

A Series of Unfortunate Events

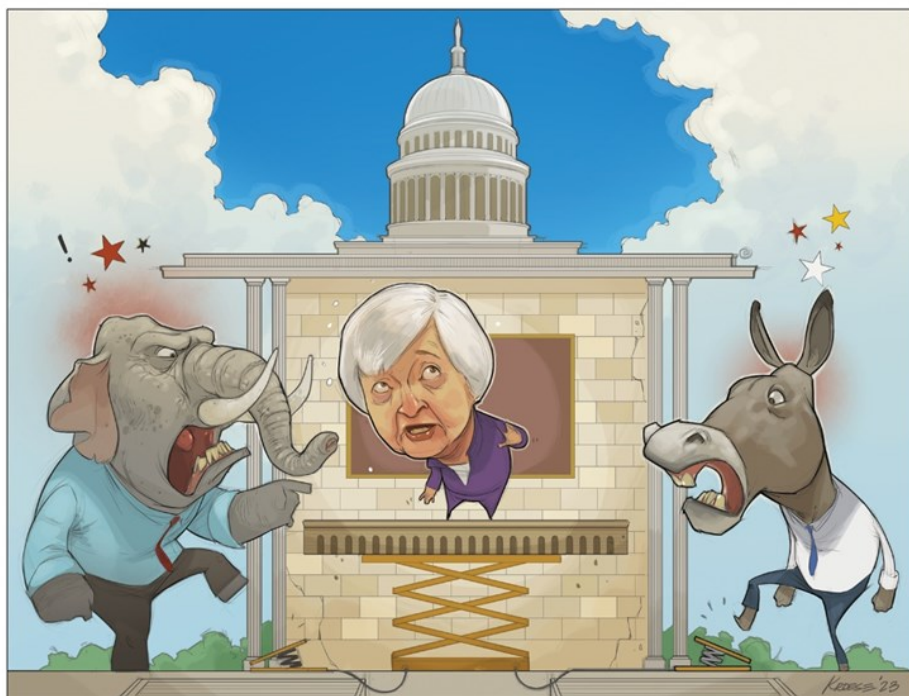
April 2023

- U.S. equity markets continued their impressive run this year, bringing year-to-date returns to over 9%; bonds also made modest gains.
- Inflation continued to moderate, but the 5% year-over-year rate for March remains well above the Fed's 2% target.
- As the debt ceiling debate intensifies, Congress remains at an impasse and has largely ignored warnings from Treasury Secretary Yellen, who now estimates that the U.S. will run out of funds to pay bills by June 1.
- For the first and second quarters of 2023, analysts are projecting year-over-year earnings declines of 3.7% and 5.0%, respectively, as the ongoing economic slowdown has continued to drag expectations lower.

American consumers are frustrated that the Fed hasn't done more to address inflation, while markets are frustrated that the Fed hasn't done more to support failing banks

Overview

Borrowing the title from the popular series of children's books, April was notable for a series of unfortunate policy-related events, which could pave the way for a potentially volatile few months for markets. Major players in these events include a Federal Reserve that has been forced to hike interest rates into an economic slowdown, a banking sector facing severe stresses, and a Congress fumbling with how to pay for a budget deficit estimated at \$1.4 trillion.¹ Unfortunately, in the real world, assigning the role of the antagonist is not as easy as in a story. American consumers are frustrated that the Fed hasn't done more to address inflation, while markets are frustrated the Fed hasn't done more to support failing banks. In terms of fiscal policy, both the left and the right sides of the political aisle view each other as the villain—and markets are caught in the middle.



Throughout the month, U.S. markets bounced around on short-term news and ended April with modest gains. The S&P 500 posted a 1.6% gain, bringing year-to-date gains to an impressive 9.2%, while the Bloomberg U.S. Aggregate Bond Index ended the month marginally up 0.6%. Inflation continued to show signs of cooling, as illustrated by a March CPI print of 5.0% year-over-year. While still well above the Federal Reserve's 2.0% target, this was an improvement from the 8.5% year-over-year increase in March 2022.²

On May 1, First Republic Bank collapsed, marking the second-biggest banking failure in U.S. history

The banking troubles that haunted March continued. On May 1, First Republic Bank collapsed, marking the second-biggest banking failure in U.S. history. Despite borrowing more than \$77 billion from the Fed's discount window and receiving more than \$30 billion in rescue funds from other large banks (including Morgan Stanley and Wells Fargo), First Republic could not be saved. It was acquired by JPMorgan, who has assumed the majority of the failed bank's assets.³ It is estimated that the collapse of First Republic will cost the FDIC approximately \$13 billion.⁴

Although the S&P 500 was up 9.2% year-to-date through April, this headline strength is not indicative of the average public company's performance. Rather, a handful of Mega Cap Tech stocks (including Meta, Apple, and Microsoft) are largely responsible for recent market gains. Microsoft and Apple alone constitute nearly half of this year's gains, and together the two companies account for 14.0% of the S&P 500—the largest concentration of two companies in the index on record.^{5,6}

First-quarter earnings season kicked off in April, and more than half (53%) of S&P 500 companies have already reported earnings. For the first and second quarters of 2023, analysts are projecting year-over-year earnings declines of 3.7% and 5.0% respectively, as well as a marginal full-year 2023 estimated earnings increase of 1.2%.⁷ Unfortunately, this is less than expectations at the start of the year, when full-year 2023 earnings were projected to increase by 3.4%.⁸

A Series of Unfortunate Events

The debt ceiling has once again dominated headlines. As a quick refresher, the debt ceiling is the total amount of money that the U.S. government is authorized to borrow to meet its existing legal obligations, such as Social Security, Medicare, military salaries, interest payments on national debt, and tax refunds.⁹ Since 1960, Congress has raised the debt ceiling 78 times—49 times under Republican presidents and 29 times under Democratic presidents—with minimal debate.⁹ This time, however, Congress has reached an impasse, unable to come to an agreement to either raise or suspend the debt ceiling.

On January 26, the U.S. officially hit its debt ceiling, and Treasury activated “extraordinary measures” to improve liquidity

The argument over whether to raise the debt limit is a political battle with implications for next year's presidential election. On one side, Republicans argue that raising the debt ceiling without any strings will encourage reckless spending and that Democrats need to cut spending and reduce the U.S. debt load.¹⁰ On the other side, Democrats argue that cutting government spending now will have disastrous effects for the basic functioning of the U.S. government, the public healthcare system, and will push the U.S. into a crisis.¹¹

Once the debt ceiling has been reached, Treasury can use a variety of “extraordinary accounting measures” to lower debt levels and avoid running out of cash and risking a technical default on its debt. On January 26, the U.S. officially hit its debt ceiling, and Treasury activated these “extraordinary measures” to improve liquidity. Treasury had been hopeful for another good year of tax receipts (Tax Day 2022 brought in more than

\$263 billion).¹² Instead, however, Treasury cash balances only increased by \$108 billion.¹³ Treasury announced that it expects to borrow \$726 billion in the second quarter, a borrowing estimate that is \$449 billion higher than announced in January 2023, due to lower cash balances, lower receipts, and higher outlays.¹⁴

Yellen: “...our best estimate is that we will be unable to continue to satisfy all of the government’s obligations by early June, if Congress does not raise or suspend the debt limit before that time...”

On Monday May 1, Treasury Secretary Janet Yellen published a letter addressed to Congress that stated that the U.S. government may run out of money and technically default on its debt as soon as June 1.¹⁵ In her letter, Secretary Yellen explained that:

“After reviewing recent federal tax receipts, our best estimate is that we will be unable to continue to satisfy all of the government’s obligations by early June, if Congress does not raise or suspend the debt limit before that time... Given the current projections, it is imperative that Congress act as soon as possible.”¹⁶

The letter spurred President Biden to invite House Speaker Kevin McCarthy and other top congressional leaders to the White House in the coming week to discuss the debt ceiling and hopefully agree to raise the debt ceiling before June 1.¹⁷ In her letter, Yellen emphasized the importance of an agreement being reached:

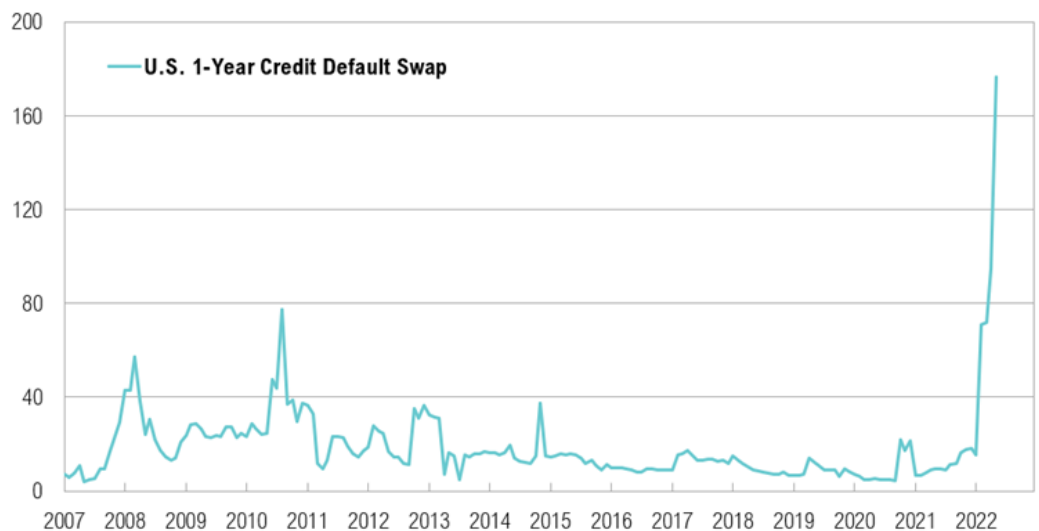
“We have learnt from past debt limit impasses that waiting until the last minute to suspend or increase the debt limit can cause serious harm to business and consumer confidence, raise short-term borrowing costs for taxpayers, and negatively impact the credit rating of the United States.”¹⁶

The debt ceiling drama caused some unusual distortions in Treasury markets late in the month, especially in short-term Treasury bills. The divergence between the one-month and three-month T-bills extended to the largest on record, as the spread between the three-month minus the one-month T-bill yields peaked at 1.72% on April 20. Further, the cost to insure against a default by the U.S. government, proxied by pricing in U.S. credit default swaps (CDS), spiked to the highest levels on record.

The cost to insure against a default by the U.S. government spiked to record levels

The Cost to Insure Against a U.S. Default Has Skyrocketed

Spread, Bps



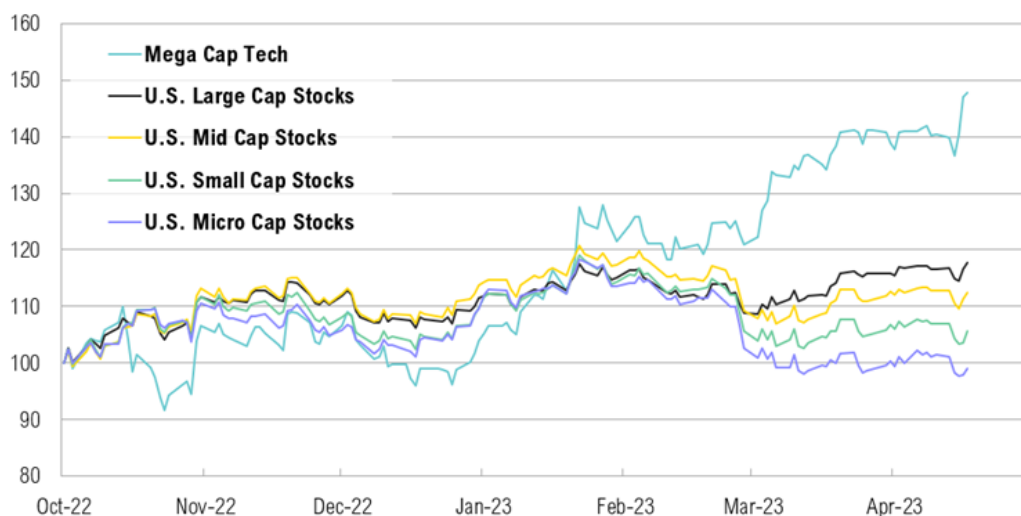
Source: Bloomberg

Unstoppable Tech

Despite uninspiring first quarter earnings results, investors appear to have focused their attention on a half-dozen large technology and consumer-related companies. These “Mega Cap Tech” companies—Microsoft, Apple, Meta, Amazon, Alphabet, and Nvidia—have contributed an estimated 9.0% of the market’s 9.2% return so far in 2023 and now represent a combined 24% of the S&P 500.¹⁸

Mega Cap Tech Has Outperformed Since the October 2022 Low

Growth of 100



Mega Cap Tech companies have contributed an estimated 9.0% of the market’s 9.2% return so far in 2023

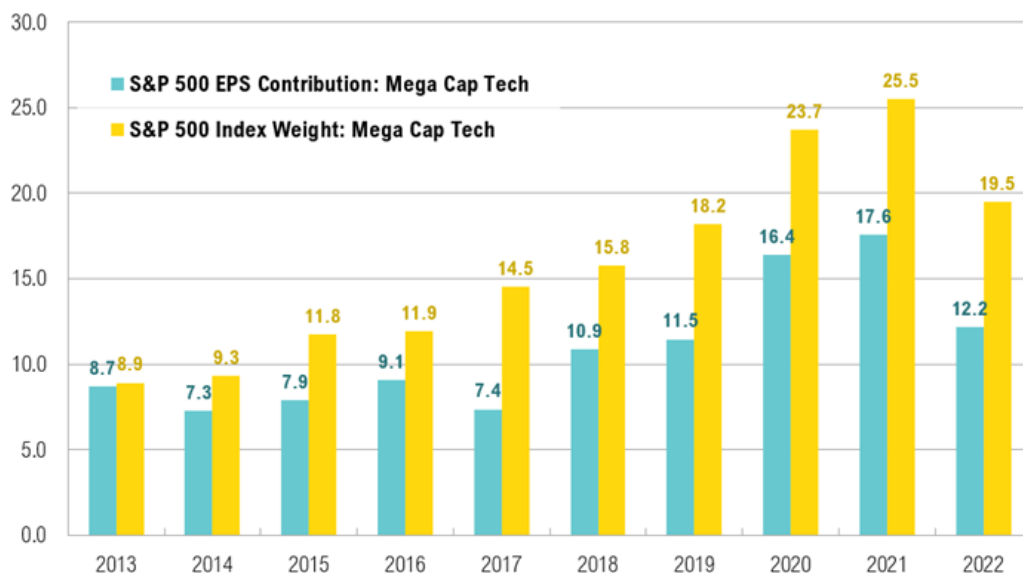
Source: Bloomberg

Microsoft, whose share price increased more than 8% after its earnings announcement, reported 7.1% year-over-year revenue growth for the quarter and beat earnings estimates by almost 10% (\$2.45 vs. the expected \$2.23).¹⁹ Alphabet has authorized a \$70 billion stock buyback and reported a 2.6% year-over-year revenue growth, beating earnings per share expectations by 9% (\$1.17 vs. the expected \$1.07).²⁰ Apple’s total revenue declined 3.0% over the quarter, falling from \$97.3 billion to \$94.8 billion.²¹ Similar to Alphabet, Apple also announced a \$90 billion buyback on its quarterly earnings call.²¹ Meta exceeded earnings per share expectations by an impressive 31% (\$2.54 vs. the expected \$1.95) as its commitment to increase efficiency by cutting more than 21,000 jobs seemed to be paying off. Meta reported 2.6% year-over-year revenue growth, though the company’s Reality Labs continued to incur significant losses—more than \$4 billion over the quarter.²² Company management will continue to ramp up investment in this new division of the company and therefore expects losses to accelerate throughout the year.²² Nvidia does not report its earnings until May 24, but its share price rose 4% over the month.

Four of these Mega Cap Tech companies—Meta, Microsoft, Alphabet, and Amazon—collectively mentioned the term “AI” no less than 168 times in their first-quarter earnings calls.²³ CEOs and investors alike are increasingly focusing on how this rapidly evolving technology might add value to large technology companies, from boosting efficiency to pushing the boundaries of technological innovations. As Microsoft CEO Satya Nadella puts it: “I have never felt this liberated in terms of opportunity in the days ahead.”²⁴

Mega Cap Tech Growth Has Outpaced Earnings Since 2013

AAPL, NVDA, MSFT, AMZN, META, GOOGL Contribution to S&P 500 EPS and Market Cap, %



Source: Bloomberg. As of 12/31/2022.

This behavior is reminiscent of an investing aphorism that warns, “In a bear market, the generals get shot last.”²⁵ In other words, during the early phases of a bear market, large-cap market leaders might outperform, but they will eventually be dragged down by broader negative sentiment and economic headwinds. It remains to be seen whether this dynamic will play out in 2023 or if these global companies can return to their above-average growth rates of the past.

Markets

Both U.S. and international equity markets ended April with positive returns. International markets outperformed their U.S. counterparts. The MSCI EAFE ended the month up 2.9% while the S&P 500 posted a 1.6% gain. The Bloomberg U.S. Aggregate Bond Index ended the month with a marginal 0.6% gain, and international developed market bonds ended the month up 0.3%.

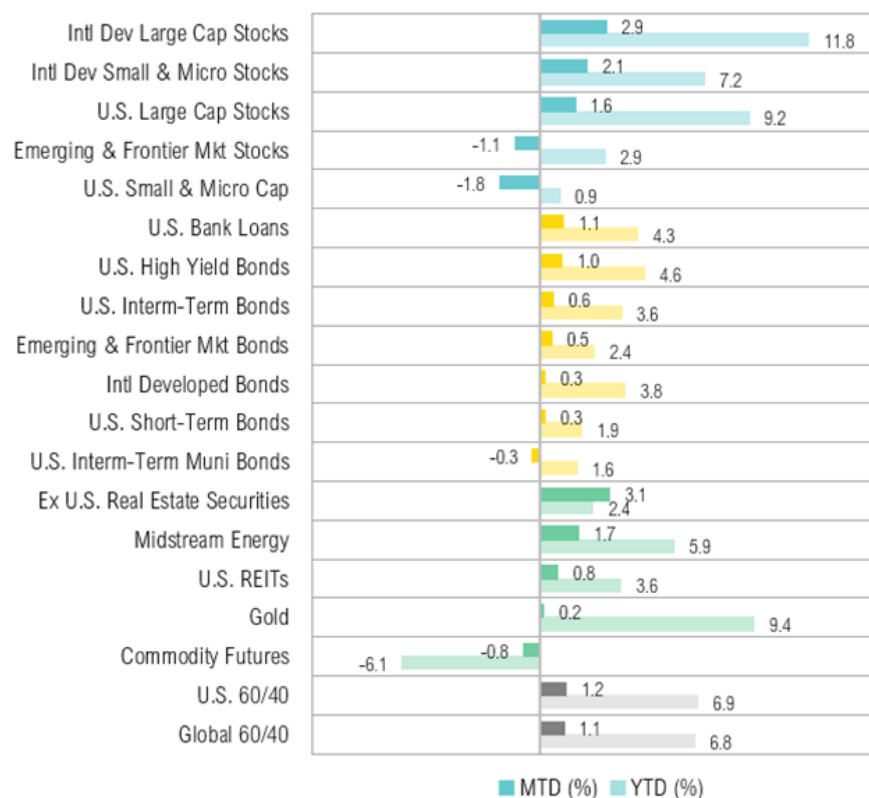
Small cap stocks have wiped out nearly all the gains made this year, ending the month down 1.8% and now only up 0.9% year-to-date. Uncertainty regarding the ongoing banking sector turmoil and the future of the Fed’s monetary policy have weighed heavily on U.S. small and micro-cap stocks because debt dynamics, higher-for-longer borrowing costs, and a potentially looming credit crunch place more pressure on smaller companies.²⁶

The BoJ’s review on its monetary policy stance could lay the groundwork for Ueda to start phasing out decades of quantitative easing

The new governor of the Bank of Japan, Kazuo Ueda, who started his first term on April 8, held his first monetary policy meeting on April 27. As expected, Ueda opted to stick to the Bank of Japan’s longstanding ultra-easy monetary policy stance and maintain ultra-low interest rates.²⁷ However, the BoJ did remove a pledge from its guidance for interest rates to stay “at current or lower levels” and announced that it will conduct a review on its monetary policy stance.²⁷ Even though this review could take as long as 18 months and offers no assurances that any policy changes will be made, it could lay the groundwork for Ueda to start phasing out decades of quantitative easing.

China's latest CPI print indicates that demand remains weak and that the country's reopening and recovery have been slower than anticipated. Inflation increased by only 0.7% year-over-year, which could force the People's Bank of China to cut rates in order to boost demand.²⁸

April 2023 Key Market Total Returns



Source: Bloomberg

Looking Forward

We continue to view the stresses facing banks as more of a symptom of the Fed's rapid rate hiking cycle than systemic solvency risk, but that may not matter if deposits continue to flee the punishingly low deposit rates paid by the banks. As the crisis has continued in an environment of sharply higher interest rates, both supply and demand for loans are drying up. The most recent Senior Loan Officer Survey, released by the Fed on May 8, showed that almost half of all banks were tightening standards for commercial and industrial loans.²⁹ These levels are some of the worst in the past 20 years, only matched or eclipsed during the Global Financial Crisis and COVID-19 pandemic.

Although there is no predefined path for policy or markets, we remain focused on downside risks. If we are wrong and the economic backdrop is stronger than current data suggests, we will still likely participate in any market upside, but to a muted degree. Further, higher short-term Treasury yields mean we are being paid—in relative terms quite handsomely—to patiently wait while things play out. Most of all, if a recession does occur, we want to be able to take advantage of any opportunities if and when they arise.

We remain focused on downside risks and want to be able to take advantage of any opportunities if and when they arise

The final book in the popular *A Series of Unfortunate Events* books by Daniel Handler is titled, *The End of Prosperity*, but we do not think investors need to necessarily resign themselves to this outcome. The Baudelaire children survived the series by drawing on their courage, adaptability, and resourcefulness. We think investors could learn from them.

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DEFINITIONS

Asset class performance was measured using the following benchmarks: U.S. Large Cap Stocks: S&P 500 TR Index; U.S. Small & Micro Cap: Russell 2000 TR Index; Intl Dev Large Cap Stocks: MSCI EAFE GR Index; Emerging & Frontier Market Stocks: MSCI Emerging Markets GR Index; U.S. Intermediate-Term Muni Bonds: Bloomberg Barclays 1-10 (1-12 Yr) Muni Bond TR Index; U.S. Intermediate-Term Bonds: Bloomberg Barclays U.S. Aggregate Bond TR Index; U.S. High Yield Bonds: Bloomberg Barclays U.S. Corporate High Yield TR Index; U.S. Bank Loans: S&P/LSTA U.S. Leveraged Loan Index; Intl Developed Bonds: Bloomberg Barclays Global Aggregate ex-U.S. Index; Emerging & Frontier Market Bonds: JPMorgan EMBI Global Diversified TR Index; U.S. REITs: MSCI U.S. REIT GR Index, Ex U.S. Real Estate Securities: S&P Global Ex-U.S. Property TR Index; Commodity Futures: Bloomberg Commodity TR Index; Midstream Energy: Alerian MLP TR Index; Gold: LBMA Gold Price, U.S. 60/40: 60% S&P 500 TR Index; 40% Bloomberg Barclays U.S. Aggregate Bond TR Index; Global 60/40: 60% MSCI ACWI GR Index; 40% Bloomberg Barclays Global Aggregate Bond TR Index.

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