CERITY PARTNERS®

Economic & Market Update

FIRST QUARTER 2023 REVIEW | APRIL 2023 OUTLOOK

- While there were concerns about an impending recession, both the U.S. and European economies showed resilience with growth rates exceeding expectations.
- Strong job security and wage growth led to continued high consumer spending. However, businesses became more cautious, and the housing sector struggled, although it began to show signs of recovery.
- Inflation remained a concern, particularly in the services sector, but the Federal Reserve increased the federal funds rate by 25 bps in March to curb it.

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REVIEW OF THE QUARTER

- The most highly anticipated recession in U.S. economic history has so far failed to materialize, as the 2.6% growth at which the economy closed 2022 has been followed by first quarter growth in 2023 that will likely come in around 3.0% when the first estimate is released at the end of April. The consumer continues to spend at a high real (inflation-adjusted) rate as the tight labor market has provided both strong job security, which boosts confidence, and ample wage growth, which fuels purchases. Businesses became somewhat more reticent during the quarter as higher interest rates and tougher credit conditions have dented the confidence of purchasing managers and CEOs. A notable trend in the economy that bears watching is the housing sector, which had fallen into recession last year and is now showing distinct signs of bottoming as we head into the second quarter.
- Overseas, the European economy has been similarly resilient in defying the calls for an imminent recession due to aggressive monetary tightening and sharply higher commodity prices. Granted, some of this surprising first quarter strength can be viewed as fortuitous as the mild winter weather appears to have forestalled the depletion of natural gas supplies. But the decline in energy prices due to continued production and distribution within OPEC as well as non-OPEC countries was also a contributing factor. The end of ill-advised “zero-COVID” policies in China helped revive an important source of demand within Asia and from some European economies. Eliminating extreme mobility restrictions also boosted production in the Chinese manufacturing sector, which helped finally bring global supply chain operations back to pre-pandemic levels.
- A negative consequence of this surprising global economic growth was some slowing in the progress of bringing inflation down to central bank target levels. Services inflation has been particularly sticky as labor is the primary input cost in most services industries and labor market slack has yet to develop despite central bankers’ efforts to slow their economies.
- Markets anticipated the near-term end of Federal Reserve (Fed) tightening as the quarter began and were further encouraged when Fed Chair Jerome Powell, in his press conference after the February 1 Federal Open Market Committee meeting when the Fed raised the federal funds rate by 25 basis points (bps), frequently cited disinflationary trends in the economy. However, this premature victory lap was met with the reality that eradicating this first truly inflationary cycle in 40 years was going to be a process met with some interim resistance. The stalled progress in the services sector caused the Fed to heighten its inflation-fighting rhetoric and encourage markets to focus on a narrower subcomponent of inflation, the core consumer price index excluding shelter. There were initial thoughts that the disappointing January and February inflation statistics would force the Fed to increase the federal funds rate by 50 bps during the March meeting, but the burgeoning turmoil in the banking industry revived concerns that the extreme tightening of policy over the previous 12 months may have caused the first “break” in an important part of the economy. So, the Fed implemented another rate increase of 25 bps in March, which took the federal funds rate up to 4.75%–5.00%, and in its statement and subsequent press conference gave markets greater hope that the Fed is nearly finished with the rate hiking cycle.
- The investment-grade bond market rallied rather sharply in March after the Treasury yield curve had shifted up slightly in the first two months of the quarter. The developing crisis in U.S. regional banks appeared to be spreading to Europe and increased concerns about an impending global recession led by the United States. Volatility in the bond market has been rather unusual as the current strength of the economy is juxtaposed against a monetary tightening policy that may prove to be too extreme. The yield curve, measured by the difference between 2-year and 10-year Treasury yields, remained inverted throughout the quarter and has now been in inversion for nine months, which is a potential indicator of impending recession. An important offset to this recessionary market signal has been the interest rate spread in the high-yield bond market, which has hovered around its 30-year average of 500 bps over the same maturity Treasury. Some spread widening occurred at the end of the quarter, but the high-yield market has yet to decline to levels that would presage a recession.

- While not to the extent seen in the bond markets, volatility increased in the equity markets due primarily to the regional banking turmoil although the situation appeared to be ebbing somewhat at quarter-end. The broad U.S. and global indexes performed better than generally expected in the quarter and have largely recovered the ground lost since the onset of the banking turmoil, despite a roughly 4.0% decline in fourth quarter earnings for S&P 500 Index companies. Perhaps the over 5.0% revenue growth in the quarter was somewhat encouraging, but the strong performance of the various equity markets was likely due to growing confidence that central banks may have reached the end of the tightening cycle as inflation retreats. While higher across the yield curve on an absolute basis, overall interest rates have merely moved back to a more normalized level and should intermediate rates peak around current levels, equity valuations still look rather attractive unless earnings drop sharply through the rest of 2023.
- When breaking down first quarter equity performance, there was distinct outperformance of growth stocks compared to value in the U.S. large cap space. This distinction was further reflected in the outperformance of the Nasdaq composite compared to the Dow Jones Industrial Average. The breadth of the quarter's price appreciation was rather narrow as the communication services, information technology and consumer discretionary sectors garnered almost all the gains. Markets moved toward defensive growth stocks and stocks that benefit from lower rates and became more circumspect around cyclicals. Weakness in the energy sector, due to lower commodity prices, and in financial services, due to the banking turmoil, added to this rather large performance differential between equity styles.
- International equities also performed well in the quarter with particular strength seen in developed European equities, as the economies in the European Union (EUROPE) skirted recession with no real escalation in the Russia-Ukraine war. Emerging market equities performed generally in line with those in the United States, as the U.S. dollar stabilized and trended down slightly. This stabilization removed a meaningful headwind to risky assets, which contributed to the poor 2022 performance in most risk-asset classes.
- In the commodities complex, there was an overall decline in most energy prices during the quarter as mild winter weather and fears of recession reduced demand while the worst of the predicted supply constraints failed to materialize. Industrial metals and agricultural prices were mixed as disrupted supply chains have largely cleared. Gold was arguably the most interesting commodity in the asset class as the specter of the end of Fed tightening drove prices higher in January only to lose all the appreciation when the disinflation trend stalled in the middle of the quarter. Then the safe-haven characteristic came to the fore as the banking crisis evolved and the yellow metal ultimately gained roughly 10% in the quarter.

TURMOIL IN THE BANKING INDUSTRY

- Central bank rate tightening cycles have a history of stopping when rates rise to a high enough level to cause unintended financial strains on the economy. The transmission mechanism of such strains is typically through banks. In most cases, higher rates expose credit quality concerns in firms with weak balance sheets, which causes higher loan default rates and a decline in the value of loans on bank balance sheets. Banks then must slow loan growth to repair and replenish depleted capital. Some banks do not survive the effects of asset impairment on their capital base and need to seek a merger partner or are forced to merge in a takeover led by the Federal Deposit Insurance Corporation (FDIC).
- The first signs of such pressure came in early March when Silicon Valley Bank experienced a classic, albeit electronic, run on deposits as news began to quickly spread about impairment of its balance sheet. What made this situation somewhat atypical was the nature of its deposit base and the assets that showed the biggest decline in value. While the loans they made were all continuing to perform with no notable impairment, their high-quality securities portfolio declined over the past year as interest rates rose 300–400 bps across the maturity curve.

- The management missteps that contributed to the collapse were twofold. First, the bank encouraged large, uninsured deposits from venture capital funds and their underlying portfolio companies. This is so-called “hot” money, which tends to be very fluid. Second, because rates had been so low for so long, the deposits they did not lend or reserve for regulatory capital were invested in longer maturity government and mortgage bonds so they can make a reasonable margin spread. When rates rose in 2022, these longer-maturity bonds suffered the most price depreciation. As deposits started to flow out, the bank was forced to realize the losses on these securities that were intended to be held to maturity.
- With bank capital fully depleted by the losses, the FDIC was forced to close the bank and look for another bank or banks to assume its assets and deposit liabilities. With FDIC deposit insurance only available for deposits less than $250,000, depositors across the system began to scrutinize their banking relationships and began pulling deposits away from certain institutions. Signature Bank suffered the same fate a few days later and to avoid a broad banking crisis, the U.S. Treasury, Federal Reserve and FDIC jointly announced that all deposits of these failed banks would be guaranteed. They also introduced a program where banks could borrow from the Fed using their government bond holdings as collateral. The unique element of the program is the banks can borrow 100% of the face value of the securities even if they have declined in value, as these securities are of high credit quality and meant to be held to maturity. So, these securities will not have to be sold and losses realized, which should theoretically quell fears of further capital impairment.
- While this government response may temporarily quell depositor anxiety, investors are scrutinizing other perceived weak banks within the system. The turmoil did extend overseas as Credit Suisse, an institution that had been struggling with customer outflows over the past year, was forced by the Swiss government into a merger with UBS that immediately wiped out their equity and certain bond holders. Breaking out the playbook from the 2007–2008 financial crisis, the Fed and other global central banks agreed to increase U.S. dollar swap operations to assure necessary global liquidity in what is effectively the world’s reserve currency.
- As the quarter came to an end, depositor outflows from the system have settled down somewhat with the scrutiny shifting to the equity outlooks of weaker banks. Uncertainty around the ultimate effect of Fed tightening and the potential for impairment of the loan portion of the asset portfolio will likely lead to less lending and further tightening in financial conditions. An added complication for the banks is the notable move by depositors away from low-yielding demand deposits to higher-yielding options such as money market funds and certificates of deposit. This trend was occurring before the recent turmoil and will affect net interest margins and profitability, causing further hesitancy in acquiring more risky loan assets.

OUR OUTLOOK

- All eyes continue to be on the Fed and the other developed market central banks to determine when they will finally end the tightening cycle. Markets will also be trying to assess if any meaningful economic damage has been inflicted on the economy due to the aggressiveness of the rate increases over the past year. The quarter-end drama surrounding the banking system is expected to lead to further tightening of financial conditions as banks may be more hesitant to extend loans. Investors will be looking at credit flows from small- and medium-sized sized banks to individual sectors such as the commercial real estate sector and to small businesses in general.
- After the high-profile layoff announcements during the quarter in the technology and communication services sectors and the expected contraction in the financial services industry, it appears inevitable that employment growth in the United States will slow and eventually decline with the unemployment rate rising throughout the coming quarters. This should help slow wage inflation, which is now of foremost concern to the Fed, but it will also slow consumer spending and the overall economy. While the magnitude of the slowdown is uncertain moving into the second quarter, there is likely enough resiliency in the economy to avoid a deep recession.

- Overseas, central bank rate increases have generally not been as stringent although the inflation rates in some countries are notably higher. A decline in energy prices helped take some pressure off consumers and businesses, particularly in northern Europe where countries were subject to dire forecasts of a dark winter and deep recession that failed to materialize. The full reopening of China from COVID-19 sanctions will obviously help the Chinese and Asian economies but will also benefit European export industries and Latin American commodity producers.
- Of course, avoidance of deeper recessions is very much dependent on central banks avoiding policy mistakes in their fight against inflation. The U.S. economy needs to see continued improvement in the overall rate of inflation for markets to more confidently believe that federal funds rate increases are near an end. As goods prices seem to be settling back to target inflation levels, services prices will be in focus and the progress will continue to be slow, but tangible. With the banking turmoil settling down to an extent, expect one more 25 bps federal funds rate increase before the Fed signals a pause, which should lead to the ultimate end of the tightening cycle. Other global central banks are likely to follow the Fed's directional lead.
- When extending this analysis on the economy and monetary policy to the overall bond market, an end to tightening does not immediately mean a pivot to lower rates unless the higher rates create great economic distress. Our call for slower, but still positive U.S. and global economic growth may exert some upward pressure on intermediate-maturity bond yields as the inverted yield curve resolves itself over the coming year through a combination of declining short rates and rising intermediate-to-longer rates. Credit quality, particularly in the below-investment-grade sector of the market may be increasingly scrutinized. We expect some spread widening in the high-yield asset class and are treading more cautiously in our exposures.
- Given continued central bank tightening, a year-over-year decline in fourth quarter earnings with a similar decline expected when first quarter earnings are published, and the turmoil in the banking industry, the strong performance of global equity markets was certainly a surprise—not so much in its direction as in its magnitude. The prospect of stable interest rates at current levels and an economy that will slow but ultimately not fall into recession appear to be the primary reasons for the first quarter's appreciation. The narrowing breadth of the advance and questions around the progression of earnings in coming quarters should lead to some consolidation of these gains over the next few months. But it appears the lows of this bull market were seen in the fall of last year and we do not believe they will be retested again.
- The end of the U.S. dollar appreciation seen through most of 2022 also removed an important headwind to equity markets and allowed for strong relative performance for many international equity markets as compared to the United States. With the Fed closer to the end of the rate increase initiative than most other central banks, the U.S. dollar should trade in a rather narrow range in the second quarter.
- Relief from the pressure of rising commodity prices has also been helpful for both the economy in general and in forestalling further margin erosion in the manufacturing and production sectors. Oil remains prone to artificial supply constraints imposed by the OPEC+ cartel although slower global demand can be somewhat of an offset to rising prices. Gold is a haven asset and an alternate store of value during times of heightened financial and geopolitical risk. Banking turmoil has subsided for now, which should quell further safe-haven appreciation, and without a near-term pivot toward loosening policy, the current level of short-term interest rates should prevent much further price appreciation.

							Annualized			
		2Q22	3Q22	4Q22	1Q23	YTD	1-Year	3-Year	5-Year	10-Year
U.S. EQUITY BENCHMARKS	**PRICE**									
Dow Jones Industrial	33,274.15	(10.78)	(6.17)	16.01	0.93	0.93	(1.98)	17.31	9.01	11.15
Nasdaq Index Composite	12,221.91	(22.28)	(3.91)	(0.79)	17.05	17.05	(13.28)	17.56	12.60	15.30
S&P 500	4,109.31	(16.10)	(4.88)	7.56	7.50	7.50	(7.73)	18.60	11.19	12.24
Russell 1000 (Large Cap)		(16.67)	(4.61)	7.24	7.46	7.46	(8.39)	18.55	10.87	12.01
Russell 1000 Growth		(20.92)	(3.60)	2.20	14.37	14.37	(10.90)	18.58	13.66	14.59
Russell 1000 Value		(12.21)	(5.62)	12.42	1.01	1.01	(5.91)	17.93	7.50	9.13
Russell Mid Cap		(16.85)	(3.44)	9.18	4.06	4.06	(8.78)	19.20	8.05	10.05
Russell Mid Cap Growth		(21.07)	(0.65)	6.90	9.14	9.14	(8.52)	15.20	9.07	11.17
Russell Mid Cap Value		(14.68)	(4.93)	10.45	1.32	1.32	(9.22)	20.69	6.54	8.80
Russell 2000 (Small Cap)		(17.20)	(2.19)	6.23	2.74	2.74	(11.61)	17.51	4.71	8.04
Russell 2000 Growth		(19.25)	0.24	4.13	6.07	6.07	(10.60)	13.36	4.26	8.49
Russell 2000 Value		(15.28)	(4.61)	8.42	(0.66)	(0.66)	(12.96)	21.01	4.55	7.22
S&P GICS SECTORS	**WEIGHT**									
Consumer Discretionary	9.80%	(26.16)	4.36	(10.18)	16.13	16.13	(19.62)	14.54	8.70	12.14
Consumer Staples	7.20%	(4.62)	(6.62)	12.72	0.83	0.83	1.22	14.69	10.63	9.62
Energy	5.20%	(5.17)	2.35	22.81	(4.67)	(4.67)	13.63	48.43	9.53	4.44
Financials	11.70%	(17.50)	(3.10)	13.61	(5.56)	(5.56)	(14.24)	18.11	5.41	10.32
Health Care	15.80%	(5.91)	(5.18)	12.80	(4.31)	(4.31)	(3.70)	15.41	11.82	12.87
Industrials	8.70%	(14.78)	(4.72)	19.22	3.47	3.47	0.17	21.72	8.43	11.19
Information Technology	25.70%	(20.24)	(6.21)	4.74	21.82	21.82	(4.55)	24.35	19.64	20.14
Materials	2.70%	(15.90)	(7.13)	15.05	4.29	4.29	(6.28)	23.93	9.60	9.75
Communication Services	7.30%	(20.71)	(12.72)	(1.38)	20.50	20.50	(17.76)	9.44	6.43	5.27
Utilities	3.20%	(5.09)	(5.99)	8.64	(3.24)	(3.24)	(6.21)	10.34	9.59	9.37
Real Estate	2.70%	(14.72)	(11.03)	3.82	1.95	1.95	(19.69)	10.06	7.42	7.36

							Annualized			
		2Q22	3Q22	4Q22	1Q23	YTD	1-Year	3-Year	5-Year	10-Year
GLOBAL EQUITY BENCHMARKS	**PRICE**									
MSCI ACWI	646.76	(15.66)	(6.82)	9.76	7.31	7.31	(7.44)	15.36	6.93	8.06
MSCI AC World x-USA	298.68	(13.73)	(9.91)	14.28	6.87	6.87	(5.07)	11.80	2.47	4.17
MSCI EAFE	2,092.60	(14.51)	(9.36)	17.34	8.47	8.47	(1.38)	12.99	3.52	5.00
MSCI EAFE Growth	1,925.56	(16.88)	(8.50)	15.05	11.09	11.09	(2.79)	10.95	4.88	6.01
MSCI EAFE Value	2,712.32	(12.41)	(10.21)	19.64	5.93	5.93	(0.31)	14.58	1.75	3.75
MSCI Emerging Markets	990.28	(11.45)	(11.57)	9.70	3.96	3.96	(10.70)	7.83	(0.91)	2.00
MSCI BRIC	263.20	(4.32)	(12.70)	8.90	0.84	0.84	(8.27)	1.65	(2.88)	1.61
MSCI Japan	3,299.16	(14.63)	(7.67)	13.23	6.19	6.19	(5.23)	7.39	1.27	5.03
INTEREST RATES	**YIELD**									
3m Treasury Bill	4.74	1.67	3.27	4.38	4.74	4.38	0.04	1.79	0.99	0.08
US LIBOR 3m	5.19	2.29	3.75	4.77	5.19	4.77	0.13	2.09	1.33	0.36
US Treasury 3m	4.75	1.64	3.23	4.41	4.75	4.41	0.05	1.81	1.06	0.09
US Treasury 10yr	3.49	2.98	3.80	3.88	3.49	3.88	1.47	1.64	2.31	1.63
US Treasury 30yr	3.69	3.12	3.77	3.97	3.69	3.97	2.04	2.10	2.87	2.82
FIXED INCOME										
Citi 3-month T-bill		0.01	0.33	0.82	1.08	1.08	2.25	0.78	1.33	0.81
BC U.S. Gov't & Related 5-7		(3.11)	(3.97)	1.79	3.02	3.02	(2.44)	(1.39)	1.66	1.72
BC Municipal Bond 1-10 Year		(0.84)	(2.30)	3.12	2.00	2.00	1.91	0.75	1.92	1.85
BC TIPS		(6.08)	(5.14)	2.04	3.34	3.34	(6.06)	1.75	2.94	1.49
BC Aggregate		(4.69)	(4.75)	1.87	2.96	2.96	(4.78)	(2.77)	0.91	1.36
ML High Yield Master II		(9.97)	(0.68)	3.98	3.72	3.72	(3.56)	5.84	3.06	4.03
Citi World Gov't Bond Index		(8.91)	(7.61)	3.82	3.51	3.51	(9.55)	(5.29)	(2.35)	(0.60)
JPMorgan EMBI Global		(10.55)	(4.20)	7.44	2.25	2.25	(5.86)	0.31	(0.20)	1.81

	PRICE	2Q22	3Q22	4Q22	1Q23	YTD	Annualized 1-Year	3-Year	5-Year	10-Year
REAL ESTATE										
MSCI US REIT		(17.16)	(10.28)	4.90	2.39	2.39	(20.17)	10.76	4.79	4.66
FTSE EPRA/NAREIT Europe		5.81	(7.15)	(28.22)	(21.55)	(2.93)	(37.48)	(4.69)	(6.72)	1.39
COMMODITIES										
Bloomberg Commodity Index		(5.66)	(4.11)	2.22	(5.36)	(5.36)	(12.49)	20.82	5.36	(1.72)
Energy		7.02	(5.36)	(9.07)	(18.69)	(18.69)	(25.11)	25.44	(1.54)	(9.19)
Agriculturals		(5.72)	(0.20)	2.42	0.02	0.02	(3.62)	23.68	8.45	(0.48)
Livestock		(8.68)	2.55	8.47	(4.28)	(4.28)	(2.77)	5.98	(2.56)	(2.96)
Softs		(4.30)	(3.86)	(2.78)	9.26	9.26	(2.27)	23.40	7.10	(1.61)
Industrial Metals		(26.35)	(7.27)	16.44	(2.09)	(2.09)	(22.14)	21.12	5.89	2.14
Precious Metals		(10.54)	(7.60)	13.32	6.29	6.29	(0.43)	8.27	7.10	0.29
CURRENCIES	**PRICE**									
ICE Dollar Index	102.51	6.48	7.10	(7.67)	(0.98)	(0.98)	4.27	1.15	2.60	2.13
Euro / US Dollar	1.09	(6.04)	(6.29)	8.94	1.80	1.80	(2.36)	(0.33)	(2.45)	(1.66)
Pound / US Dollar	1.24	(7.76)	(8.08)	7.76	2.79	2.79	(6.10)	(0.09)	(2.49)	(2.03)
US Dollar / Yen	133.09	11.93	6.54	(8.84)	0.87	0.87	9.66	7.23	4.59	3.53

Source: Factset, Morningstar Direct, iShares website

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