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QUARTERLY INVESTMENT PERSPECTIVES: **Q2 2023**

First Quarter Review

Stocks moved higher to start the first quarter, rebounding from a difficult calendar year in anticipation of a pause in the Federal Reserve's rate hiking campaign. The trajectory of the stock market and the tenor of headlines seemed to move in the opposite direction this year, as we illustrated in a recent edition of Viewpoints. Positive economic news was generally met with a decline in stocks, while negative news, most notably the collapse of Silicon Valley Bank (SVB), did not phase the broad market. The negative correlation was driven by expectations of what the Federal Reserve would do in response to these outcomes. If economic data continued to be strong, it would likely keep inflation elevated, and would thus warrant additional rate hikes. Conversely, turmoil in the banking sector will likely restrict economic growth, lead to softer inflation, and put a halt to the rate hiking program. Though we must live in the present and stocks often react to minute by minute news, they are also priced on a forward-looking basis and expectations are being formed about earnings over the next two calendar years.

Leading the way were large cap U.S. stocks and international developed stocks, with the S&P 500 up 7.1% and the MSCI EAFE index returning 8.6%. The strong returns from European equities (highlighted in the EAFE index) have come as a result of resilience in corporate earnings abroad and optimism over future economic growth exceeding expectations. Small cap stocks experienced heightened volatility, starting January and February with a return of 7.9% before declining 4.8% in March as smaller capitalization regional banks fell sharply in the wake of the SVB collapse. Fixed income investments swung to positive returns after poor returns in 2022 (the Barclays US Aggregate index was down 13%), as longer dated bond yields declined. While short-term fixed income yields remained elevated, the 2 Year Treasury yield ended the quarter at 4.06%. Longer dated Treasury yields whipsawed during the quarter. The 10 Year Treasury yield started March at 4.08% before dropping to 3.48% by the end of the month. Banking turmoil, declining inflation expectations, and a potential pause in the Federal Reserve's rate hike campaign all contributed to falling yields.

Investment Market	Q1 - 2023
U.S. Large Cap Stocks	7.1%
U.S. Mid Cap Stocks	4.1%
U.S. Small Cap Stocks	2.7%
International Developed Stocks	8.6%
Emerging Market Stocks	4.0%
Barclays US Aggregate Bond	3.0%
Barclays Global Aggregate Bond	3.0%

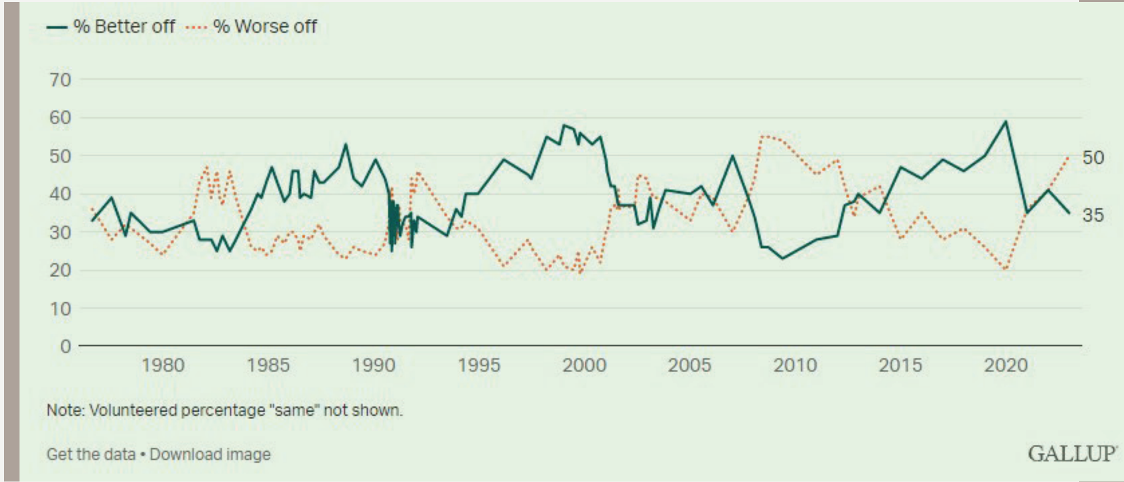
Sources: JP Morgan, as of 3/31/2023

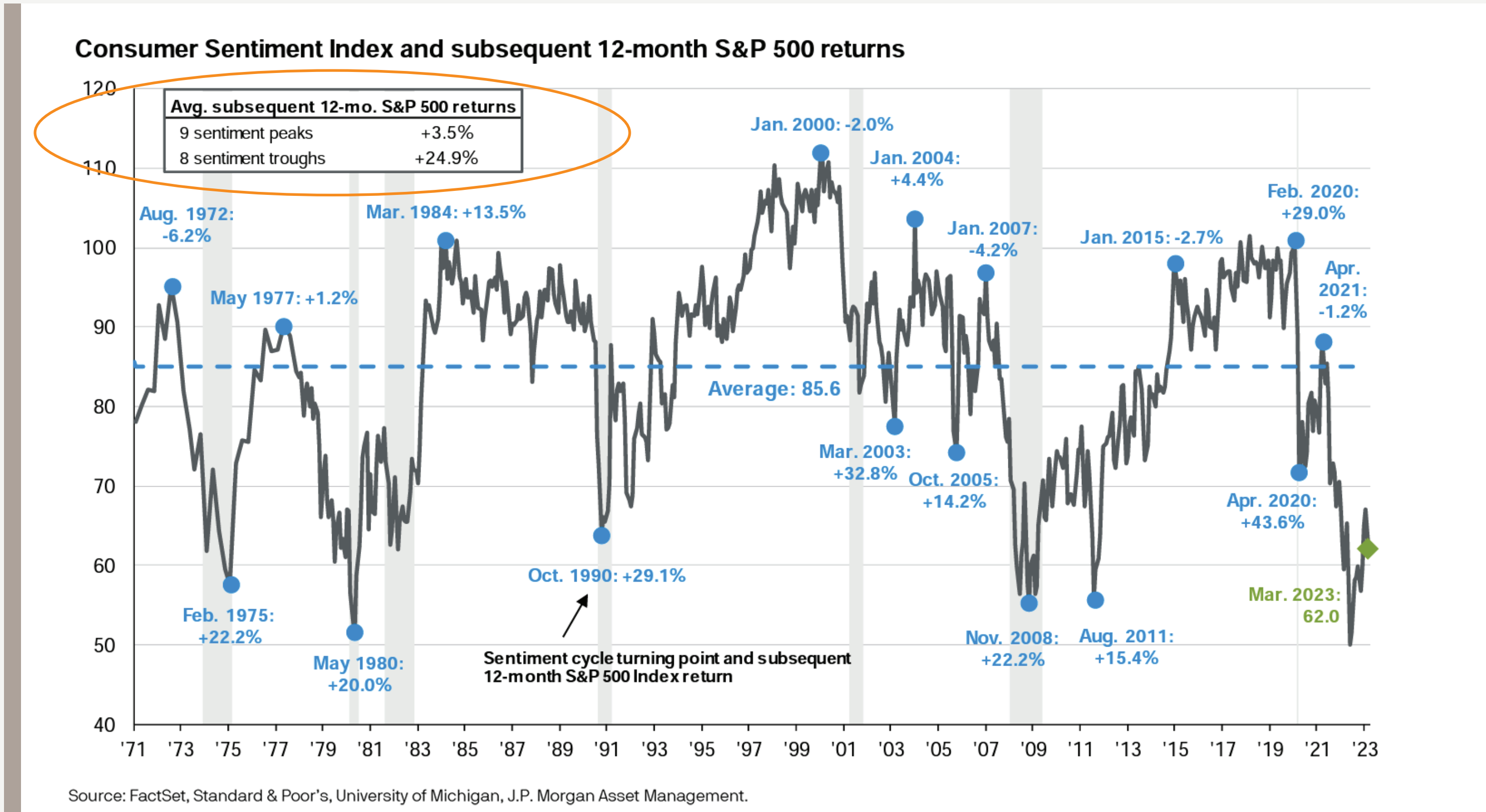
In our annual outlook, we made the case that a diversified portfolio has its best prospects in recent memory for strong forward returns, as high-quality bond yields are attractive and equity valuations have fallen close to historical averages. We still believe that to be the case; however, the potential for continued market volatility remains elevated as the Fed still has not pivoted and business lending is likely to contract as banks shore up their balance sheets. A nimble approach that balances risk and return objectives remains a necessity as we navigate the remainder of the year.

MARKET REVIEW AND OUTLOOK

News Cycle Fatigue

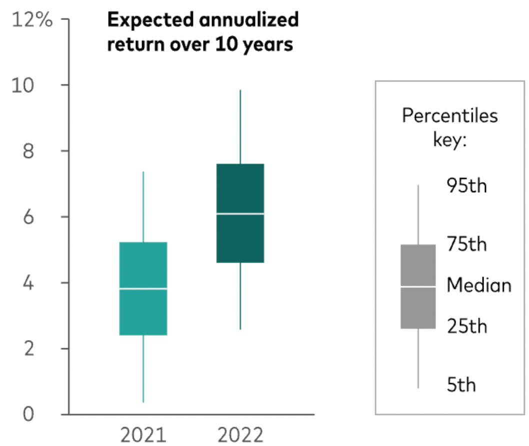
If there is a word that sums up what clients and our peers have felt over the last year, it would be "fatigue." Already worn down by the global pandemic and wanting to move on from the COVID era, the last 15 months have seemed to weigh just as heavy. Whether it is the sobering headlines about the war in Ukraine, tensions between the U.S. and China, or the constant worrying over inflation and the economy, it has been easy to just "check out" of the news cycle and not want to pay attention anymore. Considering that we just experienced the worst year for stocks and bonds in modern history, it is easy to see why investors are not optimistic about future investment returns. A recent Gallup poll noted that just 35% of Americans say their financial situation is better now that it was a year ago, while 50% believe they are worse off. You can see in the chart below, that the percentage saying they were better off peaked in January of 2020, which is not a surprise given that COVID had not happened yet, unemployment was low, and markets were coming off of a very strong year. It is unusual for half or more of Americans to say they are worse off, with the only other time occurring during the global financial crisis in 2008. In some ways, the stock market context of the "better off vs. worse off"survey is the most important data point to know, as our mood often tends to peak and trough with the market. This is why it is especially important for investors to not fall prey to recency bias, that is, the tendency to assume because investment returns in recent memory have been poor over the last year, they will be poor in the coming years. We know from looking at historical data that short-term returns for the stock market are often like a coin flip: up or down with a greater degree of unpredictability. We also know that market returns over the long term (10 years or longer) are positive much more often than they are negative (up 92% of the time with an average return of 8.1%). It is extremely important to not conflate the pessimism we have all felt recently with the potential for positive investing returns going forward. Both JP Morgan and Vanguard have highlighted this in recent research data on the following two pages.





Consumer sentiment recently hit levels last seen during 2008. When sentiment has troughed, the forward 12 month returns for the S&P 500 have averaged 24.9%

10-year outlook for the global 60/40 portfolio has improved



	Forecast as of year-end	
	2021	**2022**
Expected annualized 10-year median return	3.83%	6.09%
Expected annualized 10-year median volatility (standard deviation)	9.51%	9.86%
Expected maximum drawdown in any given year	–46.73%	–40.97%
Probability of 10% loss in any given year	59.50%	39.49%

Notes: The chart shows the range of expected annualized 10-year returns for the hypothetical global 60/40 portfolio as of year-end 2022 versus year-end 2021. The table shows risk metrics. Please see footnote 1 for the indexes and weightings used for the portfolio.

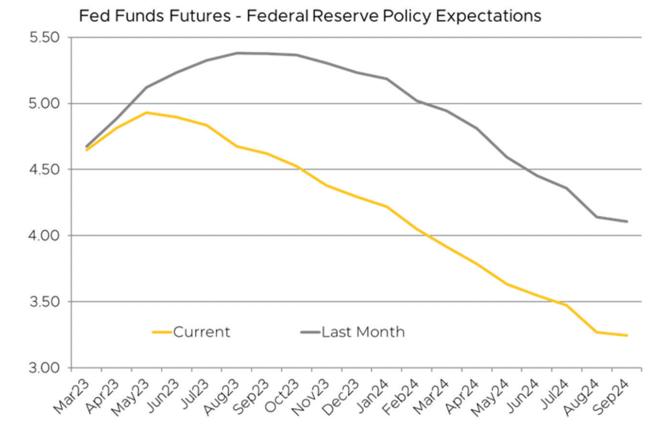
Source: Vanguard Capital Markets Model projections.

Vanguard's 10-year estimate for a 60/40 diversified portfolio return has increased from 3.8%, annually, at the end of 2021, to 6.09%, annually, as of the end of 2022.

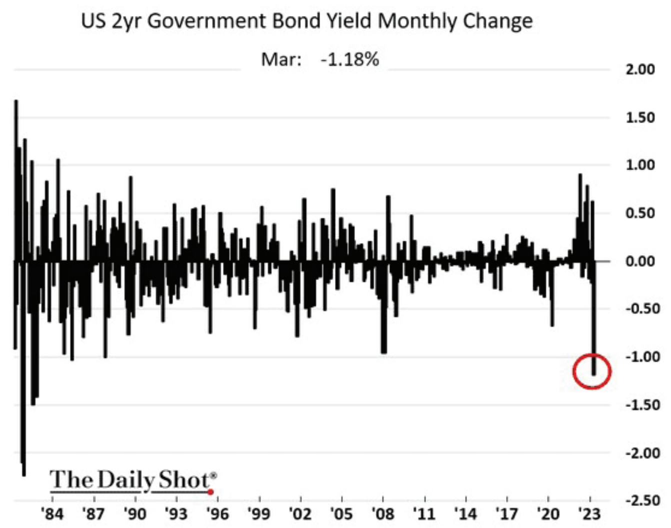
MARKET REVIEW AND OUTLOOK

Follow the Fed

As the market followed the Fed last year, steadily moving lower as they continued to ratchet interest rates higher, it is following their lead in 2023. In anticipation that the rate hike campaign may be coming to an end, stocks have started the year in positive territory. Stocks have also been buoyed by better than expected economic data, which shows unemployment still at multi-decade low levels. The collapse of SVB in the beginning of March has pushed future interest rate expectations even lower, as seen in the chart to the right. Prior to SVB's implosion, it was assumed the Federal Reserve would end the year with interest rates above 5%. Bloomberg estimates are now projecting that rates will be cut to 4.25% by the end of the year in an assumption that the Fed will pivot from fighting inflation to easing financial conditions to ward off banking system stress.



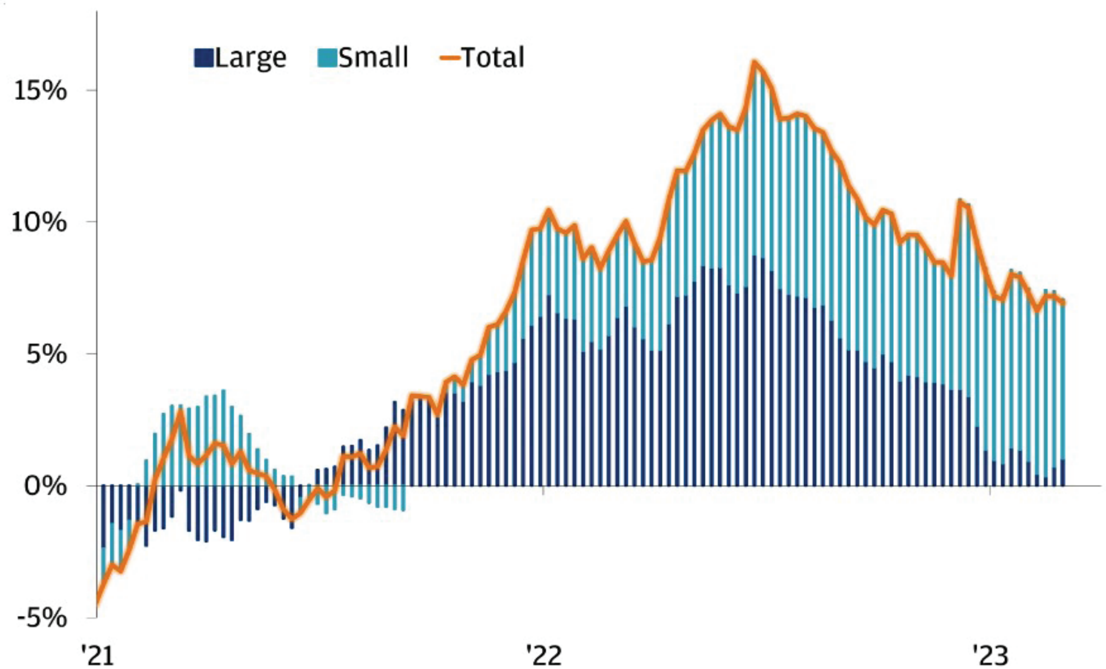
Source: Bloomberg; Cresset Capital.
Chart #0731



Markets must now weigh how likely a soft landing may be in the back half of 2023. In the optimist camp, inflation data has already started to move significantly lower as supply chains have returned to normalcy and commodity prices have fallen significantly. The Fed's work to take money out of the system has been successful in cooling the housing market and reducing spending, while the jobs market has remained strong and kept the economy afloat. In the pessimist camp, high interest rates were already choking off lending and credit availability will become even more constrained with banks tightening their standards. The negative effects of aggressive monetary policy always work with a lag, as evidenced by the SVB collapse 12 months after rates started moving higher. The lag effect could continue to work its way through corporate earnings this year and bring equity valuations down to below average levels.

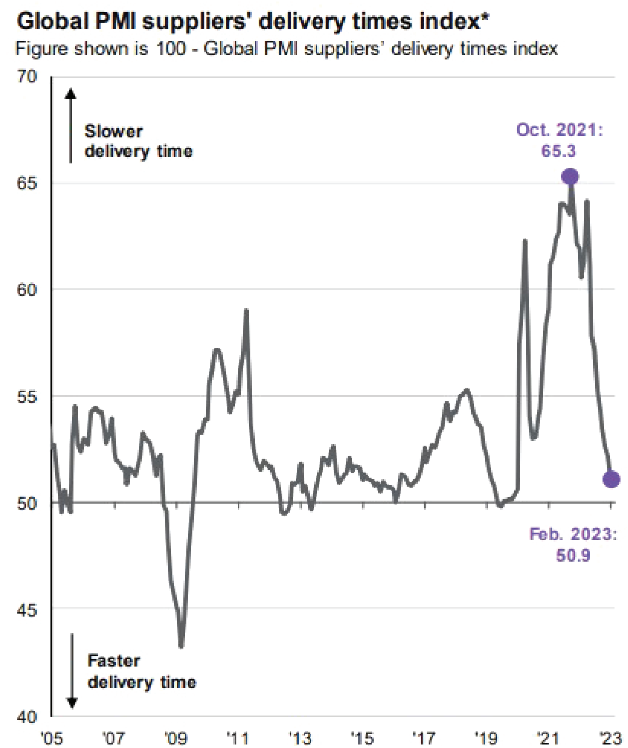
Small vs. large banks: Contributions to loan growth

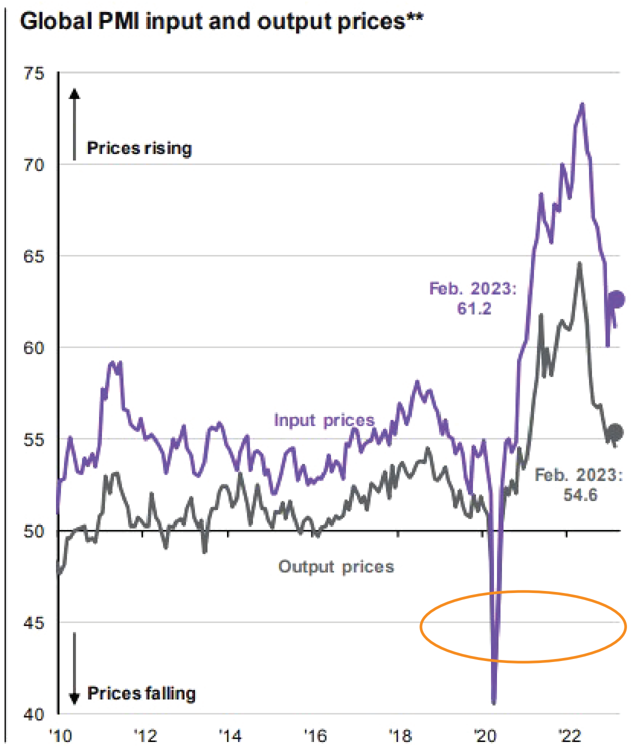
3-month change, annualized



Sources: Haver Analytics, J.P. Morgan Wealth Management. Data as of March 22, 2023.

Small banks have been the primary force behind loan growth over the last six months. This could change in the wake of the SVB collapse.





Source: Standard & Poor's, J.P. Morgan Asset Management.

Supplier delivery times have fallen back towards pre-COVID levels, indicating supply chain pressures have eased. Global industrial input and output pries have fallen substantially from their peaks last year.

MARKET REVIEW AND OUTLOOK

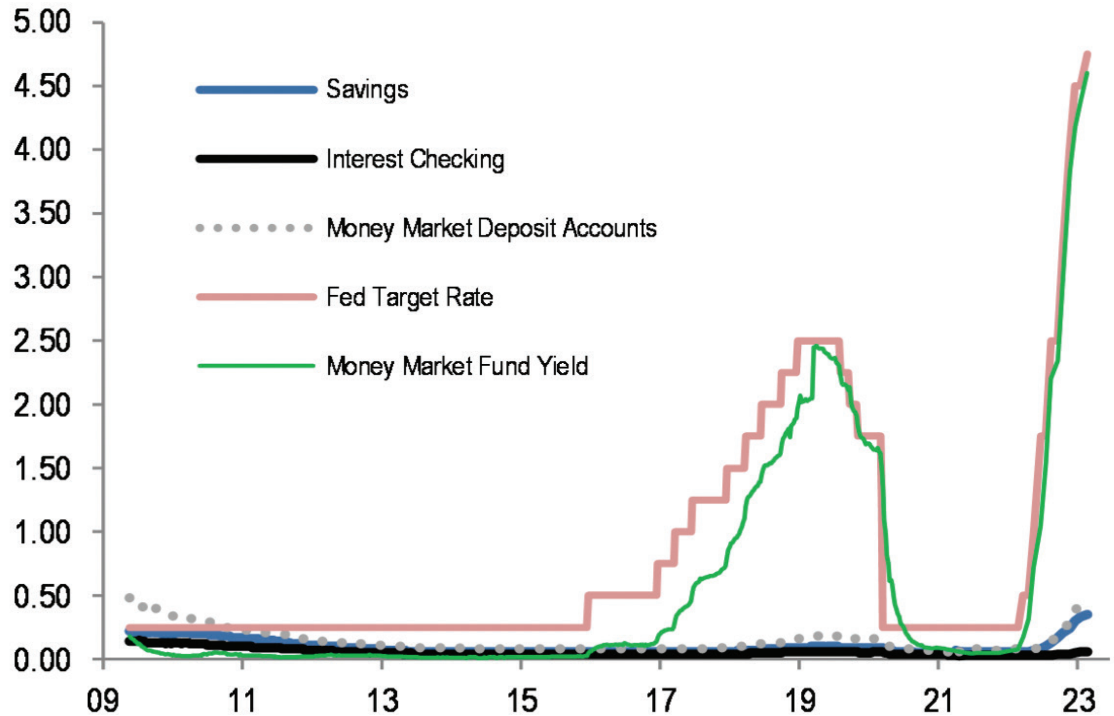
Bonds are Back

The era of zero-interest rate policy, a time period in the U.S. that lasted from 2009 to around 2019, spawned a new investing acronym: TINA (There Is No Alternative). With bonds yielding less than 1%, and in some cases even having negative yields, it was difficult to justify owning bonds over stocks. Even riskier areas of the fixed income spectrum, with yields around 5%, paled in comparison to the double digit returns the S&P 500 was delivering in the majority of calendar years during the TINA era. Looking beyond bonds, commodities lost money in most calendar years and other alternatives like managed futures and private investments sacrificed liquidity for less than stellar returns, relative to the U.S. equity market. The TINA investment thesis not only made sense; it worked with spectacular results for the last decade.

It even continued to make sense last year, despite the worst year for stocks since the global financial crisis. Heading into 2022, a 2 Year Treasury Bond had a yield of just 0.73%. Even though equities experienced a drawdown over 20%, the Barclays US Aggregate Index fell 13%. Yet the TINA investment approach seems to have come to an end, now that bond yields have risen substantially for the first time in over 15 years. U.S. Treasuries maturing in the next year yield around 4.7%. Corporate investment grade bonds have an average yield of 5.35% while more speculative U.S. high yield bonds have a yield of 8.35%[1]. The ability to generate returns in the mid to high single digits from U.S. fixed income has brought bonds back from the grave and given us an alternative to simply allocating to equities to solve for future return needs.

While there has been some volatility in the wake of the SVB collapse, short-term bond yields are still attractive relative to recent history. For example, from 2009 to the end of the first quarter, the 2 Year Treasury Bond had an average yield of 1.08% Right now, the 2 Year is at 3.97%. Given the uncertainty in economic growth through the remainder of this year, combined with the rise in yields across the U.S. fixed income category, we believe investors should closely analyze their allocation to stocks and bonds as it relates to their short-term liquidity needs and long-term investment objectives. For clients where their equity allocation has grown substantially over time due to rising markets and lackluster yields within the bond market, it may make sense to consider shifting a greater portion of their assets back into bonds, especially as markets have rallied this year and short-term bond yields remain elevated.

Figure 2: US Money Market Fund yields vs US bank deposit rates



Source: Bloomberg Finance L.P., J.P. Morgan

Bond yields are at their highest level since 2009, with money market funds now yielding over 4.0%

MARKET REVIEW AND OUTLOOK

Closing Thoughts

As we look ahead to the remainder of 2023 and into 2024, it is entirely possible that the Fed cuts rates and moves back to a "neutral" rate, which they have recently targeted as 3.1%. Lower rates would obviously make bonds less attractive and could lead to higher equity valuations. We started the year with equity valuations in line with historic averages but the first quarter rally and some decline in earnings expectations have led to valuations creeping back up above average. Even with a regional banking crisis and a potential economic slowdown, stocks are already anticipating the Fed lowering rates and the economy being "back to normal" twelve months from now.

We could certainly envision that as well - unemployment is near a multi-decade low and the economy has proven incredibly resilient over the last year in spite of one of the fastest rate hiking programs in the last fifty years. Corporate earnings have decelerated but they have not been disastrous. Inflation continues to ease and supply chains have become increasingly normalized.

However, the situation within the banks does warrant caution. CEOs were already wrestling with uncertainty after high inflation, rising rates, and now with a shock to the lending system, the potential for conservatism over risk taking is elevated. The next few quarters could be harder for economic growth than they were last year as the lag effects of tighter monetary policy ripple through the economy. Given this environment, combined with the attractiveness of fixed income yields, we think investors must be vigilant in assessing their portfolio diversification and exposure to bonds and alternatives.

As we navigate the rest of the year, we will continue to manage both the short-term risks and the long-term opportunities that have been presented. In spite of the fatigue we have all been feeling with the news cycle and market volatility, the prospects for a diversified portfolio's returns are substantially better than they were a few years ago and we are optimistic in achieving our client's long-term goals.

DISCLOSURES

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All data as of 3/31/23 via St Louis Federal Reserve, KKR, JP Morgan, Eaton Vance, the Wall Street Journal, Gallup, and Bloomberg.