Market Update: Q1 2023

Milton Friedman, the Nobel Laureate economist and father of monetary theory, coined the phrase 'long and variable lags' to describe the delayed effects of monetary policy. He recognized that changes in interest rates and the money supply take time to impact the economy and can do so in unexpected ways. Friedman is also credited with the Fool in the Shower metaphor to illustrate the concept - When a fool in the shower realizes that the water is too cold, they turn on the hot water. However, the hot water takes a while to arrive, so the fool simply turns the hot water up all the way, eventually scalding himself.

The Federal Reserve is keenly aware that raising rates to slow inflation will have negative effects on the economy. Some of the impacts have been predictable, and in the Fed's view, even desirable. A slowing housing market, accelerating job cuts, falling loan demand, and higher credit standards are indicators that tighter monetary policy is working... for better or worse. The Fed also understands the banking system is not immune to a slowing economy. What the Fed failed to anticipate was the 'scalding': the precipitous failure of Silicon Valley Bank (SVB) on March 10 and Signature Bank two days later.

The collapse of SVB sent shockwaves rippling through the market. Government regulators quickly intervened to shore up confidence in the banking system before panic could spread to other lenders. SVB and Signature Bank each had distinct niches and business models that made them more vulnerable to a sharp increase in interest rates. However, it was the speed of collapse that was troubling and demanded a strong, immediate response, which in our opinion, was deftly executed by the Fed and Treasury.

The rapid policy response to the bank failures appears to have calmed markets and contained possible contagion. However, the banking crisis presents the Fed with a dilemma: Continuing to raise rates might ignite further turmoil in the banking system; but a pause in rate hikes could fuel inflation. Against this backdrop the Federal Reserve implemented a .25% rate increase in late March, the lowest increase in a year.

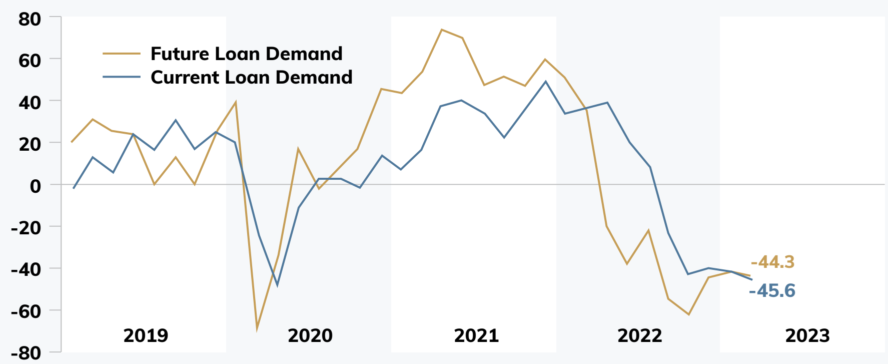
While inflation has softened in recent months, it is still well above the Fed's long-term target of 2%. The consensus belief is for another .25% rate increase in May, and then the Fed will pause to assess the impact. We agree with the consensus view; but we also believe rates will remain higher for longer while the threat of inflation persists. We do not expect the Fed to reverse course and lower rates this year. Improvement will be incremental and slow; but the U.S. economy has proven time and again to be dynamic and resilient.

Key Takeaways

- Tighter monetary policy is working... for better or worse
- The banking system is not immune to a slowing economy
- Inflation has softened, but is still well above the Fed's long-term target
- Investors flocked to a few very large, very profitable tech companies in Q1.
- In other sectors, where inflation has more of an impact on costs, earnings were broadly negative.

INDEX	Q1 2023	2022
S&P 500	7.5%	-18.1%
Russell 2000 Small Cap Index	2.7%	-20.5%
MSCI EAFE	8.5%	-14.1%
MSCI Emerging Markets	4.0%	-20.0%
Bloomberg US Agg Bond Index	3.0%	-13.0%

BANKING CONDITIONS SURVEY: CURRENT AND FUTURE LOAN DEMAND



The Federal Reserve Bank of Dallas March Banking Conditions Survey showed declining loan demand and worsening business activity. Loan volumes fell and loan non-performance increased slightly. Credit standards and terms continued to tighten. Some contacts cited waning consumer confidence from recent financial instability as a concern.

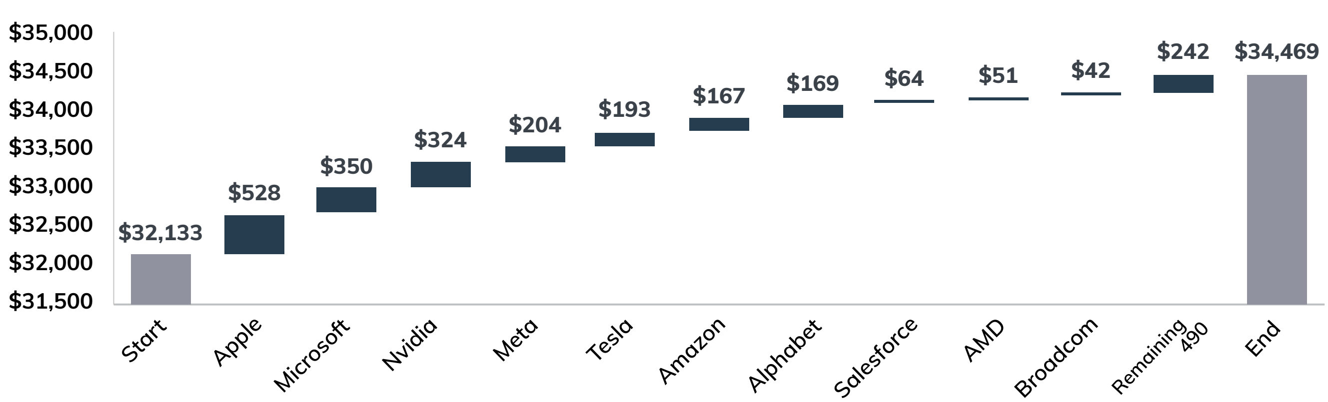
SOURCE: FEDERAL RESERVE BANK OF DALLAS

Earnings Under Pressure

The S&P 500 index traded lower as the banking turmoil unfolded, but rallied in response to the policy intervention. Stocks finished higher for the first quarter and appeared to shrug off the Fed interest rate hike in late March. Casual observers might interpret the positive performance of the stock market as growing confidence in the economy and the expectation of waning inflation. However, our friends at Strategas Research observed that just 10 stocks accounted for 90% of the gain in the S&P 500 index in the first quarter (chart below). This lack of participation is historically a bearish signal and not generally associated with a sustained rally in stocks. The stocks pulling the index higher in the first quarter were very large, very profitable technology companies. Many of the sectors that outperformed in 2022 such as Health Care, Utilities, and Energy have been lagging in 2023.

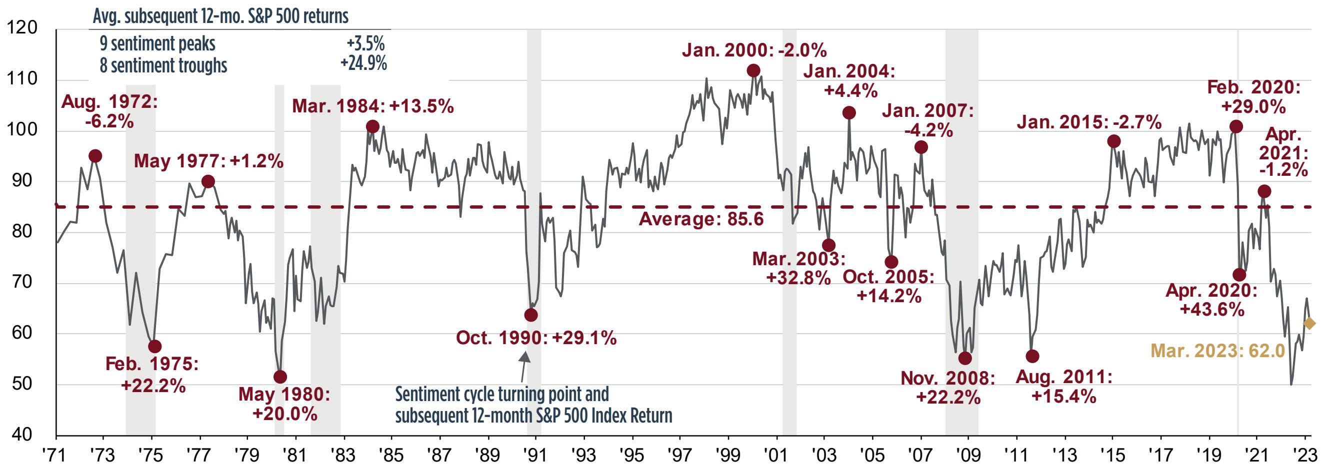
We view the market rotation away from defensive sectors as less of a demonstration of market confidence, and more an indicator of difficult earnings in the coming quarters. Large, entrenched companies with fat margins are a place to seek shelter in such an environment. This view is supported by revenue and earnings reports during the first quarter. While companies reported positive sales growth across most sectors, earnings growth was broadly negative. For the S&P 500 in the aggregate, sales growth was +5.6%, but earnings

S&P 500 YEAR TO DATE CHANGE IN MARKET CAP ($BN)



SOURCE: STRATEGAS RESEARCH

CONSUMER SENTIMENT INDEX AND SUBSEQUENT 12-MONTH S&P 500 RETURNS



SOURCE: FACTSET, STANDARD & POOR'S, UNIVERSITY OF MICHIGAN, J.P. MORGAN ASSET MANAGEMENT

growth fell -3.0%. These results suggest that sales growth failed to offset profit margin erosion. Profit margins that have been under pressure from rising input costs due to inflation, are now also challenged by softening demand. Forward-looking analyst estimates suggest lackluster sales and earnings will continue for the remainder of the year.

"What we're trying to do is we're trying to find a business with a wide and long-lasting moat around it — protecting a terrific economic castle with an honest lord in charge of the castle."

– Warren Buffett

Crisis of Confidence

A depositor run on a bank is the ultimate manifestation of a crisis of confidence. (Although, these days it's less about running and more about clicking). When the banking system is under pressure, many investors worry about systemic or structural issues in the broader financial system. In our view the current challenges are cyclical, not structural. US markets remain the global standard for transparency, efficiency and the rule of law. When confidence in US markets falls it is typically a reflection of uncertainty about the future. Right now that uncertainty stems from inflation in the economy and complexity in the global markets. Geopolitical issues also play a role, and politics has a way of amplifying fear. As in previous economic cycles, the economy and markets are adapting to new circumstances and searching for an equilibrium. At this point in the economic cycle, we should take a cue from Franklin D. Roosevelt who famously said, "the only thing we have to fear is fear itself".

At HM Payson, we do not shy away when confidence is low. As the chart above shows, many of the strongest rallies in recent market history were born out of periods of exceptionally low consumer confidence. We remain focused on our core values as investors. Those values are rooted in quality companies with consistent cash-flow, strong balance sheets and growing dividends. The focus on quality extends beyond stocks to the bonds we buy and even the money market funds we select. At present, we believe that U.S. large cap stocks represent an attractive opportunity relative to other assets classes. By featuring U.S. large cap stocks in client portfolios, we can maintain a high level of quality and profitability during a time of transition and elevated uncertainty.

We welcome your questions or comments and value the trust you have placed in HM Payson.