PENOBSCOT
FINANCIAL ADVISORS

MARKET COMMENTARY

Q1 2023

MARKET REVIEW

If we could use one theme to describe the first quarter of 2023, it could be: RESILIENCE.

- Equity markets in the US demonstrated resilience, with stock prices climbing despite bank failures and political jawboning around the debt ceiling.
- International and Emerging Market stocks made progress despite the war in Ukraine, still-strong US dollar and inflation abroad proving to be more 'sticky' than in the U.S.
- Technology and growth stocks, some of the biggest losers of 2022, demonstrated resilience, leading performance in a market that had become largely focused on value.
- Jerome Powell's Fed resiliently stuck with a hawkish tone, dismissing the likelihood of monetary accommodation despite the market pricing in expectations of rate decreases later in 2023.
- And earnings season demonstrated that US companies have remained resilient during the period of high inflation, likely because of having been able to push price increases on to a still-resilient consumer.

The quarter kicked off with stocks enjoying their best January performance since 2019, as data suggested that inflation may have peaked, raising hopes that the Federal Reserve would scale back interest-rate hikes and temper fears of an economic recession. Nevertheless, Federal Reserve Chair Jerome Powell cautioned that the battle against rising inflation was far from over and additional rate hikes were upcoming. In fact, the Federal Reserve hiked interest rates 25.0 basis points on the last day of the month. Growth stocks performed best, with Mega caps making solid gains. Consumer discretionary, communication, and tech sectors performed well, while defensive sectors, such as utilities, health care, and consumer staples, dipped lower. Bond prices advanced, pulling yields lower. While 260,000 new jobs were added in December, the growth was the slowest in two years.

Stocks gave up some of their January gains in February, with each of the benchmark indexes losing value. Crude oil prices decreased and the dollar gained ground versus a basket of currencies. Gold prices lost most of their January gains, falling 5.7% in February. Consumer prices advanced, with core prices (excluding food and energy) climbing 0.6%, the biggest advance since August. Over 500,000 new jobs were added, nearly three times the consensus estimates, and the largest increase in six months. The unemployment rate slid to 3.4%, its lowest level since 1969. Consumer spending rose 1.8%, the most in nearly two years.

March was a very choppy month for market returns. Despite an apparent banking crisis, investors stayed the course for the most part, driving stocks mostly higher. Labor remained strong, with 311,000 new jobs added. Hourly earnings rose by $0.08 for the month and 4.6% since February 2022. The Consumer Price Index rose 0.4% after

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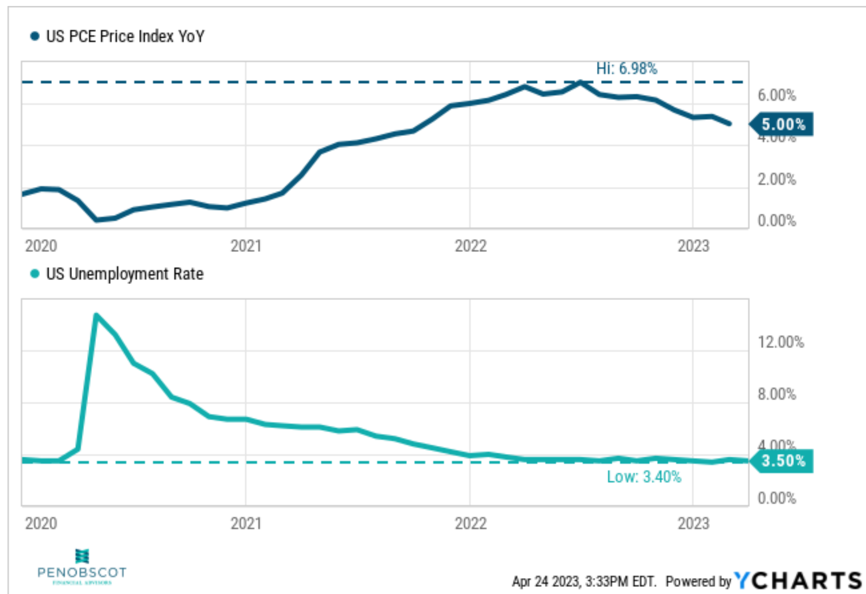
falling 0.5% the previous month. The PCE price index increased 0.3% and 5.0% over the past 12 months. The economy advanced at an annualized rate of 2.6% in the fourth quarter, short of the 3.2% increase in the third quarter. Crude oil prices and the dollar declined, while gold prices climbed higher.

Inflationary data in January seemed to show inflation may have peaked, and the Fed would scale back its interest-rate hikes, if not cut them. However, subsequent inflation data showed prices ramped up again.

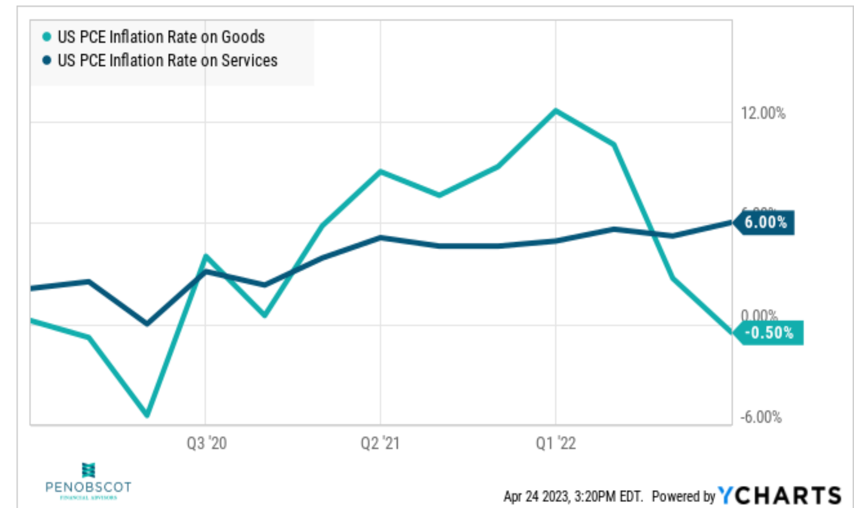
LOOKING FORWARD

As we start the 2nd quarter of 2023, the level of uncertainty over the trajectory of markets and the economy seems every bit as high as it was when we started the calendar year. The uncharted waters of a very aggressive Fed Funds rate increase, coupled with a runoff of inventory on the Fed's Balance sheet (quantitative tightening), while at the same time seeing very little evidence of a substantial impact on the jobs market, leaves analysts without much of a playbook to run with. What seems to be developing, away from a general consensus that 2023 would mark the beginning of a shallow recession, is a split between two camps: those who believe that the Fed has already gone too far and have laid the groundwork for a more severe recession, and those who see an economy resilient enough to endure the tighter monetary policy with continued (albeit lower) growth through the year.



IS INFLATION FINALLY VANQUISHED?

The Fed has made it clear that they still see inflation as being too high, and they seem much more focused on the risk of inflation flaring back up than on the risk that they slow the economy excessively. One problem with being able to factor future Fed action is that there are many ways to measure inflation. Price increases in most basic goods and materials have slowed to levels that existed prior to the pandemic. Housing prices have slowed, and rents are seeing far lower levels of inflation than at this point a year ago. Increases in the cost of services, including transportation and hospitality, however, are not showing signs that they've started to slow.



The Feds preferred PCE Inflation Index seems to have peaked in June of 2022. The path downward seems to be established, yet we remain far from the Fed's 'target' inflation of 2%. This should make investors skeptical of assertions that the Fed will remove its foot from the brake anytime soon.

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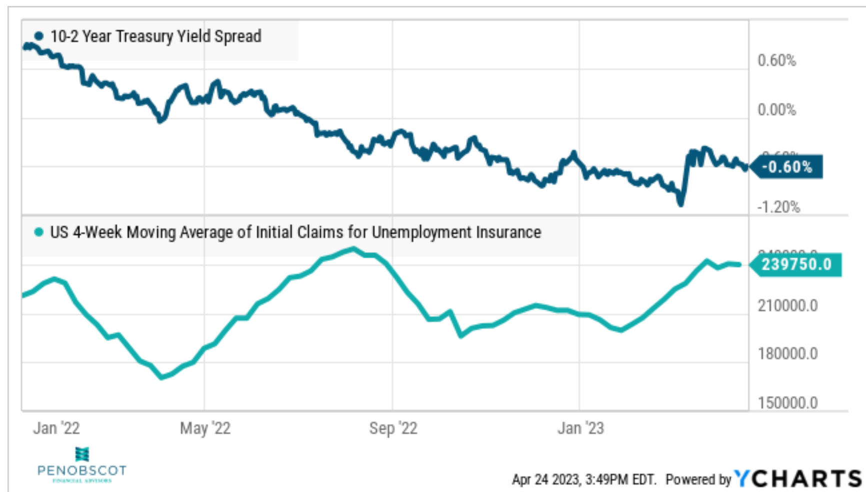
Increasing unemployment is an inevitable expectation once the economy begins to slow as a result of the tighter monetary conditions – but that hasn't materialized yet.

Also, while yield curve inversions have preceded the last six recessions, so has an increase in initial jobless claims. The latter isn't materializing (yet) to a convincing degree. This, despite a surge in the number of layoffs. This reduction in job market slack could give the Fed just the cover it needs to continue raising rates but it may also contribute to the Fed reaching its inflation targets quicker if the tightening jobs market reduces worker bargaining power for greater wages.



GETTING INTO THE FED'S HEAD

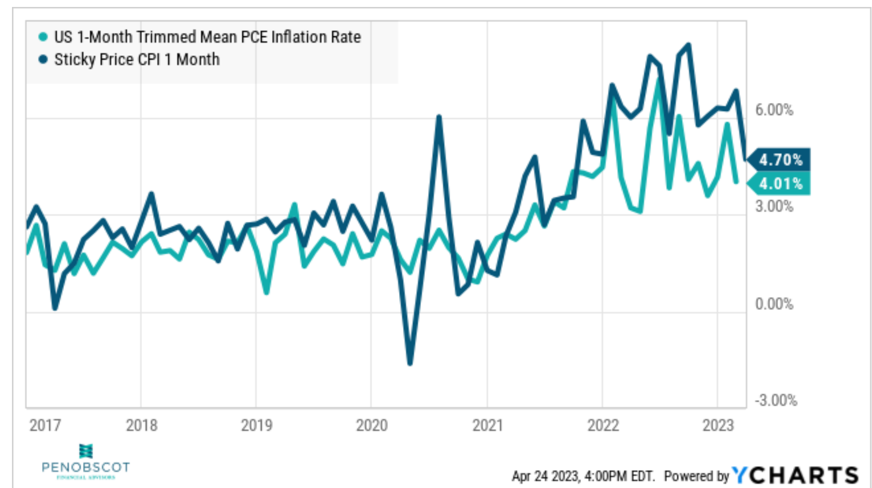
The reality, however, is that we do have some insight into what the Fed is thinking, because they do provide quarterly reports on what their twelve members are expecting. The median projections from the FOMC governors show economic growth (GDP) slowing in 2023, and regaining strength in 2024 and 2025. Unemployment is expected to increase, but not significantly beyond longer run averages. Inflation is expected to return to the longer-run target of 2.0 percent, but notably, not within the next two years.

Another factor of note is that the FOMC doesn't seem to rely very heavily on the most popular measure of inflation: the CPI (Consumer Price Index). They do seem to put more weight into Personal Consumption Expenditures deflator (the PCE). They also provide us with tweaks on the traditional indices that they seem to feel better reflect pricing trends. Two of the resulting metrics are the 'Trimmed Mean', provided by the Cleveland Fed, and the 'Sticky' price index, provided by the Atlanta Fed. The Trimmed Mean throws out the most volatile up-and-down parts of the CPI and averages the remainders, while the 'sticky' Atlanta Fed number gives us an insight into price movements of items that usually don't move as quickly as the more volatile parts. Both indices showed substantial downward movement in March, which could add substance to the argument that the Fed may be on the verge of a 'pause' in rate increases.

Median FOMC economic projection

	Meeting date	2023	2024	2025	Longer run
Real GDP	Mar '22	2.2	2.0		1.8
	Jun '22	1.7	1.9		1.8
	Sep '22	1.2	1.7	1.8	1.8
	Dec '22	0.5	1.6	1.8	1.8
	Mar '23	0.4	1.2	1.9	1.8
Unemployment rate	Mar '22	3.5	3.6		4.0
	Jun '22	3.9	4.1		4.0
	Sep '22	4.4	4.4	4.3	4.0
	Dec '22	4.6	4.6	4.5	4.0
	Mar '23	4.5	4.6	4.6	4.0
Core PCE inflation	Mar '22	2.6	2.3		2.0
	Jun '22	2.7	2.3		2.0
	Sep '22	3.1	2.3	2.1	2.0
	Dec '22	3.5	2.5	2.1	2.0
	Mar '23	3.6	2.6	2.1	2.0

Source: Federal Reserve Board, J.P. Morgan



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Relative to where we started 2023, expectations of further rate increases – and decreases – have changed substantially, as slowing economic indicators have paired with more convincing evidence that inflation may be coming under control.

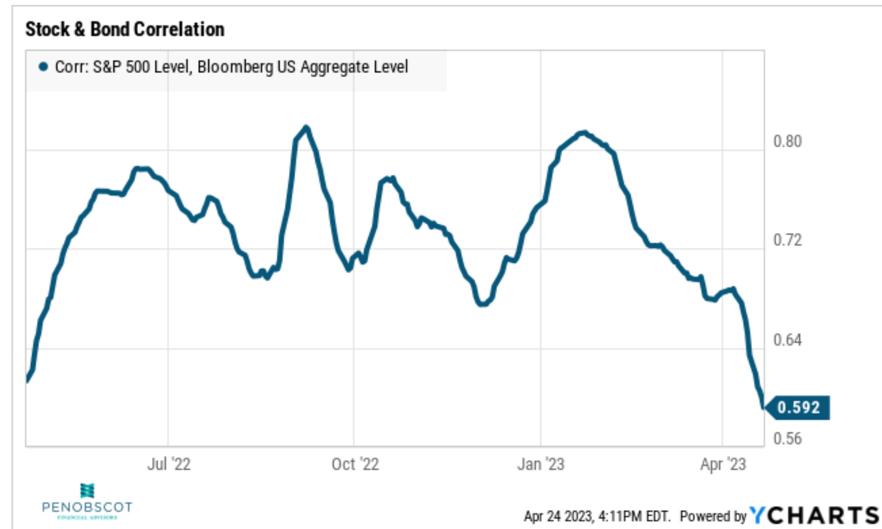
Whereas two more rate increases were priced in (one in May, one in June) at the beginning of 2023, now only one more, in May, is priced into futures markets. If these indications reflect reality, the fed may start to decrease the Fed funds rate as early as this summer. Importantly, Jerome Powell's Fed is providing no such expectation.

This doesn't so much represent a significant change as it does reverse the reactionary environment in the first quarter that pushed up year-end rate expectations.

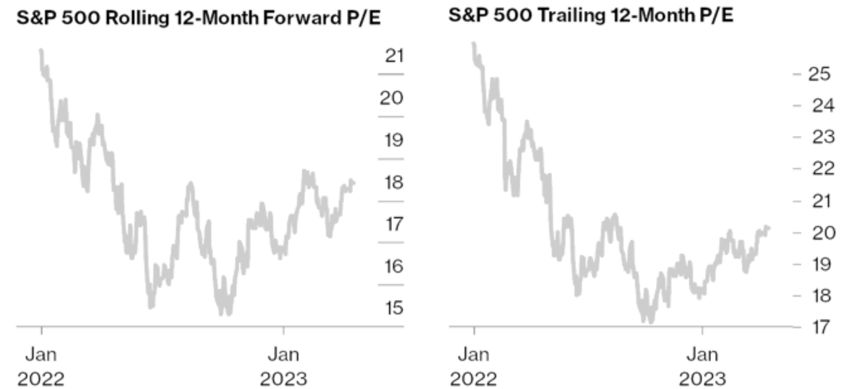
We're back to where we were six months ago, from a rate expectations standpoint.

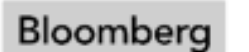
INVESTMENT IMPLICATIONS

Following a dismal 2022, the 1st quarter of 2023 gave investors a much-needed break from the gloom.   High levels of correlation between bond and stock price movements seem to be abating, which is helpful. Bonds tend to outperform during periods of economic slowdown and yields are high enough at this point to be able to absorb some further rate increases. Rate decreases, on the other hand could provide a real tailwind to the bond markets.



Of concern is the fact that stock prices are now seeming to factor in higher multiples of projected earnings. This results in lower earnings yields from stocks, so without either a significant decrease in the yield environment or an increase in earnings, prices we've achieved in the first quarter could be under pressure if either of these don't play out.





While we maintain some optimism that both future earnings increases and a more normal rate environment will materialize, we see some manner of economic slowing though the duration of 2023 as being likely. How this slowdown reflects in asset prices is yet to be seen, but we are increasing our reliance on fixed income for total return, and exercising caution around some of the more extended areas of valuation in the equity markets. In search of value for the dollar, we continue to focus on geographical diversification given the relatively high price multiples on US shares vs the remaining developed and developing world.

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