HIGHTOWER
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Market Commentary Q1 2023

After a challenging 2022, U.S. stocks gained during the first quarter of 2023 in a surprising show of resilience despite a multitude of headwinds – a banking crisis, cryptocurrency meltdowns, and uncertainty around the Federal Reserve ("Fed") and what's next for the economy. In fact, nothing about the first quarter's performance was linear. Across the S&P 500, we witnessed volatility throughout the quarter, with January finishing up strong only to fall back in February, just to rise again in March and ultimately end the quarter up over 7%.[1]

Leading US Indices (Total Return)	3Q'21	4Q'21	1Q'22	2Q'22	3Q'22	4Q'22	1Q'23 (sorted)	TTM
Nasdaq	-0.2%	8.4%	-8.9%	-22.3%	-3.9%	-0.8%	17.0%	-13.3%
S&P 100 Mega-Cap	1.0%	11.3%	-4.6%	-16.9%	-5.4%	5.6%	10.1%	-8.6%
S&P/Citigroup Growth	1.9%	13.4%	-8.6%	-20.8%	-3.9%	1.4%	9.6%	-15.3%
S&P 500 Total Return	**0.6%**	**11.0%**	**-4.6%**	**-16.1%**	**-4.9%**	**7.6%**	**7.5%**	**-7.7%**
Dow Jones Wilshire 5000	-0.6%	8.1%	-5.9%	-17.6%	-4.6%	6.2%	6.9%	-10.7%
S&P/Citigroup Value	-0.8%	8.3%	-0.2%	-11.3%	-5.8%	13.6%	5.2%	-0.2%
S&P 400 Mid-Cap	-1.8%	8.0%	-4.9%	-15.4%	-2.5%	10.8%	3.8%	-5.1%
Russell 2000	-4.4%	2.1%	-7.5%	-17.2%	-2.2%	6.2%	2.7%	-11.6%
S&P 600 Small-Cap	-2.8%	5.6%	-5.6%	-14.1%	-5.2%	9.2%	2.6%	-8.8%

S&P 500 Sectors (Total Return)	3Q'21	4Q'21	1Q'22	2Q'22	3Q'22	4Q'22	1Q'23 (sorted)	TTM
Technology	1.3%	16.7%	-8.4%	-20.2%	-6.2%	4.7%	21.8%	-4.6%
Communication Services	1.6%	0.0%	-11.9%	-20.7%	-12.7%	-1.4%	20.5%	-17.8%
Discretionary	0.0%	12.8%	-9.0%	-26.2%	4.4%	-10.2%	16.1%	-19.6%
S&P 500 Total Return	**0.6%**	**11.0%**	**-4.6%**	**-16.1%**	**-4.9%**	**7.6%**	**7.5%**	**-7.7%**
Materials	-3.5%	15.2%	-2.4%	-15.9%	-7.1%	15.0%	4.3%	-6.3%
Industrials	-4.2%	8.6%	-2.4%	-14.8%	-4.7%	19.2%	3.5%	0.2%
Real Estate	0.9%	17.5%	-6.2%	-14.7%	-11.0%	3.8%	1.9%	-19.7%
Staples	-0.3%	13.3%	-1.0%	-4.6%	-6.6%	12.7%	0.8%	1.2%
Utilities	1.8%	12.9%	4.8%	-5.1%	-6.0%	8.6%	-3.2%	-6.2%
Health Care	1.4%	11.2%	-2.6%	-5.9%	-5.2%	12.8%	-4.3%	-3.7%
Energy	-1.7%	8.0%	39.0%	-5.2%	2.3%	22.8%	-4.7%	13.6%
Financials	2.7%	4.6%	-1.5%	-17.5%	-3.1%	13.6%	-5.6%	-14.2%

Source – Strategas Securities, LLC – 4/11/2023

Last year, value outperformed growth for the first time in approximately five years. So far year-to-date, that trend has reversed, with growth outperforming value by about 13%.[1] Sector performance is also the opposite of 2022, with last year's best-performing sectors, energy and utilities, being this year's weakest and last year's laggards, communication services, consumer discretionary, and IT, being the strongest in 2023.

A closer look at the S&P 500's year-to-date performance reveals that a select group of stocks (think FAANG) delivered most of the gains. So far this year, the market cap of the S&P 500 has increased by more than $2.3 trillion, with 90% of the gain attributable to just 10 stocks![1] Historically, that's very extreme.

One metric that has come into focus recently is market breadth, which is used to assess the health of the stock market and to forecast its future direction. When market breadth is "narrow," like it was in the first quarter, it means that the market is being driven by a handful of stocks. When the majority of the companies in an index drive performance, the breadth is considered "wide." When markets are performing well, investors generally prefer a wider breadth or a more balanced market that suggests stability across the macroeconomic environment. A return to a top-heavy market is extremely challenging for active managers, as most will not own these names in the weights necessary to outperform the broader index.

Much has been said about the bank collapses of Silicon Valley Bank and Signature Bank, but the vast majority of the banks domiciled in the United States appear to be very well capitalized. As one would expect, investigations at multiple regulatory levels were launched, lawsuits were filed, and finger-pointing followed. From all accounts, the circumstances at the two failed banks were outliers and not indicative of a broader issue in the sector. In other words, this is not a 2008 type scenario. In general terms, risk was badly managed at Silicon Valley Bank and Signature Bank. Investor jitters eased following governmental and corporate reassurances, with bank stock performance stabilizing after two weeks of declines.

It is difficult to assess the duration of this banking crisis at the current moment. Assuming credit spreads stay at their current level, the VIX and the fed funds rates remain elevated, we will see how serious this shock will be if bank funding costs remain elevated and banks tighten lending standards over the coming quarters.

But under the assumption that growth is already slowing because of the lagged effects of Fed hikes, the bottom line is that if the ongoing banking crisis results in tighter bank lending standards over the coming quarters, it increases the risks of a hard landing.

U.S. bond markets suffered their worst returns in market history last year. But they recovered a bit in the first quarter as yields, which move inversely from bond prices, fell. The 10-year U.S. Treasury yield opened the year at 3.88% and ended the quarter at 3.54%.[1] Bond volatility was some of the highest in recent memory as that same 10-year U.S. Treasury had an almost 1% peak to trough move within the quarter.[1] By quarter end, the Bloomberg U.S. Aggregate Bond Index, the bond market proxy, gained 2.5%.[1]

The increased volatility in interest rates also had a large impact on the shape of the yield curve. The hawkish sentiment early in the quarter caused an already inverted yield curve to become even more exaggerated, with the 2-yr/10-yr Treasury curve inversion hitting its largest gap in 40 years at over 1%.[1]

US Yields	4Q'21	1Q'22	2Q'22	3Q'22	4Q'22	1Q'23	Q/Q Chg (bps)	Y/Y Chg (bps)
Fed Funds Target Rate	0.3	0.5	1.8	3.3	4.5	5.0	50	450
3-Month T-Bill	0.1	0.5	1.7	3.3	4.4	4.9	43	433
2-Year Note	0.7	2.3	2.9	4.2	4.4	4.1	-35	178
5-Year Note	1.1	2.5	3.0	4.1	4.0	3.6	-39	109
10-Year Bond	1.4	2.4	3.0	3.9	3.9	3.5	-33	118
30-Year Bond	1.9	2.4	3.1	3.8	3.9	3.7	-25	125

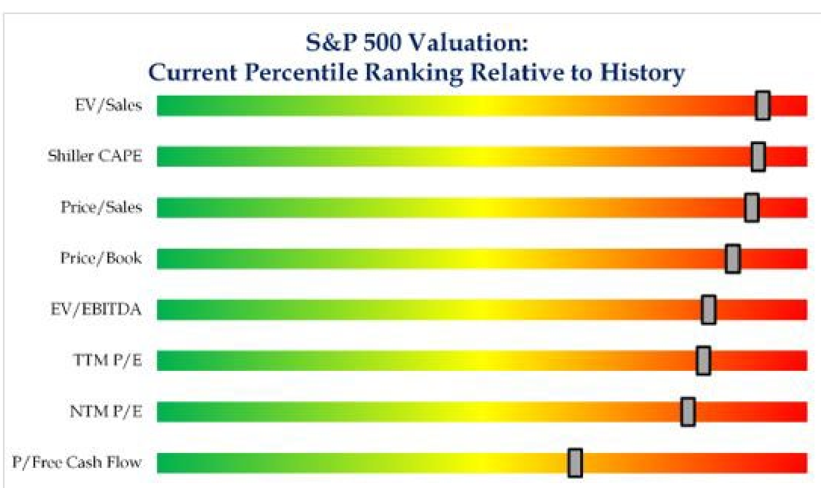
Source – Strategas Securities, LLC – 4/11/2023

As rates increased sharply throughout 2022, the yield opportunities on fixed income products became much more attractive. We even witnessed the yield on the Bloomberg Barclays Aggregate Bond index hit 5% at points.[1] The first quarter was the second quarter in a row of positive returns for the bond market.

In 2022, municipal bonds ("munis") had their worst year since 1981, posting a −8.5% total return, according to the Bloomberg Municipal Bond Index.[1] Last year's sharp move higher in yields and record fund outflows reset the baseline for the municipal bond market, establishing strong initial conditions entering 2023. Already we see signs of a rebound, as munis appear positioned to continue providing attractive, tax-advantaged income and potential portfolio diversification benefits, particularly as the effects of tighter monetary policy play out across the U.S. economy and financial markets.

Issuers have benefited from increased post-pandemic economic activity, unspent federal stimulus funds, and robust tax collections. As a result, many issuers are carrying large cash reserves that could soften the impact of a possible slowdown in the economy.

By just about every valuation metric we track, broadly speaking, it's difficult to make the case today that the S&P 500 is cheap. When we factor in many analysts' earnings outlooks for the year ahead relative to where the consensus stands today, the valuation outlook appears even less appealing. In our view, it's difficult to make the case that there's a high margin of safety embedded in today's multiples given the macro backdrop.



Source – Strategas Securities, LLC – 4/11/2023

Two weeks after the failure of Silicon Valley Bank, Federal Reserve Bank Chairman Jerome Powell announced a 0.25% increase in the federal funds rate. Powell may have threaded the needle in a very difficult situation, yet he has refused to step back from the inflation fight, despite the trouble in the banking industry. Some market observers believe March's rate hike will be the last in this cycle. Equity markets responded favorably to Powell's comments, with long-duration stocks (e.g., technology stocks) leading the way.

The job market remains strong, which is likely one of the reasons the economy has stayed afoot. Notable job gains have occurred in leisure and hospitality, retail trade, government, and health care. While employment declined in information technology, transportation, and warehousing. The unemployment rate edged higher to 3.6%. In February, the labor force participation rate was little changed at 62.5%, and the employment-population ratio held at 60.2%.[1] These measures have shown little net change since early 2022 and remain below their pre-pandemic February 2020 levels. [1]

Many company executives are saying they are no longer scrambling to retain workers, after several years of doing whatever it took. Job vacancies are low in the U.S., while average hourly earnings are increasing. We are seeing some companies seize this opportunity to create efficiencies and streamline operations, even if that means eliminating staff or cutting projects. Looking at what happened in technology is a good example. Could that mean a wave of additional layoffs in other industries is to follow?

Additionally, while consumer spending remains strong, the steep increase in credit card debt highlights the degree to which spending is being supported by borrowed money. The consumer's increasing reliance on borrowing could make further increases in consumer spending unsustainable. The University of Michigan consumer sentiment index for the U.S. was revised lower to 62 in March 2023.[1] It was the first decline in sentiment in four months, as consumers increasingly expect a recession ahead.

Eurozone shares saw gains in the first quarter despite volatility in the banking sector. Gains were led by similar outperformers to the U.S.; IT, consumer discretionary, and communication services sectors. Financials were volatile in the wake of the failure of U.S. lender Silicon Valley Bank. A week later, Credit Suisse was bought by UBS. However, the eurozone financials sector posted a gain for the quarter, with Credit Suisse's problems largely seen as being contained.

The European Central Bank ("ECB") raised interest rates by 0.50% in both February and March. Eurozone inflation declined to a one-year low at quarter end. Consumer prices rose but were down from February levels.[1] However, core inflation (ex. food and energy) rose slightly.

International Indices (Price Chg)	3Q'21	4Q'21	1Q'22	2Q'22	3Q'22	4Q'22	1Q'23 (sorted)	TTM
CAC 40 (France)	0.2%	9.7%	-6.9%	-11.1%	-2.7%	12.3%	13.1%	9.9%
IBEX 35 (Spain)	-0.3%	-0.9%	-3.1%	-4.1%	-9.0%	11.7%	12.2%	9.3%
DAX (Germany)	-1.8%	4.1%	-9.5%	-13.8%	-5.3%	14.9%	11.9%	5.0%
Bolsa (Mexico)	2.2%	3.7%	6.1%	-15.9%	-6.1%	8.6%	11.2%	-4.7%
Kospi (South Korea)	-6.9%	-3.0%	-7.4%	-15.4%	-7.6%	3.8%	10.8%	-10.2%
OMX Stockholm 30 (Sweden)	-0.2%	7.1%	-13.4%	-10.6%	-2.3%	11.7%	8.8%	6.1%
Shenzhen SE A Shares (China)	-2.9%	5.6%	-16.3%	5.0%	-14.0%	3.3%	7.6%	0.3%
Nikkei 225 (Japan)	2.3%	-2.2%	-3.4%	-5.1%	-1.7%	0.6%	7.5%	0.8%
MSCI EAFE	**0.7%**	**3.6%**	**-4.4%**	**-8.8%**	**-4.3%**	**8.4%**	**6.7%**	**1.0%**
MSCI AC World	**-0.8%**	**6.7%**	**-5.1%**	**-14.1%**	**-5.3%**	**7.0%**	**6.5%**	**-7.3%**
S&P/TSX (Canada)	-0.5%	5.7%	3.1%	-13.8%	-2.2%	5.1%	3.7%	-8.2%
Swiss Market Index	-2.5%	10.6%	-5.5%	-11.7%	-4.4%	4.5%	3.5%	-8.7%
Hang Seng (Hong Kong)	-14.8%	-4.8%	-6.0%	-0.6%	-21.2%	14.9%	3.1%	-7.3%
FTSE 100 (UK)	0.7%	4.2%	1.8%	-4.6%	-3.8%	8.1%	2.4%	1.5%
All Ordinaries (Australia)	0.6%	2.0%	0.1%	-13.4%	-1.0%	8.1%	2.1%	-5.3%

Source – Strategas Securities, LLC – 4/11/2023

The ECB also updated its macroeconomic projections and now expects higher growth and lower inflation this year. While the door remains open to future rate hikes, these will be data-dependent.

Emerging markets ("EM") posted positive returns over the quarter but lagged the MSCI World Index. There was a sense of renewed optimism at the beginning of the year given the reopening of China's economy and its surprise shift away from its zero covid policy. However, throughout the quarter, we saw U.S.-China tensions re-escalate following the shooting down of a Chinese high-altitude balloon in U.S. airspace. Inflation remains low there, giving the People's Bank of China ("PBOC") the ability to maintain an easy monetary policy. Against this backdrop, the PBOC announced a 0.25% cut to its reserve requirement ratio for banks in March, which was earlier than expected.[1]

The S&P GSCI Commodity Index was negative in the first quarter. Energy and livestock were the worst-performing components of the index, while precious and industrial metals did well. Within the energy complex, prices for natural gas, gas oil, and heating oil were all significantly lower. Copper and aluminum prices both advanced in the quarter.

Gold also rose to approach a record high. As investors sought less risky assets late in the quarter, prices for gold, viewed as the ultimate safe haven asset, surged. For the quarter, spot gold increased 8.5% to almost $2,000 per troy ounce, its highest level since March 2022 and near an all-time high.[1] Since the S&P's closing low on October 12th, 2022, gold has outperformed stocks by some 3%.

Oil prices fluctuated during the quarter, falling sharply as concerns about the banking system arose but rebounded along with stock prices just prior to the quarter's end. But oil prices have fallen recently and ended the quarter down as the banking crisis fueled fears of prolonged stress in the financial sector and a potential recession.

The U.S. economy started out 2023 with momentum, but some cracks are appearing as we move into the second quarter. The shock to the banking system in March promises to further stall activity. While the Fed aspires to potentially another hike in their dot plot forecast for 2023, we are not sure they are going to be able to get it this cycle.

The base case outlook for this year is that we expect to experience a slow-growth, or no-growth, environment. Higher interest rates and tighter lending standards will restrict access to credit. Aggregate demand will steadily weaken as the cumulative effects of tighter policy take hold, and businesses will slow fixed investment and shrink their workforces to adjust to the lower demand. Unemployment may rise during the coming quarters, and consumers could turn increasingly cautious and slow their spending as the outlook weakens. In terms of the degree of a potential slowdown, it is more likely that there will be a prolonged period of below-average growth rather than a meltdown. A lot of demand was pulled forward across nearly every economic data point in the past few years, and the coming years will focus more on integrating new assets, rightsizing operations, and cleaning up balance sheets. It will not be disastrous, but it will be a grind with the potential for decreased profitability.

While the odds of a U.S. recession have increased, the risk outlook for the markets is becoming more balanced. Monetary policy should pose less of a headwind for stocks going forward as the Federal Reserve is at, or close to, peak rates. Economic data is moving in the right direction, and the slowdown in inflation, wages, and activity should become more pronounced in the coming months. Moreover, if the outlook worsens, the Fed could ease monetary policy, which could provide significant support to financial markets. Meanwhile, the investment landscape still presents opportunities. Bonds can provide portfolios with attractive income and some capital appreciation when the Fed eventually cuts rates. An emphasis on quality is important, but broadly speaking, equity markets have priced in a slowdown and tend to perform well in the 12 months following the end of a tightening cycle.

Eventually, inflation should be tamed and anchored (if that's at 2-3% vs. 2%, we could live with that). We continue to care less about the precise number that inflation settles at as long as it is low enough where it doesn't influence business decisions much and anchored so that returning to a neutral policy stance does not cause an immediate reacceleration.

It could be said of both bulls and bears alike that few investors are planting their feet and going for the big play. The tape, of course, is the ultimate arbiter of who's right and who's wrong in our business. But an enthusiastic bull now would need to ignore the second-largest bank failure in U.S. history and what is likely to be the second quarter in a row of declining year-over-year gains in S&P 500 earnings.

A pause in the rate hike cycle does not guarantee an immediate shift to a rate cut cycle, yet current yields suggest a shift with the Treasury yield curve sloping negatively. Historically, an inverted yield curve has preceded a recession as investors anticipated future rate cuts to stimulate demand.

We remain disciplined and diversified. Focusing on the fundamentals while tuning out the noise. Price and earnings continue to matter, as they always have. Bond yields have been attractive for the first time in over a decade but have been volatile. Regarding equities, the first quarter earnings season is set to begin in a couple of weeks, providing opportunities to validate investment theses and measure recession probability.

We continue to maintain a defensive posture within client portfolios. Taking yield in short-term bonds and holding a sensible allocation to alternative investments should help to dampen volatility while providing a solid risk-adjusted return given the market environment.

At this stage, there are considerable uncertainties in both directions over the extent to which the recent turmoil will affect sentiment and activity. This uncertain backdrop argues against extreme positioning between or within asset classes. We believe that investors should maintain balance in their portfolios with a focus on quality within both equity and bond allocations.

We appreciate your confidence and support and hope you reach out with any questions.

To discuss this commentary further, please contact us at 914-825-8630.

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[1] FactSet – 04/11/2023

[2] Strategas Securities, LLC – 04/11/2023