The first quarter of 2023 certainly did not lack excitement, yet surprisingly, given the heightened uncertainty and turbulence, both stocks and bonds recorded solidly positive performance. One could be forgiven for being slightly incredulous to this fact, as every news article and market event seemed to imply that the sky was falling, but despite the chatter, the S&P 500 returned 7.5% and the aggregate bond market was in the black by 2.96%, a far cry from the consistent red of last year.

While risk assets seemed to shrug off much of the negative sentiment, the underlying picture remains murkier, as the Fed's aggressive inflation-fighting policy seems finally to be catching up to the economy. So far, the biggest crack to show has been the collapse of several banks, notably Silicon Valley Bank (SVB) and the ensuing re-evaluation of the larger banking sector in absorbing rapidly increasing interest rates. Luckily, decisive action by regulators prevented a systemic issue and while the issue at the heart of SVB's failure was a liquidity one, in times of stress, sentiment can become unanchored from reality quickly.

The more interesting analysis is found in examining the impact of these banking stresses through the lens of Fed action and if/how their policy stance will change as a result. While at the margins, other banks may face more stress or deposit pressure, the larger effect will almost certainly be an overall tightening of lending standards and therefore a reduction in capital availability in the economy. This contraction of credit should serve to further slow inflationary pressure and decrease aggregate demand, in essence diminishing the need for further Fed rate hikes. It seems likely that the Fed will only proceed with one more 25 basis point hike this year, though past that, the consensus diverges. The market is pricing in 50 basis points in cuts by year-end, while many economists, as well as the Fed's own projections, show only a pause through December.

The actual path of rates will do much to determine the return on risk assets for 2023, though the performance of the economy will weigh substantially as well. The economy is indeed decelerating; slowing retail sales, coupled with reduced industrial production and factory output, weakening consumer sentiment and some softening in the labor market, all point to slowdown in the coming quarters. Likewise, while recent headline CPI and PPI reports showed declines, when stripping out the volatile food and energy categories, inflation remains stubbornly high. On a positive note, it is important to remember the starting level for many of these figures: the labor market and consumer spending remain at historically strong levels and while inflation has not fallen as quickly as many have projected, prices *are* decelerating.

Given the uncertain macro backdrop, the strong performance in the equity markets has been a bit of a surprise. The forward P/E on the S&P rose to 18.3, still below the 5-year average of 18.5, but a whole point higher than at the start of the year, as well as the long-term average of 17.3. Corporate earnings are reporting their largest year-over-year declines since Q2 2020, yet so far, 90% of S&P companies have recorded earnings above estimates and 63% have exceeded revenue expectations.

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As we wrote at the end of 2022, at this level, the equity market seems fairly-valued, given the macroeconomic uncertainty. It still seems likely that the market will range-trade from here, with the biggest potential catalyst being the path and magnitude of both Fed rate hikes and cuts, by year-end.

Despite the positive performance and heightened valuations in both equity and fixed income markets, we have continued to find opportunities. On the equity side, we have been focusing on companies that generate outsized, positive free cash flow, a characteristic that helps to weather economic turbulence and return value to shareholders. Similarly, we have further bolstered our individual fixed income holdings, bringing that weighting to over 10% of the portfolio, with an average all-in yield of approximately 6%. These are strategies that we will continue to execute going forward, serving to increase the overall portfolio yield and take advantage of the ability to lock in rates at historically attractive levels. As always, please do not hesitate to contact us if you have any questions or concerns, or to schedule a portfolio review. We look forward to speaking with you and hope that you are enjoying this wonderful Spring weather!

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