Market Newsletter
March 31, 2023

EXECUTIVE SUMMARY

- Stocks and bonds rose in the first quarter of 2022. Commodity prices fell. In stocks, there was a reversal, as industries that fell last year did well this year and vice versa.

- The US economy is showing mixed signs with employment still strong but manufacturing, services and the real estate sectors are coming under pressure.

- The Fed has said that curbing inflation is a priority. It has used other tools than interest rates to stabilize the banking sector that came under pressure when a few banks became insolvent.

- The operating earnings of companies in the S&P 500 fell by 5% last year but are expected to increase by 11% in 2023. The forward Price Earnings multiple of the S&P 500 is higher than its 25-year average but historically it has produced a positive return when trading at this multiple.

- The recent collapse of the Silicon Valley bank has many direct and indirect lessons for investors.

Table 1: Market indices

(Returns include dividends)	**Quarter to date**	**Year to date**	**1 Year**	**3 Year Annualized**	**5 Year Annualized**
S&P 500	7.50%	7.50%	-7.73%	18.60%	11.19%
S&P Mid Cap 400	3.81%	3.81%	-5.12%	22.10%	7.67%
S&P Small Cap 600	2.57%	2.57%	-9.70%	21.71%	6.30%
MSCI Emerging Markets	4.0%	4.02%	-10.30%	8.23%	-0.53%
MSCI EAFE	8.62%	8.62%	-0.86%	13.52%	4.03%
Vanguard Total Bond Market Index (VBMFX)	3.13%	3.13%	-4.83%	-2.88%	0.82%
Investment Grade Credit (C0A0)	2.80%	2.80%	-5.78%	-0.49%	1.54%
Non-Investment Grade Credit (H0A0)	2.80%	2.80%	-4.42%	5.53%	2.87%
Bloomberg Commodity Index Total Return	-5.36%	-5.36%	-12.49%	20.82%	5.36%
Dollar Index (DXY)	-0.98%	-0.98%	4.27%	1.15%	2.64%
10 Yr. Rate	3.49% 03/31/2023	3.49% 12/31/2022	2.33% 03/31/2022	2.41% 03/31/2019	2.40% 03/31/2017

Source: S&P Dow Jones, ml.com, MSCI.com, Morningstar, Bloomberg, Yahoo Finance

Table 2: Recent Major US Economic Releases (These indicators have a significant impact on the stock market)

As of 04/07/2023			
	Latest Release	Recent Trend	Notes
Non-Farm Employment	236,000	Positive	Employment continues to be strong and the unemployment rate is a low 3.5%. More people are looking for jobs as reflected in the relatively high labor participation of 62.6%
Weekly Claims for Unemployment Insurance	228,000	Positive	Claims continue to be relatively low. However, the labor department revised some previous numbers, which now show that cracks are emerging in the employment situation.
ISM Manufacturing Index (over 50 indicates growth)	46.3	Negative	US manufacturing activity is at three year lows hurt by rising interest rates. All underlying components of the index were below 50, a level indicating contraction. This points to a possibility of a recession at least in the manufacturing sector.
ISM Non Manufacturing Index (Over 50 indicates growth)	51.22	Negative	Like the manufacturing sector, the services sector is slowing down significantly. The index is still above 50, which indicates that it is still growing but at a much lower rate that in previous months. On the bright side, services inflation is cooling.

	Latest Release	Recent Trend	Notes
Consumer Prices (Month over month change)	0.4%	Positive	Consumer inflation was 6% over the last year- 5.5% excluding volatile food and energy prices. Inflation has continued to fall from the high set in the middle of last year, when yearly inflation was over 9%.
Producer Prices (Month over month change)	-0.1%	Positive	Like consumer price inflation, producer price inflation has dropped from the high set last year. The latest year-over-year reading was 4.6%, a significant drop from the 11.6% set last year.
Retail Sales (Month over month change)	-0.4%	Positive	Although headline retail sales dropped last month, underlying components show positive momentum. Core retail sales increased 0.5% last month. Inflation continued to weigh on consumer expenditure.
Consumer Confidence (Conference Board)	104.2	Positive	Despite turmoil in the banking sector and expectation of recession, consumer confidence is holding up well.
Durable Goods Orders (Month over month change)	-1%	Negative	Total demand for durable goods fell in the first quarter. However, in the most recent release, core capital goods sale, which excludes aircraft and military sales, showed resilience.
Industrial Production (Month over month change)	0%	Positive	Although overall industrial production was flat recently, factory output (which excludes mining and utilities) rose following a similar rise the previous month.
Capacity Utilization	77.6%	Positive	Capacity utilization continued to ease off
Housing Starts	1.45 Million	Negative	After five consecutive months of drops, housing starts rose recently. It is still down more than 18% from a year ago. High mortgage rates have dampened home construction activity.
Home Prices (Case-Shiller Home Price Index- Year over Year)	3.8%	Negative	Home prices are up from a year ago, however they have been falling from the middle of last year.
GDP (Real, Annualized)	2.6%	Positive	Gross domestic product is expected to have grown in the fourth quarter of 2022. But a tight labor market, high interest rates and turmoil in the banking sector is expected to negatively impact GDP this year.

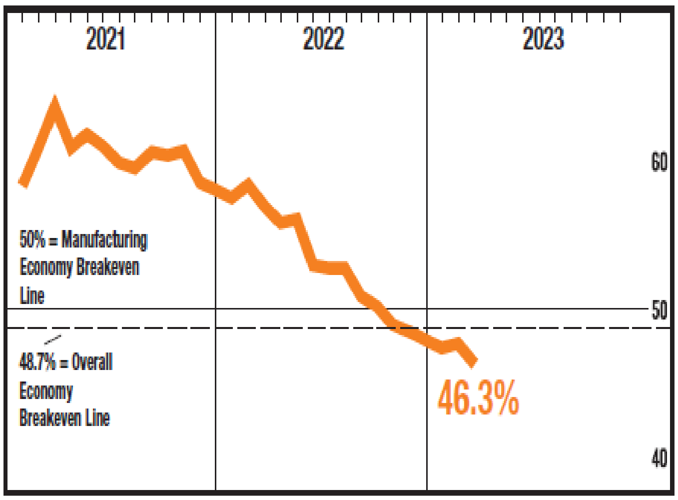
Source: Bloomberg, www.federalreserve.gov, www.bls.gov, www.ismword.org, www.nahb.org

Global stocks of all kinds rose in the first quarter of the year, continuing the rally that started in the last quarter. Interest rates fell and global bonds rose in response (Prices of bonds are inversely related to the interest rates). Within stocks, there was a reversal of performance from last year as stocks of companies in the defensive industries such as utilities and healthcare underperformed, while those in high growth sectors such as technology and consumer discretionary outperformed. In particular, the 10 largest stocks in the S&P 500 were responsible for 90% of the performance in the quarter. Foreign stocks, especially those of developed countries, continued their outperformance. Commodity prices continued to fall.

The US economy is sending mixed signals regarding its health as seen in the table above. Manufacturing and housing are showing clear signs of stress while the services sector is still expanding, although at a significantly lower level than in the recent past. The US employment situation is still strong, and employers continue to hire, although cracks are beginning to appear as evidenced by layoffs from some large firms. Despite all the negativity, the US Gross Domestic Product (GDP- a measure of the economic output of the country) grew by a little over 2% in 2022 and is expected to grow marginally in 2023.

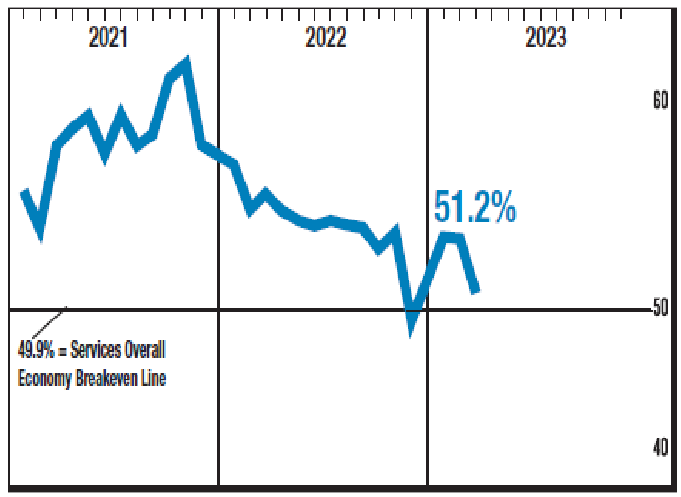
Earlier in the quarter the 'economic mantra' changed from 'hard landing' (A deep recession is expected) or 'soft landing' (A relatively mild recession is expected) to 'no landing' (No recession is expected). The optimistic expectation was based on falling inflation and the hope that the Federal Reserve (The Fed) would pause its interest rate hiking campaign and could even start cutting interest rates towards the end of the year. That changed in March with the turmoil in the banking sector.

Fig 1: ISM Manufacturing Index



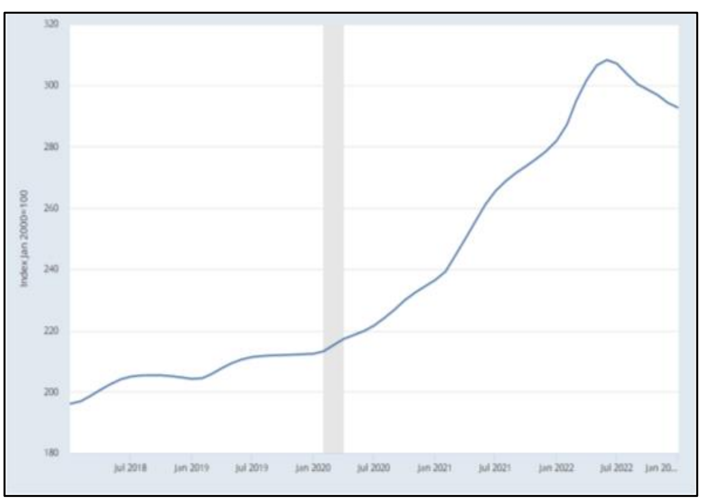
Source: *Institute of Supply Management*

Fig 2: ISM Non-Manufacturing Index



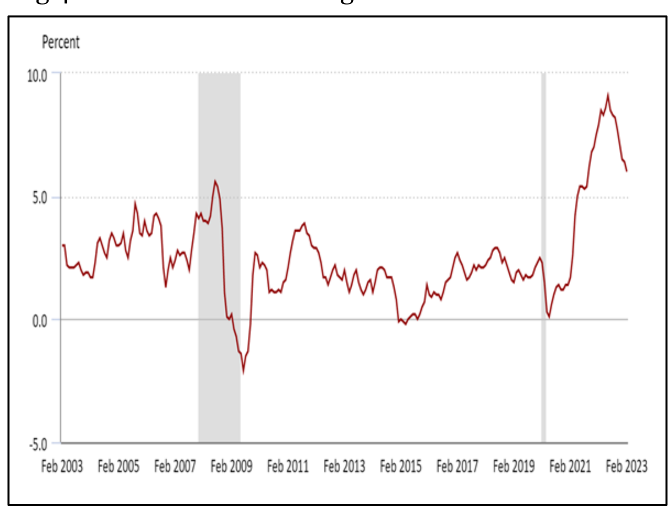
Source: Institute of Supply Management

Fig 3: Case Shiller Home Price Index



Source: Federal Reserve of St Louis

Fig 4: CPI: Inflation is falling.



Source: US Bureau of Labor Statistics

A few relatively small banks had undiversified and mismatched assets and liabilities. For eg Silicon Valley Bank, the largest of the banks in the news, was predominantly catering to tech start-ups and used the deposits from clients to buy long term US Treasuries, which fell when interest rates rose. When depositors lost confidence in the bank, they started withdrawing their deposits all at once, requiring the bank to sell the treasuries at a steep loss. The bank became insolvent and was seized by the Federal Deposit Insurance Corporation, the US government entity that offers insurance to depositors. The Fed continues to be razor focused in bringing inflation down to an acceptable level (2% excluding prices of food and energy- its preferred indicator being the Personal Consumption Expenditure index) and has lived up to the expectation that 'it raises rates until something breaks', as cracks have emerged in the banking sector. The Fed has always said that the cost of curbing inflation would be high but less than the eventual cost of letting inflation run lose. Apart from its dual mandate of price stability and full employment, the Fed has an unsaid mandate of financial stability, and in line with this, it joined forces with the Treasury department to stabilize the banking sector with an expanded deposit insurance (FDIC) and lines of credit to help the troubled banks. The hope was that in a further attempt to stabilize the banking sector, the Fed could pause hiking interest rates or even cut it, however, in the latest press conference, Fed Chair Jerome Powell said that bringing inflation down continues to be a focus and he did not expect to cut rates in 2023.

The economic situation outside the US is mixed as seen in Fig 5. Inflation and rising interest rates have resulted in a contraction of the GDP of many countries, while some like Canada and Japan have avoided a slowdown.

Fig 5: Quarterly GDP growth rates G-7 countries

GDP G7 countries	1Q 2023*	4Q 2022	3Q 2022	2Q 2022	1Q 2022	4Q 2021
Canada	0.0%	0.0%	0.6%	0.9%	0.6%	1.7%
France	-0.2%	0.1%	0.2%	0.5%	-0.2%	0.6%
Germany	-0.4%	-0.4%	0.5%	0.1%	0.8%	0.0%
Italy	-0.3%	-0.1%	0.4%	1.0%	0.1%	0.9%
Japan	0.4%	0.0%	-0.3%	1.2%	-0.5%	1.1%
United Kingdom	-0.3%	0.0%	-0.2%	0.1%	0.5%	1.5%
United States	0.2%	0.7%	0.8%	-0.1%	-0.4%	1.7%

Source: Charles Schwab

Revenue per share of companies in the S&P 500 grew by over 11% in 2022 but high inflation and labor costs depressed margins. As a result, the operating earnings per share fell by a little over 5% last year. For 2023, analysts expect operating earnings to grow by 11%, however they have been reducing their estimates since the beginning of the year and are expected to continue doing so. Using forecasted earnings, the Price/Earnings multiple (P/E-A measure of how expensive or cheap stocks are- lower means cheaper) of the S&P 500 is 17.8, which is higher than the 25-year average of 16.8. Historically, when stocks in the S&P have traded at this P/E, it has produced positive performance over the next 1 and 5 years.

The collapse of the Silicon Valley Bank- lessons for investors

The recent collapse of the Silicon Valley Bank (SVB) has taught many lessons for investors. A direct lesson is to ensure that your cash is deposited in a bank with a solid foundation and is adequately protected by the FDIC insurance. See an article here on how the FDIC insurance works when a bank declares bankruptcy. A second direct lesson is to do your due diligence before reaching out for yield and depositing your cash in banks that offer a high interest rate. Some of these banks offering a relatively higher yield may have doubtful fundamentals.

In addition, the operations of the bank and its eventual demise has several indirect lessons for investors:

The importance of diversification: SVB did not diversify its assets or its liabilities. It predominantly worked with Silicon Valley startups and venture capital firms and grew remarkably during the pandemic when these firms were flush with cash and deposited large amounts of money. It invested a vast majority of these deposits and primarily invested in longer term US treasury securities and did not diversify its assets.

The need to invest based on your objectives and not based solely on the attractiveness of the asset class: The long-term US treasuries that SVB bought were very sound investments with almost zero probability of loss through maturity. However, they were not a suitable match for the bank's liabilities i.e. the deposits by the kinds of clients (Technology startups) that SVB worked with, who as it turns out, had a much shorter duration than the US Treasuries the bank bought.

The importance of time in any investment decision: In investing, time is the most underappreciated factor for success and so it was with SVB. Long term US treasuries are a very safe asset class but only if they are held to maturity. Before maturity, their performance depends on the time to maturity especially when interest rates are rising.

Not understanding different kinds of risk: Long term US treasuries have the full faith and credit of the US Government. This is why they are often called 'risk free' assets. Risk in this context is credit risk i.e the risk of default by the borrower (The US Government). However, long term US treasuries have non-negligible and material interest rate risk, that is the sensitivity of these instruments to the direction of interest rates before maturity. While the bank was lulled into complacency by the negligible credit risk, it was blindsided by the considerable interest rate risk that the asset class posed.