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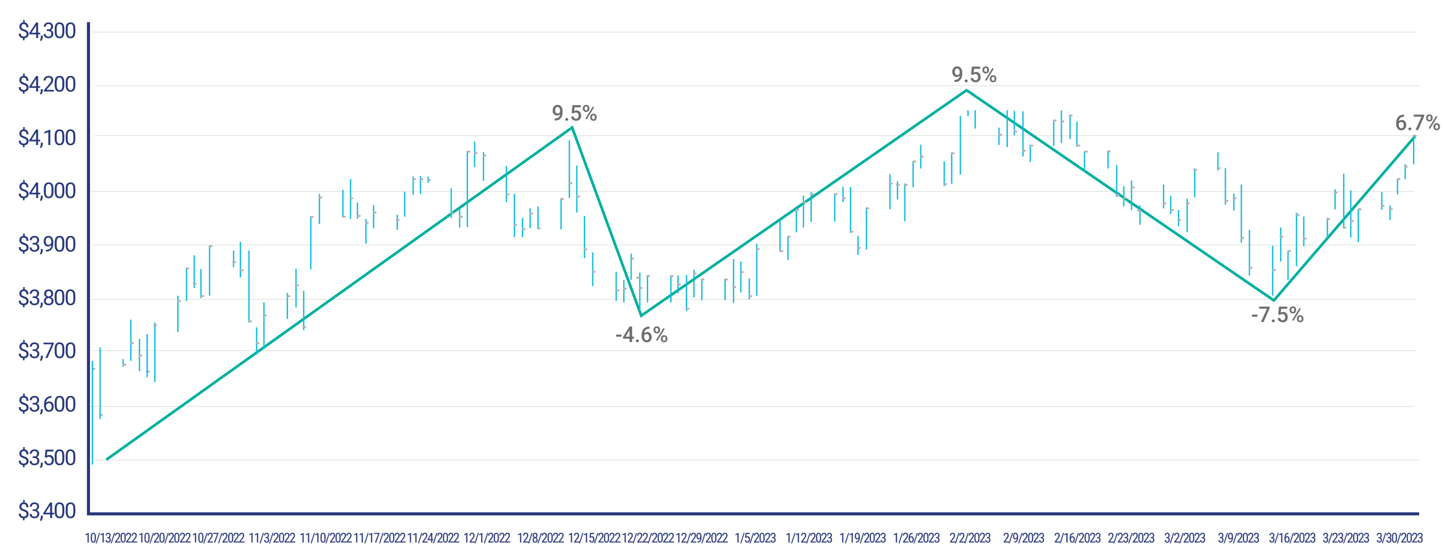
Partly Sunny or Partly Cloudy?

To the casual observer equity markets continued their sharp recovery from the October 13, 2022 low, returning 15.8% through the end of the first quarter 2023. That very solid return masks the erratic behavior that the stock market has exhibited over the past six months. Ongoing concerns about the health of the economy and the usual culprits of inflation, recession, rising interest rates and Fed policy have led to fits and starts within the benign market returns over the full six-month period. While March's banking crisis caused turmoil in the financial sector, the market overall has largely shrugged the events off at this point. As concerns linger over weakness in the banking sector, we may not be out of the woods just yet.

The chart below shows the continued volatility as persistent inflation data, Fed rate increases, continued low unemployment readings and resilient GDP reports either raised fears or bolstered hopes for a soft landing.

S&P 500: October 13, 2022 through March 31, 2023



Source: FactSet

After hitting a low for the year 2022 on October 13th, market volatility kicked in as confidence and fear traded leadership. The S&P 500 rose 9.5% as confidence in the economic recovery gained steam. Fears of an overactive Fed, persistent inflation, and recession likelihood prompted a reversal of -4.6% through year-end, only to see another 9.5% recovery as we started 2023. Market weakness was exacerbated by the failure of Silicon Valley Bank and the subsequent panic, resulting in a decline of 7.5% as the ghost of 2008 sparked fears across the market. As the panic quickly subsided, the market recovered into the quarter end, climbing 6.7%.

Capital Markets Review

For the first quarter, international equities advanced 8.5%, beating the 7.5% return for the S&P 500. Emerging markets returned 4.0% as investors assessed the impact of China's reopening to international visitors for the first time since March 2020. U.S. small caps, with significant exposure to regional banks, declined 4.8% in March to post a 2.7% return for the quarter.

Fixed income returns were buoyed by a backup in rates due to the banking crisis. The aggregate bond index posted a 3% return, while high yield and TIPS returned 3.6% and 3.3% respectively. Alternative investments were flat for the quarter.

Asset Class Returns

	Asset Class	Index	March 2023	Q1 2023
Equity	U.S. Large Cap	S&P 500	3.7	7.5
	U.S. Small Cap	Russell 2000	-4.8	2.7
	International Developed	MSCI EAFE	2.5	8.5
	Emerging Markets	MSCI EM	3.0	4.0
Fixed Income	U.S. Investment Grade	Barclays U.S. Aggregate Bond	2.5	3.0
	U.S. Inflation-Indexed	Barclays U.S. TIPS	2.9	3.3
	U.S. High Yield	BBgBarc U.S. Corp High Yield	1.1	3.6
	EM U.S.$ Debt	JPM EMBI Global	1.0	1.9
Alternative	Absolute Return	HFRX Global Hedge Fund	-1.2	0.0

Source: Morningstar

Sector Review

Looking at the U.S. sector breakdown, last year's laggards were the first quarter's leaders, as technology stocks led the charge, up 21.8%, after a 28% decline in 2022. Communication Services posted a 20.5% gain after declining 40% in 2022, and Consumer Discretionary returned 16.1% after a 37% drubbing last year. Energy, which soared 65% in 2022, declined 4.7% in the first quarter and Financials fell 9.6% in March to end the first quarter down 10.5%.

Sector Returns: Q1 and 2023

Sector	Index	March 2023	Q1 2023	2022
Technology	S&P 500 Sec/Information Technology	10.9	21.8	-28.2
Communication Services	S&P 500 Sec/Commun Services	10.4	20.5	-39.9
Consumer Discretionary	S&P 500 Sec/Cons Disc	3.1	16.1	-37.0
Materials	S&P 500 Sec/Materials	-1	4.3	-12.3
Industrials	S&P 500 Sec/Industrials	0.7	3.5	-5.5
Real Estate	S&P 500 Sec/Real Estate	-1.4	1.9	-26.1
Consumer Staples	S&P 500 Sec/Cons Staples	4.2	0.8	-.6
Utilities	S&P 500 Sec/Utilities	-4.9	-3.2	1.6
Health Care	S&P 500 Sec/Health Care	2.2	-4.3	-2.0
Energy	S&P 500 Sec/Energy	-0.2	-4.7	65.7
Financials	S&P 500 Sec/Financials	-9.6	-5.6	-10.5

Source: Morningstar

Looking Forward

Lingering concerns over banking sector

As we look ahead, concerns over continued banking sector weakness linger and fears over the Fed's ability to navigate the economic minefield will serve as key challenges impacting our asset allocation decisions.

While bank failures are less common than in the past, they still occur. Four banks failed in 2019, and four more in 2020. During the financial crisis of 2008 – 2013, 489 banks failed. The collapse of Silicon Valley Bank (SVB) represented the largest bank failure since the 2008 crisis. So, what happened?

SVB's collapse was partially caused by a panic known as a bank run. A **bank run** entails too many customers attempting to withdraw their money at the same time. SVB's customers lost confidence in the bank, which caused anxious depositors to create a "run" on the bank. This resulted in a panic known as **financial contagion**, which occurs when the failure of one institution creates a panic throughout the related industry. SVB's collapse increased fear of contagion as investors and customers grew anxious about the stability of their banks. Signature Bank became the second bank failure in March, based mostly on this contagion.

Why couldn't SVB meet depositors' withdrawal requests? As banks take in deposits from customers, they typically invest required cash reserves in safe investments, such as U.S. Treasuries. In SVB's case, the investments were made in long-term U.S. Treasuries in 2021, when interest rates were at record lows. When interest rates rose in 2022 and 2023, SVB's bond portfolio sustained large unrealized losses. As customers withdrew funds from SVB they were forced to sell bonds, turning unrealized losses into realized losses. As the panic spread, SVB failed to meet customers' withdrawal requests, and the bank became insolvent.

How will recent bank failures impact lending practices?

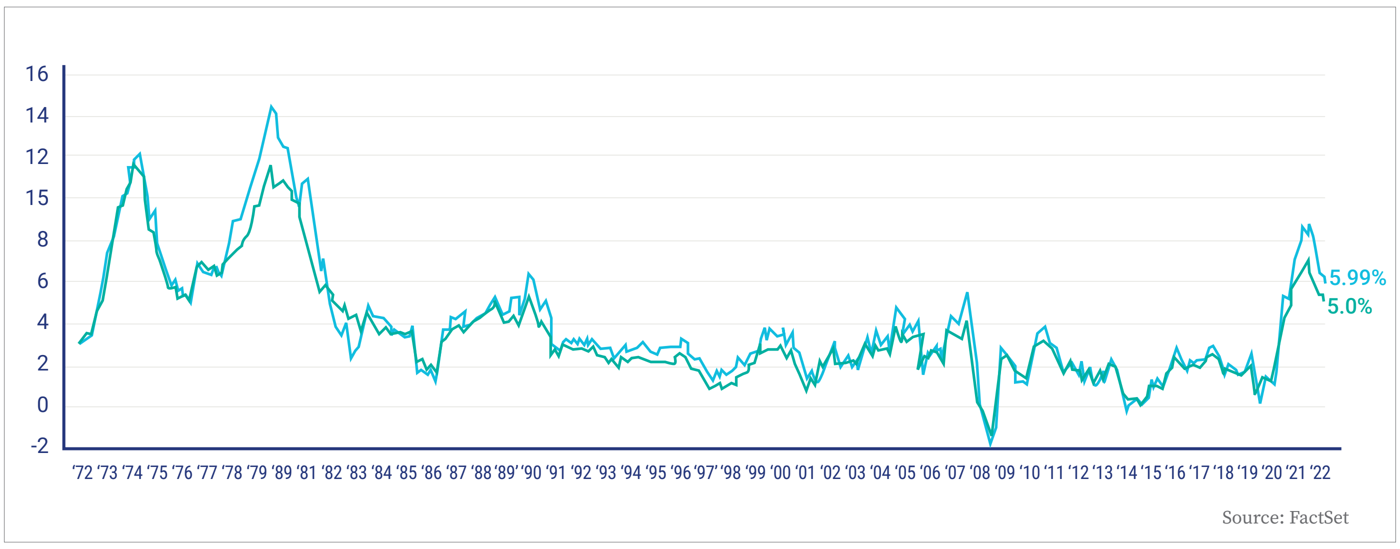
The question now is how much the events at SVB and Signature in March will impact credit conditions moving forward. Credit risk is the risk that a borrower will default on their loan. Banks try to lower their credit risk in many ways. Besides making sure borrowers are trustworthy, banks structure loans in ways that limit their potential losses. With increased credit risk around the world, banks will be much more reluctant to lend. This will ultimately have a slowing effect to economic growth and possibly put more people out of work. How much will banks curb/change their lending practices, and how much impact will that have on the overall economy? We may not know the answer for months.

Smaller regional banks are likely to feel the brunt of the pain, possibly requiring material adjustment to lending practices (either due to government intervention, or good old fashioned risk management).

While the banking sector continues to feel the impact, the broader market has shrugged off the banking crisis, moving its collective focus back to the Fed and its fight to tame inflation without triggering a recession.

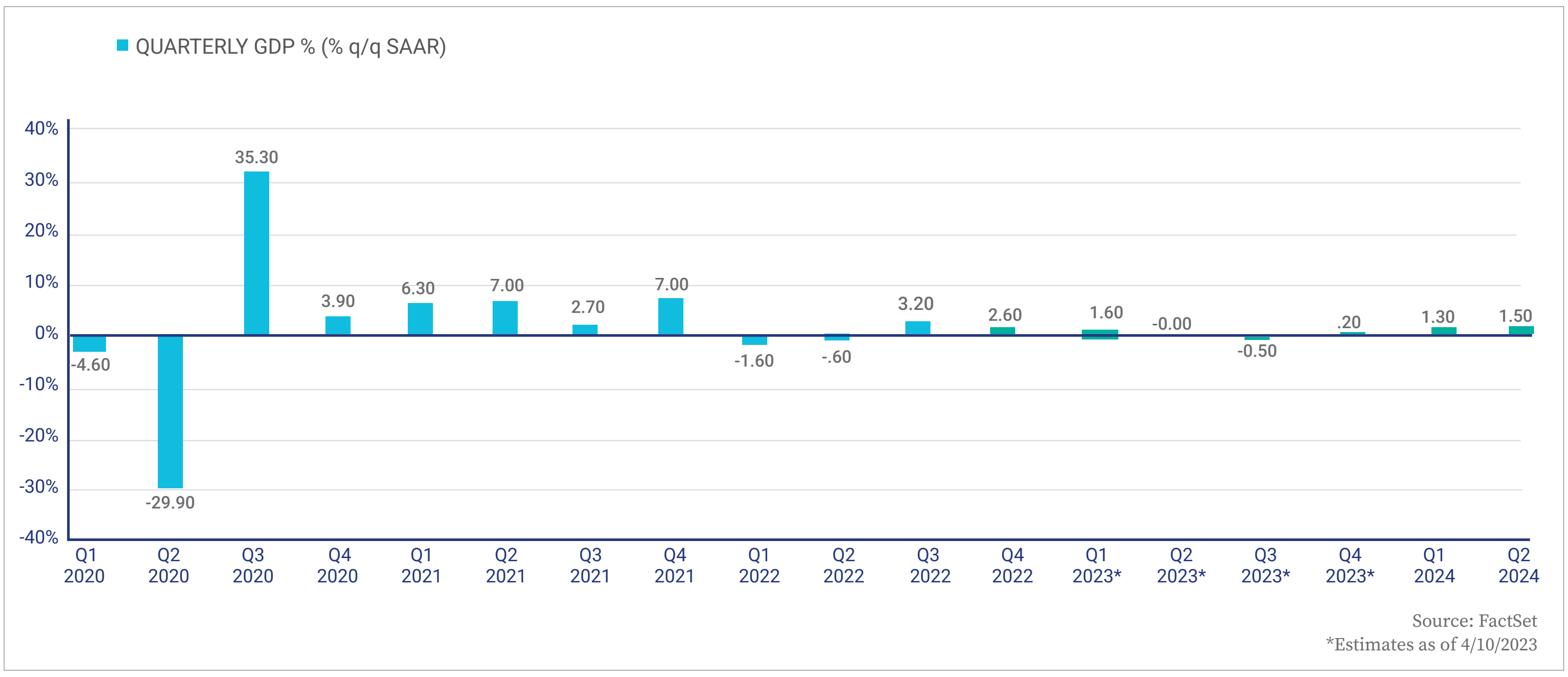
Recent data suggests that the Fed's interest rate hikes are slowly but surely having the desired impact on the economy. Inflation, as measured by the Consumer Price Index, has declined from the recent 9% high to 6% in the lastest to avoid repetition of recent reading (Source: FactSet). The Fed's preferred inflation measure, the Personal Consumption Expenditure (PCE) price index, also showed significant declines, as the chart below shows.

Inflation



U.S. Gross Domestic Product (GDP) expanded in the fourth quarter at an annualized rate of 2.6% (Source: FactSet, March 30, 2023). The most recent consensus estimate for Q1 2023 GDP, due out on April 27th, is 1.6%, followed by two quarters of flat-to-mildly negative GDP readings. While some would call that a recession, it would be a very mild recession should those numbers prove accurate.

Quarterly U.S. Real GDP Growth Including 2023 & 2024 Forward Estimates



The unemployment remains near 50-year lows despite the 236,000 jobs added in March, the lowest increase since December 2020. Jobs data remains a mixed bag, with selected data hinting at slowing jobs growth.

The final puzzle piece that pulls it all together is Fed policy. The CME Group's FedWatch Tool shows a 72% probability of a 25-basis point rate hike, and a 28% probability of no change to policy at the May 3rd meeting. By the December Fed meeting, there is a 66% probability for a 25 – 50 basis point cut in the fed funds rate.

Portfolio Positioning

Balance investment styles and sectors

Despite the numerous challenges and crosscurrents (or perhaps because of them), our portfolio positioning remained largely unchanged in the 1st quarter of 2023. We came into the year expecting additional bouts of volatility in early 2023 and advised our clients to "ride that out" and not try to time the market. We reminded our clients that market behavior around idiosyncratic events can be unpredictable. Case in point, who would have guessed that as Silicon Valley Bank and Signature Bank both failed the market would churn higher? We do not think this is the end of the volatility, but we continue to recommend that our clients with a reasonable time horizon stay fully invested.

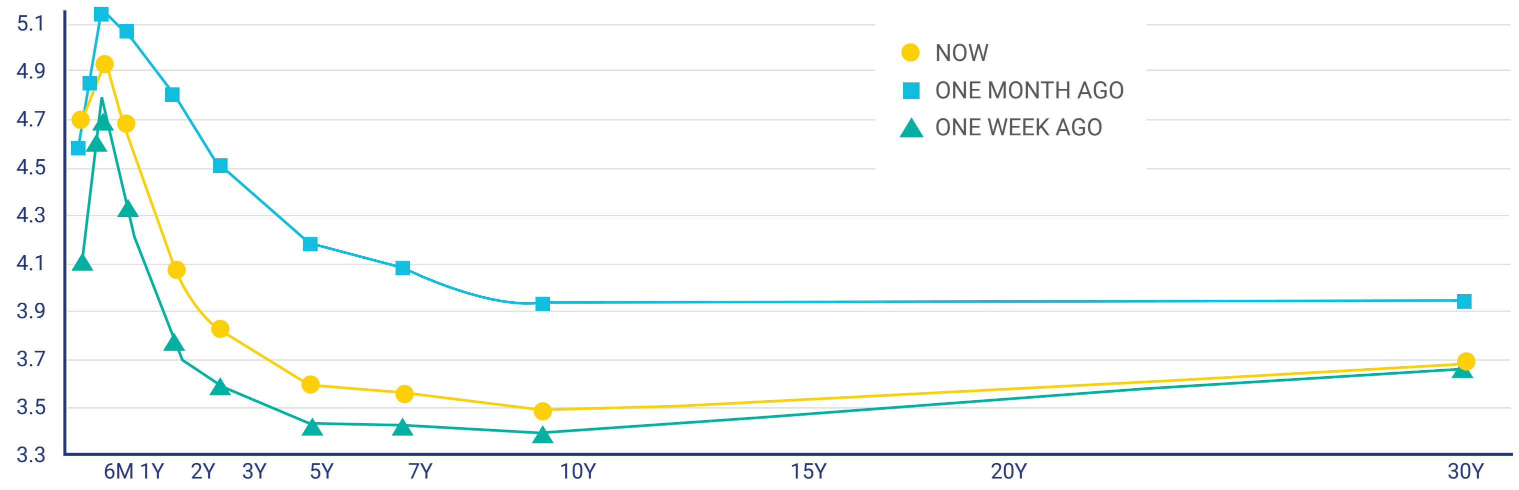
We also mentioned coming into the year that it would be important not to go "All In" on either Growth or Value–but to find balance among styles and sectors. Those expecting growth to suffer again (as it did in 2022) were caught flat footed. Sector leadership has done a complete reversal from 2022 in the first quarter of 2023, and technology, which was down 28% in 2022 led the way in the first quarter. Meanwhile, Energy and Financials which were the top returning sectors in 2022 have been the laggards thus far in 2023. We continue to seek balance in portfolios and look for characteristics of companies that we like–rather than be constrained by the traditional growth/value dichotomy.

Keep an eye on fixed income

We also wrote at the beginning of the year that Fixed Income would play a more important role in portfolios in 2023. The bond market continues to be a difficult area to maneuver with an inverted yield curve and extreme interest rate volatility. However, there are attractive yields and "hold to maturity" investors, in particular, can do quite well.

The banking crisis that unfolded in mid-March caused yields to crater, causing longer dated bonds to rally. The 10-year treasury yield decreased from 4.08% on March 2nd to a current yield of 3.49% on March 31st. Despite this strong short-term move, we still think that as the banking crisis moves to the backburner, yields will resume a creep higher. This will make long duration bonds a risky proposition relative to shorter maturities (not to mention that the inverted yield curve continues to provide more income for short maturities).

U.S. Treasury Yield Curve



Source: FactSet
As of 4/3/2023

Conclusion

We selected the title "Partly Sunny or Partly Cloudy" due to the range of interpretations that might be applied currently to the economic outlook. There are an increasing number of economic variables moving in the right direction, while the banking panic of March serves as a reminder of the variables that are more difficult to predict. We have not discussed the continued conflict in Ukraine, the implications of a China – Russia – Saudi Arabia alliance, labor protests in France, or the countless other variables that might challenge the economic recovery scenario. The Fed continues to have its hands full: cooling the economy just enough to bring down inflation, but not so much as to plunge us into a deep recession. We, like them, will continue to be "data dependent" and be ready to make tactical moves to enhance our clients' risk-adjusted returns.

As always, please don't hesitate to reach out to your contacts at Webster Private Bank if you have any questions. It is a pleasure to serve you during these difficult times and we appreciate the trust you have placed in us.