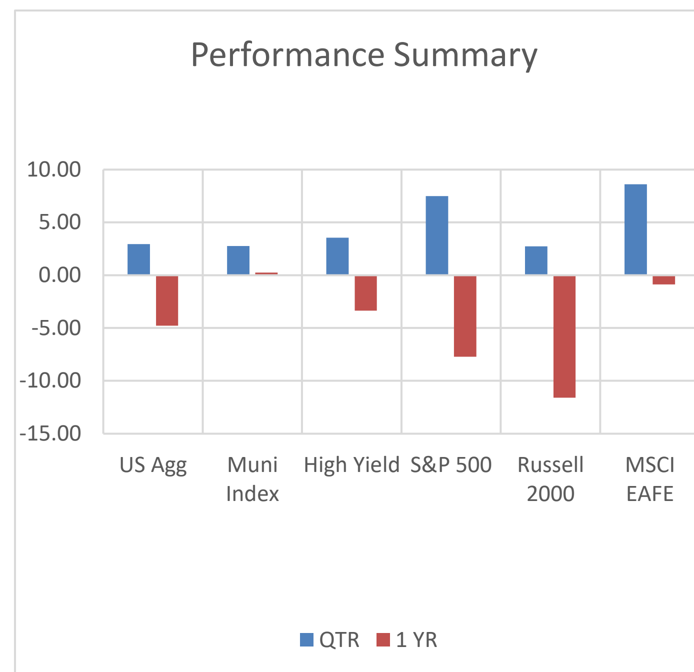
Despite the stress in the banking system, including the second-largest bank failure in U.S. history (Silicon Valley Bank), global equity markets held up remarkably well in March and posted solid returns for the quarter.



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 index returned 1%. The Nasdaq Composite surged 17%, while the Russell 2000 Small Cap Value Index dropped 0.7%. The Technology and Communications Services sectors gained 21.8% and 20.5%, respectively, while Financials and Energy lost 5.6% and 4.7%, respectively.

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).

In this quarter's commentary, we focus on: the Economic and Financial Markets Outlooks.

Economic Outlook

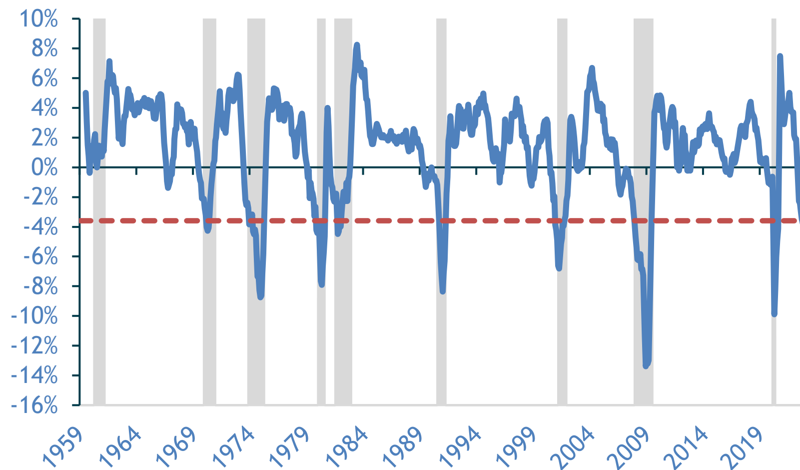
With above-normal inflation and the Fed sharply tightening, the short-term outlook for economic growth was already poor coming into the year. Add to that the negative impact of tighter credit conditions due to the recent banking stress, and the growth outlook has gotten worse. How much worse isn't clear.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

The FOMC's updated economic projections from March showed a further reduction in their GDP growth expectation for 2023, to just 0.4%. Given the first quarter's GDP growth will likely be solidly positive, this implies negative GDP growth for the rest of the year.

The FOMC left its unemployment rate forecast roughly unchanged at 4.5% for this year. If that occurs, history strongly suggests a recession is likely. Since 1950, there has *never* been an instance where the U.S. unemployment rate increased by a half percentage point or more from its cyclical low without an accompanying recession. The unemployment rate bottomed at 3.4% in January 2023 and was 3.6% in February.

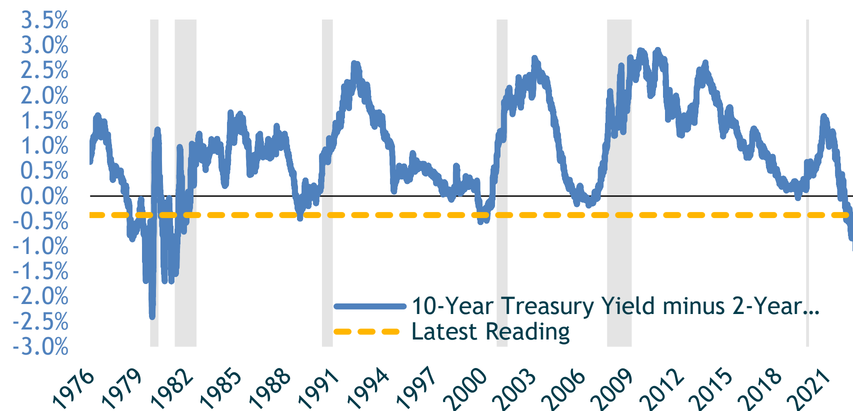
In addition, two leading indicators with long track records continue to signal a recession is coming sooner than later. The Conference Board Leading Economic Index (LEI) has declined for 11 straight months and its rate of change is clearly in recessionary territory. As we’ve said before: No economic or market-leading indicator is 100% predictive. But in terms of recession *probabilities*, based on the weight of the evidence, we believe the odds are starting to tilt in the direction of a recession sometime in the next 12 months. In the next section we discuss how the increasing odds of a recession impact our outlook for global stocks and bonds.

The U.S. Leading Economic Indicator (LEI) is Plunging, Signaling Recession is Likely



Source: Bloomberg LP. Data as of 2/28/2023.

A Sharp and Sustained Inverted Yield Curve is Another Recessionary Signal



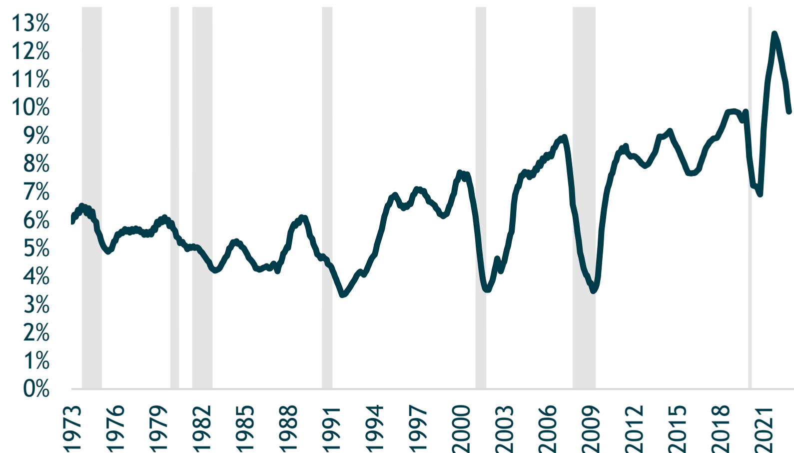
Source: Federal Reserve Bank of St. Louis. Data as of 03/24/2023.

Financial Markets Outlook

Equity markets:

In an economic recession, it is almost certain corporate earnings will decline, i.e., an "earnings recession." 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.

S&P 500 Net Margins (GAAP) Always Fall Sharply in Recessions



Source: Bloomberg LP, Standard & Poors, Robert J. Shiller. Data as of 12/31/2022.

As such, our assessment of the U.S. equity market is we do not believe current valuations are adequately discounting the likelihood and severity of an oncoming earnings recession**.** In fact, despite the recent banking turmoil, the S&P 500 is actually higher than it was at year-end. If an earnings recession scenario plays out, there is a strong likelihood that US stocks may correct, especially large-cap stocks which are the most overvalued.

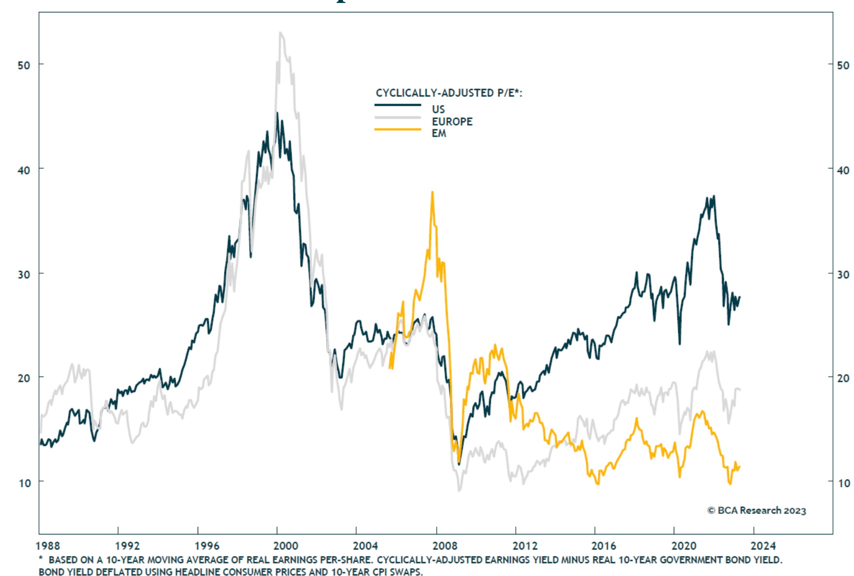
As long-term investors, it is important not to get caught up in the day-to-day noise, news headlines (almost always designed to attract attention rather than inform), and general volatility of the financial markets. This is why we look at expected returns for major asset classes over a longer time horizon and factor in a range of scenarios to account for the uncertainty. Long-term investment success requires minimizing the role of emotions in investment decisions. Emotions will lead most of us to want to chase (buy) asset classes or funds with recent strong performance and flee (sell) when prices are dropping. Put succinctly: that is buying high and selling low. While it may feel good at the moment, it's a recipe for poor long-term investment results.

Often, the best long-term investment decisions *feel* the most uncomfortable at the time you make them. That's the way financial markets work. Or, as Warren Buffett put it, "The stock market is a device for transferring money from the impatient to the patient." The near-term is always uncertain and often can be scary – there are *always* lots of things to worry about in the world. Keeping one's eyes on the medium-to-longer-term "*most likely*" outcomes is a key investment discipline.

Our expected return estimates for U.S. stocks are for mid-single-digit annualized returns over the next five years, which assumes a recessionary bear market happens at some point. This is a decent but not great expected return for U.S. stocks given their risks. It is also below our five-year return expectations for developed international and emerging markets (EM) equities of high single to low double-digit annual average returns. The higher expected returns for foreign stocks are based on some improvement in the valuation discount between EM and US indexes, see the chart below. Finally, we 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, we will look to add back exposure by selling more-defensive assets. This typically happens *during* a recession when investor pessimism and fear are widespread. Eventually, stocks bottom out and then start to rebound as investors anticipate an earnings growth recovery. And the next cycle and bull market begins.

Foreign Equities Absolute Valuations Remain Attractive and at a Deep Discount to U.S. Stocks

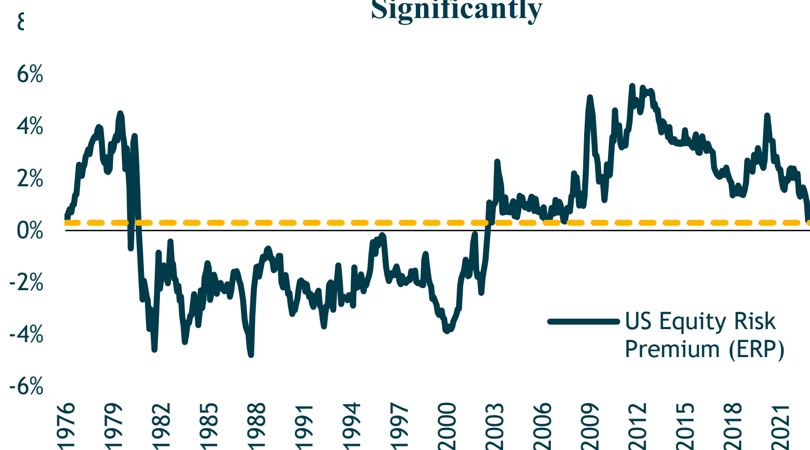


Fixed Income:

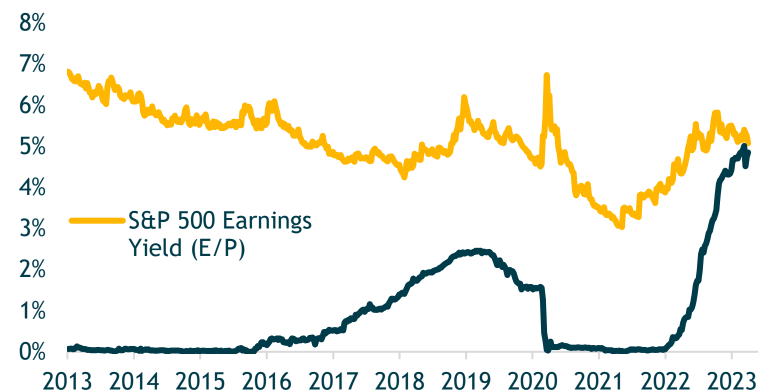
At the end of March, the yield on the core U.S. aggregate bond index was 4.4%. This is down from yields in the high 4% range but still more attractive from a risk and return perspective than they had been in years.

The *relative* valuation/attractiveness of U.S. stocks versus core bonds (known as the "equity risk premium") continues to slightly favor bonds relative to historical averages, as shown in the first chart on the next page. To revert to a more normal, i.e., higher, equity risk premium will require either a decline in equity valuations, lower bond yields, or some combination of the two.

As the Fed has continued to raise short-term interest rates, the yield premium between stocks and "cash" (short-term Treasury bills) has shrunk even further since year-end, as the second chart below shows. In general, we believe it makes sense to hold safety assets at higher than normal levels, as better opportunities to invest those assets lie ahead.



Source: Bloomberg LP and Robert J. Shiller. Data as of 3/31/2023.



Source: Bloomberg LP and Board of Governors of the Federal Reserve System. Data as of 3/31/2023.

Closing Thoughts

We believe 2023 will present us with some excellent long-term investment opportunities. However, we also believe the odds of a recession and possible correction in stocks have increased as well as uncertainty. While a recessionary bear market is possible, we do not rule out the possibility the U.S. economy avoids recession this year, or that the recession is mild. A lot still depends on the Fed and how much further they tighten (raise rates). If the Fed pauses its 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 we doubt it's been rescinded.

If you have any questions about your portfolio or investment strategy don't hesitate to give us a call.

Best regards,

Steve Giacobbe, CFA, CFP®

Asset Class		* ↔ Neutral weight ↓ Underweight ↑ Overweight
Equities	***View****	***Comments***
U.S. Large Cap	↓	Valuations for large-cap stocks have fallen but remain relatively high. Given the increasing odds of a recession we would remain underweight due to better opportunities in other asset classes and risk mitigation.
U.S. Small/Mid Cap	↔	Valuations for small-cap stocks relative to large-cap have fallen to historically low levels. However in the short-term, there may be some additional downside as the odds of a recession increase. Long-term investors should be looking for opportunities to overweight the asset class on a 3 to 5-year time horizon.
International Developed	↔	We believe the valuation of foreign stocks is attractive relative to US stocks and investors with a longer time horizon should be overweight. Foreign stocks outperformed US stocks in 2022 and we believe it may be the start of an outperformance cycle that may last several years. Keep in mind, relative performance is never a straight line, so stay patient.
Emerging Markets	↔	Valuations are attractive for the long term. Emerging markets tend to be volatile and are always susceptible to further selloffs, but over a multi-year time frame, they should outperform. Stay disciplined and keep overweight positions.

Fixed Income		
Investment Grade	↔	Interest rates have pulled back but are still relatively high, making bonds a more attractive investment option relative to stocks. At current levels, bonds should provide decent risk protection, returns, and diversification in balanced portfolios.
High-Yield Bonds	↓	We don't believe they have priced in the risk of a potential recession in 2023. We would stay on the sidelines for now and look for opportunities to buy into this asset class on further sell-offs.
Municipal Bonds	↑	With higher yields, municipal bonds continue to be attractive, especially for high tax bracket investors.
TIPS	↔	TIPs are a hedge against higher inflation, we would hold positions in tax-deferred accounts as a long-term hedge against inflation hedge.
Floating-Rate Loans	↓	Similar to HY bonds, FRLs have a significant risk in a recessionary environment. We would move to the sidelines for this asset class for now and look for better opportunities down the road.
Emerging Markets	↔	EM bonds appear attractive on a relative value basis to other global bonds. However, given the complexity of this asset class, our default is to leave it to the pros, several of our bond managers have the flexibility to add to this asset class when attractive.

Alternatives		
Absolute-Return/Alternatives	↑	We like alternative funds as a way to hedge volatility, provide real returns, and improve the risk vs reward in portfolios. We favor simple and low-cost strategies like hedged equity, real return, clean energy transition, and global macro. Over a full market cycle, they should add value to portfolios. If traditional stocks and bonds become "cheap" we would reduce our weighting in this asset class.
REITs	↓	We remain are concerned with the impact of the banking crisis will have on the commercial real estate market. We view the risk reward as slightly unfavorable and would be underweight this asset class until valuations improve.
Commodities/Gold	↔	We view exposure in this area as an effective way for long-term investors to diversify their portfolios and hedge against higher inflation. These positions can be volatile in performance but may provide some relief over a full market cycle.