain and likely volatile remainder of the year. With this in mind, we continue to recommend a disciplined investment process that includes a well-defined long-term asset-allocation policy. ■

Source: Asset Strategy Consultants and Callan Associates

PRELIMINARY RETURNS FOR VARIOUS PERIODS: 1Q23

		January	February	March	Last Quarter	Year to Date	Last Year	Last 3 Years	Last 5 Years	Last 10 Years	Last 15 Years
	1 Russell:3000 Index	6.89	(2.34)	2.67	7.18	7.18	(8.58)	18.48	10.45	11.73	9.90
	2 Russell:1000 Index	6.70	(2.38)	3.16	7.46	7.46	(8.39)	18.55	10.87	12.01	10.02
	3 Russell:1000 Growth	8.33	(1.19)	6.84	14.37	14.37	(10.90)	18.58	13.66	14.59	12.11
	4 Russell:1000 Value	5.18	(3.53)	(0.46)	1.01	1.01	(5.91)	17.93	7.50	9.13	7.68
	5 Russell:Midcap Index	8.30	(2.43)	(1.53)	4.06	4.06	(8.78)	19.20	8.05	10.05	9.49
	6 Russell:Midcap Growth	8.73	(0.99)	1.38	9.14	9.14	(8.52)	15.20	9.07	11.17	10.10
	7 Russell:Midcap Value	8.08	(3.20)	(3.15)	1.32	1.32	(9.22)	20.69	6.54	8.80	8.71
	8 Russell:2500 Index	10.00	(2.35)	(3.75)	3.39	3.39	(10.39)	19.42	6.65	9.07	9.05
	9 Russell:2500 Growth	10.01	(1.58)	(1.59)	6.54	6.54	(10.35)	14.75	6.82	10.05	9.70
EQUITY	10 Russell:2500 Value	9.99	(2.83)	(5.13)	1.40	1.40	(10.53)	21.80	5.61	7.72	8.09
	11 Russell:2000 Index	9.75	(1.69)	(4.78)	2.74	2.74	(11.61)	17.51	4.71	8.04	8.10
	12 Russell:2000 Growth	9.95	(1.08)	(2.47)	6.07	6.07	(10.60)	13.36	4.26	8.49	8.67
	13 Russell:2000 Value	9.54	(2.31)	(7.17)	(0.66)	(0.66)	(12.96)	21.01	4.55	7.22	7.24
	14 S&P:500	6.28	(2.44)	3.67	7.50	7.50	(7.73)	18.60	11.19	12.24	10.06
	15 S&P:400 Mid Cap	9.23	(1.81)	(3.21)	3.81	3.81	(5.12)	22.10	7.67	9.80	9.82
	16 S&P:600 Small Cap	9.49	(1.23)	(5.16)	2.57	2.57	(8.82)	21.71	6.30	9.87	9.64
	17 MSCI:ACWI ex US	8.11	(3.51)	2.44	6.87	6.87	(5.07)	11.80	2.47	4.17	2.62
	18 MSCI:EAFE	8.10	(2.09)	2.48	8.47	8.47	(1.38)	12.99	3.52	5.00	3.00
	19 MSCI:EM	7.90	(6.48)	3.03	3.96	3.96	(10.70)	7.83	(0.91)	2.00	1.69
	20 MSCI:ACWI	7.17	(2.87)	3.08	7.31	7.31	(7.44)	15.36	6.93	8.06	6.02
	21 Blmbg:Aggregate	3.08	(2.59)	2.54	2.96	2.96	(4.78)	(2.77)	0.91	1.36	2.71
	22 Blmbg:Gov/Credit	3.01	(2.59)	2.82	3.17	3.17	(4.81)	(2.63)	1.16	1.50	2.81
	23 Blmbg:Credit	3.81	(3.01)	2.74	3.45	3.45	(5.31)	(0.70)	1.54	2.18	3.93
	24 Blmbg:Corporate High Yld	3.81	(1.29)	1.07	3.57	3.57	(3.34)	5.91	3.21	4.10	6.56
FIXED INCOME	25 Blmbg:Municipal Bond	2.87	(2.26)	2.22	2.78	2.78	0.26	0.35	2.03	2.38	3.61
	26 Blmbg:US TIPS	1.83	(1.37)	2.89	3.34	3.34	(6.06)	1.75	2.94	1.49	2.93
	27 Blmbg:Glob Agg ex USD	3.48	(3.99)	3.73	3.06	3.06	(10.72)	(4.13)	(3.17)	(0.99)	0.15
	28 S&P:LSTA Levg Loan	2.73	0.82	(0.03)	3.55	3.55	3.03	8.69	3.73	3.82	4.98
	29 ML:US Treasuries 1-3 Yrs	0.69	(0.72)	1.60	1.55	1.55	0.20	(0.81)	1.11	0.81	1.12
	30 LIBOR - 3 Month	0.41	0.39	0.45	1.25	1.25	3.44	1.33	1.74	1.19	1.07
	31 3 Month T-Bill	0.31	0.33	0.43	1.07	1.07	2.50	0.89	1.41	0.87	0.69
	32 S&P GSCI	(0.09)	(3.83)	(1.07)	(4.94)	(4.94)	(10.04)	30.53	4.93	(3.84)	(5.85)
	33 MSCI:US REIT Index	10.60	(4.76)	(2.47)	2.73	2.73	(19.17)	11.99	6.02	5.94	6.22
	34 Alerian:MLP Index	6.61	(1.19)	(1.18)	4.09	4.09	14.70	47.08	7.42	0.57	6.21
	35 DJB:Glbl Infrastructure	5.36	(4.92)	2.30	2.49	2.49	(7.26)	10.52	5.97	5.83	6.70
	36 US DOL:CPI All Urban Cons	0.80	0.56	–	–	–	–	–	–	–	–

Source: Callan Associates