Your *Trust* Matters

Q1 2023 Newsletter

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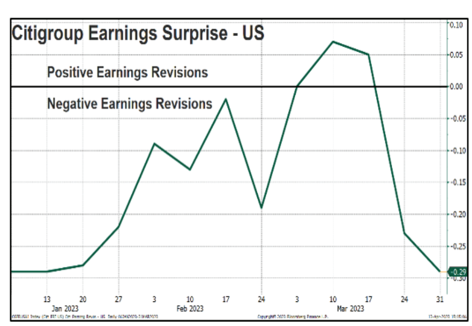
MWO Market Perspectives: Q1 2023

Headline Recap

The Federal Reserve raised interest rates twice more by 25 bps. The FOMC raised the Fed Funds Rate by 25bps at the February and March meetings, a downshift from the super-sized rate hikes that were the norm in 2022. The March hike was in question, considering the banking scare that unfolded in March. However, the Fed reiterated their intent on bringing down inflation, and unanimously voted on another quarter percent hike in March, pushing the Fed Funds Rate to a range of 4.75% - 5%. Inflation is trending lower; however, economists are predicting that inflation will not drop down to the Fed's 2% target until 2024, suggesting the FOMC will keep short-term interest rates higher for longer. If the global economy slows down more than expected, and inflation falls faster than expectations, the Fed could be forced to cut rates despite their projections. The treasury yield curve remains deeply inverted; the 3Mo to 10Yr yield spread is at the widest level in history, signaling an economic slow-down and that the Fed will need to cut short-term rates in response.

Bank failures cause consumers to worry. With the fallout of the Silicon Valley Bank and Signature Bank failures, consumers were worried about the safety of their money. These banks had a high concentration of venture capitalists' funds and an even higher percentage of uninsured deposits. When depositors began withdrawing funds, banks were forced to sell off their securities at a loss to fund the withdrawals, damaging their capital position. The larger fallout resulted in depositors at other banks moving cash from their small and regional banks to larger banks to ease their worries. The cash moves were not as large as feared, easing concerns of a larger bank run. The recent bank failures will have lasting consequences, including increased bank regulation, additional oversight, and in the near-term – tighter lending standards.

2023 Corporate earnings. The 2022 fourth quarter earnings came in better than expectations despite sticky inflation, higher interest rates and a projected economic slowdown. Current year earnings face similar economic headwinds, as well as an unsettled banking industry. An early signal of a broader slowdown in economic activity started in the fourth quarter of 2022, as spending on stock buybacks, CAPEX, and R&D each saw decreases. Forward guidance provided by companies will focus on cash spending, margins, and cost cutting. A potential tailwind to margins and overall productivity is the use of artificial intelligence (AI). Analysts believe AI could the next wave of innovation for software companies and the broader technology industry. However, given recent macro uncertainties, earnings revisions have been biased lower in recent weeks after trending upward throughout much of Q1.



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Equities

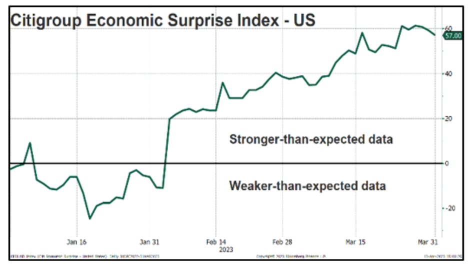
“Optimism that the Fed is nearing the end of the current rate hiking cycle and growing signs of disinflation were among the key drivers for equity markets in the first quarter.”

Data as of 03/31/2023	Trailing Returns			
	YTD	1Yr	3Yrs	5Yrs
EQUITIES				
US Equities				
S&P 500	7.50	-7.73	18.60	11.19
S&P MidCap 400	3.81	-5.12	22.10	7.67
Russell 2000	2.74	-11.61	17.51	4.71
DJ Industrial Average	0.93	-1.98	17.31	9.01
NASDAQ 100	20.77	-10.35	20.00	15.96
International Equities				
MSCI EAFE NR	8.47	-1.38	12.99	3.52
MSCI EM NR	3.96	-10.70	7.83	-0.91
Russell Styles				
Russell 1000 Growth	14.37	-10.90	18.58	13.66
Russell 1000 Value	1.01	-5.91	17.93	7.50
Russell Mid Cap Growth	9.14	-8.52	15.20	9.07
Russell Mid Cap Value	1.32	-9.22	20.69	6.54
Russell 2000 Growth	6.07	-10.60	13.36	4.26
Russell 2000 Value	-0.66	-12.96	21.01	4.55

Source: Morningstar Direct

US Equities

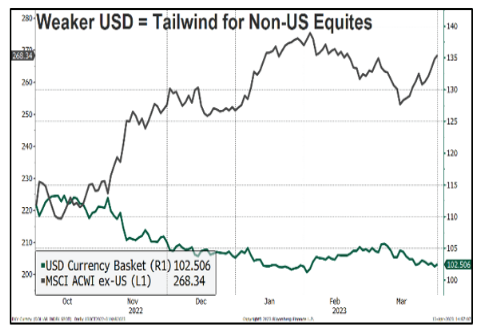
Equity market leadership throughout the first quarter of 2023 was a far cry from what worked in 2022. Growth outperformed Value – by a wide margin across market caps – a stark reversal in trends from the prior calendar year. This was most evident with the tech-heavy NASDAQ posting a return of 20+% for the quarter, breaking a four-quarter losing streak and registering the strongest quarterly gains since the initial pandemic bounce in Q2’20.



Economic data, including inflation readings, came in stronger-than-expected, driving interest rate volatility higher during Q1. After steadily building momentum throughout the first two-thirds of the quarter, conditions began to deteriorate as forward-looking indicators like the ISM PMI surveys weakened from very healthy levels (ISM Services) or have continued to deteriorate from already depressed levels (ISM Manufacturing). While the pull-back in forward-looking economic activity indicators is concerning, this is typically thought of as a “feature”, not a “bug”, in an environment where monetary policy is being tightened so aggressively.

Non-US Equities

US investors with exposure to overseas equity markets stand to potentially benefit from US being at the end of the current hiking cycle. A pause and eventual cut to rates should allow the USD to give back some recent strength vs other major currencies, which would serve as a powerful tailwind for non-US equities. We’ve already seen this occur in markets – as inflation expectations began to moderate, so too did expectations for the ceiling on interest rates, which has allowed the USD to recede from peak levels last fall. As such, overseas equity markets have enjoyed solid returns to start the year as the MSCI EAFE is up 8.47% and the MSCI Emerging Markets Index is 3.96% higher.

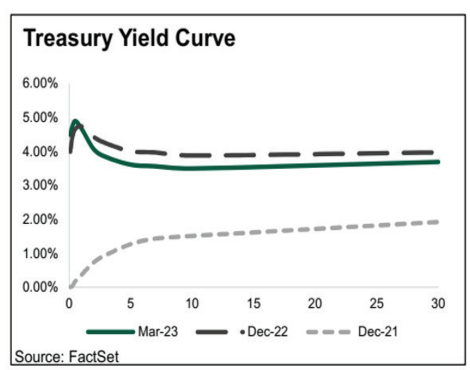


Fixed Income

“Volatility has been at the forefront of the fixed income landscape as central banks combat persistently elevated inflation amidst a backdrop of slowing economic conditions.”

Interest Rates

The push and pull between aggressive Federal Reserve interest rate policy and stubbornly high inflation has resulted in dramatic shifts in the level of interest rates. While the present shape of the yield curve has twisted substantially since the beginning of the year, rising upwards to +50bps at the short end while falling -50bps across the intermediate and long ends, this conceals the fact that the path to current levels has been wrought with turbulence. The sharp swings in interest rates have been driven by fluctuations in investor sentiment between the hopes for a “soft landing” and the fears of a painful recession. With the US central bank nearing the end of its policy actions, expectations are for interest rates to plateau and potentially descend. That notwithstanding, the path of interest rates going forward will be closely connected to the pace and direction of travel for inflation. Moreover, present inflation levels remain leagues apart from the Federal Reserve’s 2% long-term target suggesting that the road to “normal” levels may be a long one.



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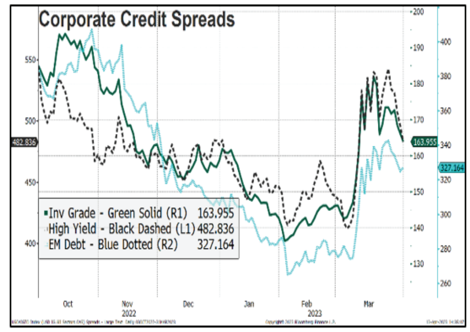
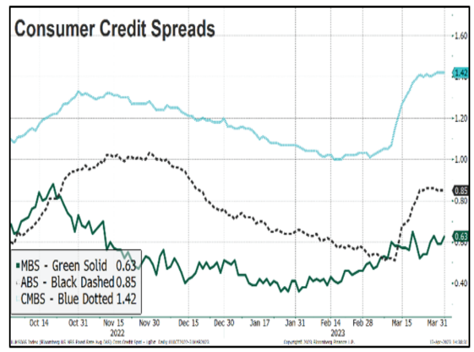
Credit Assets

Credit assets across the board had demonstrated considerable resilience in the face of rising volatility within the capital markets. Since early Q4 2022, corporate credit assets such as Investment Grade (IG), High Yield (HY), and Emerging Market (EM) debt rallied substantially seeing their credit spreads compress -60bps, -120bps, and -50bps respectively. Similarly, consumer credit assets such as Mortgage-Backed Securities (MBS), Asset-Backed Securities (ABS) and Commercial Mortgage-Backed Securities (CMBS) have also rallied meaningfully as their respective spreads narrowed -20bps, -50bps, and -30bps as well.



This behavior reversed quite rapidly on the heels of recent banking sector contagion fears, as corporate and consumer credit assets returned most, and in some cases all, of their strong performance in the latter half of March 2023. Despite the recent credit spread widening, current spread levels are approximately one-half of the levels observed in past recessions, suggesting that more pain is possible under a severe contraction scenario. Sentiment remains cautious among credit investors as they assess the expanding risk and magnitude of an economic slowdown.



Real Assets

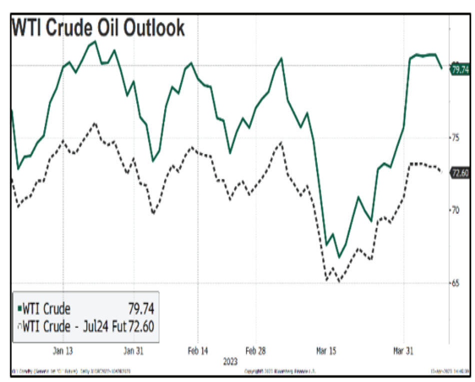
"Within Real Assets, Real Estate and Commodities face a stiff headwind from higher interest rates and the increased likelihood for recession in the coming months."

Real Estate

Generally weak fundamentals and a higher cost of capital will pressure the asset class. Opportunities are bifurcated. Urban office and retail sectors face a reduction in post-pandemic demand for 'footprint', driving vacancy rates uncomfortably high and straining profitability as projects are re-priced. In contrast, strength in the industrial sector persists, driven by high demand in transportation logistics and warehousing. The suburban retail sector is benefitting from the relative strength of the consumer and increased post-pandemic foot traffic.

Commodities

On a production-weighted basis, oil accounts for approximately 60% of the commodities complex. With OPEC announcing a cut in production, price is likely to rise from the current $80 / barrel for WTI Crude, although the futures curve indicates prices falling to $72 /bbl by July, 2024. Precious metals (representing 5%), such as gold are widely considered to be safe-haven investments and have rallied over the past five months. Gold is trading at record price of over $2,000 per ounce. Industrial Metals (11%), Agricultural goods (16%), and Livestock (7%), indicate mostly lower forward price targets, resulting from the expected slowdown in economic activity and higher financing costs.



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Summary

Stocks have held up better than many anticipated to start the year, and equity markets view the Fed's current rate-hiking regime, for all intents and purposes, as complete. If the economy doesn't back-track meaningfully on the path to lower inflation, equity investors seem to be content to look through some of the noise and uncertainty to hopes of a recovery in 2024. The upcoming Q1 earnings season is likely to reflect a contraction vs the prior year. However, many companies are implementing very aggressive cost-cutting measures, and there continues to be evidence of disinflationary forces gaining momentum, so there's a chance this earnings season could be characterized as "better-than-feared". Interest rate volatility likely peaked in March, but odds are good that it remains at above average levels over the next few months as markets continue to grapple with macro uncertainties and re-price risk assets accordingly.

Your long-term plan provides the context for your investment portfolio. To take a fresh look at your financial plan, please contact your Relationship Manager. For additional information, visit our website at www.midwestone.bank.

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