Quarterly Market Update – 1Q, 2023

Market Summary & Outlook

Recap

- **Inflationary Pressures Decelerate, Most Asset Prices Rise in Q1 –** key drivers of inflation continue to moderate in Q1, as energy prices fall along with a modest decrease in treasury yields. Major central banks remain in tightening mode but for how much longer?
- **Yields Drop but Still Near Multiyear Highs –** Real yields (inflation adjusted) of the 10-year Treasury bond fell slightly in Q1, helping push equity prices higher for some of the most beaten down sectors of 2022, Info Technology and Consumer Discretionary. Inflation expectations are little changed and remain steady over the past few quarters, with the 10-year Treasury forecasting a long-run inflation rate of approximately 2.3%.
- **Global Manufacturing Activity Continues to Slow –** Bullwhips – new orders minus existing inventories – remained negative for developed markets in Q1; typical signaling of more slowing ahead. However, industrial activity remained slightly expansionary in emerging markets, suggesting economic activity may be asynchronous across the globe.
- **Regional Bank Failures Shake Financial Sector –** With the failures of SVB and Signature Bank, the Federal Reserve may need to consider some of the unattended consequences of their fast-paced monetary tightening, paired with the previous decade's long zero-rate lending environment. SVB was forced to sell long dated Treasuries at a loss to meet its liquidity needs when large depositors began withdrawing their funds, leading to a classic "run on the bank".
- **Consumers Remain Strong but Spending Down Their Savings –** Personal savings as a percentage of disposable income has steadily decreased over the past eight quarters, though stabilizing in late 2022. However, real wage growth remains flat at 0.1% as the CPI and consumer household costs remain elevated.
- **Earnings Decelerate but Remain Surprisingly Resilient –** On March 31, 2023, the projected decline in S&P 500 earnings was -6.7%, according to FACTSET. However, as of April 28th with 53% of companies reporting for Q1, 79% of them have reported positive EPS surprises and the actual blended decrease in quarterly earnings has only been -3.7%, thus far.
- **Inverted Yield Curve as a Reliable Recession Indicator –** The inversion of the yield curve (short-term rates higher than long-term) typically signals a recession within 4 to 21 months, according to AART. As of March 31, 2023, the 10-year less the 3-month Treasury was -1.34%.

ABOUT THE FIRM

Virtus Capital is an independent investment advisory firm serving high net-worth individuals, families, and business owners.

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Performance

Equity Benchmarks	Returns as of 3/31/23	
	3 Month	YTD
S&P 500 PR	7.03%	7.03%
DJ Industrial Average PR	0.38%	0.38%
Nasdaq Composite PR	16.77%	16.77%
Russell 2000	2.74%	2.74%
MSCI AC World Index ex USA Net	6.87%	6.87%
FTSE Emerging Index	2.95%	2.95%

Bond/Commodity Benchmarks	Returns as of 3/31/23	
	3 Month	YTD
Bloomberg US 1-5 Year Treasury	1.87%	1.87%
Bloomberg US 5-10 Yr Treasury	3.19%	3.19%
Bloomberg US Long Treasury	6.17%	6.17%
Bloomberg US 5-10 Yr Corp	3.64%	3.64%
Bloomberg Municipal Bond	2.78%	2.78%
Bloomberg Commodity Index TR	-5.36%	-5.36%

*Data Source: Morningstar and Vanguard Funds

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Discussion

Equity Markets

Over the past two quarters equity investors across the board enjoyed positive gains, with Information Technology and Communication Services leading the charge, as the storyline for markets shifted from Fed policy interventions to the corporate earnings outlook. Perhaps these outsized positive results from the Q1 darlings of 23' is primarily owed to a technical rebound from their very poor performance in 2022. Meaning, the beaten down valuations and share prices of large-cap technology and communication stocks, timed with an anticipated peak of the rate hiking cycle in 2023 was just too enticing for forward-looking investors to pass up. It remains to be seen, however, if the current sector-based rallies can maintain "all-steam-ahead" for the entirety of 2023. Q1 saw strong momentum from cyclicals and growth stocks as Information Technology, Communication Services, and Consumer Discretionary were the leading 30-day Relative Strength Index (RSI) sectors. Another interesting quirk of 2023, thus far, has been the relatively range bound VIX Index. The "VIX", as it commonly goes by, is a broad indicator of volatility in the equity market and is (generally speaking) a measure of the magnitude and pace of price changes. Equity investors may be especially attuned to the CBOE S&P 500 VIX Index during times of higher market volatility. The average S&P 500 VIX reading since 1990 is around 20, which signals a fairly ordinary market environment of buyers and sellers. However, when the VIX spikes above 30, as it did in March 2020 when it reached an atmospheric level of 66.04, the market reacts with much greater uncertainty in the form of widening spreads and large intraday price swings. Q1, 2023 has seen a fairly stable VIX thus far, with more days below 20 than above. An increase in the VIX could spell greater uncertainty for markets and weigh on the positive momentum driven returns that investors have enjoyed YTD. Again, as discussed in our previous outlook, a looming question for markets to opine is the degree to which recession-like data, such as earnings deceleration, high inflation, credit usage, etc., is currently being reflected in today's market prices. Median stock-price drawdowns seem to have some degree of correlation to the depth of change in earnings. Whether a decrease in earnings growth causes stock prices to fall, or vice versa, is unclear. However, from a historical perspective (1872-2023), significant decreases in quarter-over-quarter earnings growth have resulted in varying depths of market drawdowns, with the average non-recessionary drop in the market of -22% versus a -35% drawdown during a full-on recession with significant earnings impairment. A key take-away here to avoid a prolong period of lower stock returns may, in part, be the resilience of corporate earnings. In 2023, thus far, earnings have surprised generally to the upside, with 53% of S&P 500 companies reporting actual results, 79% of S&P 500 companies have reported a positive EPS surprise and 74% of S&P 500 companies have reported a positive revenue surprise, as of April 28, 2023, according to FACTSET.

Fixed-Income Markets

Generally speaking, investors in fixed-income securities have enjoyed a much better start to 2023 than the previous year's bond market rout, which left the traditional 60/40 portfolio reeling from historic double-digit losses in its fixed-income allocations. As of March 27, 2023, Year-over-year (YoY) yields on the 10-year Treasury are up 109 bps, or 1.09%, offering an increasingly attractive alternative for the risk adverse investor. Even with a lack of consensus, the majority of the 80 economists in a recent Reuter's survey generally support the idea that the Fed continues to raise the Federal Funds Rate (the base rate of borrowing) to a terminal value of between 5.1-5.625% by the end of 2023. Rate cut whisperings are now receiving some minority attention as well, with almost a third of the economists surveyed predicting one rate cut by 2024. Fed watchers have signaled a better than 50/50 chance of another 0.25% increase in the base rate for the FOMC's upcoming May meeting, which would bring the terminal rate to between 5.00-5.25% - almost smack in the middle of 2023' s "consensus" (used lightly) terminal rate. Could we be closing in on the end of this historic rate hiking cycle? Fed Chairman, Jerome Powell, and the rest of the FOMC members sure do have their work cut out for them on this doozy of a question. On one hand, the steady climb in rates has not dampened CPI inflation at the pace the Fed had anticipated 12 months ago. As noted by the Federal Reserve Bank of St. Louis, in August 2022, the consensus from the Philadelphia Fed's Survey of Professional Forecasters (SPF) was that the CPI inflation rate would decline from

7.5% in August of 2022 to 3.2% in 2023. As of March 2023, the current CPI reading came in right at 5%, near consensus. However, core CPI – excluding gas and food prices – was stronger at 5.6%, with a hefty drop in gas prices of -17% YoY being excluded from core. On the other hand, the Fed has already witnessed some of the consequences of their unprecedented hiking spree, with three regional banks going into receivership in March and April, the most notable of which is the venture capital lender Silicon Valley Bank (SVB). It remains to be seen whether the Fed will reach its targeted goal of 3.2% inflation by this coming August, as they anticipated they would nine months ago. A pivot by the Fed to a more dovish stance of either rate cuts or a tonal shift to “easing” could certainly provide a powerful impetus for equity markets to rally. However, the dual mandate of the Fed – low unemployment and 2% inflation – is consistently their top-of-mind objective they have yet to waiver on. As multi-asset investors wait and see how the financial themes of 2023 play out, at least they will be compensated for their time in fixed-income assets relative to much of the past decade, with current yields on the 2-year Treasury topping 4%, and the average money market fund yielding around 2.3%, as of March 31, 2023.

Outlook

In our previous outlook we noted Goldman Sach’s Chief U.S. Economist, David Mericle, was forecasting only a 1 in 3 chance of a U.S. recession in 2023, which at the time was an out-of-consensus view. A main tenet of his rationale was that the Fed’s tightening cycle in 2022 resulted in a front-loaded drop in GDP, and that the negative effects of tightening would likely diminish throughout 2023. So far, Mericle may be at least partially correct, with a large number of S&P companies reporting earnings surprises to the upside in Q1 (as previously noted), however, GDP growth of only 1.1% (annualized) underperformed analysts’ expectations of 2% for the first quarter. Nevertheless, his optimism may still ring true in 2023 if the Fed hits their inflation targets and are able to engineer the most over used phrase of 2022, “a soft landing”. Recall though, according to research conducted by Haver Analytics and AART, after a yield curve inversion of the 10-year and 3-month Treasuries, a recession typically follows within 4 to 21 months. Since 1950, the yield curve has inverted prior to the last eight recessions, and occurred only twice without a recession (1966, 1998). So, the moral of this recession story is: Mericle may be correct about lower odds of a recession in 2023, but we won’t be out of the woods for at least the remainder of 2024 and perhaps into 2025. All else being equal, if a recession is unavoidable due to persistent, challenging macro-economic factors, such as sticky inflation, the piper will have to be paid at some point either now or in the very near future. Another historical factor to note is that of the economic cycle just prior to pandemic shock in 2020. Looking back at global earnings per share (EPS) growth, there had been a steady deceleration since late 2017 for developed and U.S. markets, and early 2018 in emerging markets. If one were to remove the 12-18 month COVID shock and game-out the lagging effects of 17/18’s slower global growth and earnings deceleration, the argument could be made that 2023 is simply experiencing a reboot of the interrupted economic contraction that 17/18’ had already set into motion. Admittingly, the global factors driving the current economic trends are different than 5 years prior, however, business cycles have an inexplicable way of coming home to roost even when faced with unimaginable disruption. A common Wall Street expression, “The melody may change, but it all rhymes the same.” Meaning, even though each set of global economic circumstances are almost always unique, the general course of outcomes tends to follow a predictable path. We don’t put much stock into the expression – “This time will be different.”

Market valuations moved higher during Q1 as stocks rallied and prices rose. On a forward basis, developed and emerging markets (DM, EM) continue to trail their long-run P/E averages and trade at slight discount to U.S. stocks. Don’t be fooled though by the “undervalued” P/E trap. The composition of U.S. markets are notably differently than that of their DM and EM brethren. The S&P 500, a broad measure of the U.S. equity market, owes a much larger proportional share of its market capitalization to sectors in Technology, Communication Services, and Health Care, which generally speaking carry higher P/E ratios than say that of Industrials or Utilities sectors. Developed and emerging markets have a higher concentration to these lower P/E sectors (Industrials, Utilities, Resources), and thus the U.S. equity markets typically fetch a slightly higher P/E premium from willing investors. With all that said, as of April 15th, DM is trading at about a 10% valuation discount over its own long-run average, and with the U.S. market at around 18x P/E (approximate long-run average), a case could be made for doing some "value" shopping abroad.

Given a still ever-present risk of inflation surprises, the market may look to the business cycle playbook of return sensitivities. From 1972-2022, return sensitivity to higher inflation surprises has upside for commodities, gold, natural resources, and energy. If inflation numbers stay persistently "sticky" or start to again surprise to the upside, the 50-year return sensitivity analytics might suggest an overweight to the aforementioned asset classes. But hold your horses, an all too familiar storyline on Wall Street is the "surprise to the surprise" – you may ask, what is the return sensitivity of those same asset classes to growth surprises, instead of inflation surprises? Well, not very good to be blunt. During the same 50-year period, growth surprises to the upside led to significant over performance by a completely different cast of characters - Information Technology, Consumer Discretionary, and non-U.S. equities. Natural Resources is a notable crossover for both scenarios, which perhaps provides some confidence as a diversifier during times of uncertain inflation direction.

YTD, the global business cycle remains asynchronous as China took their licks earlier on in 2022 and are now emerging into an expansionary growth phase, while most other major markets are accelerating into late-expansion/recession, including the U.S. economy. Typical of late-cycle dynamics - tightening credit, moderating growth, earnings pressure, etc. - consumers are now utilizing higher credit limits and their credit delinquencies are up in late 2022, increasing chances for a U.S. recession in 2023 and 2024. Spenders are also using a higher percentage of their credit facility to pay for household essentials, according to a Bankrate report published in early March, which again is indicative of continued financial strain on the consumer's pocketbook. Historically, housing activity begins to contract well before a recession begins and is considered a leading indicator for future economic conditions. As compared to the Global Financial Crisis of 2008, or "GFC" as colloquially known in financial circles, the current economic conditions appear very different than they did in 08'. For one, the banking system is overall better capitalized, households are not fully tapped out on their leverage (73% in 23', vs. nearly 100% in 08'), and the housing market is still tight with only 2.5 months of supply vs. 11 months at the peak of the GFC. Helping as a pull force into economic contraction though is the continued tight labor market. A recent report by Fidelity Investments using data compiled from the Bureau of Labor Statistics (BLS) shows labor force participation rates bottoming in early 2020 but has only modestly recovered since then. Prime age workers, 16-54, have mostly returned to the labor force post-pandemic but there remains a significant shortage in the 55+ category, which is constraining employers, and perhaps, lowering the median age of work experience at management levels. This trend is unlikely to reverse anytime soon as baby boomers continue to evaluate their entry point into retirement lifestyle.

Virtus Capital's investment management strategies continue to highlight portfolio diversification and strategic asset allocations to quality companies that possess competitive advantages. Our investment philosophy focuses on a long-term approach to portfolio construction and security selection. So far in 2023, many of our investors have taken the opportunity to build their cash reserves in anticipation of favorable market entry points. We help investors take advantage of these opportunities in our actively managed portfolios. Virtus Capital's 2023 market outlook calls for a disciplined and thoughtful approach to portfolio construction, that aims to deliver greater long-term value through our risk-adjusted and customizable investment management strategies.

Q1, 2023 Quote:

"An investment in knowledge pays the best interest."

-**Benjamin Franklin**

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