Q1 2023 Commentary

April 2023

"Baseball is the only field of endeavor where a man can succeed three times out of ten and be considered a good performer."

Ted Williams

Q1 Market Recap

Stocks and bonds rebounded strongly in the quarter fueled by lowered interest rate expectations. The global economy likely grew during the quarter, buoyed by demand from the U.S. consumer and China's reopening. Data suggests we are not in a recession yet, but higher interest rates appear to be slowing down the economy as intended by Central Bank policymakers. Uncertainty remains in the banking sector following the failure of Silicon Valley Bank and Signature Bank, yet panicked depositor behavior seems to have abated. While the S&P 500 posted a strong return for the quarter, gains were driven by a handful of mega cap tech companies such as Apple, Microsoft, Google, Amazon, and NVIDIA. On an equal weighted basis, the S&P 500 was up 2.89%. Foreign equities continued to outperform, aided by a weaker U.S. dollar and better than expected corporate earnings.

Bonds rallied to start the year as investors became increasingly convinced the Fed will pause hiking rates this quarter. Junk bonds outperformed investment grade and municipals. The yield curve remains inverted, albeit at a smaller spread than observed earlier in the year. Publicly traded REITs continue to struggle facing an uncertain interest rate environment and hybrid workplace policies. Gold prices rose during last month's market volatility.

Asset Class	Benchmark	March	Q1 2023	1 Yr
U.S. Large Cap Stocks	S&P 500 TR USD	3.7	7.5	-7.7
U.S. Small & Micro Cap	Russell 2000 TR USD	-4.8	2.7	-11.6
Intl Dev Stocks	MSCI EAFE NR USD	2.5	8.5	-1.4
Emerging Mkt Stocks	MSCI EM NR USD	3.0	4.0	-10.7
Global Stocks	MSCI ACWI NR USD	3.1	7.3	-7.4
U.S. Municipal Bonds	Bloomberg Municipal TR USD	2.2	2.8	0.3
U.S. Taxable Bonds	Bloomberg US Agg Bond TR USD	2.5	3.0	-4.8
U.S. High Yield Bonds	Bloomberg High Yield Corporate TR USD	1.1	3.6	-3.3
Intl Dev Bonds	S&P International Sov Ex-US Bond TR USD	4.6	3.5	-12.8
U.S. REITs	MSCI US REIT NR USD	-2.7	2.4	-20.2
Broad Commodity Futures	Bloomberg Commodity TR USD	-0.2	-5.4	-12.5
Energy Partnerships	Alerian MLP TR USD	-1.2	4.1	13.9
Gold	DJ Cmmdty Gold TR USD	7.6	8.1	0.7

Data from Morningstar as of 3/31/2022

Credit spreads remain elevated, suggesting bond investors have not forgotten about last month's stressors in the global banking system. However, equity investors appear to have less concern as the CBOE Volatility Index suggests smooth sailing ahead.[1] Inflation remains higher than policymakers' targets, largely driven by housing costs and other core services. Sticky inflation may be the driver for continued restrictive monetary policy. Market technicians will quickly point out that a strong first quarter is a bullish signal. Every time the S&P 500 recorded a +7% return in the first quarter, the full year market performance was positive.[2]

[1] Chicago Board Options Exchange, CBOE Volatility Index: VIX [VIXCLS], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/VIXCLS, April 7, 2023.

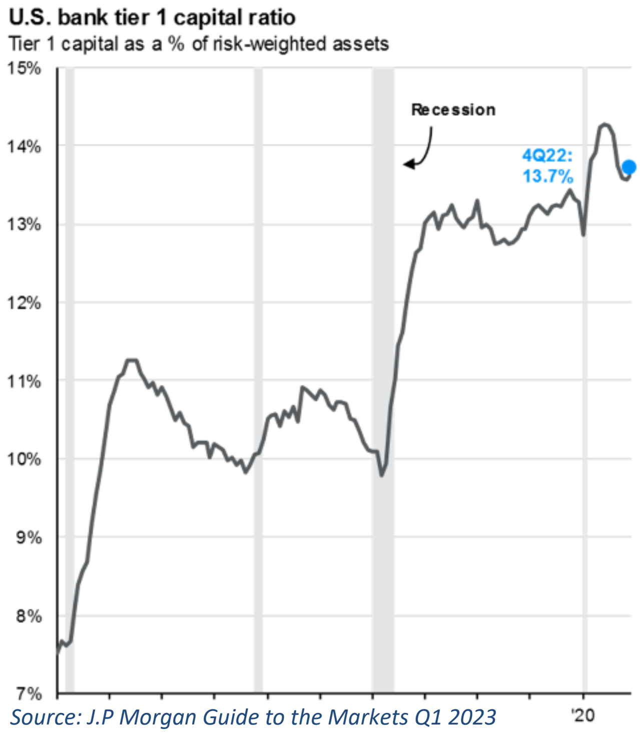
2 Carson Investment Research, FactSet 03/31/2023.

Banking Anxiety

In mid-March, Silicon Valley Bank and Signature Bank went into FDIC receivership due to a combination of rapid depositor withdrawals among a homogenous client base and poor risk management procedures. The collapse of these institutions sent shockwaves through the global banking system. Regional bank stock prices fell precipitously, and depositors moved money to larger and more diversified banks. At the core, this was a liquidity, not a solvency crisis. Unrealized losses incurred on bank balance sheets came from mark to market losses of longer-dated, high quality bonds that are classified as held-until-maturity. This accounting treatment allows companies to record a bond's value at amortized cost rather than fair value. As such, unrealized gains/losses from held-until-maturity bonds are not recognized in bank income statements unless they are sold. Recognizing that enhanced liquidity in the banking sector would reduce funding challenges, the Federal Reserve created a new program, the BTFP, allowing banks to use U.S. Treasuries and Mortgage-Backed Securities as borrowing collateral at par value (rather than a discount). This program, when combined with the Fed's discount window and borrowing options through the Federal Home Loan Bank, will give banks more operating liquidity. It is important to note that since the beginning of last month's crisis, interest rates have fallen, which has decreased the unrealized losses on longer-dated bonds kept on banks' balance sheets.

Many of our clients are wondering what they need to do with their cash? First off, stay calm. Review your FDIC coverage at your bank/credit union. Ask your bank about their financial strength. Ask about insured cash sweep products. If you still have concerns, you may wish to consider investing in U.S. Treasury or Government Money Market Funds. Business owners realize operating a business while keeping cash under FDIC insurance limits may not be practical. Follow the steps listed above for peace of mind.

We encourage investors to keep in mind that banks started the year with strong balance sheets, which is a vast improvement from the years preceding the 2008 Global Financial Crisis. Unrealized gains/losses on held-until-maturity investments do not show up in the tier 1 capital ratio[3] shown to the right. Again, the current stress in the banking sector is related to liquidity, not solvency.



Source: J.P Morgan Guide to the Markets Q1 2023

Still No Recession

The U.S. economy continues to grow and defy skeptics. The March unemployment data showed an increase of 236,000 non-farm payrolls, a decrease in the unemployment rate to 3.5%, and rising labor force participation. Average hourly earnings grew by 0.3% for the month and 4.2% year-over-year, representing a continued trend of wages rising slower than inflation. Encouragingly, wage growth is falling despite a tight labor market, which further moderates expectations for future Fed interest rate increases.

[3] Tier 1 capital ratio is the ratio of a bank's equity capital plus disclosed reserves to its total risk-weighted assets.

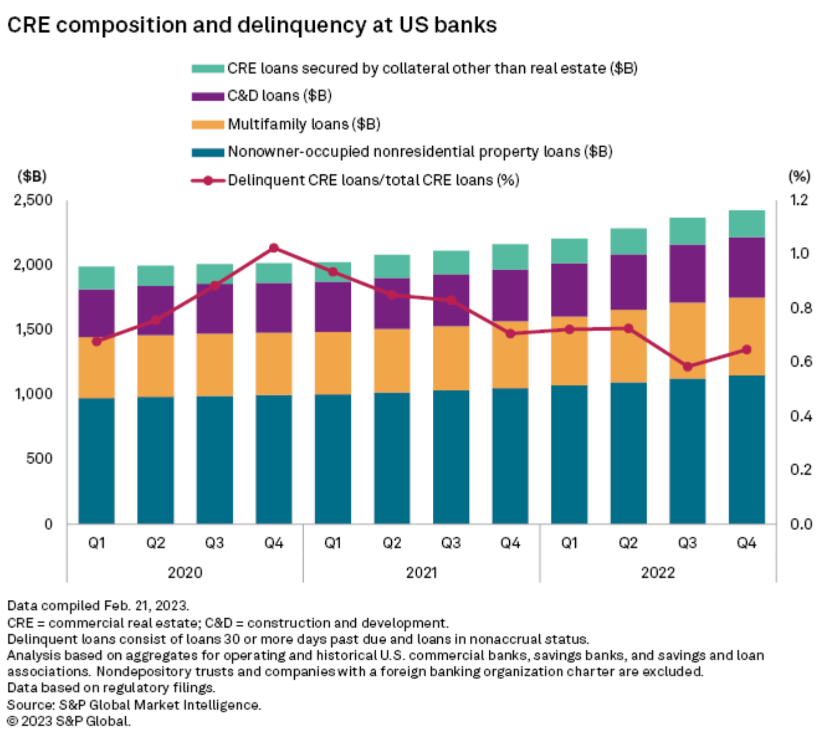
We compile various leading and lagging economic indicators to help inform our view on economic trends (see chart to the right). Global economic growth accelerated in the quarter led by a rebound in services business activity. The J.P Morgan Global Composite Output Index rose to 53.4 in March which represents a nine-month high for the series. Input and output prices increased at a slower pace during the month, another positive sign that inflation is cooling off.[4] Manufacturing continues to drag on GDP growth, with the J.P. Morgan Global Manufacturing PMI Index registering the seventh consecutive monthly decline.[5]

	Indicator	Latest Data	Date	Q1 2023 Recession Signal	Q4 2022 Recession Signal
Leading Economic Indicators	Interest Rate Spreads (2Y - 10Y Trsy Yield)	0.57%	March-23	Yes	Yes
Leading Economic Indicators	Stock Market Performance (S&P 500)	7.5% YTD	March-23	No	Tbd
Leading Economic Indicators	Quit Rate	2.6%	February-23	No	No
Leading Economic Indicators	U.S. Consumer Spending (MoM)	0.2%	February-23	No	No
Lagging Economic Indicators	Manufacturing PMI	46.3	March-23	Yes	Trending yes
Lagging Economic Indicators	Services PMI	51.2	March-23	Tbd	Trending yes
Lagging Economic Indicators	Global PMI	53.4	March-23	No	Trending yes
Lagging Economic Indicators	Unemployment Rate (U3)	3.5%	March-23	No	No
Lagging Economic Indicators	Inflation (CPI)	.1% (MoM) / 5% (YoY)	February-23	Yes	Yes
Lagging Economic Indicators	Index of Consumer Sentiment	62.0	March-23	Yes	Yes
Lagging Economic Indicators	Real GDP Growth (Quarter over Quarter)	2.6%	December-22	No	No
Lagging Economic Indicators	Corporate Earnings Growth (S&P 500 - Annual)	-6.6%	March-23	Trending yes	No
Lagging Economic Indicators	Housing Prices (YoY)	3.8%	January-23	No	Trending yes
Lagging Economic Indicators	Residential Building Permits (National - YoY)	-17.9%	February-23	Trending yes	Trending yes

Sources (in descending order): CNBC, Morningstar Advisor Workstation, U.S. Bureau of Labor Statistics (BLS), U.S. Bureau of Economic Analysis (BEA), Institute for Supply Management, IHS Markit and JP Morgan Chase, BLS, BLS, University of Michigan, BEA, Factset (Q4 2022 data is an estimate), S&P Case-Shiller U.S. National Home Price Index, U.S. Census Bureau

Last month's banking crisis brought a swift repricing of Fed Funds rate expectations. Many investors predict that banks will tighten credit standards, send the economy into a recession, and force the Federal Reserve to start decreasing interest rates later this year. The Fed disagrees. In its March 2023 economic projections, the Fed called for lower, but positive, expected real GDP growth, higher inflation, and the Fed Funds rate to peak in the 5.00-5.25% range.

Commercial Real Estate Woes



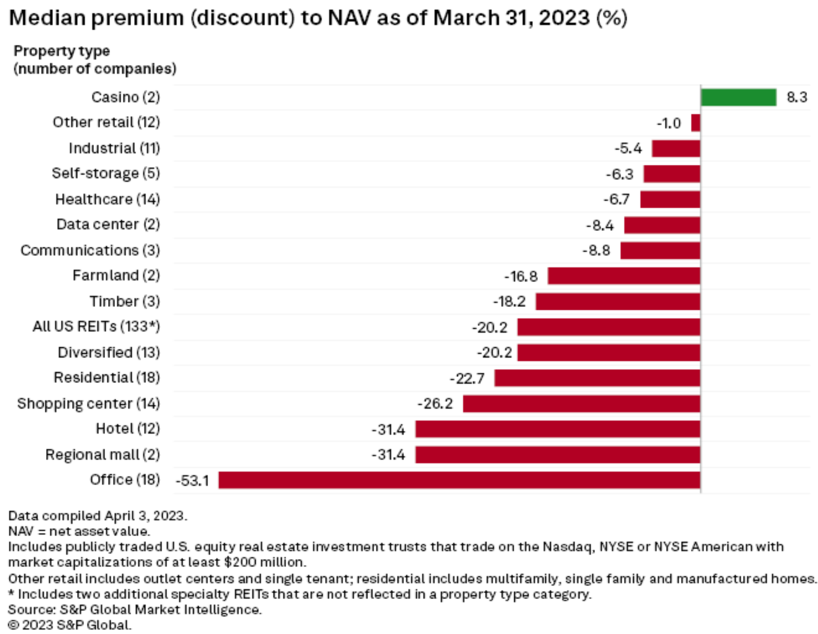
Concerns about the commercial real estate (CRE) sector grew during the quarter as investors scrutinized regional banks' balance sheets relative to the volume of commercial real estate debt maturing over the next few years. An estimated 70% of commercial real estate loans outstanding are serviced by regional and local banks. Investors fear that rising interest rates, higher office vacancy rates and tightening lending standards will create a credit crunch for commerical real estate borrowers.

CRE loan deliquency rates climbed in the fourth quarter to 0.65% from 0.58% in Q3 2022. While the uptick is worth monitoring, these delinqency

[4] J.P Morgan Global Composite PMI, retrieved from https://www.pmi.spglobal.com/Public/Release/PressReleases?language=en, April 7, 2023
[5] J.P. Morgan Global Manufacturing PMI, retrieved from https://www.pmi.spglobal.com/Public/Home/PressRelease/5c9ad0804dd34d4ab5e1af7f16072fef, April 7, 2023

rates are lower than pre-pandemic and pre-GFC levels. Default rates naturally increase during recessions, but concerns that falling commercial property values will create solvency problems for banks may be overblown at this time.[6] Recall that equity investors are in a first loss position when a loan defaults. Banks who lent at conservative loan to value ratios still have plenty of cushion built into their loans before facing signficant losses.

Real estate investors reacted negatively during last month's turmoil by selling shares of publicly listed REITs and mortgage backed securities. Both asset classes are underperforming broader market capitalization weighted benchmarks on a year-to-date basis.[7] As evidenced by the wide discount to net asset value shown on the chart to the right, REIT investors continue to be concerned about future operating conditions for office, malls, and shopping centers. At month end, U.S. Commercial Mortgage Backed Securities had the highest yield relative to other investment grade bond sectors.[8]



Parting Thoughts

The best response to last month's volatility was to maintain the course throughout market turbulence. We eagerly await first quarter earnings to assess the health of U.S. banks and consumer loan demand. While global growth may be slowing down, the tight labor market and strong consumer continue to propel the economy forward.

As always, we recommend clients stay diversified across multiple asset classes and remember that bonds, as portfolio diversifiers, may offer relatively attractive returns.

Our team is here to help you navigate these challenging times. Thank you for your continued trust.

Sincerely,
The Private Capital Management Team

[6] Business Insider, Commercial Real Estate Loan Defaults May Rise but Severe Crisis Unlikely: UBS, retrieved from https://markets.businessinsider.com/news/bonds/commercial-real-estate-loan-defaults-svb-offices-banking-crisis-deliquencies-2023-4, April 6, 2023

[7] Morningstar as of 3/31/2023, VNQ ETF +1.66 YTD vs. 7.5% for S&P 500 and CMBS ETF +1.06% vs. 2.96% for the Bloomberg US Agg Bond.

[8] Eaton Vance, Monthly Market Monitor, https://funds.eatonvance.com/monthly-market-monitor.php#page=3&id=5265pdf, April 10, 2023. CMBS YTW 5.2%.