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Investment Commentary

May 2023

Global and U.S. stocks delivered solid gains in April, even as headwinds persisted. Foreign-developed market stocks led the way, with close to a 3% return for the month.

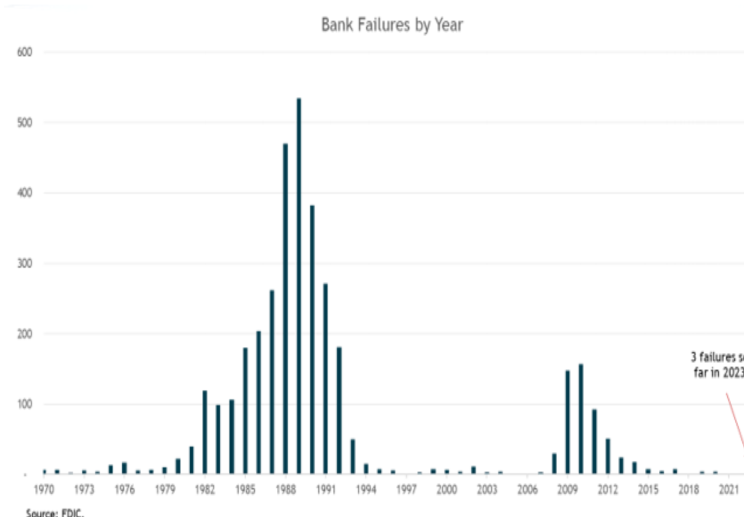
Return (%)	1 MO	3 MO	YTD	1 YR
S&P 500	1.56	2.72	9.17	2.66
Russell 2000	-1.80	-8.07	0.89	-3.65
MSCI EAFE	2.93	3.42	11.80	9.00
MSCI Emerging Markets	-1.11	-4.68	2.86	-6.09
Bloomberg U.S. Aggregate Bond	0.61	0.49	3.59	-0.43

Data as of 4/30/2023, Performance in USD. Source. Morningstar.

- Despite lingering concerns about high inflation, banking failures, growing recession risk, and Fed policy uncertainty, U.S. stocks advanced in April. Better-than-expected earnings, especially from large tech companies, helped the S&P 500 finish 1.56% higher.
- Foreign developed market stocks outperformed U.S. stocks, while emerging market stocks posted a small loss.
- U.S. economic growth slowed to an annualized pace of 1.1% in the first quarter, down from 2.6% in the fourth quarter. First-quarter economic growth in the Eurozone was nearly flat.
- Annualized headline inflation eased in March, while core inflation inched higher. The Federal Reserve raised the fed funds rate in early May to a range of 5%-5.25%. Expectations are the Fed may be pausing rate increases for now, but will remain data dependent and may increase further if future inflation data comes in higher than expected.
- U.S. Treasury yields were volatile for the month, but most bond market segments posted gains.

Bank Failures

Unlike the bank failures in March, the leadup to First Republic Bank's failure was largely shrugged off by markets. In fact, at the end of the month, the CBOE Market Volatility Index (VIX) hit its lowest level since 2021. First Republic's failure is the second largest bank failure in US history and makes it the 3rd bank to enter FDIC receivership since March. Bank failures have been relatively modest over the past decade—and even this year's failures are significantly less than the thousands of banks that failed during the Savings & Loans Crisis of the 1980s or hundreds of banks that went under in the wake of the Great Financial Crisis.



That being said, a case can be made that U.S. regional banks will continue to struggle. Implicit guarantees for depositors and the Federal Reserve's lending facilities may have helped stave off the immediate crisis, but the core problems facing banks have not been addressed: rising funding costs and lower profits, unrealized losses on existing assets, and poor lending margins on new loans. We would remain cautious about smaller regional banks in the current environment.

Market Thoughts

While the S&P 500 Index is up a strong 9.2% so far this year, the narrowness of the market has been notable. A recent Goldman Sachs report noted that 90% of the S&P 500's year-to-date return is accounted for by the largest 15 stocks. Look no further than the 5 largest tech stocks (AAPL, MSFT, GOOGL, AMZN, META) which have clocked in a return of more than 30% this year, after being down close to 40% last year. The S&P 500 Equal Weighted Index is up just 3.3% this year, nearly 600 basis points behind the S&P 500 (market cap weighted index).

The month was filled with mixed data on the economy. First quarter real GDP growth came in at 1.1%, which was below the consensus of 1.9%. It was a notable slowdown from the 2.6% GDP growth in the previous quarter. However, first quarter GDP was not a result of weak consumer spending (real personal consumption expenditures increased by 3.7% in the quarter). The drag on first-quarter GDP was declining business inventories.

Leading indicators on the economy continue to worsen. The Conference Board Leading Economic Index (LEI) declined further in its latest March reading—falling into recession territory and its lowest level since November 2020. The Conference Board "forecasts that economic weakness will intensify and spread more widely throughout the US economy over the coming months, leading to a recession starting in mid-2023." According to the Conference Board, there is a 99% probability of a recession in the next 12 months. The broader consensus view is that a recession will happen in the second half of 2023 or early next year.

The timing of a recession may impact its severity. If a recession begins this year it may be deeper than if a recession were to take place next year. This is especially the case in the near term because inflation remains well above the Fed's target level. Hence, the Fed may be more reluctant to cut interest rates in the face of a recession out of fear of inflation picking up. However, if a recession were to start next year or later, when inflation is likely to be a lot lower, there will be more room for the Fed to start cutting rates. Making any recession relatively mild. Either way, we think the odds of a recession happening have increased.

Best regards,
Steve Giacobbe, CFA, CFP®