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WEALTH MANAGEMENT

Newsletter

April 18, 2023

Executive Summary

We all want to know where we stand in the current market cycle. Are we firmly in recovery, or will we retest the October lows?

The outlook is particularly uncertain right now. Analysts and experts are evenly split over whether the recession will produce a hard or soft landing.

However, they agree that the Fed's interest rate cycle is at a peak and interest rates may start to come down later this year. This is important for investors. It may be your last chance to secure higher interest rates for a while.

The Fed's policy has caused the current banking crisis as customers liquidate deposits in seeking higher interest rates. This, too, will pass.

Stay alert, balanced, and conservative.

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Market Data as of March 31, 2023

		YTD 2023
US Equities	S&P 500 ETF	7.48%
International Equities	MSCI EAFE ETF	8.56%
Emerging Markets Equities	MSCI Emerging Mkts ETF	4.12%
US Bond Market	iShares US Core Bond ETF	3.13%
Commodities	S&P GSCI Comm ETF	-5.21%
Real Estate	iShares US Real Estate ETF	1.46%

Where Are We in This Market Cycle?

As investors, we all want to know where we stand in the current market cycle. ***Did we hit bottom last October? Are we firmly in recovery, or will we retest the October lows?*** These are all critical questions, and there are no clear answers. I believe the outlook is especially uncertain right now.

Here is what we do know. The last stock market peak was on January 12, 2022. The last trough was on October 12, 2022. We have been in recovery mode since that time.

S&P 500 Index

Peak	January 12, 2022	4,726.35	
Trough	October 12, 2022	3,577.03	-24.32%
Recovery (so far)	April 12, 2023	4,091.95	+14.40%

SPDR Bloomberg US Aggregate Bond Index

Peak	January 12, 2022	109.19	
Trough	October 12, 2022	91.99	-15.74%
Recovery (so far)	April 12, 2023	97.03	+5.48%

The stock market was down 24% last year for the 10-month period from January through October. If October turns out to be the low point, this bear market was about average. The average bear market drops 29% over 12 months. It would end up being the fourth worst bear market in the post-WWII era – assuming it's over.

The bond market had its worst year on record last year. Unfortunately, when the Fed rapidly raised rates, the price of existing bonds collapsed. This is why last year was so difficult for investors. Normally, during a bear market in stocks, bonds tend to hold their value and help soften the blow. That didn't happen this time. Nothing worked last year.

Will the markets move down again this year, or are we finished? Let's look at some of the risks we currently face.

Recessionary Risks

We look to be heading into a recession (or we are in one already). ***Leading economic indicators have moved down for 11 straight months,*** and the yield curve has been inverted for some time. Also, the Federal Reserve has been raising interest rates since March 2022. ***It takes an average of 9-12 months for the economy to slow down after the Fed raises interest rates.*** That is exactly where we are right now. The economy is poised to weaken.

But while there are strong recessionary signals, the economy is not yet showing signs of overwhelming stress. There has been no hard landing yet. But why?

Schwab's chief investment strategist, Liz Ann Sonders, believes ***we are currently in a "rolling recession."*** According to Sonders, different sectors of the economy have been, or will be, in recession at different times. This is because of the pandemic. When the pandemic hit, the demand for certain goods collapsed. When restrictions were lifted, demand soared and then cooled again. The demand for certain services increased during the pandemic. When restrictions were lifted, demand cooled and then heated up again.

The point here is that the demand for goods and services in different sectors is moving independently instead of in a synchronized fashion. ***This may explain why the overall economy does not seem to be in a recession, even though we know certain segments of the economy are struggling.***

If we are currently in recession, it is a shallow one so far. Many analysts, including Sonders, advise caution. There is a chance the recession may deepen in the next six months and then lift late in the year. The outlook is uncertain.

Economic Activity vs. Asset Prices

While we nervously look at economic data, it is important to acknowledge that asset prices (e.g., the prices of stocks and bonds) can move independently of the economy.

For example, just because the economy is heading into a recession does not necessarily mean that stocks will retest the October lows. Certainly, economic activity and asset prices are correlated, but not as perfectly as many investors believe. ***Stock prices are forward-looking. Most economic data is backward-looking.*** Historically, the stock market declines in advance of a recession and recovers before the recession ends.

So, is a recession priced into today's stock and bond prices? Analysts are split. Some think that the market has priced in most of the pain. Others believe we may retest the October lows at some point in the next few months. ***Most agree things will improve later in the year.*** Given the uncertainty, we should be cautious.

The Interest Rate Cycle Has Likely Peaked

Most analysts agree that the Fed's rate tightening cycle is at an end. Many predict one more rate increase in May and then a pause. ***Many believe the Fed will actually lower rates later in the year to stimulate economic growth.*** Of course, this depends on inflation. If inflation continues to come down slowly, the Fed will be able to stop raising rates. If inflation starts to increase again, the Fed may have to raise rates further.

This is important for investors. If you are looking to get a good return on fixed income investments or have cash that you want to earn more interest, ***this may be your last chance to get higher rates for a while.*** Rates will likely be coming down soon. Consider adding some duration to your portfolio or investing in a good bond fund.

The Banking Crisis and Fed Interest Rate Policy

Over the past 12 months, the Fed has aggressively raised interest rates to combat inflation. This policy has many consequences, intended and unintended. Inflation seems to be coming down gradually, which is what the Fed wants.

Turmoil in the banking sector is an unintended consequence of the Fed's rate policy. As the Fed has raised interest rates, bank customers were still only paid a very small amount of interest on their cash deposits. However, the rates on Treasury obligations and money market funds increased with Fed policy. ***As a result, bank customers have withdrawn trillions in cash bank deposits to invest in higher-paying Treasury bonds and money market funds.***

As cash deposits leave banks, banks have to scramble to create liquidity to meet withdrawals. That has put a lot of pressure on smaller regional banks that do not have to hold as much liquidity as the huge money center banks.

As the flow of deposits out of banks increased, something finally broke. Silicon Valley Bank needed to create liquidity to meet depositor demand, but it did not want to sell long-term government bonds at a loss to create that liquidity. The bank sought additional capital in the market. Rumors swirled on social media, and in only four hours, $42 billion of deposits fled the bank. The next day, half of the bank's deposits were withdrawn.

This surprised regulators. ***They underestimated how quickly a bank run can take place given today's technology. Today, moving money is as simple as reaching for your mobile phone.*** Making matters worse was the fact that most of the bank's customers were Silicon Valley start-up firms that had millions of uninsured deposits at the bank. Instead of risking loss, customers simply moved money from Silicon Valley Bank into the large money center banks.

The point here is that trillions of dollars have been flowing out of low-paying bank deposits into higher-paying Treasury bonds and money market funds. This was an unintended consequence of the Fed's interest rate policy.

It is important to note that ***the current banking crisis is a liquidity problem, not a solvency problem***. Back in the 2007-09 financial crisis, banks made poor investments in real estate and collateralized debt obligations. This was a solvency crisis. Today, banks seem to be holding high-quality investments (like long-term Treasury bonds); they just don't want to sell them at a loss to meet depositor demands. This is a liquidity crisis. In response, the Fed has created a special lending facility to help these banks meet

depositor demands. In my view, you would much rather have a liquidity crisis than a solvency crisis in the banking sector.

It is also important to note that to conserve cash, many of these regional banks are pulling back on lending. This is an important source of capital for small-and medium-sized businesses. ***When credit is less available, this is often a precursor of a recession.*** While things appear to have settled down, additional runs on deposits are still a possibility. It's a crisis of confidence that will eventually pass.

Potential Debt Crisis

The federal government has reached its debt limit. The debt limit needs to be raised, or the government will be unable to meet its obligations to debt holders – a potential default. Any threatened or actual default would, in my view, be extremely disruptive to global financial markets.

Some sort of political solution will have to be found. I expect this drama to unfold over the summer. ***I believe a deal will be struck, but the potential for political drama and market volatility is very real.***

Recommendations

As discussed, there are a lot of unknowns right now, and the bulls and bears have equally compelling cases.

The ***bulls*** believe that stock and bond prices are in recovery mode and will stay there. Recessionary risks have been priced in. The recession seems to be rolling through different market segments. The economy lands softly. Banking sector fears are contained. The Fed pauses further rate increases. A political solution to the debt crisis is reached early this summer.

The ***bears*** believe that recessionary risks will deepen, and the economy will land hard. Corporate earnings will slump, causing stock prices to fall back to October lows. Inflation rises again, and the Fed raises rates further, which hurts economic growth. The banking sector remains unstable with several more failures. There is a debt crisis this summer.

Although there are many unknowns right now, here are some recommendations:

1. ***Stay diversified*** **–** With so many risks present, diversify your portfolio so that no one investment can tank your portfolio.

2. ***Stay disciplined*** **–** Resist the temptation to go to cash or to try and pick home run investments based on forecasts or guesses as to what may happen. Avoid speculative investments. Rebalance your asset allocation.

3. ***Stay conservative*** **–** Balance your investments between growth and value stocks at companies with established profitability. On the fixed income side, stay high in credit quality.

4. ***Stay patient*** **–** These risks will pass and then be replaced by others. It appears we are at the tail end of a bear market and are currently heading into a recession. This is usually a good time to stay on course.

5. Look for opportunities to ***take advantage of higher interest rates*** that may come down soon. If you have large cash balances, consider putting that cash to work in relatively safe Treasury bonds or higher-yielding money market funds.

6. ***Make sure that all your bank accounts are under FDIC insurance limits.*** Have an emergency plan and a secondary banking relationship that you can use if your bank has a problem and the FDIC needs a week or two to give you access to your money.

If you have questions about your portfolio or your long-term financial plan, give us a call.

Thank you.

D. Austin Lewis

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