STEWART CAPITAL

Market Commentary – First Quarter 2023

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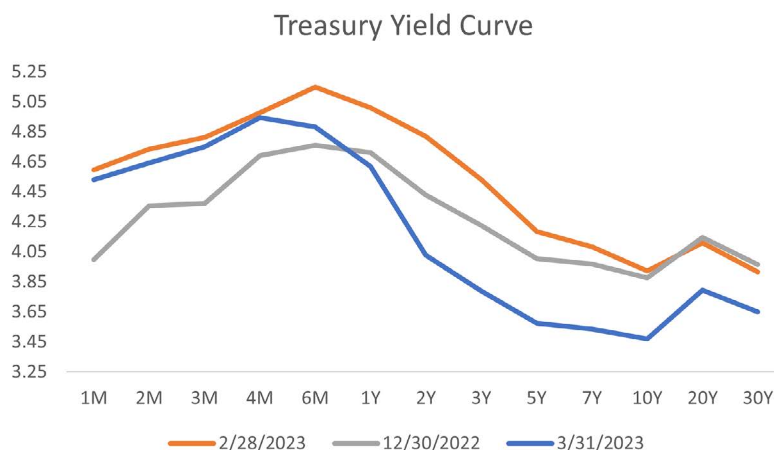
It might not look like much, but the bond markets have been through a bit of a whipsaw in the first quarter.

Interest rates rose strongly from the end of 2022 until approximately the end of February, throwing cold water on bond pundits's expectations for positive returns in fixed-income securities. Then came the Federal Deposit Insurance Corporation's (FDIC) closure of two banks (Silicon Valley Bank, or SVB and Signature Bank, or SB), the closure of a bank that catered to the crypto market (Silvergate) and a year that began with a primary focus on the fight against inflation suddenly pivoted to the likelihood of recession.

The chart below points out that shift. The grey line is where bonds ended in 2022. The orange line is where we were at the end of February when the primary market focus was on the inflation fight and the blue line is where we ended in March. Expectations for higher rates look to have shifted to expecting a recession at some point this year, which kind of leaves the Federal Reserve (Fed) in a conundrum. . . Do they continue their fight against inflation, or do they give a nod to the market's concerns about an increased likelihood for an economic downturn? For the record, we have upgraded the likelihood of a recession this year from less than 50% to more than 50%.



It's interesting, really.

The Fed had talked a good game since last spring when they began aggressively hiking short-term interest rates.

Of note, as we wrote in our third-quarter 2022 commentary, were Fed Chairman Powell's comments in his Jackson Hole speech when he quoted former Fed Chairman Paul Volker that, "inflation feeds in part on itself, so part of the job of returning to a more stable and more productive economy must be to break the grip of inflationary expectations." He then followed that statement with the third lesson learned from the Great Inflation, "we must keep at it (raising rates) until the job is done."

Former Fed Chairman Volker knew that hiking rates to the point that it broke the grip of inflation would cause a recession, and he chose to pursue that tactic as he also knew that not putting out the inflation fire meant that the task would only get more onerous. Does the current Federal Reserve have that kind of tenacity? Only time will tell.

The Economy

While we have softness in non-services ISM/PMI (ISM: Institute of Supply Managers; PMI: Purchasing Managers' Index), we still see strength in services where the data remains nicely above the 50 level, considered the dividing line between growth and contraction. (The ISM Manufacturing data further declined in March to 46.3 compared to a 47.7 reading in February. The ISM Services Index was well below expectations for a March reading of 54.4, but still showed growth at 51.2.)

Inflation, as indicated by the Fed's preferred metric – the Personal Consumption Expenditures Deflator or PCE – ebbed a bit from its reading a month earlier (up 0.3% month-over-month and 4.6% year-over-year)

and was a tad lower than had been expected. While the lower-than-expected numbers might give the Fed some cover to slow its rate hikes, they are still above its 2% target.

Employment remains strong with JOLTS (Job Openings and Labor Turnover) data still showing substantially more jobs available than unemployed people. Even though the gap has narrowed, with the unemployed to jobs ratio rolling over, it is still strong at 1.67. Quits (people who voluntarily leave their jobs) also remain strong at more than 4 million. We would expect to see significant weakness in the employment data prior to the economy entering a full-blown recession, and we point to the strength of the employment data as a reason why the economy might avoid a traditional recession.

Recessions tend to be prefaced by a credit crunch, and credit standards for commercial and industrial (C&I) and credit card lending have been tightening since July of 2022 and are currently at levels that would indicate a recession is distinctly possible. However, we believe that this tightness is more a response by banks to dramatically higher interest rates causing them to take the logical step of dialing back credit for those projects that no longer make economic sense (capital cost is higher than project return) rather than a response to slower economic conditions.

A bigger issue created by these higher short-term rates, and one that banks have not had to face in a couple of decades, is something called disintermediation.

Disintermediation happens when short-term rates go high enough that money leaves bank deposits to be directly invested in money market funds and other short-term fixed-income securities. This was a particular issue during the 1980s and 1990s, when interest rates were significantly higher than they have been for most of this century. This can be a problem if a bank needs funding for its lending activities, forcing them to pull back on lending. As deposits leave, funding for lending declines, forcing further pull-back on lending and creating a vicious circle that ultimately generates a credit crunch. Will it lead to a recession now? We reserve our opinion until we get more data. However, we believe it far more likely that we encounter a rolling recession as pockets of economic difficulty pop up rather than a full-blown recession.

Interest Rates

What a difference a few weeks make. Rates may have likely seen their peaks for the year and the current cycle. Could the Fed give us one more rate hike? Certainly, but the market is warning of negative consequences if they get too aggressive. Will the Fed channel Volker or listen to the market?

Short-term interest rates have risen nearly 500 basis points, or 5%, since this point a year ago. While the market was pushing for higher rates not that long ago, the closure of SVB and SB have thrown cold water on the rate-hike fire. Where we had expected the fed fund rate to push modestly above 5.25%, we now believe it's likely that the Fed will give in to market pressures. The market has now turned to the expectation of rate cuts by year-end.

While we believe the prospect for short-term rate cuts to be a bit premature, we would not be surprised to see a prolonged period of wait and see as the Fed allows the data to help them decide.

This simply reinforces what we have believed for some time: that the Fed doesn't set policy so much as it allows the markets to tell it where it needs to be and then follows. Do they always get it right? No, but they (either the market or the Fed) are also not operating with complete information.

Both the market and the Fed operate with the information available to them at and up to a point in time. While it is as complete as it can be, the reaction to the information is often a judgement call with the level of magnitude being a consequence. This is why we have often said that the market's typical reaction is *ready, shoot, aim*, whereas the Fed is trying to respond to a knowledge-based economy with industrial-based economic info. So where does that leave us in terms of rate expectations?

As we indicated above, we believe that the markets have likely seen a peak in interest rates for the year. Does this mean that rates will likely be lower by year-end? In our view, while it is quite likely that we will continue to see significant rate volatility along the yield curve, it is less likely that rates come down.

Market Overview

After a year of ugly, we have (so far) returned to positive returns. Returns were nicely positive across the broad index universe with larger capitalization stocks outperforming smaller capitalization stocks and longer-term bonds outperforming shorter-term bonds. While we expect market volatility to remain elevated throughout the year, we continue to expect positive returns for the full year.

It is interesting to us that shorter-duration assets (both equity and fixed income) underperformed longer-duration assets. In a rising rate environment, one would not think that to be the case – particularly if you expected, as we did, that rates would rise along the curve. However, given that the market is forward-looking, it makes some sense if you believe that the end to rate increases is imminent.

From an equity standpoint, that has meant that growth outperformed value and dividend-paying stocks (also considered value stocks) underperformed more broad-based indices.

We do not believe that relationship should hold for the entirety of the year, as expectations for earnings and cash flows are also trending downward.

Assuming interest rates stabilize, lower forward earnings and cash flow expectations should weigh heaviest on longer-duration asserts.

Outlook

What the rest of this year looks like will largely depend on what happens to interest rates between now and year-end. If rates remain stable through year-end (the yield curve remains sharply inverted), then bonds should enjoy modest single-digit returns across the yield curve and equities should also provide modestly positive returns. This is most likely if the Fed simply holds fast on interest rates through year-end. If rates don't hold steady through year-end, then how asset classes perform will largely depend on the direction and change in the shape of the yield curve and the duration of portfolio assets.

Given where we are in the economic cycle, we continue to believe that it makes sense to pay attention to risks. As we transition from cyclical rising rates to a peak and then (eventually) falling rates, it doesn't make sense to take on any more risks than necessary.

In our analysis of potential returns, we continue to let rate and duration be our guide, and we are getting to a point where it makes more sense to expect longer rates to, at best, remain steady.

If they do, then, as indicated above, returns should be modestly single-digit across the board. If rates rise on the long end of the yield curve, however, then returns for assets with a duration of longer than roughly four years would see at least modestly negative returns.

We are modifying our outlook for short-term interest rates and see a peak in the fed funds rate at about 5.10%, indicating the likelihood of at least one more quarter-percentage increase. This would likely increase the market's view regarding the likelihood of a recession and drive longer rates modestly lower. The ten-year Treasury Bond, which reached its 2023 peak yield of 4.06%, could well decline modestly from current levels, going through the lows reached in the very early days of the second quarter before ticking modestly higher.

Equities will also trade in sympathy with the likelihood of recession before turning to next year's expectations at mid-year.

We believe that expectations for 2024 rate cuts will provide a more constructive outlook for earnings as the economy stabilizes.

This should allow equities to post modest returns through year-end with lower duration equities resuming leadership.

Strategy Overview

Uncertainty regarding the rate cycle and increasing economic and geopolitical uncertainty give us pause about getting very constructive with the current investment landscape.

We continue to view the downside risks and upside potential roughly equally.

Increasing risk exposure will likely not be met with appropriate returns. Discretion remains the better part of valor.

What tends to get most investors in trouble is losing sight of the fact that risk and return are inextricably linked. We have always kept – and will always keep – that reality at the forefront of our thought process. While it does not mean that we won't take risks, it reminds us daily that we must be well-compensated for the risks that we do take.

Linking investment decisions to something tangible, like the cash-generating capabilities of a business or investment, and assuming a minimum acceptable rate of return for each investment decision should add value.

Elevated risks should translate into higher return requirements and lower valuations, all else equal.

Further understanding that increasing market turmoil can often create dislocations that lead us to places where mispriced risks provide above-average opportunities.

Looking at investments as would any rational person helps us focus on those things that are most important: return of and return on capital invested.

Regardless of the environment or level of market uncertainty, when we see investment opportunities that allow us to earn returns more than our requirements, we jump. Over time, this should allow us to be well-compensated for the decision we make. In our mind, the real risks are those not taken.

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