# Investment Perspective

The combination of yield alternatives and the mixed outlook for corporate earnings is moderating the near-term enthusiasm for equities

We first met TINA approximately 10 years ago and now we also have TARA. TINA (There-Is-No-Alternative) became popular during the past decade of exceptionally low interest rates when investors embraced equities as an alternative to low yield bonds. Now, TARA (There-Are-Reasonable-Alternatives) is generating attention as tighter monetary policy is producing 5% short-term U.S. Treasury bill yields. Investors have more income producing options to earn moderate returns with less principal risk. The combination of yield alternatives and the mixed outlook for corporate earnings is moderating the near-term enthusiasm for equities. Patience will be required in 2023 as we await eventual interest rate cuts and accelerating earnings growth in 2024. We believe it will be worth the wait. A summary of year-to-date index returns for the period ending March 31, 2023 is as follows:

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|---|---|---|---|
| Dow Jones Industrials | 0.9% | Russell 2500 | 3.4% |
| MSCI EAFE | 8.6% | S&P 500 | 7.5% |
| NASDAQ Composite | 17.1% | Wilshire 5000 | 7.3% |

## GLOBAL ECONOMY

World economic growth (ex. U.S.) is expected to increase 2.9% this year after 3.7% in 2022. Slow growth in the major G6 economies will be offset by faster gains in China and emerging markets. Restrictive monetary policies by the Federal Reserve, European Central Bank (ECB), Bank of England and other central banks are restraining GDP growth in the developed markets to 1% or less. Fighting inflation remains a priority for nearly all central banks as it is a global problem. Growth in China is reaccelerating after a subdued period of economic activity during late 2022 due to a spike in coronavirus infections. China's GDP is likely to increase 5.5% in 2023, benefitting its global trading partners.

The key drivers of growth include consumer spending, capital expenditures and government spending

The U.S. economy is expected to grow approximately 1.0% in 2023. Last year, real GDP increased 2.8% in the second half after declining in the first half. This year, the Fed and economists project the reverse as the lagged effects of tighter monetary policy curtail growth in the third and fourth quarters. The key drivers of growth include consumer spending, capital expenditures and government spending. In general, service industries are expected to show more relative strength compared to manufacturing. The purchasing managers index (PMI) for services in March registered 51.5, down from 55.1 in February, but is still in expansionary mode. In contrast, the manufacturing PMI recently registered 47.1, which is a contractionary reading. There are signs of a manufacturing slowdown. In addition, housing is anticipated to slow the economy with residential investment down 15%. The sharp rise in 30-year mortgage rates to 6.3% over the past year is suppressing housing activity. Net imports will also serve as a small drag on growth. With the unemployment rate at 3.5% and reliable labor in short supply, wages are rising with average hourly

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earnings up 4.2% y/y. However, wage increases have been slowing over the past year indicating that inflation is moderating. The number of people employed part-time has fallen from 11 million in 2020 to 4 million, near the pre-pandemic level. There is barely any slack in the labor markets, which is helping to support overall consumer spending.

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At this juncture, the most important economic issue is the looming risk of recession. Several indicators, including the inverted yield curve - when the three-month Treasury bill yield exceeds that of the 10-year Treasury note - suggest a future economic contraction. If a recession occurs, we think the odds favor a mild or shallow recession. However, the Congressional battle to increase the U.S federal debt ceiling is adding political uncertainty to the outlook.

## MODERN DAY BANK RUN

The banking industry has suddenly become a wildcard in the investment outlook. The rapid failures of Silicon Valley Bank (SVB) and Signature Bank ignited new concerns about the stability of the banking industry. SVB suffered a modern-day bank run with depositors losing confidence in the bank prompting the swift withdrawal of funds. In response, regulators took over the bank to ensure an orderly process. Uninsured depositors were protected by the regulators. This deposit flight exposed the fact that SVB had invested heavily in medium duration bonds that declined in price due to rising interest rates. The bank was caught with an unhedged mismatch of assets and liabilities. Depositors were concerned about accessing their funds and moved their money either to a larger bank or money market funds to receive a higher yield. To prevent panic from spreading, the Federal Reserve launched the Bank Term Funding Program (BTFP) to provide banks with liquidity in exchange for collateral in the form of bonds. This helped banks meet depositor withdrawals and lessened the pressure to sell bonds at losses. Related, the regulators recently took over First Republic Bank and sold the assets to J.P. Morgan in order to protect uninsured depositors from potential losses. Over in Europe, Credit Suisse (CS) was weakened by these banking developments and the Union Bank of Switzerland acquired CS to avoid any further damage. These problems differ from the 2008-style credit crisis and should be less severe.

The total lending capacity within the banking system will shrink, which is consistent with the Fed's restrictive monetary policy

In summary, there are several important ramifications: 1) smaller banks will lose market share to bigger banks, 2) some banks will increase the interest rate paid on deposits to retain customers, reducing profitability and 3) the banking system will lose deposits as customers reallocate to Treasuries, municipals and money market funds outside the banks. Lastly, as aggregate deposits decline, the total lending capacity within the banking system will shrink, which is consistent with the Fed's restrictive monetary policy. Effectively, the higher cost of money and reduced bank lending capacity will slow the economy and the pace of inflation.

## RUSSIAN-UKRAINAIN CONFLICT

This rate of attrition is much higher than in any Russian war since WW II

The war in Ukraine has become a war of attrition. Russia and Ukraine have constructed extensive trench systems and made heavy use of artillery similar to WW I. Russia has employed human-wave frontal assaults against fixed Ukrainian positions that attempt to seize ground by sheer numbers. Neither side has gained much territory since Ukraine's successful offensives in late 2022, even as casualty rates have increased. Russia has reportedly suffered more than 200,000 troops killed or wounded. This rate of attrition is much higher than in any Russian war since WW II. Putin has been willing to accept a substantial number of fatalities with limited domestic political repercussions. Both militaries have suffered significant impairment to their weapons inventories. At this stage, Ukraine needs advanced systems to conduct counteroffensive operations. These include air defense systems, armored vehicles, fighter aircraft, long-range artillery, munitions and unmanned aerial systems (UAS). Ukraine has succeeded thus far versus a larger enemy due to the "will to resist", western support and its technological innovation. The proliferation of unmanned aircraft systems is changing the battlefield and permanently altering warfare. These UASs are used for reconnaissance, target identification, lethal strikes and disruptive tactics that challenge conventional military strategy. Importantly, unmanned systems have improved the efficiency of Ukrainian forces to compete in a war of attrition versus a bigger adversary. UASs are a strategic low-cost force multiplier. Unfortunately, there is no end in sight to this war as Ukraine is preparing a counteroffensive soon. The U.S. and NATO are continuing to support Ukraine with financial aid and military supplies. Belarus, China, Iran, and North Korea are aiding Russia. This war continues to spread. It is also impacting military spending patterns for the U.S. and its allies as they rebuild stockpiles and identify long term needs.

## INVESTMENT OUTLOOK

Corporate earnings growth is either slowing or moderately contracting this year

The financial markets continue to transition from a decade of above-average earnings growth, benign inflation, and low interest rates to a changing fundamental environment. We are in a "tug of war" between earnings gains, interest rates and valuations. Specifically, corporate earnings growth is either slowing or moderately contracting this year. Investor sentiment is cautious as the dual threat of lower valuation multiples and slower earnings growth persists. It is important to proceed carefully. Near term, the Fed is expected to increase the federal funds rate another 25 basis points in May. From there, it is likely to remain on hold and data dependent as the end of this tightening cycle is near. Positively, the financial markets may rally on the prospects of fed funds rate cuts later this year or next. This may support stock prices in advance of improving fundamentals. Also, individual investors bought $78 billion of stocks and exchange traded funds in the first quarter and corporate buyback announcements are near record highs. We are in a transition year with 2024 offering a more bullish outlook.

We expect Standard & Poor's 500 (SPX) operating earnings per share to decline modestly in 2023 to approximately $210 after growing 5% last year to $219. This year's estimate is subject to considerable variability depending upon the timing of an economic slowdown or softness in bank earnings. SPX earnings estimates for this year range from $195 to $230, with the consensus bottoms-up estimate at $221. However, the SPX may benefit from the weakening dollar and its translation effects since 40% of revenues are international. Given the wide range of possible outcomes, it is prudent to maintain a conservative view until downside risks diminish. Currently, the SPX is valued at 18.9x the consensus 2023 earnings estimate versus its long-term average of 16.6x.

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Headline inflation as measured by the consumer price index (CPI) was up 5.0% y/y in March, decelerating at the slowest pace since May 2021. The inflation rate has declined for nine consecutive months. Core inflation (CPI excluding food and energy) rose 5.6% y/y in March. The Fed's preferred measure of inflation, the core personal consumption expenditure price index (PCE), excluding food and energy, increased 4.6% y/y. Inflation is moderating, though the pace of deceleration remains slower than expected. It is taking longer for the lagged effects of monetary policy to reduce inflation in services, shelter costs and wages. Economists expect core PCE inflation to decline to approximately 4.0% this year and 2.4% in 2024. Higher interest rates are rolling through the economy as intended. For example, many of the most interest-rate-sensitive sectors of the economy are already feeling the pressure from higher rates, including commercial real estate, housing, durable goods (used motor vehicles), and regional banks. Short-term interest rates may remain elevated as the Fed controls this end of the yield curve. However, long term interest rates may settle between 3.25-4.25%, similar to levels before the 2008 global financial crisis. Recently, the 10-year Treasury yield has declined to 3.52%.

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From a technical perspective, the stock market finished the first quarter with weak breadth after the Silicon Valley Bank collapse spooked investors. Initially, the year started with a broad rally as cyclically exposed companies, fallen angels and smaller companies performed best in January. However, that faded as large capitalization technology stocks in the NASDAQ Composite showed leadership in a flight to quality. But breadth is improving again in April. Market leadership continues to evolve, and it is difficult to determine if the recent advances are durable and sustainable. Positively, the fear gauge – the VIX option volatility index – is at 15.7 indicating less risk and one of the lowest levels over the last year.

We expect a choppy and challenging year in the stock market that will eventually climb the "wall of worry." The SPX has only declined two years consecutively twice over the last 80 years. If recession fears abate, the stock market could respond favorably to the "soft landing" thesis. Similarly, stocks may react positively to the expectation of Fed easing following nine interest rate hikes that total 500 basis points in the last 12 months. We favor adding to equities during periods of individual issue or overall market weakness. The key risks include banking problems, cyber-attacks, earnings recession, energy security, higher short-term interest rates, Taiwan, trade policies with China and the Russia-Ukraine war. In our opinion, quality small and medium-sized growth companies remain likely to achieve above-average annual returns over the next few years. We are cautiously optimistic and remain alert to take advantage of stock market opportunities as they arise.