As we near the end of the second quarter, we take a look at the macroeconomic backdrop, the next Fed move, and what we think this means for the remainder of 2023.

Recap: 1st Quarter 2023

The primary theme was the banking sector meltdown triggered by the failure of Silicon Valley Bank. Despite the resulting spike in bank stock volatility, global stocks still gained handily as the bulls triumphed over the bears with growth outperforming its value counterparts by 10x on average during the quarter. In bonds, government yields fell while credit spreads, despite dipping intra quarter, came in 5 basis points wider at quarter end. The *S&P 500 Index* rose +7.5% while WTI Crude Oil fell -6.0% to just under $76/barrel.

All eyes remain on the Federal Reserve and how it might respond after signaling a possible pause to its hiking cycle for the rest of the year. GDP and inflation are showing signs of softening while the labor market remains tight elevating expectations for a recession at some point in 2023 or early 2024.

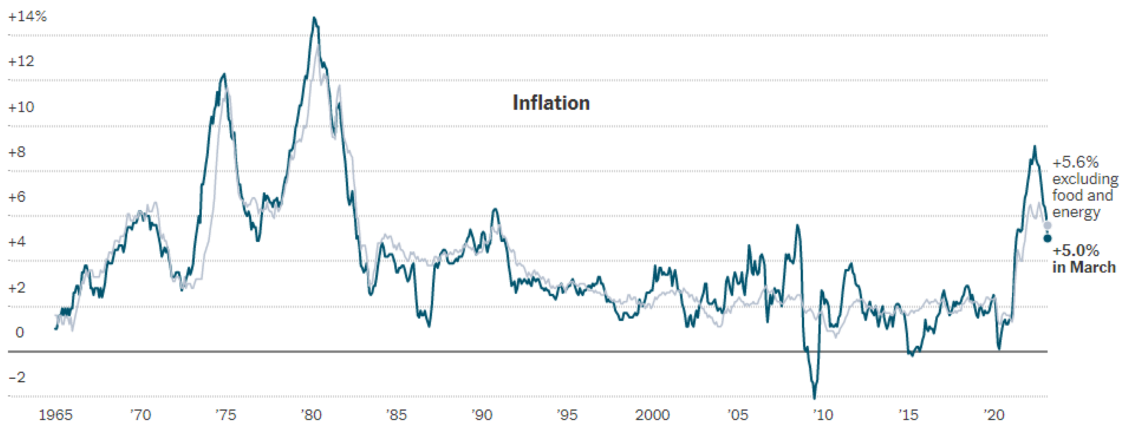
Macroeconomic

The war in Ukraine has had a significant impact on the global economy, causing energy prices to soar while also disrupting trade flows. The IMF has downgraded its growth forecast for 2023, citing the war as a major factor. Central banks around the world have raised rates to combat inflation sitting at multi decade highs. Higher rates are making it more expensive for businesses to borrow money leading to signs of slower business investment and hiring. Further, supply chains are still recovering from widespread disruptions from the pandemic. These disruptions are still being felt in many parts of the world making it more difficult and expensive for businesses to get needed goods and materials leading to higher prices and slower production.

Labor
The labor market remained strong with an average of 355,000 jobs added per month during the quarter (517,000 in January, 311,000 in February, and 236,000 in March). As a result, the unemployment rate stayed in a historically tight range ending the quarter at 3.5%. The strength of the labor market and its impact on the outlook for future inflation led the Fed to increase the federal funds rate by 25 basis points at each meeting in February and March. The smaller rate hikes alleviated investor concerns over more aggressive 50 basis point hikes once on the table.

GDP
Economic growth, as measured by the Gross Domestic Product (GDP) index, came in at 1.1% on an annualized basis and below the 2.0% estimate for the quarter. Given higher economic costs for goods and financing, impacts on consumer confidence and spending has not shown to be overtly negative thus far. However, there are indications of average credit card balances and late payment rates beginning to rise. Consumer Confidence numbers are important as consumer spending contributes almost 70% to domestic economic growth. With the lagged impact of interest rate hikes, several are projecting a meaningful slowdown, and more likely a recession.

Inflation
The March inflation data showed inflationary pressures easing to the lowest levels in nearly two years but these levels are still above average and are likely to keep the door open for more rate hikes. The CPI, a closely watched gauge measuring what consumers pay for goods and services, rose by +5% in March, compared to a year earlier, after being down from +6% in February. According to the minutes released last week from the March Fed meeting, officials have signaled the possibility of raising rates again in May, despite the higher likelihood of a recession later in the year. The Federal Reserve’s target for inflation over the long-term is 2% with it remaining well above this target.



Year-over-year percentage change in the Consumer Price Index • Source: Bureau of Labor Statistics • By Lazaro Gamio

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Equities

The short-lived market turbulence following the collapse of Silicon Valley Bank ("SVB") in March did not prevent investor optimism from leading stocks higher by the end of the quarter.

In U.S. stocks, a departure from the last few quarters, all market capitalizations and styles were positive on an absolute basis with the expectation of small cap value. Growth was the best performer with the information technology sector being the largest contributor by a wide margin. Mega cap growth companies, such as Apple, Microsoft, Alphabet and Amazon, accounted for a majority of the returns resulting in the narrowest market leadership since the early 2000s dot-com collapse. Energy and health care sector stocks were the worst performers.
As the failure of SVB reverberated across Europe, causing stocks to dip sharply, the financial sector largely shrugged off the events as investors concluded systemic risk was minimal.

Large cap growth, as shown by the *Russell 1000 Growth Index* +14.4%, was the best performer followed by mid cap growth (*Russell Mid Cap Growth Index* +9.1%) and small cap growth (*Russell 2000 Growth Index* +6.1%) for the quarter. Value underperformed its growth peers with large cap value (*Russell 1000 Value Index* +1.0%), mid cap value (*Russell Mid Cap Value Index* +1.3%) and small cap value (*Russell 2000 Value Index* -0.7%) barely making it into positive territory.

International stocks ended in positive territory with developed markets (*MSCI EAFE Index* +8.5%) outperforming emerging markets (*MSCI Emerging Markets Index* +4.0%) with similar style dispersion as its U.S. peers (*MSCI EAFE Growth Index* +11.1% versus *MSCI EAFE Value Index* +5.9%).

Returns (%) as of 3.31.23			Trailing (Annualized)		
	March	QTD	1-Yr	3-Yrs	5-Yrs
U.S. Large Cap Equity					
Russell 1000 Growth Index	6.8	14.4	-10.9	18.6	13.7
Russell 1000 Value Index	-0.5	1.0	-5.9	17.9	7.5
U.S. Mid Cap Equity					
Russell Mid Cap Growth Index	1.4	9.1	-8.5	15.2	9.1
Russell Mid Cap Value Index	-3.1	1.3	-9.2	20.7	6.5
U.S. Small Cap Equity					
Russell 2000 Growth Index	-2.5	6.1	-10.6	13.4	4.3
Russell 2000 Value Index	-7.2	-0.7	-13.0	21.0	4.5
International & Emerging Market Equity					
MSCI EAFE Index	2.5	8.5	-1.4	13.0	3.5
MSCI EAFE Growth Index	5.3	11.1	-2.8	10.9	4.9
MSCI EAFE Value Index	-0.3	5.9	-0.3	14.6	1.7
MSCI Emerging Markets Index	3.0	4.0	-10.7	7.8	-0.9
MSCI ACWI ex. U.S. Small Cap	0.2	4.7	-10.4	15.0	1.7

[1] Source: Morningstar (all ex. blended)

Fixed Income

Coming off of the worst year for bonds since the Great Depression, and by far the worst year for the major bond indices since the early 1970s, there were some bright spots for the asset class.

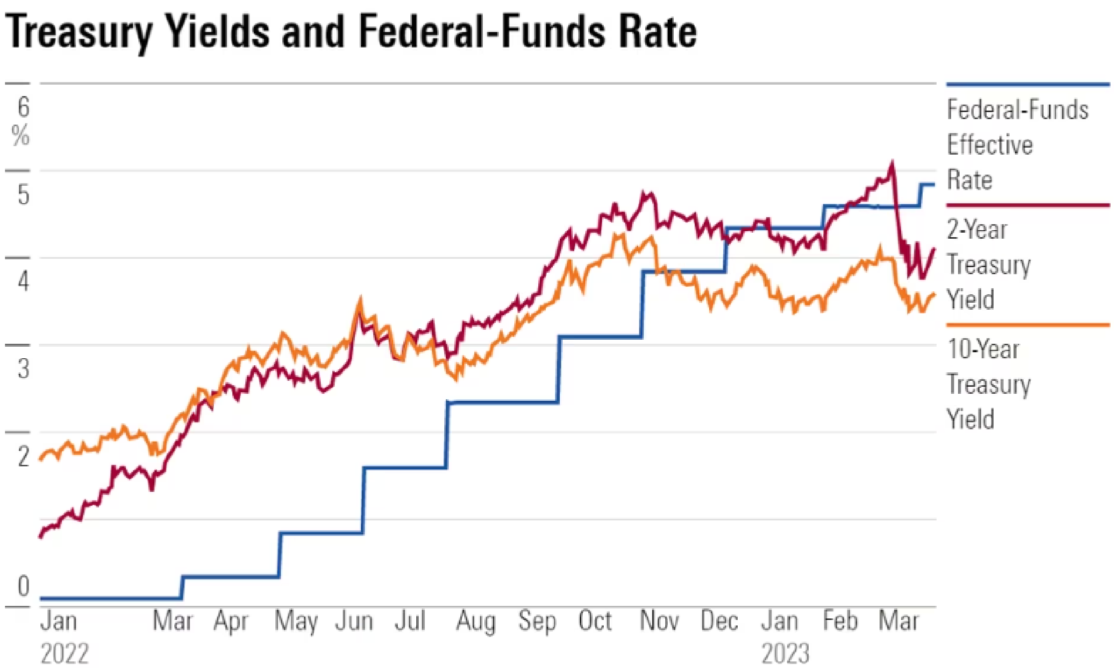
As bond yields fell, the *Bloomberg US Aggregate Index* was up +2.5% for March and up +3.0% during the quarter. Investors shifted from a narrative of a "higher for longer" fed funds rate to repricing the Federal Reserve's interest rate trajectory, due to banking sector concerns, near quarter's end.

From a corporate bond perspective, credit spreads were mixed as high-yield spreads tightened while investment-grade spreads widened as shown by the *Bloomberg US Intermediate Credit Index* +2.5% and *BofA US High Yield Credit Index* +3.7%. Longer maturity bonds were the top-performers with the *Bloomberg US Long Credit Index* +5.4%

(Note: Credit spreads are the compensation investors receive, i.e., higher rate, for not owning risk-free government bonds. A higher spread is deemed as more risky than a bond with a lower spread on a relative basis. When a spread widens, the market is saying a bond or a sector of bonds now has more risk of default based on forward-

looking prospects. These prospects can relate to a specific company, the bond market as a whole, or overall deteriorating economic conditions and vice-versa as spreads tighten.)

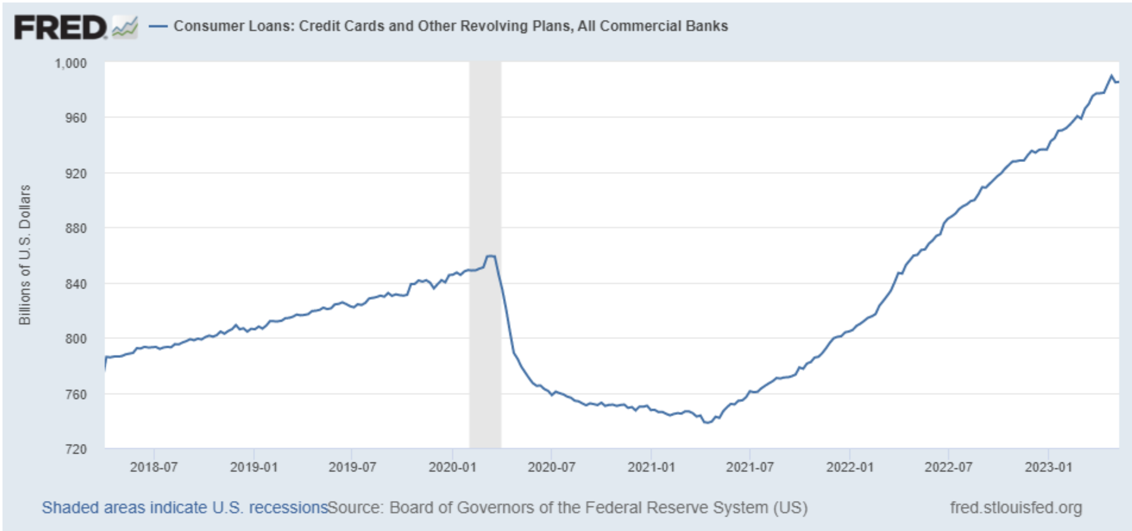
From an international standpoint, US dollar-denominated emerging market (EM) bond spreads widened while EM local-currency (non-US dollar) yields fell. The US dollar weakened versus EM currencies but strengthened versus some developed market currencies. This is evident in the performance of the *JP Morgan EMBI Global Diversified Index (USD denominated)* +1.9% and *JP Morgan EMBI Global Diversified Index* +5.2%.



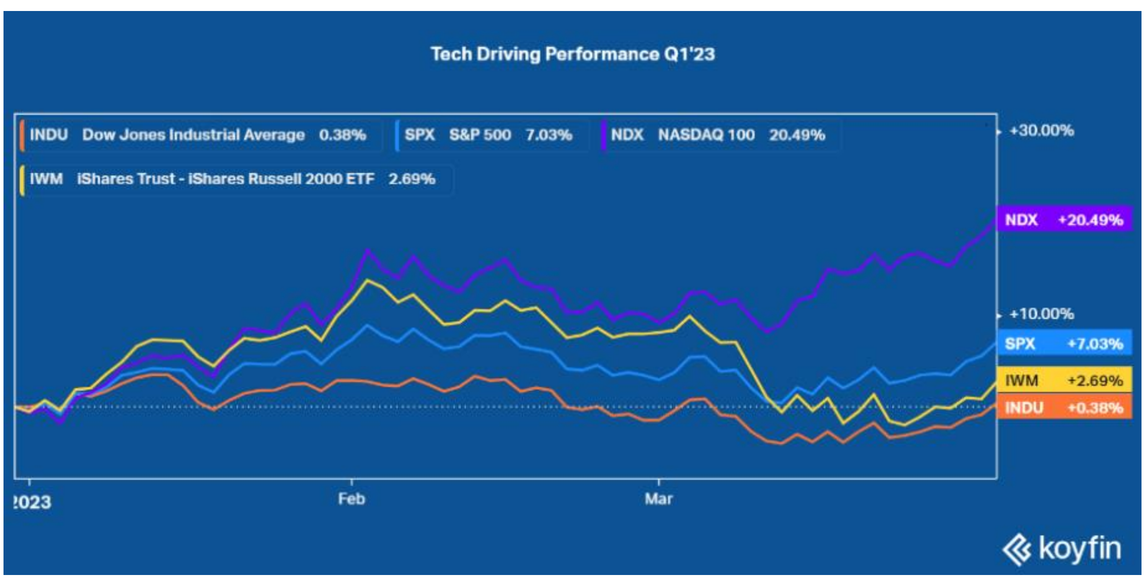
Source: Federal Reserve Economic Database. Data as of March 31, 2023.

Market Outlook

As goods and service input costs have risen due to inflation along with elevated interest financing costs for working capital and long-term debt, corporations will start to adjust by slowing down production, laying off workers, and cutting operating costs. This puts downward pressure on economic activity eventually leading to a slowdown in overall growth. Separately, consumers are feeling the pinch of higher prices, mortgage rates, and credit card interest rates. For example, since April 2021, a recent FRED (Federal Reserve Economic Data) statistic showed a dramatic 33% increase in the average consumer credit balance and an average interest rate of 24.4%.



From a financial markets perspective, we are beginning to see cracks appear in the broader valuation framework with significant performance dispersion across sectors. Investors, having been on the sidelines for the last year, are looking to buy any positive news and have recently allocated to speculative growth sectors. This is evident in the extreme runup of technology heavy indices such as the *Nasdaq 100 Index* on the heels of artificial intelligence ("AI") rollouts like ChatGPT. There are currently very few ways to invest directly in established AI companies with investors flocking to anything even remotely related to it.



The *Nasdaq 100 Index* (NDX) was up close to +21.0% during the quarter. By comparison, the *S&P 500 Index* (SPX) was up +7.0%, *Russell 2000 Index* (IWN) +2.7%, and *Dow Industrials Average* (INDU) +0.4%. As noted, the the *Nasdaq 100 Index* is heavily weighted toward technology with the top seven companies comprising approximately 50% of the total index weight *(in order by weight: Microsoft 13.3%, Apple 12.5%, Amazon 6.8%, Nvidia 5.5%, Google 8.3%, Facebook 4.0%).*

From a valuation standpoint, these technology names trade at an average forward price-to-earnings ratio ("fwd. P/E") of 39.5x earnings relative to the fwd. P/Es of the *S&P 500 Index* of 18.4x and the *Dow Jones Industrial Average* of 17.8x. This is a significant premium to historical averages (fwd. P/E of around 15.0x-17.0x for the *S&P 500 Index*) and causes concern around our forward outlook as major leading economic indicators flash signs of a slowdown.

The market's enthusiasm for technology stocks is not representative of the overall health of the economy or corporate profits. After stripping away the impact from technology stocks, the remaining performance is lackluster (see chart above). The most recent earnings season saw forward earnings guidance revised lower by many of the companies reporting. While the revisions were smaller than anticipated, the overall trend is still lower.

Looking Ahead & Positioning

We maintain our expectations for volatility to remain elevated over the remainder of the year. We do see the potential for both stock and bond markets to end the year higher if inflation declines further/faster and the Federal Reserve slows or ends its hiking cycle.

However, we continue to believe bonds are better positioned to outperform if recession fears persist and inflation slows at a faster pace. As of now, given uncertainty around economic health, we see more risks to the downside for stocks. As such, we have reduced or even eliminated most of our stock exposure in favor of a better entry point in the back half of 2023. In the meantime, we are maintaining an overweight to bonds as they exhibit healthy yields and the prospect of short-term outperformance in the face of stock market volatility spikes and investors flee to the safety of bonds.

We appreciate your continued support and partnership. In the meantime, stay disciplined- stay invested.

If you have any questions or want to discuss further, please reach out at info@eamoncap.com

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