Perspectives

A Quarterly Newsletter for Clients of Parsons Capital Management

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by John Mullen and Ruth Mullen

It is often said that when the Fed embarks on a tightening campaign, it doesn't stop until something breaks. On March 10, we finally got the answer to what the casualty of this rate hike cycle would be: Silicon Valley Bank being closed by the government in the face of an unprecedented bank run. Two days later, Signature Bank was also closed before various federal government agencies announced sweeping protections intended to halt the nascent contagion in the banking system. The stunning collapse of SVB occurred six days before the one-year anniversary of the current tightening cycle, which has proven to be one of the most aggressive on record. Q1 2023 market action was, broadly speaking, a complete reversal of what worked throughout most of 2022. Value stocks, which consistently bested growth last year, barely managed to eke out a gain for the quarter, while growth powered higher. Emerging markets had begun to outperform domestic markets toward the end of 2022 but lagged well behind both the U.S. markets and developed international indices. In the U.S., performance worsened as investors moved down the capitalization scale from large cap to small cap. In a dramatic sign of how top-heavy performance was for the quarter, the S&P 100 (largest 100 stocks) returned +10.15% versus the equally weighted S&P quarterly return of +2.93%. Bitcoin rallied as investors, perhaps, began to look at it as a store of value or safety.

Data as of March 31, 2023	March '23	Qtr. 1 '23	YTD '23
S&P 500	3.67%	7.50%	7.50%
MSCI AC World Index (incl. U.S.)	3.15%	7.44%	7.44%
MSCI EAFE (Europe, Asia, Far East)	2.61%	8.62%	8.62%
MSCI EM (Emerging Markets)	3.07%	4.02%	4.02%
Russell 1000	3.17%	7.46%	7.46%
Russell 1000 Growth	6.84%	14.37%	14.37%
Russell 1000 Value	-0.46%	1.01%	1.01%
Russell Midcap	-1.53%	4.07%	4.07%
Russell 2000	-4.78%	2.74%	2.74%
Bitcoin	23.03%	72.25%	72.25%

Data provided by Tamarac Inc.

Fixed Income Markets

The mirror image theme carried over into the fixed income markets. While bonds were positive across type (municipal, Treasury, corporate) and maturity, the best performers were the longest dated Treasuries with a positive total return of +6.16% for the quarter after returning -31% last year. This more than doubled the return for the U.S. Aggregate Bond Index, which was +2.96% for the quarter, as rates fell the most on the longer end of the yield curve. Even with increasing concerns of a looming recession throughout the quarter, notably the high yield index still returned +3.72% in that period.

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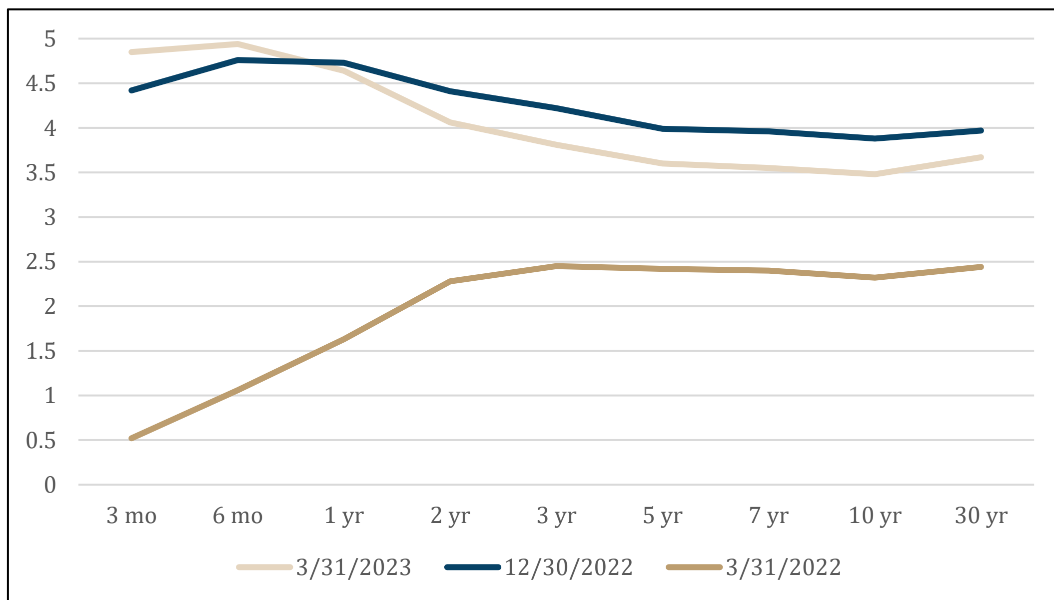
US Treasury Yields

Market trying to send the Fed a signal…

In March the Federal Reserve approved the ninth hike in its yearlong tightening campaign, bringing the target for the Fed Funds Rate (FFR) to 4.75%-5%. Of particular note at the end of the quarter, beyond the increasingly inverted yield curve, was the fact that each maturity on the curve was below the high end of the FFR. The market is clearly telling the Fed that it has hiked enough, or too much, and should pause to take stock of where things stand. The current Fed dot plot, its projection of where the FFR is going, points to one more hike this year of 25 basis points (0.25%); however, pressures are mounting against it.



Data from US Treasury

Commodities

Price returns in commodities a mixed bag…

Headline commodity price action as measured by the CRB (Commodity Research Bureau) showed a tame quarter, but the dispersion under the hood was quite pronounced. Copper, with its +7% advance, nearly matched gold while soybeans, wheat and corn all fell (-2%, -13% and -3% respectively).

The most pronounced weakness in the commodity space was found in energy. While oil dropped nearly -6% in the quarter, natural gas plummeted -44%, marking the worst quarterly performance ever.

Commodity	Qtr. 1 '23	Year to Date '23
CRB (broad index)	-0.75%	-0.75%
Oil	-5.94%	-5.94%
Gold	7.96%	7.96%

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Economic Overview

Muddled outlook for the economy…

Recession was the word of the quarter, with most of the debate around the imminence of a recession. Were we already in one? Can we still have a "soft landing"? Perhaps unsurprisingly there were strong points to support either argument.

The final reading of the Institute for Supply Management (ISM) manufacturing report in the quarter fell to 46.3. Going back to 1950, there are 16 recorded instances where the manufacturing ISM report was at an equal or lower reading; 12 of those readings occurred either just before or in the early stages of a recession. While the manufacturing report shows clear signs of contraction, the ISM services reading notched its third consecutive month of expansion (and 33 out of the last 34 months) at 51.2. While the measure itself indicates expansion, the headline number was down 3.9 points from February. Two encouraging signs were that the pace of delivery improved (pointing to continued healing in the supply chain); also, the measure of prices paid dropped, helping to moderate inflation.

Domestic economy clearly decelerating…

No single aspect of the domestic economy has been more resilient than the jobs market, continually defying expectations (and the hopes of the Fed) to weaken and take some of the inflationary pressure off the economy. As March came to a close, however, the employment picture started to show the first meaningful signs of weakness since the recovery from Covid lockdowns.

Job market starting to show cracks…

After adding 326,000 jobs in February, the U.S. saw gains of 236,000 in March while average hourly earnings gains moderated to 4.2% year over year. Encouragingly, the labor force participation rate increased to 62.6%, which is the highest reading since before Covid. The number of job openings fell below 10 million in February, the first time in two years it had been that low. At the same time, hiring looks to be moderating and layoffs are ticking up. The Federal government reworked how it calculates unemployment insurance claims at the end of March, causing revisions going back to 2018. Regardless of whether one were to look at the old data set or the revised one, however, a clear picture emerges of steadily increasing claims since the beginning of 2023. While the job market remains firm, it is by no means overheating as it was through much of 2022.

Banking blowup to have an unknown impact on the economy…

Perhaps the biggest potential constraint on economic activity going forward is the pullback in bank lending tied to the implosion of Silicon Valley Bank and Signature Bank in the closing weeks of March. In the last two weeks of the quarter, commercial lending dropped by $105 billion, the largest dollar decline on record. With bank lending tightening, economic activity should slow.

The global economic picture is, perhaps, more robust than that in the U.S. Looking to Europe, many countries are seeing improving survey readings that have moved firmly into expansion territory. The Eurozone Purchasing Managers Index (PMI) rose 2.3 points to 55 in March. This has occurred after massive inflationary shocks have worked their way through the system. Chinese activity also looks to have accelerated. Their PMI rose to 51.9 in March, after a messy reopening once they finally abandoned their Zero-Covid policy.

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Investment Implications

Leadership reversal in the quarter…

As touched on in the opening paragraph of this *Perspectives*, market action in the first quarter of the year was a near-total reversal of leadership that had emerged during the yearlong hiking campaign from the Fed. The quarterly performance was notable from the marked outperformance of growth compared to value, interest rate volatility that scored an all-time high while regional banks registered their deepest oversold conditions ever. With such a departure from what had become a yearlong trend in relative performance, it's now critical to dissect what was behind the leadership reversal and examine how sustained the change may be.

A flood of liquidity to counteract headwinds…

A little-discussed hallmark of one of the most aggressive tightening cycles the Fed has ever undertaken is the draining of liquidity in the marketplace. As the Fed engaged in Quantitative Tightening, actively shrinking their balance sheet, liquidity (the life blood of financial activity) drained from the system. One measure compiled by the research firm Strategas estimates that a net $1.02 trillion in liquidity was drained from the system over the five quarters ended 12/31/22. Nearly all of that was reversed in the first quarter of 2023 as the Fed prepared for the technical breaching of the government debt limit and then reacted to the incipient banking crisis. All told, the Fed injected $755 billion of liquidity into the economy in the quarter, much of it in the final two weeks. In response, gold, Bitcoin and growth stocks all surged while inflation continued its downward drift. Consumer discretionary outperformed the more defensive sectors of consumer staples and healthcare; the NASDAQ rose +17%. In other words, it was risk on against the liquidity backdrop, much like the bull market conditions that prevailed from 2009 to 2021.

Tightening likely to take the lead again as the year rolls on…

Our contention is that monetary conditions will revert to being tight rather than loose as the pressure from potential bank failures recedes and the prospects for a successful debt ceiling negotiation improve. It follows, then, that market leadership should also change to be more like what we saw in 2022: value over growth, defensive sectors over cyclical. We don't want to paint with too broad a brush here, however, as there will be exceptions to that trend based on stock-specific factors.

There are a number of ways in which conditions can tighten. Fed actions to raise interest rates and remove liquidity from the system are discussed above. We expect bank lending standards to tighten as well, restricting the loan activity of individuals, corporations, builders, developers and investors.

Market performance as concentrated as ever…

Ten stocks have accounted for 90% of this year's S&P 500 rally. They were all growth stocks, most in the technology sector. The conditions we expect to reappear in the second quarter are not broadly conducive to growth stock outperformance. There is also a good chance of earnings disappointments and lowered earnings estimates as the quarter progresses, so we're not out of the woods yet.

Now for the good news: The stock market is a forward-looking discounting mechanism. It moves between bull and bear cycles. We've been in a bear market for most of the past year. The anatomy of a bear market usually includes

- an event that kicks it off, in this case the Fed's aggressive rate hiking campaign as a late response to inflation
- a period of volatility with lower highs and lower lows
- the formation of a bottom, which we believe began in November 2022
- a financial accident-think the bank failures of March 2023
- broad investor negativity, which we are seeing now

The last two factors usually mark the end of the bear, so while we are still cautious, we think we are moving ever closer to the end of this one. We expect the emergence to be led by other than the recently outperforming growth stocks.

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