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John's Market Outlook – March 28, 2023

Let's start with an industry in the news lately: banks. US banks experienced a large inflow of deposits in 2021, partly from the "liquidity flood" discussed in my December 2021 note. Some banks conservatively placed those funds in safe loans and short-term bonds, other banks chose to aggressively invest in long-term bonds. When inflation forced the Federal Reserve to begin raising rates in 2022, long-term bonds lost market value, which is a problem if the bank must sell the bonds before maturity.

As rates kept rising and the liquidity flood ebbed, customers began withdrawing their bank deposits to buy higher-yielding money market funds and Treasury bills, or to spend. The aggressive banks become stressed and some had to start selling their long-term bonds at a loss. Two smaller banks, Signature Bank of New York and Silicon Valley Bank, suffered deposit runs due to their aggressive positioning and overexposure to cryptocurrency traders and venture capital-backed startups. The Federal Reserve, and FDIC closed those two banks, protecting all deposits, and made liquidity support available to all US banks.

Large US banks have seen deposit inflow this month. Small banks have seen moderate deposit outflow. The Fed will require banks to be more conservative and bank profits may decline. Even if a few more small banks may close, depositors will be protected.

I do not expect a broad "crisis" in US banks. However, banks will be more cautious, increasing cash reserves and making fewer loans at higher rates. Bank credit contraction tends to slow the economy. The effect can be similar to Fed rate increases. As a result, the Federal Reserve slowed its Fed Funds rate increases, raising only 25bp this month.

Now we'll turn to the Market Outlook. Between my September 2022 note and my December 2022 note, the S&P 500 went down, up, and ended a little (-3%) lower than where it started. Between my December 22 note and today's note, the S&P 500 is little changed (about flat as I write this).

In the last quarter:

The Federal Reserve raised the Fed Funds rate another 100 bp to 4.75-5.00%. Rate increases may slow, a positive for markets and large companies, but that will be offset by bank credit contraction, a negative for small companies, consumers, and certain industries reliant on bank lending.

Leading economic indicators ("LEI") continued declining. As shown in the Appendix, the decline in LEI is similar to what we've seen before prior recessions.

S&P 500 earnings estimates continued declining. Estimates have fallen more than the S&P 500 index's decline, so S&P 500 valuation has gotten more, not less, expensive.

Inflation has declined but remains very high, still almost 3X the Federal Reserve's 2% target.

Yield curve inversion reached high levels in early March, then quickly became *less* inverted during the bank volatility, as money flowed to short-duration US Treasuries and markets adjusted to slower Fed interest rate hikes. When inverted yield curves start to *"de-invert"*, the economy is historically closer to the ensuing recession. For details, please see the charts in the Appendix and compare with the December note's Appendix.

The *overall* picture looks broadly similar to three months ago. Economic indicators have moved further in the direction of a recession, which I think will be moderate (not like 2008-09). The coming dispute in Washington DC over the federal debt ceiling is a mid-year risk. I continue to expect the S&P 500 – and, by extension, most equity indices – to turn down in coming months.

Portfolios are still positioned with very substantial "dry powder" in anticipation of opportunities to purchase quality assets at lower prices in the coming months. As interest rates rose in the past year, most of that dry powder has been moved from cash to Treasury bills, money market funds, and similar very-low-risk, liquid investments that now earn reasonable yields. Going into year-end, I shifted most portfolios more conservative and may shift further soon.

As for sectors and asset classes:

- I still favor US markets. China's post-Covid "reopening", while delayed, is getting underway and merits some exposure.
- Copper and certain other metals will benefit from China's re-opening, are vital for renewable energy infrastructure, production is limited, and some related stocks are attractively valued.
- Energy names are attractively valued, as are some consumer and real estate names, *if* the recession is moderate. Healthcare, staples and utilities are defensive sectors.
- Military/defense names enjoy strong fundamentals, as Europe re-arms in the face of Russia's threat and the US focuses on China. Recent portfolio additions include L3Harris (LHX) and General Electric (GE).
- I am continuing to add, selectively, to technology names, when I can find low expectations and acceptable valuations. Recent portfolio additions include semiconductor makers Micron (MU) and Infineon (IFNNY).
- In financials, while I have favored insurers over banks, some bank stocks now look oversold.
- High-quality bonds are getting more attractive; I continue to favor shorter duration Treasuries.
- In general, smaller and mid-sized companies are more attractively valued than large-cap companies.

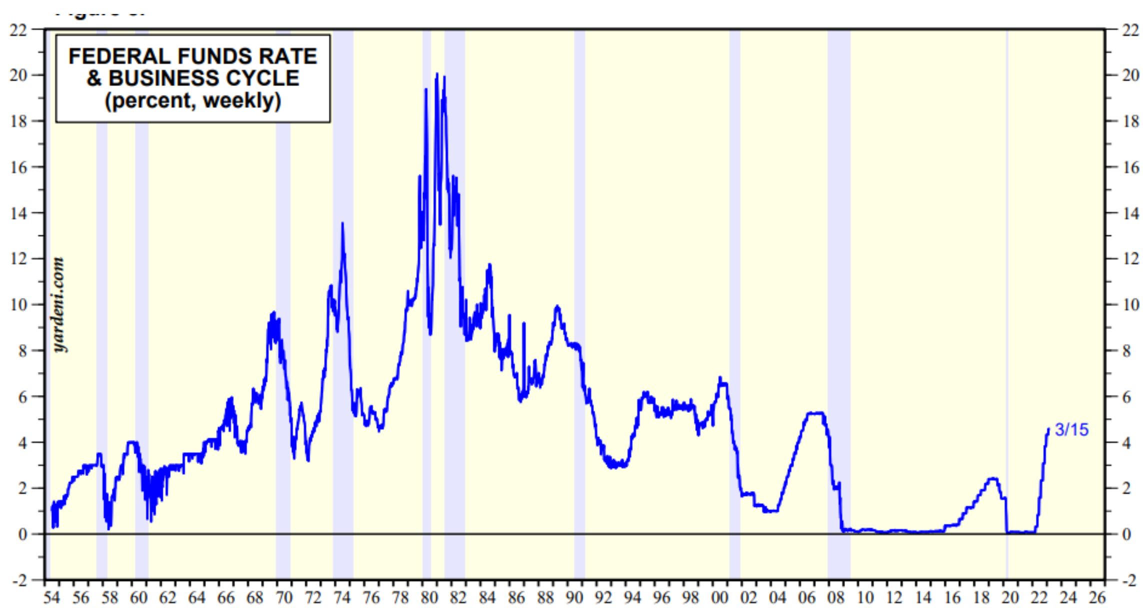
I would be happy to go deeper into this outlook and other investment topics than was possible in this brief summary. Please email johnliu@laurelhurstasset.com or call 510 847 0070.

Thank you!

My opinions and best judgment as of the date written, not investment recommendations or guarantees.
For clients of Laurelhurst Asset Management, 1001 SE Water Ave Ste 217 Portland OR 97214.

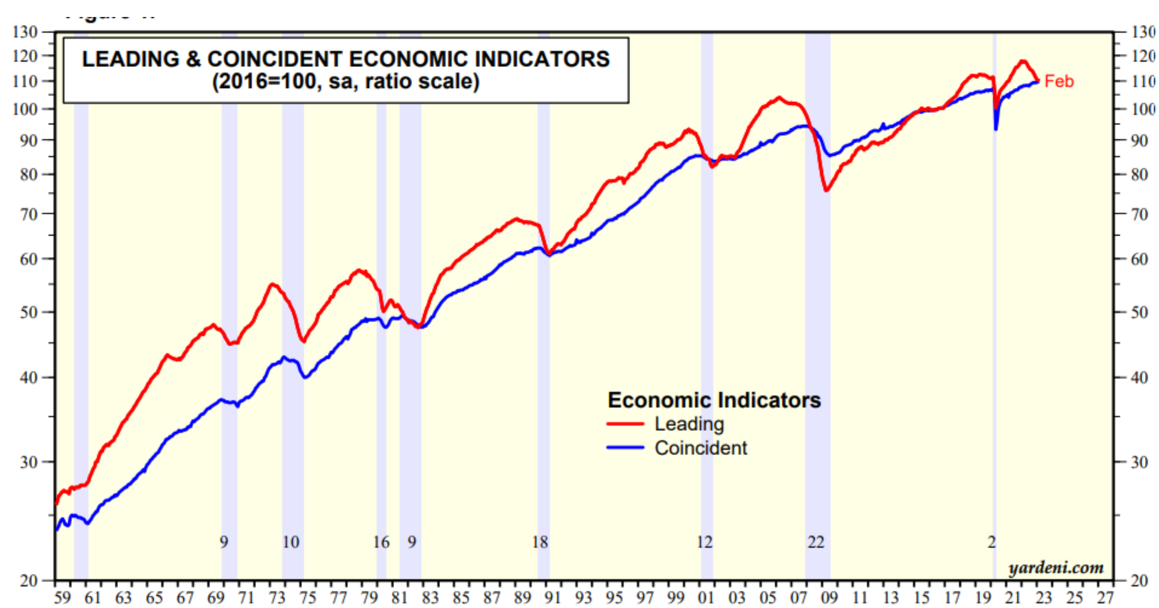
APPENDIX TO MARCH 2023 OUTLOOK – SELECTED CHARTS AND TABLES

The Fed funds rate is now at 4.75-5.00%, after the March 23 Federal Reserve actions. I previously expected the rate to ultimately reach 5-6%; we can probably trim the high end of that range by 0.25-0.50%, depending on how much bank credit contraction replaces Fed Funds rate increases.



Shaded areas are recessions according to the National Bureau of Economic Research.
Source: Federal Reserve Board.

Leading economic indicators (red) have continued falling, similar to prior recessions (shaded).



Note: Shaded areas are recessions according to the National Bureau of Economic Research. Numbers above timeline reflect number of months from peak of leading indicators to peak of business cycle.
Source: The Conference Board.

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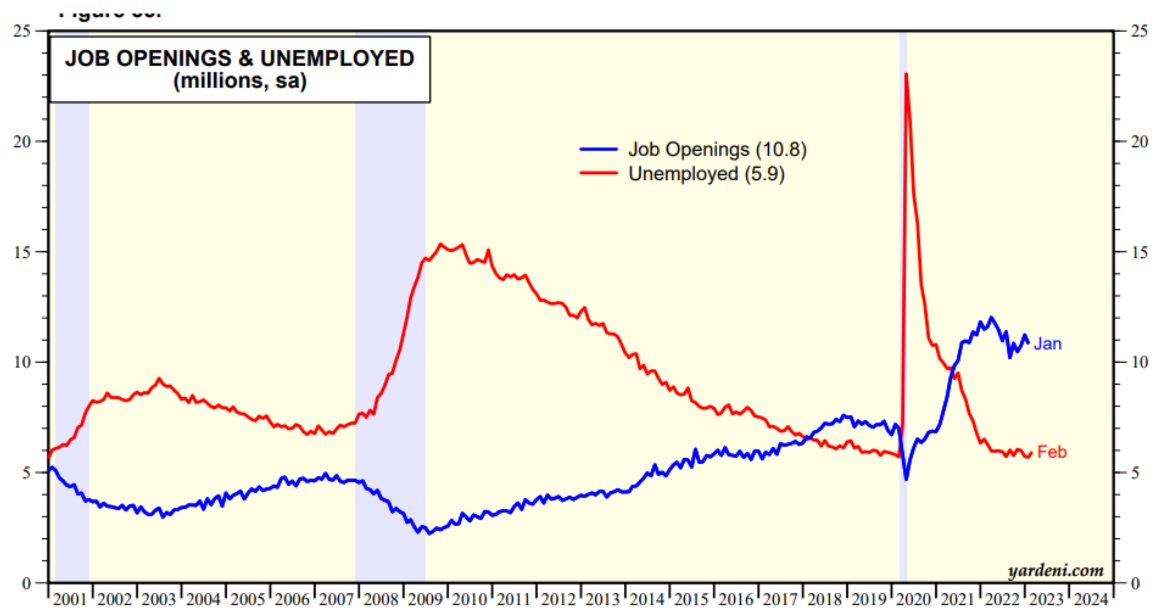
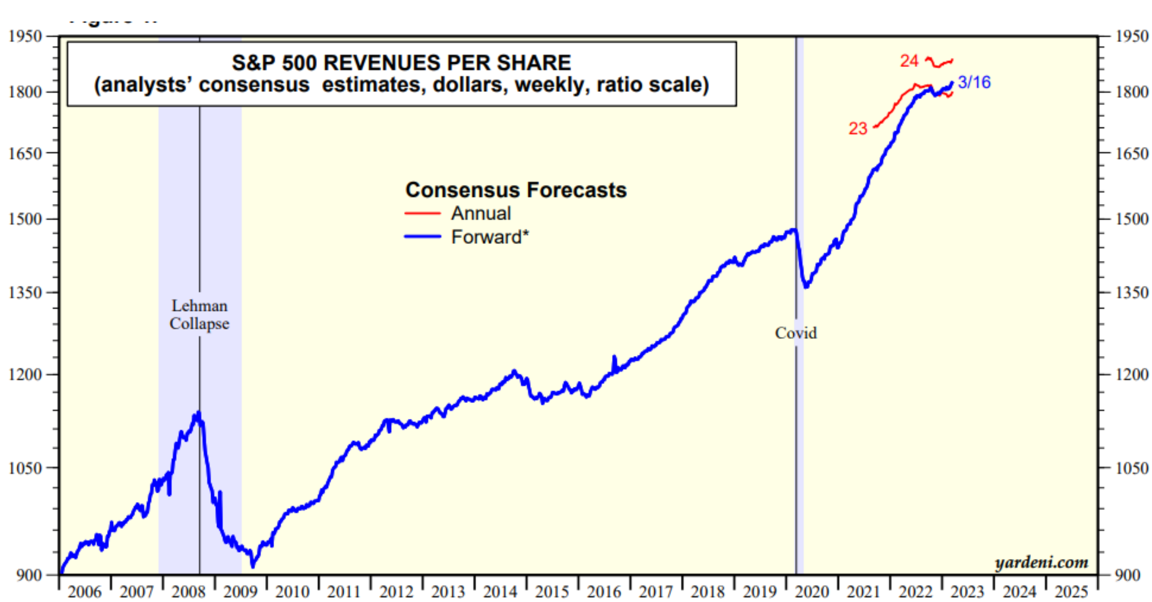
Coincident indicators represent the economy as it is now. Leading indicators represent the economy as it is likely to be in the future. The shaded periods are recessions.

The job market has not softened much (if at all) in the past quarter, and remains very strong with more open jobs (blue) than persons seeking work (red).



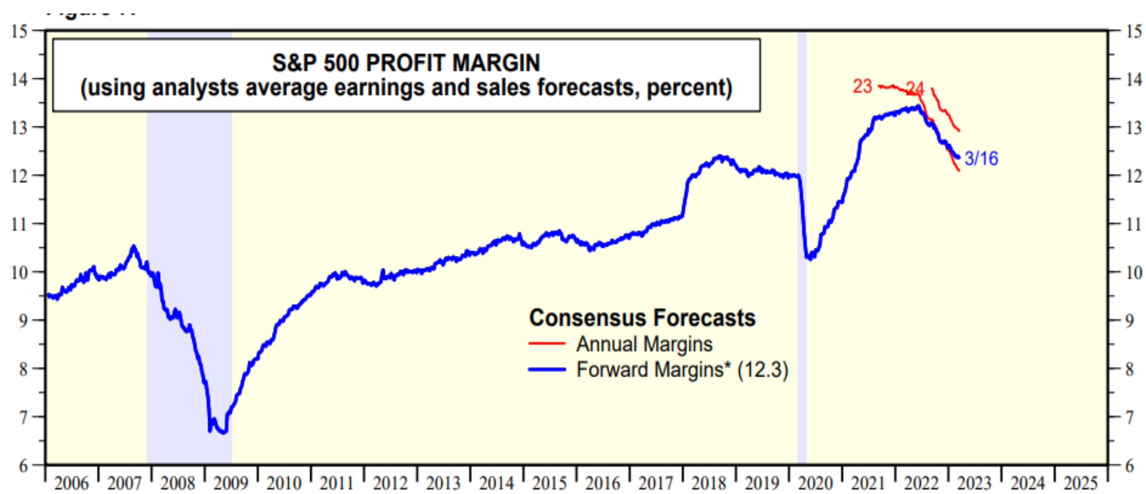
Note: Shaded areas are recessions according to the National Bureau of Economic Research.
Source: Bureau of Labor Statistics.

S&P 500 consensus forecasts started declining in mid-2022.

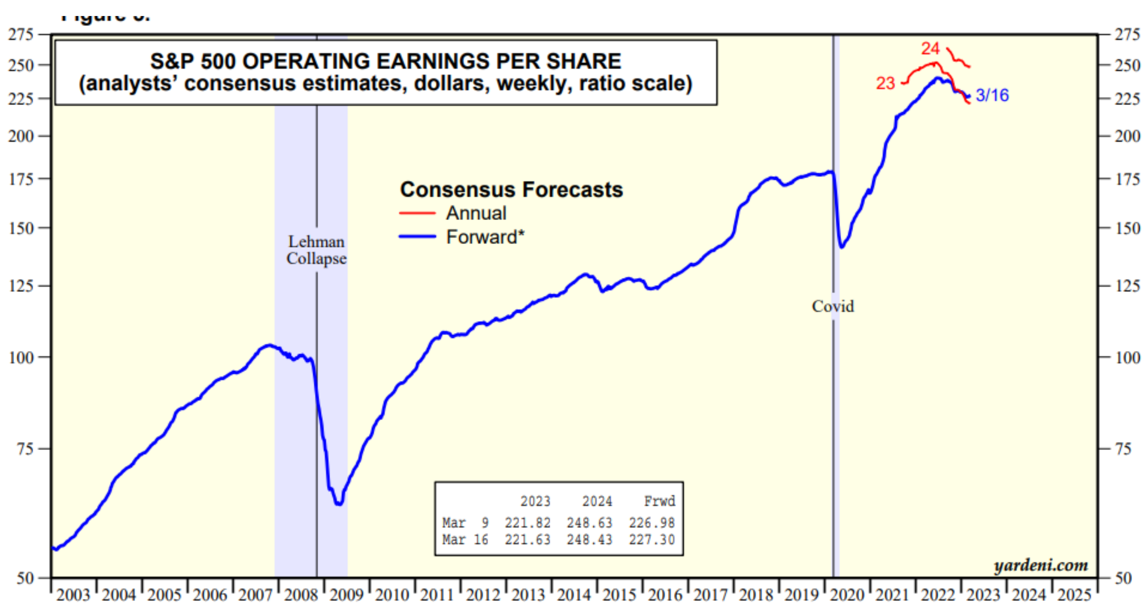


* Time-weighted average of consensus revenue estimates for current and next year.
Note: Lehman collapsed 9/15/2008. WHO declared global COVID-19 pandemic on 3/11/2020.
Note: Shaded areas are recessions according to the National Bureau of Economic Research.
Source: I/B/E/S data by Refinitiv.

The chart above shows forecast **revenue**. Red lines show progression of forecasts for calendar years 2023 and 2024. The blue line shows the "next 12 months" forecast. The 2023 forecast has continued declining; 2024 forecast has improved, from Energy and Utilities. Inflation is supporting revenues - most of the forecast decline is margins and earnings, as shown next.



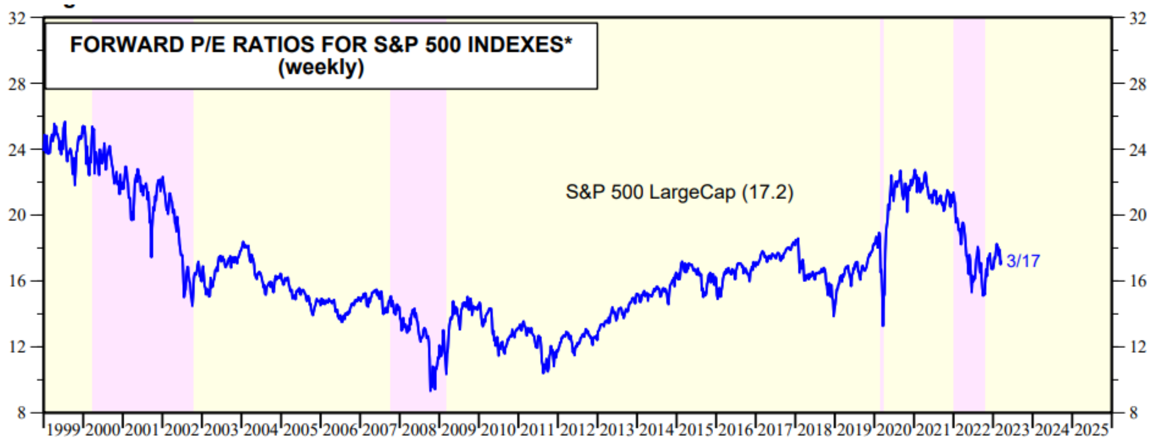
S&P 500 profit **margin** rose to record highs during the pandemic. That gain is temporary. Margins are falling toward pre-2020 levels. In a moderate recession, margins should fall further.



* Time-weighted average of analysts' consensus estimates for S&P 500 operating earnings for current year and next year.
Note: Shaded areas are recessions according to the National Bureau of Economic Research.
Note: Lehman collapsed 9/15/2008. COVID-19 = WHO declares global pandemic on 3/11/2020.
Source: I/B/E/S data by Refinitiv.

Forecast S&P 500 **earnings** has declined to $221, but that still implies +2% growth over 2022's reported $216 which itself missed forecast $220. In recession years, earnings typically declines -10% or more. A *very* mild recession or mid-cycle correction may see earnings flattish.

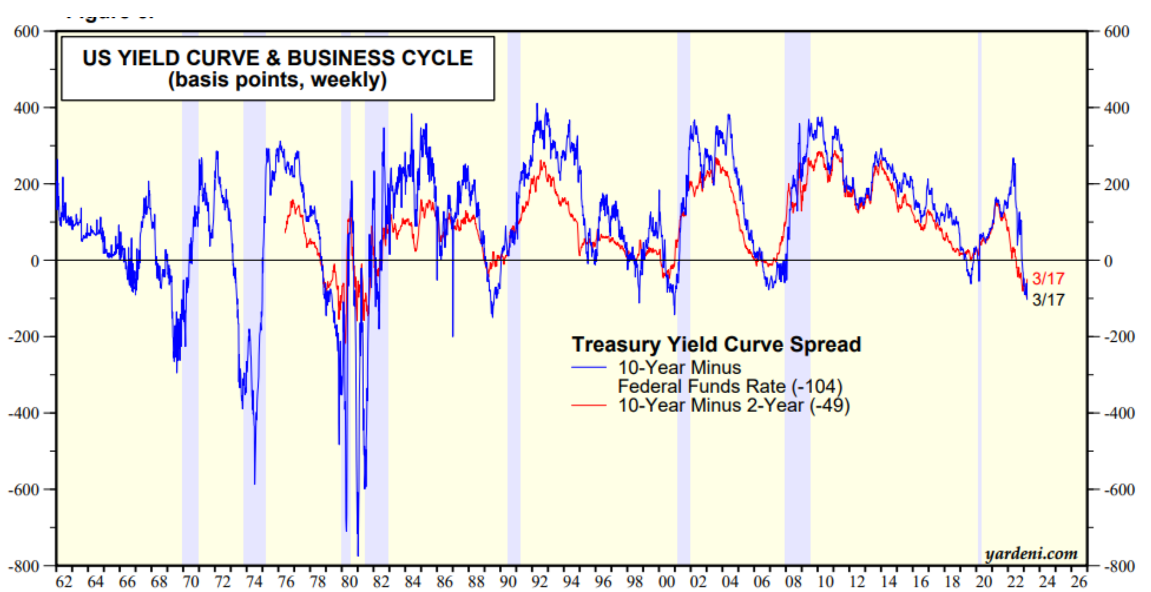
The S&P 500 price/earnings ratio had declined to the pre-pandemic range (15-17X), but is now bumping against the upper end of that range.



* Weekly stock price index divided by 52-week forward consensus expected operating earnings per share
Note: Shaded red areas are S&P 500 bear market declines of 20% or more. Yellow areas show bull markets.
Source: I/B/E/S data by Refinitiv and Standard & Poor's.

Since the S&P 500 has declined only about -4% since September, while forecast 2023 earnings has declined about -10%, the market has gotten *more* expensive in recent months.

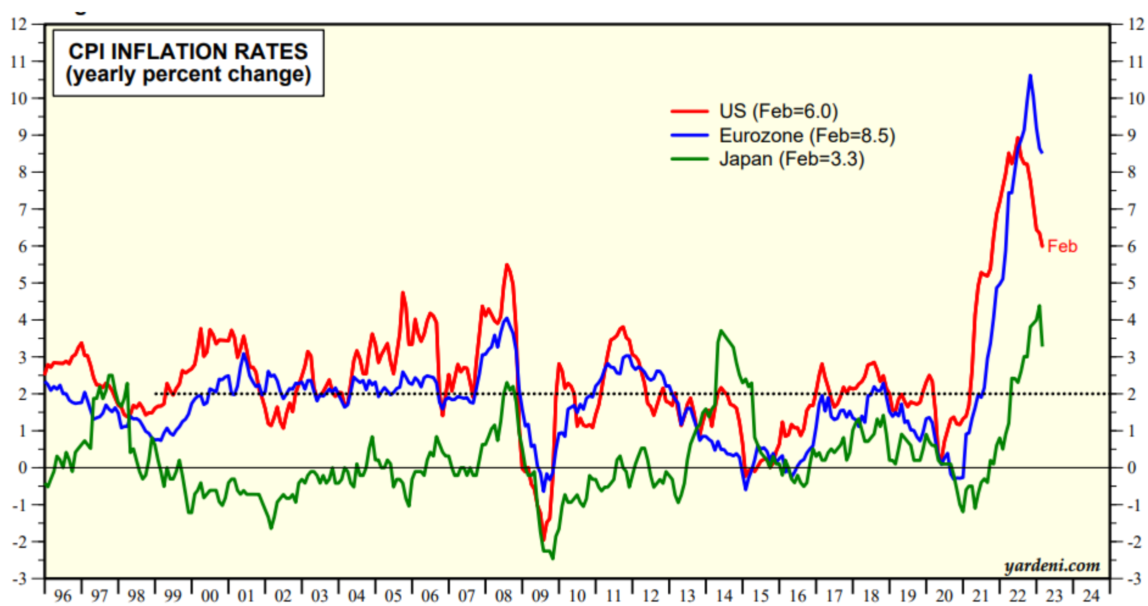
Yield curve inversion is historically a reliable recession indicator.



Note: Shaded areas are recessions according to the National Bureau of Economic Research.
Source: Federal Reserve Board.

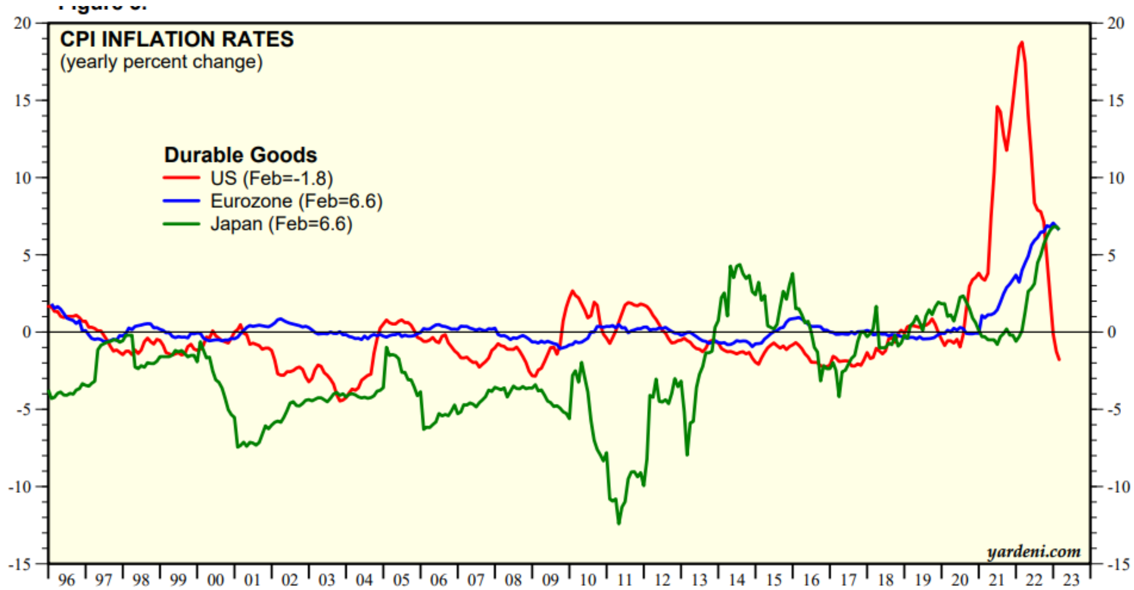
"Inversion" means that long rates are lower than short rates. Inversion reached a peak in mid March; since then, bank volatility has reduced the inversions. Inversions usually start "de-inverting" before recessions start.

US inflation is declining but remains high.



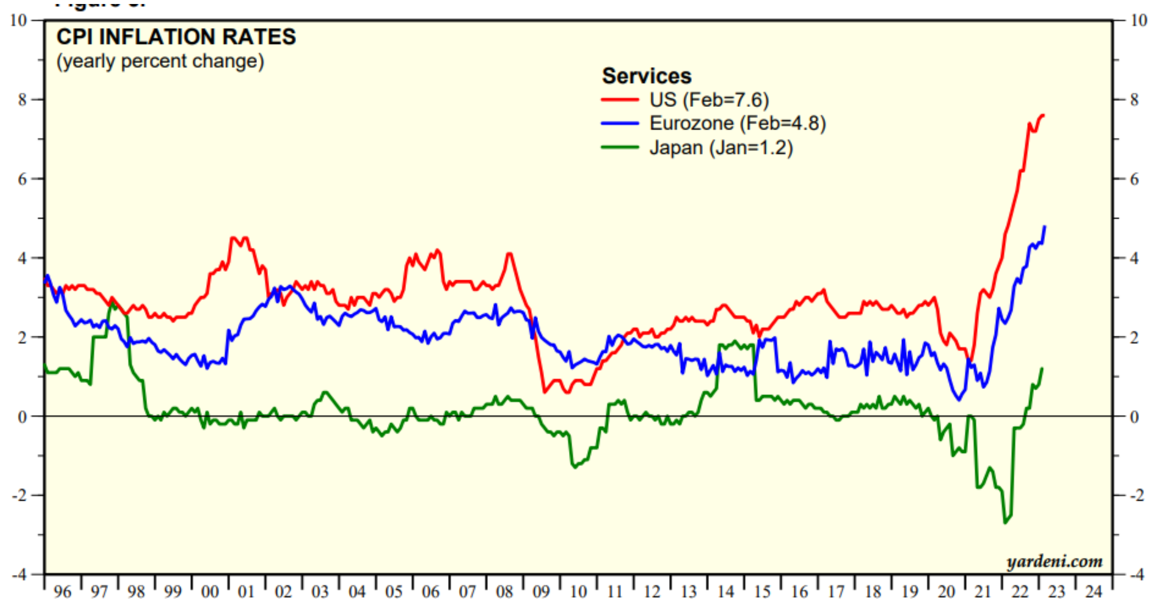
Note: Dotted line is the 2.0% inflation target of the Fed, ECB, and BOJ.
Source: Haver Analytics.

The US and Europe are making progress on reducing inflation, with US CPI down from almost 9% last year to 6% now. However, the Federal Reserve's target is 2%; a long way to go.



Source: Bureau of Labor Statistics.

Durable "goods" inflation has reversed to"dis-inflation" in the US and starting to peak elsewhere.



Source: Haver Analytics.

"Services" inflation is still rising. These prices are driven by wages, which are being lifted by the very strong jobs market. Services including housing are the large majority of the inflation index.