CLIENT BRIEFING

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The first quarter began with investors feeling largely upbeat. Inflation appeared to be subsiding, and many bet that would lead the Federal Reserve to switch quickly from raising interest rates to cutting them. Then economic data started coming in hot, fueling worries that the Fed would have to keep rates higher for longer.

The biggest shock of the quarter came in March, when Silicon Valley Bank (SVB) and Signature Bank collapsed. The reason SVB failed was a poor risk management and investment process. In fact, SVB did the opposite of what we do to benefit our clients. While we took steps to reduce interest rate risk in our client's portfolios, SVB piled into high-quality, long-term bonds but didn't hedge against the possibility of a rapid rise in interest rates. Rising rates exposed a fatal flaw in its portfolio. As the losses became public, the bank and its stock began to crash.

In the face of significant uncertainty, markets proved to be more buoyant than many investors thought possible. The S&P 500 rose 7% in the first quarter, while the technology-heavy Nasdaq soared 17%. Overall, it was the Nasdaq's best quarter since the second quarter of 2020. In general, growth stocks (S&P 500 Growth) outperformed value stocks (S&P 500 Value), returning 9.6% and 5.2% respectively. Value stocks were hampered by a -5.7% performance from the financial sector tied to the banking fallout. Developed international (MSCI EAFE) returned 8.5% for the quarter. As I've shared many times, after more than a decade of underperformance, foreign stocks have recently offered significantly lower valuations than US stocks and should be a part of an investor's overall equity allocation. Meanwhile, bond prices climbed as the yield on the 10-year Treasury note fell to 3.49% from 3.82% at the end of last year.

What explains the relative calm and outperformance of stocks though the first three months of the year? Well, a widely anticipated recession has yet to materialize, at least so far. The labor market has remained strong, even with a pickup in layoffs in the technology sector in recent months. And inflation, while still high, has continued to ease. The consumer price index, CPI, rose 5% last month, down from February's 6% increase and the smallest gain since May 2021, according to the Labor Department. The combination of these factors has helped investors to stay optimistic about the future of the US economy.

As earnings season kicks off in April, we will be closely watching the banking sector. We think the failures of SVB and Signature Bank will prove to be outliers rather than endemic. As inflation trends lower, we think stocks have room to rally further, and bonds can serve as a viable hedge against market volatility.

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Sources:
1. Wall Street Journal: Stocks Cap Wild Quarter to Notch Gains, 4.1.23
2. Bureau of Labor Statistics: May Inflation Meeting, 4.12.23
3. Valmark: TOPS Quarterly Update Q1 2023, 4.13.23