

Key Takeaways

Global equity markets held up well and posted solid returns for the quarter, though underneath the calm market surface, there was a wide dispersion in returns across sectors and asset classes.

Fixed Income markets had strong quarter across most fixed income sectors, probably due to anticipation of smaller and fewer future interest rate increases.

The quarter saw the swift collapse of Silicon Valley Bank and a few other regional banks due to losses realized from the sale of bonds, but the contagion has failed to spread and seems unlikely to bring about a repeat of the 2007 financial crisis.

The government's response to the collapse of SVB was immediate and its actions have, for now, calmed fears that other regional banks will suffer a similar fate as SVB.

In response to the collapse of SVB, the Fed set up The Bank Term Funding Program, which gives banks the ability to borrow at a low rate of interest using the face value of bonds it owns as collateral.

The Fed's 0.25% interest rate hike in March was its ninth consecutive rate increase, its most aggressive tightening cycle since the early 1980s.

The likelihood of a recession has increased but is far from a certainty.

A strong labor market, rising disposable income, strong corporate balance sheets and a high level of personal savings are reasons for optimism.

My 5-year base case for U.S. stock market returns is mid to high single digit returns, though current US stock valuations make high single digit returns less likely.

Attractive valuations of foreign developed and emerging market stocks, and the prospect of a declining dollar, have me feeling more constructive about returns in the international markets; high single-digit to low double-digit returns over the next 5 years looking possible.

Broadwing portfolios continue to hold meaningful "defensive" positions, which in light of current economic and market uncertainty should help to protect investors if events take a turn for the worse.

Market Recap

Despite the stress in the banking system, including the failure of Silicon Valley Bank, global equity markets held up remarkably well in March and posted solid returns for the quarter. The S&P 500 index was up 3.7% in March and gained 7.5% in the first quarter. Developed international stocks (MSCI EAFE Index) did a bit better, rising 8.5% for the quarter (and returned 2.5% in March). Emerging markets stocks (MSCI EM Index) gained 4% for the quarter and rose 3% in March.

Underneath the calm market surface there was wide dispersion in returns across sectors, market caps and styles. Large-cap growth stocks (Russell 1000 Growth Index) gained 14.4% in the quarter, while the large-cap value stocks returned 1% (Russell 1000 Value Index). The Nasdaq Composite Index surged 17%, while the Russell 2000 Small Cap Value Index dropped 0.7%.

Fixed-income markets had a strong quarter as longer-term bond yields fell, generating price gains. Core investment-grade bonds (Bloomberg U.S. Aggregate Bond Index) returned 3%, as the 10-year Treasury yield fell to 3.5% from 3.9% at year-end. Riskier high-yield bonds (ICE BofA U.S. High Yield Index) outperformed core bonds gaining 3.7%. Municipal bonds gained 2.3% (Morningstar National Muni Bond Category). Flexible/nontraditional bond funds gained around 3%.

Alternative strategies and nontraditional asset classes generally underperformed traditional stock and bond indexes for the quarter. Trend-following managed futures strategies had a particularly tough period, losing anywhere from 6% to 10%, as some of the major trends from 2022 sharply reversed – particularly interest rates.

Quick Recap: The Silicon Valley Bank Failure – What happened and why it is not the beginning of another financial crisis?

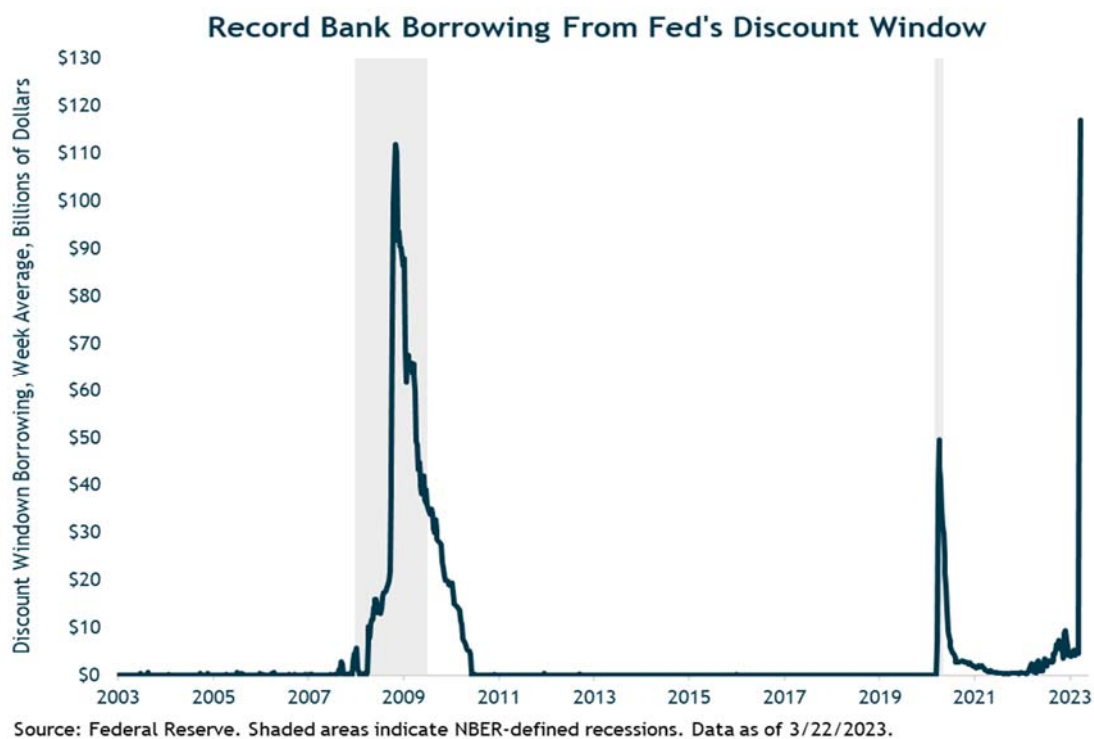
By now, the story of the Silicon Valley Bank (SVB) failure is well known. But I think a quick recap is worthwhile as it provides context for my investment outlook and portfolio positioning which follow. In a nutshell, Silicon Valley Bank was the victim of a classic “bank run” – too many depositors wanted their money back simultaneously and SVB didn’t have the cash on hand to meet customer withdrawals. All it took was a widely followed Silicon Valley blogger posting the question, “Hey, has anyone noticed that Silicon Valley Bank is functionally insolvent?” and his post spread quickly through social media to the folks with large deposits at SVB. That’s all it took to take down a bank with a 40-year history.

Importantly, SVB had unique characteristics that made it particularly susceptible to such a run that don’t necessarily apply to the broader banking industry, or at least to the same degree. This is one reason why I don’t see the failure of SVB as the beginning of a replay of the Great Financial Crisis (GFC) of 2008. But there clearly will be broader economic and financial market impacts.

SVB was particularly exposed to interest-rate risk as it held an unusually large share of its assets in long-duration bonds (bonds that mature in 10 to 30 years at their \$1,000 maturity value). As such, SVB faced extremely large unrealized losses on their bond portfolio when interest rates rose sharply last year as the Fed sought to choke off inflation. Imagine you buy a bond for \$1,000 that promises to pay you \$30 per year for the next 30 years, at which time you get your \$1,000 back. Imagine one year passes and folks buying a bond for \$1,000 are now promised \$50 per year and \$1,000 back at the end of 30 years. You hear about this and are upset, so you decide to sell your bond. Do you think folks in the market for a bond will want to pay you the full \$1,000 you paid for the bond that pays just \$30 per year? Not a chance. To compensate for the reduced income, they can expect to receive (\$30 per year versus \$50 per year), they would likely offer you \$650 to \$700 for your bond, a 30% to 35% loss on the \$1,000 you paid for your bond. This is essentially what happened at SVB.

Moreover, unlike most banks with a diversified deposit base that includes individuals of all sizes and types of businesses in different sectors, SVB's depositor base was comprised of start-up technology, venture capital firms and the like; and almost its entire depositor base was above the FDIC insurance limit of \$250,000 per account.

Combined, these characteristics of SVB caused some of their concentrated, large, uninsured depositors to start pulling their money from the bank. This forced SVB to raise capital (liquidity) to meet the withdrawals by selling bonds at losses, turning the unrealized losses on their balance sheet into realized losses, raising the question of not only liquidity risk for the bank but solvency/bankruptcy risk, leading to even more depositor flight, etc. Ultimately, the FDIC and Fed stepped in over the weekend of March 11 to take over the bank, guarantee all SVB deposits above \$250,000, and set up a broad banking system liquidity backstop (the Bank Term Funding Program (BTFP)). The BTFP allows banks to borrow from the Fed for up to a year, based on the issued face value (maturity value) of their treasury and agency MBS bonds, rather than the current (lower) market value. This new facility enables banks to meet deposit withdrawals and other liquidity needs without having to sell currently underwater bonds at a loss. As we can see in the chart below, banks have taken the Fed up on its offer, and then some.



While the banking system is not out of the woods and there may be more small-bank takeovers, it seems these steps and subsequent actions from authorities have stemmed the risk of a widespread bank-run contagion.

Investment Outlook and Portfolio Positioning

I always consider a range of macroeconomic scenarios when constructing my investment view and diversified portfolios. My approach is particularly valuable during periods of heightened uncertainty, which I would argue is the case today given the dynamics of inflation, fed policy, and stress in the banking system.

On the inflation front, while inflation likely peaked last year and has come down, it remains too high relative to the Fed's 2% long-term target. February's year-over-year core CPI inflation rate was 5.5%, while core CPE inflation – the Fed's preferred measure - clocked in at 4.6%.

While Headline CPI Has Peaked, Core Inflation Measures Remain Far Above the Fed's 2% Target



Source: U.S. Bureau of Labor Statistics and U.S. Bureau of Economic Analysis. Data as of 02/28/2023.

Given persistently high inflation, the Fed has continued its rate hiking campaign this year, although the magnitude of rate hikes has diminished.

At its March 22 FOMC meeting, the Fed hiked its federal funds policy rate by 25 basis points (0.25%) to a range of 4.75% to 5.0%. This was the Fed's ninth consecutive hike since March 2022, representing a total tightening of 475bps (4.75 percentage points). This is the most aggressive monetary policy tightening campaign since the Paul Volcker days in the early 1980s. It was inevitable something would "break" (in this case SVB and other poorly managed banks), given the magnitude and speed of the hikes.

The Fed is still hoping they can land the economy softly without causing much more damage, let alone a recession. It's not impossible, but the odds are low, and history is not on their side given the complexity of the task and the multitude of economic and behavioral variables outside of their control.

With above-normal inflation and the Fed sharply tightening, the short-term outlook for economic growth was already tepid coming into the year. Add to that the negative impact from tighter credit conditions due to the recent banking stress, and the growth outlook has gotten worse. How much worse isn't clear. But this turn of events definitely hasn't improved the chance of avoiding a recession this year.

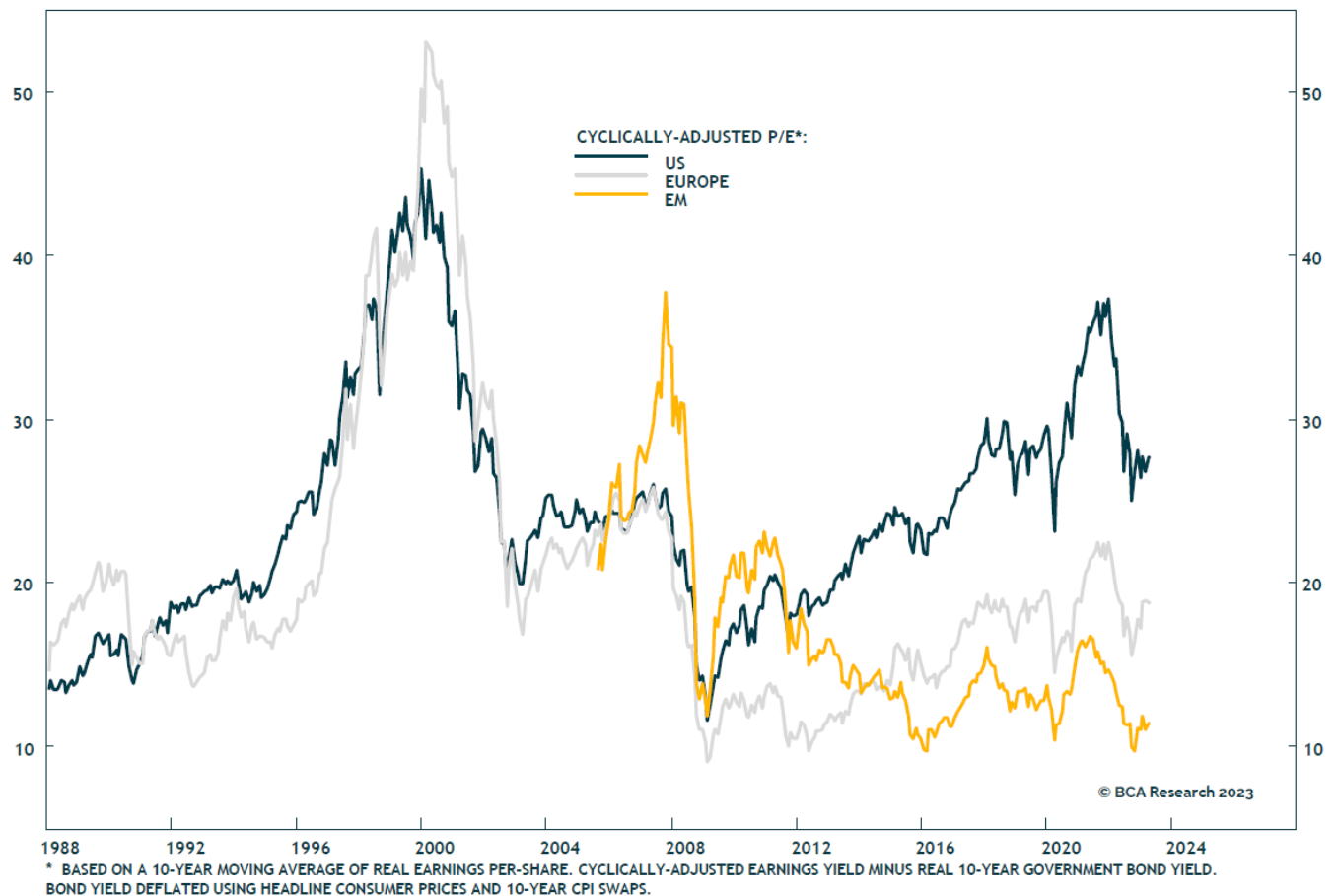
However, all is not gloom and doom for the economy. Household and business balance sheets remain healthy and supportive of continued spending. U.S. households are still sitting on an estimated \$1.4 trillion in pandemic-era savings. Employment remains robust, with a stronger than expected 311k new jobs in February, following the shockingly strong 504k jump in January. Real disposable income is rising as wage growth is now stronger than CPI inflation. Moreover, the U.S. and other major global economies appear to have grown in the first quarter of the year. So even if a recession does play out, these are all reasons to believe it may be relatively mild.

In an economic recession, it is almost certain corporate earnings will decline. S&P 500 index earnings typically decline around 15% to 20% (peak-to-trough) during economic recessions as both sales growth and profit margins compress. In a mild recession, the earnings decline might be closer to 10% to 15%.

Yet, the current consensus earnings expectations for 2023 do not reflect nearly that magnitude of decline; nor do current stock market valuations. If my base case earnings recession scenario plays out, there is a strong likelihood that the S&P 500 index will materially decline from current levels.

Longer term, my current base case five-year expected return estimates for equities is for mid- to high- single digit annualized returns over the period, which assumes a recessionary bear market happens. This is a decent but not great expected return for U.S. stocks given their risks. It is also well below my five-year return expectations for developed international and emerging markets (EM) equities of high single to low double-digit annual average returns.

Valuations for Foreign Stocks are Attractive



Between the three regions, I tactically favor Emerging Markets (EM) stocks right now, based on their higher expected returns, which are a function of what I expect will be faster sales growth and improving profit margins over the next several years. This comes after more than 10 years of stagnant EM earnings growth. I also expect some narrowing of the historically large valuation discount between EM and US indexes.

Finally, I expect the U.S. dollar to decline versus most other currencies over the medium-term, which would further add to EM and international equity returns for dollar-based (unhedged) investors. When the U.S. stock market declines to levels that offer more compelling medium-term returns and adequately discount shorter-term risks, I will look to add back exposure by selling more-defensive assets (bonds).

Speaking of defense, in addition to core bond exposure, I continue to maintain a meaningful allocation to Treasury Inflation-Protected Securities (TIPS), trend-following managed futures, gold, and hedged equity, all areas with lower correlation to the stock market. Also, there are many fixed-income sectors outside of traditional core bonds that offer attractive risk-return potential. I elect to access these more nuanced areas of the fixed income markets through actively-managed PIMCO Income fund, which counts more than 10 unique sectors amongst its significant bond holdings, including international holdings.

The goal in owning these defensive non-correlated assets is to maintain a portion of the portfolio in investments that can perform well whether the macro backdrop is deflationary, inflationary, stagflationary, or growth-oriented. Never is it more important to own these kinds of investments than when uncertainty is extreme, as is the case now. The downside of owning these types of investments is underwhelming performance during strong stock market rallies, as was the case during this past quarter, but given the still-hazy outlook for the economy and markets, my conviction in owning these strategies remains high.

Closing Thoughts

I believe 2023 will present us with some excellent long-term investment opportunities. Unfortunately, in my base case I also expect we'll first have to go through a recessionary bear market with a likely meaningful drop in global equity prices. While a recessionary bear market is my base case, I do not rule out the possibility the U.S. economy avoids recession this year, or that the recession is mild, and stocks do not drop as sharply as I expect.

A lot still depends on the Fed and how much further they tighten (raise rates). If the Fed pauses their hiking campaign sooner than later, equities may positively respond (at least over the short-term), as lower interest rates imply higher P/E multiples. But there are numerous other key variables for the economy and financial markets that are beyond the Fed's or any policymaker's control. The recession may be pushed out to 2024 but I doubt it's been rescinded.

Even with a recession as my base case near-term scenario, I currently see attractive medium-term expected returns from international and emerging markets stocks – better than what I expect from the U.S. market. As such, I have a relative overweighting to equities outside the U.S., especially for our more growth-oriented portfolios.

Fixed-income assets and high-quality bonds are also now attractively priced with mid-single digit or better expected returns, depending on duration and credit quality. Core bonds will also provide valuable portfolio ballast in the event of a recessionary bear market. My investments in alternative strategies and managed futures funds should provide further resilience to portfolios.

Best,

Kelly D. Kane, ChFC, CFP