ADVOCATING CAUTION

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PRIVATE WEALTH MANAGEMENT

Welcome to April! Every month, we like to impart some perspective on the financial markets or shed light on a current headline or two, all in an attempt to help our clients sift through the noise and become slightly more educated investors. We welcome your comments and suggestions, and as always, we invite you to share this piece with anyone you believe may find it of interest.

Largely ignoring the weight of the headlines these last few months, stocks pulled out an impressive rally during the first quarter. It seems much of what crossed our desks centered on imminent recession, rising interest rate risks and of course bank failures, so we were amongst those pleasantly surprised by the S&P 500's 7.5% first quarter return. Bonds rallied during the quarter as well, and even cash was in the mix, with Treasury Bills posting their largest gains since 2007's second quarter[1]. One reason for the good performances could simply be the starting point – last year was a particularly harsh one, the first time on record that both the stock and bond markets fell more than 10%[2].

So what does this all mean for the remainder of the year? Ultimately the answer lies in the trajectory of Fed policy, economic growth and corporate profits, but history's message here is positive. According to Ned Davis Research, in the eleven cases when the S&P 500 fell the previous year then rallied in the first quarter, the index was up over the remaining nine months of the year every time, and by a median of 11.2%.

But that doesn't necessarily mean a smooth ride lies ahead. Sure, we may end up with a positive 2023, but we believe there are several issues investors must resolve before the markets can sustainably move on to new highs. As our readers know, we've been cautious these last few months, and we continue to advocate caution today. Here's why:

Corporate Earnings: with the S&P 500's recent advance – really going back to last October - stocks are now trading at 18.2x forward earnings[2] - a valuation that solidly supports the notion that corporate profits growth in the quarters ahead will be not just positive, but actually pretty good. In reality, while stocks have been moving up these last few months, first quarter S&P 500 earnings estimates have actually moved down by over 6%. Year-over-year earnings for the quarter are now expected to decline by -6.8%, the steepest drop since the second quarter of 20203. Naturally then, we call to attention the disconnect between earnings and stock prices and ask whether stocks have perhaps gotten ahead of themselves. Earnings announcements will begin later this week with the bulk of announcements coming the week of April 24, so we shall see.

Fed Policy: because of the lag effect of Federal Reserve monetary policy (think of stopping an 80mph freight train) it will take time for the full impact of the fastest interest rate tightening cycle in 60 years[4] to be felt. The record shows that economic growth slows materially in the second year after the Fed begins raising rates. And fast tightening cycles, like this one, typically experience more pronounced slowdowns in economic growth. If we are correct, the Fed has engineered a slowdown that will begin to affect the economy soon, and we believe it could take businesses and investors by surprise.

Market Breadth: only eight stocks – Facebook, Amazon, Apple, Netflix, Google, Microsoft, Nvidia and Tesla - have been behind the S&P500's progress this year; the other 492 are collectively down[5]. In all fairness it's not unusual for an advance in stocks to be concentrated in a handful of companies – the S&P500 is a capitalization-weighted index after all where larger companies exert greater price influence on the index - but when stocks are transitioning from bear to bull phases, it's especially important to see broad participation as confirmation of the market's overall health. What we believe we're seeing instead is a lack of breadth that calls into question the sustainability of the market's recent advance.

And Other Issues: the need to throw billions of federal dollars at struggling banks last month chewed through cash and moved up the Debt Ceiling deadline, potentially to late May[6]. As we wrote here in February, the Washington analysts whose perspectives we respect are saying the probability of a last-minute deal still looks likely but it's unlikely to be without drama and discomfort. As Republicans and Democrats wrangle over budget cuts and spending details, the markets are likely to get jittery. With an already-slowing economy and softening earnings, the last thing investors will want is the threat of a U.S debt default.

So yes, 2023 may end up nicely positive, but as we view the current level of risk assets relative to the environment, we cannot help but believe we may need to make our way through an adjustment period first. But how to approach it? First, remember that we always advocate well-diversified portfolios of companies which have historically formed the backbone of American enterprise and have demonstrated – over time – their ability to survive whatever chaos or crisis comes their way. Remember that the only way to participate in the dynamic returns these companies offer is to ride out the frequent and often uncomfortable, but always temporary setbacks in their prices. And finally, it is to tune out the noise of "stock market volatility" and instead focus on the long-term rationality of the businesses we own. Because patience is an indispensable component of investing success.

But more than anything, we remind you that we are here.

Onward.

1 Wells Fargo Investment Institute 2 Birinyi Associates 3 FactSet 4 First Trust Advisors 5 Bianco Research 6 Macquarie Group

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