Quarterly Market Review and Outlook

Q1 2023 Market Re-Cap

The 1st quarter provided a bit of a rebound in the financial markets from the volatility of last year. So far in 2023, the S&P 500 and the NASDAQ indexes have posted positive returns. We would point out that virtually all these gains came in January as the major indices are down from early February. Global stock markets have mostly run on a parallel path and are modestly positive this year as well.

The fixed income market also regained some traction during the 1st quarter. After the worst U.S. bond market in 50 years last year, it looks as though bonds are having a nice recovery so far this year.

The relevant question should be, is this a calm before a storm or the start of a prolonged recovery?

Q2 2023 Outlook & Beyond

Banking Crisis / Here We Go Again or Much Ado About Nothing?

Many people likely experienced a dreaded DeJa'Vu moment as news began to circulate of bank failures in mid-March. It was just 15 years ago that fear and panic ensued, when it seemed as if there were daily bank failures. So far there have been three bank failures in this crisis in the U.S. A common question we have received is, should we pull money from our bank?

First, it is important to remember that FDIC-member banks offer deposit insurance up to $250,000.[i] In short, depositors with $250,000 or less in a FDIC-member institution have no reason to worry. For depositors with over $250,000, there is some theoretical concern. However, in the immediate aftermath of Silicon Valley Bank's collapse, the Treasury Department, Federal Reserve and FDIC issued a statement saying all depositors will be covered.[ii]

Second, it is important to remember that these three banks had unique business models. Two of them, Silvergate Bank and Signature Bank, focused heavily on cryptocurrency. Cryptocurrency is a highly volatile and risky asset class with little regulatory oversight. Silicon Valley Bank's primary focus was startup technology and biotechnology firms. Startup firms are notorious for burning through massive amounts of cash. Additionally, Silicon Valley Bank overexposed themselves to long term fixed income assets that were blasted during the Federal Reserve's interest rate increases in 2022.

With that being said, we currently see little evidence that these three banks are about to tip the entire banking industry into Financial Crisis 2.0. Moreover, there are many reasons to believe the banking system is in much better shape today than in 2008. In fact, we are looking at using the short-term weakness in the financial sector as a potential buying opportunity. We will watch this closely in the coming weeks and months as the situation completely unfolds.

Securities offered through **First Heartland Capital ®, Inc.**, member FINRA/SIPC. Advisory Services offered through **First Heartland ® Consultants, Inc.** Walker, Higgins & Associates, LLC and Walker, Higgins & Associates Wealth Management, LLC are independent of **First Heartland Capital ®, Inc.** and **First Heartland ® Consultants, Inc.**

Interest Rates & the Federal Reserve

The Federal Reserve started an interest rate hiking program over a year ago to combat inflation—they increased rates from .25% to 4.25% last year. In addition to bringing inflation down a bit, this has caused some problems. The stock and bond markets both suffered a double digit decline last year—a first in U.S. history. The housing boom after COVID has seemingly grinded to a slow trickle. Investors are fearful of a looming recession. Interest rates have already risen by .50% this year with maybe another .50% increase yet to come.

Some are forecasting (with a 70%+ probability) that the Federal Reserve will start decreasing interest rates by September this year.[iii] This stands in direct conflict with Fed projections following their March meeting.[iv] Said plainly, the Fed is saying they don't anticipate an interest rate cut in 2023.

Confused yet? Don't be—we think it's simple. We'd suggest that for a rate cut to occur, one of two conditions need to be present.

First, inflation must at least approach the Federal Reserve's stated mandate of 2%. The Fed's preferred inflation indicator, PCE, stands at 5.4%.[v] While inflation has come down from the highs of last year, it seems unlikely that PCE will decrease from 5.4% to around 2% in the short-term. Energy prices will need to go much lower to get PCE to 2% and we don't see that happening anytime soon.

Secondly, we believe the Fed won't cut rates unless the economy goes into recession. As we said in our last quarterly, we do believe the U.S. will have a recession later this year. As we have previously pointed out, the current yield curve is inverted—the 3-month treasury rate is higher than the 10-year rate! The yield curve is more inverted now than at any point in the last 40 years. When the yield curve is inverted, there is no better warning sign that a recession is coming.

So, if inflation continues to moderate and the economy goes into recession, we think the Fed will cut rates to stimulate growth. We just don't think both of those things will happen by September. Our best guess is rates won't start to decline until later in 2023 or, more likely, in 2024.

Stock Market Direction

The impact of elevated interest rates is having a positive impact upon bonds and cash-equivalent assets. As we discussed in our previous writing, CDs offer attractive rates that have not been seen in years—we recently bought 6-month CDs at a rate of 5.1%. Additionally, the money market fund we use is currently yielding in the +- 4% range. This is one of the reasons that we have felt comfortable holding cash-like assets at elevated levels recently.

The issue for the stock market is that higher interest rates create competition. If investors can buy a 5% CD, why would they want to put money at risk in the stock market? Less interest in the stock market leads to lower trading volume—often producing lower stock prices. Additionally, higher interest rates make lending more expensive, which will put a drag on economic growth.

Also, the stock market is a leading indicator of the economy. If the economy goes into recession late this year, the stock market will decline months in advance in anticipation of that.

For all those reasons, we remain cautious of stocks in the short term. There is an old saying— "you should not fight the Fed." We don't plan on engaging in that fight.

Securities offered through **First Heartland Capital ®, Inc.**, member FINRA/SIPC. Advisory Services offered through **First Heartland ® Consultants, Inc.** Walker, Higgins & Associates, LLC and Walker, Higgins & Associates Wealth Management, LLC are independent of **First Heartland Capital ®, Inc.** and **First Heartland ® Consultants, Inc.**

Account Strategies & Tactics

We do think some stock exposure is smart because nobody's crystal ball is perfect. To the extent that we hold stocks, we want high quality companies, and we prefer companies that pay good dividends. We believe that the U.S. is in significantly better shape than the rest of the world, so we continue to have a strong U.S. bias.

As interest rates move higher, but not so high prices can't keep up, we think the overall bond market in the U.S. should have a decent year. We favor some corporate names and are generally looking for quality and shorter-term maturities.

Particularly, based on the market environment we have described above, we are holding larger amounts of cash. We feel good about that considering cash is paying the highest rate we have seen in 15 years.

Simply put, on balance, we are under allocated to risk. We don't see that changing in the coming weeks and months. Maybe in late fall or early winter we can see smoke clearing and can find confidence to change that.

Summary

If all of these makes your head hurt, we understand. Just earlier this week, we received an email with one article claiming that a recovery is underway and just below another article claiming to head for cover. Even several of our trusted economists and money managers don't seem to agree. For instance, Bob Brinker states, "This valuation level should support S&P 500 Index levels in the mid-to-upper 4000s range by next winter, and new record highs during 2024".[vi] On the other hand, Brian Wesbury at First Trust states, "The bottom line is that we think the Fed is right about a recession, which means earnings will take a hit and investors should remain wary".[vii]

It is possible that both are correct. For all to occur, we'd need a recession with a stock market decline, but then a relatively quick recovery. We tend to focus on the data, and we'd rather be cautious. One of the advantages of holding larger amounts of cash now is it will allow us to be opportunistic when the market does in fact bottom—you gotta have cash to "buy low"!

Through numerous conversations with our clients, it is our sense that they agree. The appetite for risk now seems to be low. We want to be prudent, but flexible.

As always thank you for your continued trust and confidence. Please know that we understand the nervousness that many feel. If you are nervous, please contact us. We'd love to talk.

We hope that you and your family have a wonderful spring!

---

[i] https://www.fdic.gov/resources/deposit-insurance/index.html
[ii] https://www.federalreserve.gov/newsevents/pressreleases/monetary20230312b.htm
[iii] https://www.cmegroup.com/markets/interest-rates/cme-fedwatch-tool.html?redirect=/trading/interest-rates/countdown-to-fomc.html
[iv] "Summary of Economic Projections". Federal Reserve Board. March 22, 2023. Page 2 of 17.
[v] https://www.bea.gov/data/personal-consumption-expenditures-price-index
[vi] Brinker, Bob. "Bob Brinker's Marketimer". Volume 38, Number 3. March 2023. www.bobbrinker.com.
[vii] Wesbury, Brian; Stein, Robert; Elass, Strider; Opdyke, Andrew; Gill, Bryce. "Monday Morning Outlook: The Fed Waffles". First Trust. March 27, 2023.

Securities offered through **First Heartland Capital ®, Inc.**, member FINRA/SIPC. Advisory Services offered through **First Heartland ® Consultants, Inc.** Walker, Higgins & Associates, LLC and Walker, Higgins & Associates Wealth Management, LLC are independent of **First Heartland Capital ®, Inc.** and **First Heartland ® Consultants, Inc.**