INVESTMENT UPDATE

First Quarter 2023

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MARKET REVIEW

In stark contrast to 2022, both Equity and Fixed Income markets were higher for the first quarter of 2023, leading many to question if reports of the death of the 60/40 portfolio have been grossly exaggerated. Mean reversion fueled Equity strength, particularly in Large Growth names, while higher absolute rate levels, alongside peaking interest rates, buoyed Fixed Income performance.

Similar to last quarter, all major Equity markets finished higher during the first quarter, despite significant changes to the overall inflation, interest rate, and sentiment narratives. Once again, Non-US Developed Equities bested peers and generated a return of 8.6% as the economy and earnings proved more resilient than feared and favorable weather persisted. Emerging Markets climbed higher amid China reopening optimism, supply chain improvement, and global trade normalization.

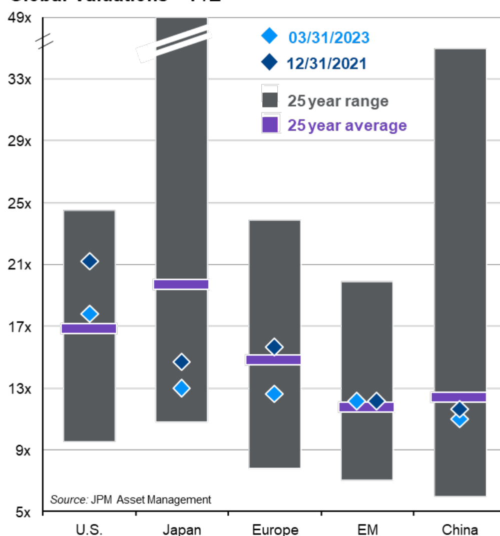
Large Cap stocks were up 7.5% for the quarter, coincidentally the same amount as last quarter. Characteristic of late-cycle markets, strength was narrow as investors became rather selective in bidding up Large Cap names; in fact just five names accounted for two-thirds of the S&P 500 return. Elsewhere, Small Cap performance lagged as banking headlines weighed on sentiment, and the impact was most acute in the higher beta asset class with an outsized mix of financial services.

Total returns for Fixed Income sectors were uniformly positive for the period, ranging from low- to mid-single digits. Amid growing levels of uncertainty, higher quality bonds such as Investment Grade Corporate and Government Debt were favored by investors, with tax-adjusted Municipal Bonds generating particularly compelling returns. Despite the Fed raising rates for the 9th time in a row, yields fell as a result of the banking turmoil, moderating inflation, and the corresponding increased expectations of a rate cut sooner vs. later.

> *Following the Fed's final rate hike, a 60/40 portfolio was decidedly positive two years later in 7 of the last 8 cycles.*

OUTLOOK

The quarter started off with positive momentum reflective of decelerating inflation, favorable economic indicators, and strong Equity markets. However, banking concerns and negative inflation surprises led to increased apprehension about banks' ability and willingness to lend – a necessary ingredient for economic momentum. Fortunately, government and industry leadership acted swiftly and decisively to help mitigate the risks. As the quarter came to an end, some pundits were espousing that tighter lending standards would enable the Fed to discontinue hiking, if not initiate rate cutting by year-end.



Encouragingly, while the current 6% level of inflation is more than double the Fed's target, inflation has decreased by one-third in under a year and is likely to further cool. Layoffs will provide relief to wage pressures and consumer behavior changes will cause service spending to slow amid savings rate decreases and personal debt increases, all of which will occur alongside other lagged impacts of prior actions.

That's not to suggest that a recession will be avoided. Rather, it portends an increased possibility of a soft landing or if not, an economic recession that would be mild and short-lived. The degree and length of a US recession depend in part upon management team discipline, balance sheet strength, and margin compression absorption ability, as well as the extent to which there is a successful resolution to the debt ceiling uncertainty. Outside the US, economic strength should be supported by continued resiliency in Europe, increasing momentum from China reopening, and a weaker dollar as interest rate differentials compress.

From a portfolio positioning standpoint, recall that the markets and the economy are different; some of the best returns in the market cycle have been generated prior to an economic bottom. As such, investors should look to close Equity underweights, possibly sourcing capital from Bond maturities or accumulated Cash. Within Equities, valuation sensitivity is especially prudent when uncertainty is high, suggesting increasing the mix of Non-US Equities. Within Fixed Income, given the uncertain interest rate and economic outlook, high quality Debt should continue to be favored, with perhaps an increased appetite for extending duration; Intermediate-to-Long Term Municipal Bonds appear especially compelling, offering a steeper curve relative to Treasuries.

Q1 Market Performance

US Large Cap	7.5%
US Small Cap	2.7%
Non-US Developed	8.6%
Emerging Markets	4.0%
Treasuries	3.0%
Investment Grade	3.4%
High-Yield	3.6%
Oil	-5.7%
Gold	8.0%

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