MARKET REPORT
FIRST QUARTER 2023

Key Points

- Five days and 15 ballots to elect the Speaker of the House was not a record.
- The pace of Fed rate increases slowed during the quarter.
- Market concentration is declining but is still elevated.
- The yield curve is deeper into inverted territory.
- We share a few comments about investment account custodians.

Total Return as of March 31, 2023						
			Annualized			
	QTD	**YTD**	**1 Yr.**	**3 Yr.**	**5 Yr.**	**10 Yr.**
S&P 500	7.5%	7.5%	-7.7%	18.6%	11.2%	12.2%
NASDAQ	17.0%	17.0%	-13.3%	17.6%	12.6%	15.3%
Russell 3000						
Index	7.2%	7.2%	-8.6%	18.5%	10.5%	11.7%
Value	0.9%	0.9%	-6.4%	18.1%	7.3%	9.0%
Growth	13.9%	13.9%	-10.9%	18.2%	13.0%	14.2%
Russell Mid Cap						
Index	4.1%	4.1%	-8.8%	19.2%	8.1%	10.1%
Value	1.3%	1.3%	-9.2%	20.7%	6.5%	8.8%
Growth	9.1%	9.1%	-8.5%	15.2%	9.1%	11.2%
Russell 2000 (Small Cap)						
Index	2.7%	2.7%	-11.6%	17.5%	4.7%	8.0%
Value	-0.7%	-0.7%	-13.0%	21.0%	4.6%	7.2%
Growth	6.1%	6.1%	-10.6%	13.4%	4.3%	8.5%

A Review of the Quarter

The quarter began with political fireworks as it took **five days and 15 ballots** to elect the Speaker of the House. The media sensationalized the process, of course, but it was pale in comparison to the roughly **two months and 133 ballots** necessary to elect Nathanial Banks of Massachusetts to the position in **1856** for the 34th Congress.

On the heels of the spirited Speaker election, a Chinese spy balloon traversed the United States and elevated levels of saber-rattling ensued on the world stage. Then, an unnecessary bank debacle unfolded as Silicon Valley Bank's depositors lost faith in management and voted with their checkbooks – withdrawing an estimated $42B in a single day. Wow! According to The Wall Street Journal, "It took **four decades** to build Silicon Valley Bank and its parent company, SVB Financial Group, into the startup world's pre-eminent financier. It took **36 hours** to dismantle it."

Social media and the ability to electronically transfer funds played a role in this modern day "bank run." The banking and financial systems are built on **trust, integrity and confidence**. When those elements are **compromised**, the **psychology of crowds** coupled with digitization can result in near-instantaneous failures. Understanding a financial institution's funding sources is as important as understanding its culture, credit policies and asset profile, in our view.

Source: Quarterly Chartbook, Q2 2023

The Federal Reserve (the "Fed") **slowed its pace** of rate increases during the quarter, increasing only 0.25% to a range of **4.50% – 4.75%**, as inflation continued to moderate and leading economic indicators (see accompanying chart), as well as manufacturing and non-manufacturing data suggest a period of lower economic activity lies ahead.

A confounding aspect, however, is the low unemployment rate which may need to increase from rock bottom levels for the Fed to achieve its targeted 2% average rate of inflation. The number of employees "quitting" their jobs appears to have peaked in April 2022. This, coupled with an increasing number of corporate directives requiring that employees return to the office are reflective of the proverbial employee / employer relationship **pendulum** swinging back toward center from an extreme.

Our investment strategies generally resumed compounding after experiencing, in our view, modest losses during 2022. U.S. equity averages, excepting small cap value, lifted as well. Although many companies are requiring employees to spend more time in the office, it could be too little too late for some office building landlords facing lower rents and higher interest rates upon refinancing.

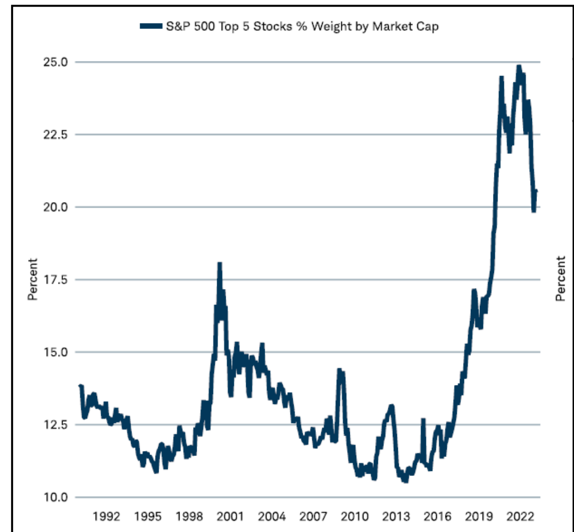
U.S. Equities

The U.S. equity market (S&P 500) posted a strong quarter after a dismal 2022 as shares of those companies most negatively impacted last year generally "reverted to the mean."

Seven of the 11 economic sectors logged gains with Technology (+21.8%), Communication Services (+20.5%) and Consumer Discretionary (+16.1%) logging the strongest returns for the quarter after leading to the **downside in 2022** (**-28.2%, -39.9% and -37.0%, respectively**). Financials (-5.6%), Energy (-4.7%) and Healthcare (-4.3%) declined the most during the period. Based on quarter-end data, the market is a little expensive in our estimation.

Fortunately, our strategies holding individual equities are trading at a discount to our estimates of intrinsic value which should create a margin of safety (i.e., the difference between intrinsic value and market price) and support long-term compounding.

Although the weight of the top five stocks in the S&P 500 as a percentage of market cap has **declined** since the 2022 peak, the concentration is **still elevated** (see accompanying chart). As a point of reference, the top five companies accounted for roughly 46% of the S&P's first quarter total return.[1] We believe less concentration provides for a healthier market overall.



Source: Quarterly Chartbook, Q2 2023

On average, we remain focused on higher quality companies capable of producing adequate amounts of free cash flow with conservatively structured balance sheets. In our view, **flexibility** is more valuable than usual in the current environment. Additionally, having the ability to successfully pass along price increases to protect margins is important.

Fixed Income & Commodities

Corporate bonds' total returns, as measured by the ICE BofA U.S. Corporates 1-10 Yr. index, lifted 2.5% during the quarter but are down 1.9% y/y. U.S. Treasuries and Agencies, as measured by a similar index, gained 2.2% and declined 1.6%, respectively.

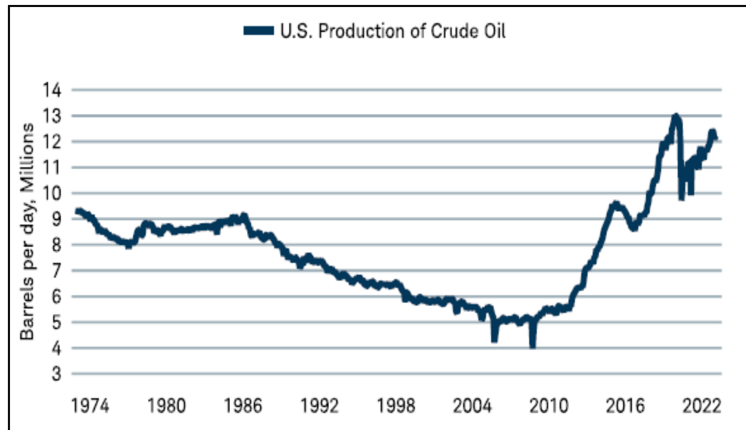
Treasury yields declined during the quarter with the 2-Year ("2s") decreasing 27 basis points to 4.16% and the 10-Year ("10s") decreasing 33 basis points to 3.55% at quarter-end. With a **negative 61 basis point** (a basis point is 1/100th of a percent) spread between 10s and 2s, the yield curve is **more deeply inverted than at year-end**. An inverted yield curve often portends economic weakness. The yield curve should normalize by either short-term rates declining once inflation cools or long-term rates increasing.

BBB yields increased out to the one-year mark and declined thereafter. Credit spreads widened out to seven years with the short end widening the most. Some forecasts (not ours) have the Fed Funds rate peaking in the mid-5% range around late summer. We offer this for context and not as a forecast, because prognosticators are often notoriously wrong.

[1] Based on beginning of period weightings.

We have slightly increased longer dated maturities within our fixed-income strategies and willingly accepted marginally lower yields in exchange for longer income streams which can be beneficial if near-term yields decline.

Commodities, as measured by the Bloomberg Commodity Index, decreased 5.4% for the quarter and 12.5% y/y. Oil (WTI) declined 5.7% for the quarter and 24.5% y/y. Natural gas (Henry Hub) declined precipitously, **contracting 40.3%** during the quarter and 61.7% y/y. Lower commodity prices are currently benefiting consumers.



Source: Quarterly Chartbook, Q2 2023

U.S. oil production has been on the rise since around 2012 (see chart above) and has gained momentum in recent quarters after retrenching in 2020 due to COVID. Strong domestic oil production is important from an economic and national security perspective as the country continues its pursuit of low-carbon energy solutions.

Account Custodians

As a Registered Investment Advisor ("RIA"), we are required to hold your investments at a qualified custodian. Many custodians have integrated banking and brokerage operations and sweep cash to the banking side of their business which is covered by the FDIC up to "$250,000 per depositor, per insured bank, for each account ownership category."

Although there can always be an exception, we typically hold large cash balances in money market funds or short-term fixed-income ETFs, both of which are considered "securities," covered by the SIPC and held on the brokerage side of the business.

Looking Ahead

Heeding lessons from the '70s and early '80s, the Fed has telegraphed its intent to keep rates higher for longer, as necessary, to rein in inflation. The restrictive monetary environment, slowing economy and rising tensions between the U.S. and China and Russia as they seek to rearrange world order, could lead to increased levels of volatility in the quarters ahead. Our focus on price-to-intrinsic value relationships, position sizes and understanding of the companies in our strategies are all factors that can help reduce risk. Some volatility should create new opportunities, which we would welcome.

Past performance is not indicative of future results. Market and economic data have been provided by third party sources. This data, while believed to be reliable, has not been independently verified by EBS.