Market Strategy
by STRATEGAS A BAIRD COMPANY

BAIRD
Private Wealth Management

Quarterly Market Update

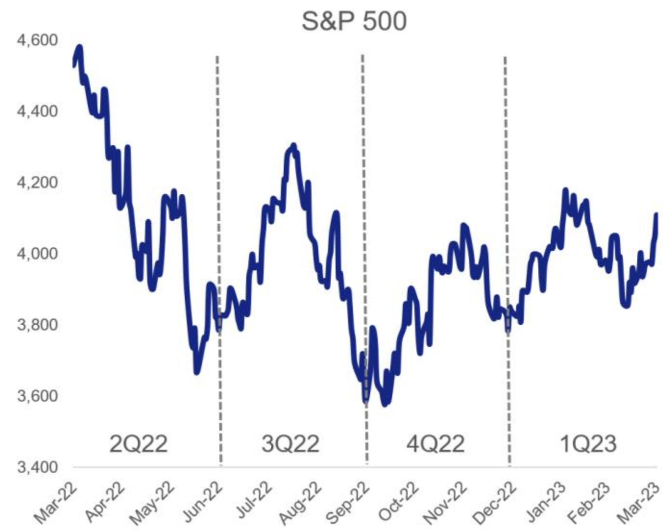
First Quarter, 2023

ASSESSING THE FIRST QUARTER RALLY

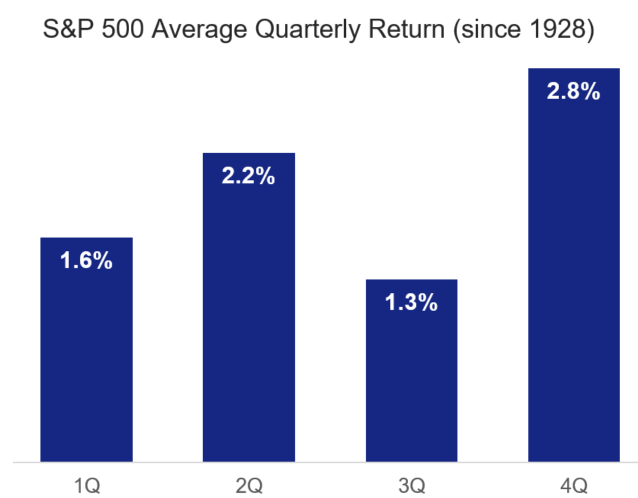
The first quarter was far more satisfying for bulls on risk assets than it was for bears. Growth stocks were up while Value stocks were flat. The NASDAQ gained an impressive 17% and 10-year Treasury note yields fell. And yet it could be said of both bulls and bears alike that few investors are planting their feet and going for the big play. The market, 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, what is likely to be the second quarter in a row of declining year-over-year gains in S&P 500 earnings, spiking credit default swap spreads on U.S. sovereign debt, and bank borrowings at the Fed's discount window that are higher than they have been at any time since 2008.

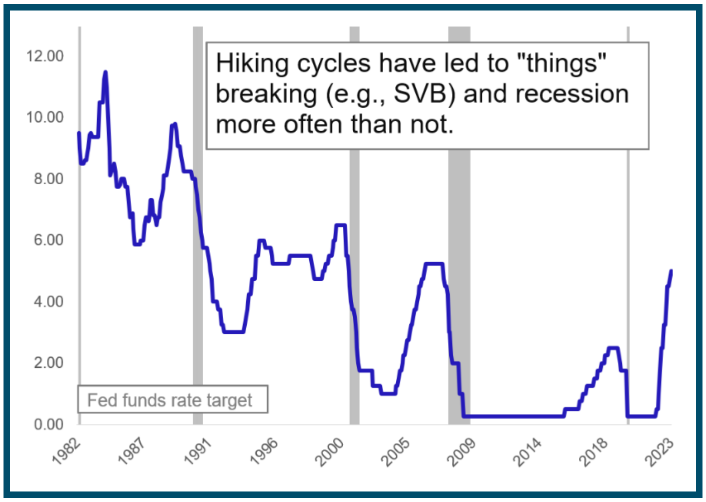
With Technology, Discretionary, and Communications sectors all outperforming in Q1, equity markets seem to be pricing in a mild recession or no recession at all. But given that the lags in monetary policy are long and variable, we continue to believe caution is warranted, especially among longer duration stocks dependent on low (or at least declining) long-term interest rates. In yet another example of how everything old becomes new again, we are finding investors clamoring to get a read on liquidity today in much the same way that we were held hostage to the money numbers released on Thursdays in the 1980s. Our policy team's proprietary Net Liquidity Indicator had an uncanny record of sniffing out the direction of risk assets in the first quarter (i.e., liquidity up, stocks up). Unsurprisingly, net liquidity actually increased in the last three months, underlining the Hotel California nature of using Quantitative Easing to solve all of the world's problems – "you can check out any time you want, but you can never leave."

We believe that it is safe to say that the bill for more than 12 years of fiscal and monetary profligacy will come due in 2023. The Fed is finding itself in the rather odd position of having to tighten to control inflation and ease to control financial conditions at the same time (i.e., pyromaniac and fire fighter). While only time will tell whether the problems in the banking system are idiosyncratic or systemic, it would be hard to argue that the odds of a recession have not increased since Silicon Valley Bank failed three weeks ago. All banks, regardless of size or quality, appear to be in the process of tightening lending standards and risk controls. The Prime Rate currently stands at 8% while the S&P 500 still trades at more than 18x earnings. Inflation clearly appears to have peaked but is well above the Fed's stated target of 2%. It would seem that the Fed, the Administration, Congress, and especially investors, are in store for some hard choices in the second quarter and beyond.

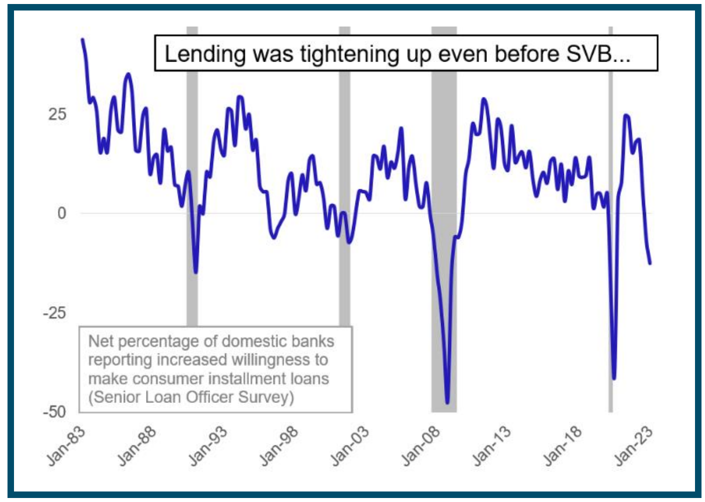


Asset Class	Representative Benchmark	Q1 Return
US Large Cap	S&P 500	7.5%
US Small Cap	Russell 2000	2.7%
International	MSCI AC World ex-USA (USD)	7.0%
Commodities	Bloomberg Commodity	-5.4%
Municipal Bonds	Bloomberg Municipal Bond	2.8%
Taxable Bonds	Bloomberg US Aggregate	3.0%
Cash	Bloomberg 3-Month T-Bill	1.1%

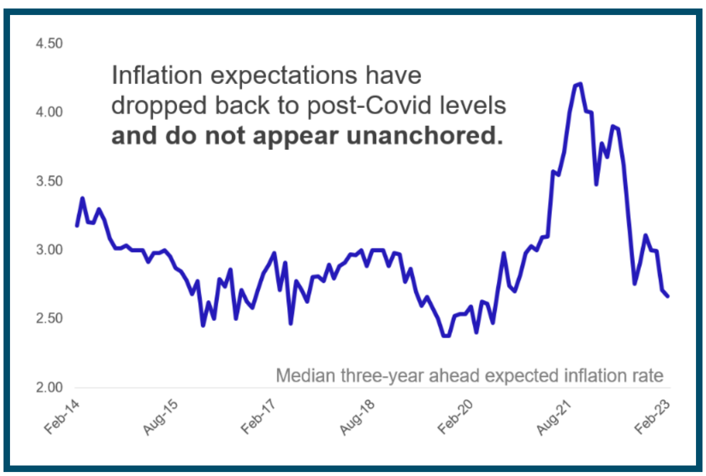




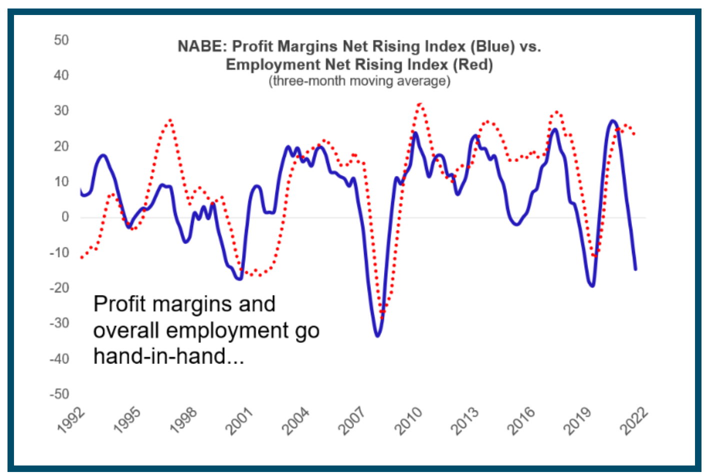
The Federal Reserve has raised interest rates rapidly in order to combat historic inflation. In fact, the current rate hike cycle stands as the second fastest in the last 50 years, behind only Paul Volcker's famous early-1980s campaign. Ultimately, there needs to be a sustained period of below-trend growth to bring demand down to meet supply. As such, economic risks skew to the downside and odds of a recession remain elevated (we estimate 75% chance over the next two years). The Fed slowed down to a +25bp rate hike at their recent meeting, but now things are starting to break (e.g., bank stress). **We believe the Fed is done hiking at the current ~5% fed funds rate.**



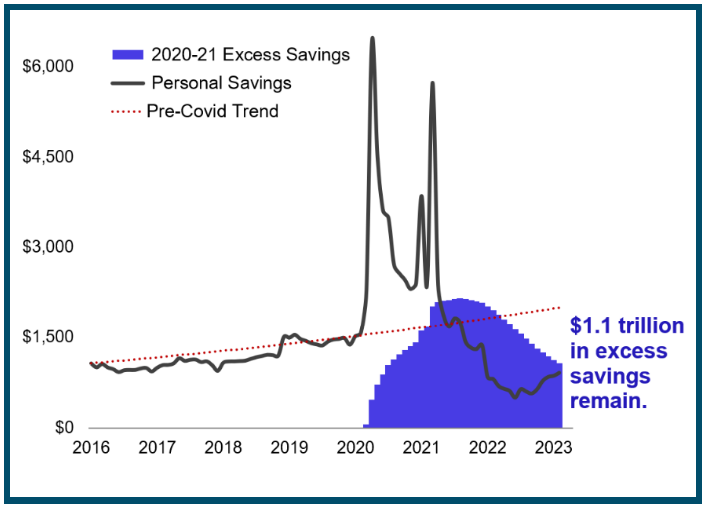
Banks had already begun to tighten lending conditions in 2022 as the Federal Reserve raised interest rates and the economy slowed. Tighter lending conditions ultimately lead to less economic activity, and can be a harbinger of recession. As we note in our opening, we only expect this trend to continue to ramp up Post-Silicon Valley Bank collapse. While the federal government stemmed contagion with its quick action, the recent strain in the financial sector weakens confidence in the banking system and should lead to an overall chill in economic activity.



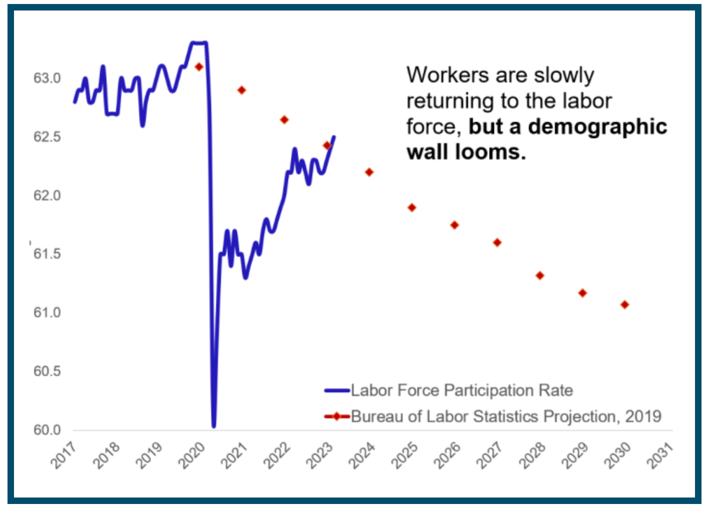
What people expect future inflation to be matters because it affects behavior. If consumers expect inflation to be higher and they act on it, they could, in fact, cause inflation to be higher. If businesses expect higher inflation, they may raise prices at a faster rate – even if that inflation doesn't materialize. The biggest problem in the 1970s was that the Fed had to fight inflation 3 times. They never anchored inflation expectations and eased prematurely before the battle was ultimately won. The key today is to avoid a similar "stop and go" policy. It is critical that inflation expectations remain anchored.



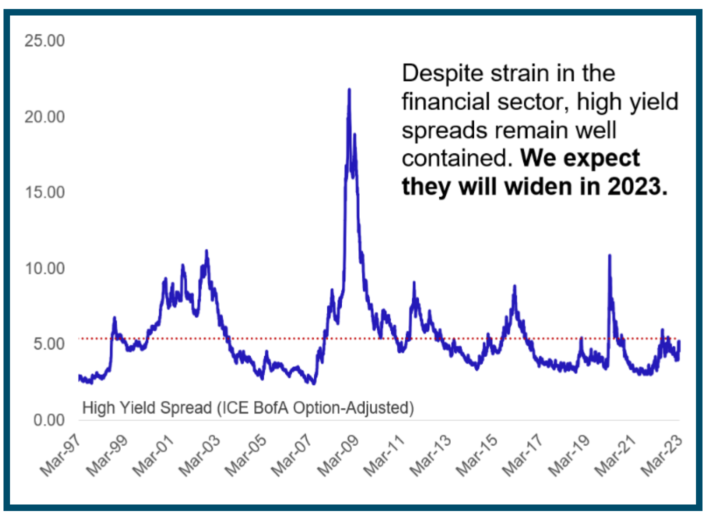
Though high profile layoffs have picked up in recent months (especially in the Tech sector), the overall employment picture has remained quite strong. Unemployment is steady, claims for unemployment insurance are low, and the overall level of job openings is elevated. However, as profit margins compress, companies will be forced to make difficult choices with regards to labor costs. Historically, as profit margins have fallen, so has employment. Margins are already well off their 2021 highs, and we forecast more pressure to come on the earnings side of things in the coming years.



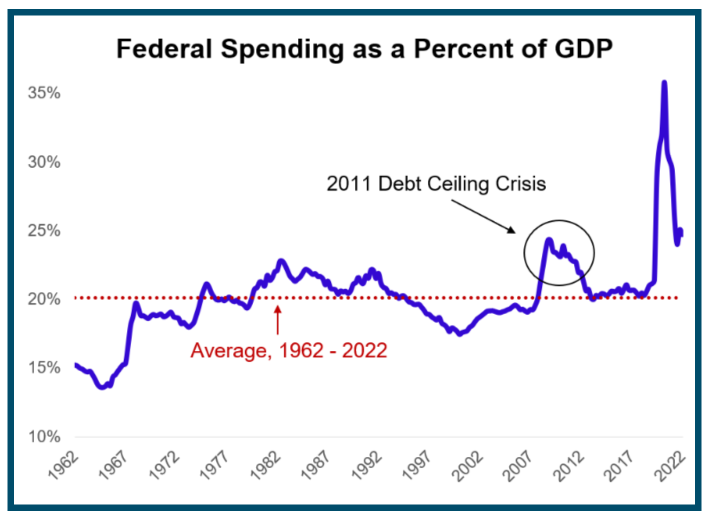
While today's inflation problem can be partially traced to the exorbitant fiscal policies of 2020-21, so too can the cash cushion in the consumer sector that is helping support retail and services spending. Though consumers have begun to drawdown excess savings in recent months, a strong labor market plus extra cash accumulated in the early pandemic months has kept U.S. consumption – responsible for roughly 70% of economic output – afloat. Though consumers are increasingly tapping credit, this savings cushion is an asset not usually found heading into an economic downturn.



Post-pandemic labor shortages have helped those still working gain bargaining power and garnish above-average wage growth. And while the labor force participation rate (those 16+ who are employed or seeking employment as a percentage of the total working-age population) has been ticking slowly towards its pre-Covid level, the U.S. faces a more structural problem going forward. Due to demographic trends (aging population, slowing growth), worker shortages and tight labor markets will likely be more commonplace in years to come. This will keep upward pressure on inflation.



In times of economic strain, high yield spreads (the difference in yield between a junk bond and a Treasury note) typically widen. As the economy slows and the likelihood of high yield bond default rises, investors demand a higher yield to hold said credit – higher risk, higher reward. Spreads have remained relatively well contained amid the Silicon Valley Bank collapse (at least vs. past system-rocking events), but they ultimately did widen somewhat into quarter-end. We expect them to rise further from here – especially with recession now on everyone's radar.



When federal spending is above its long-run average, the debt ceiling is often a tool to impose austerity on policy-makers. In the coming months, Congress must raise the debt ceiling. This sets up a fight between Republicans, who want spending cuts, and Democrats, who do not want to negotiate at all. This process is likely to be bitter. While it's possible that Republicans pass a short-term debt ceiling hike with modest spending cuts to buy time for a larger package, with federal spending as a % of GDP and interest costs as a % of tax revenue elevated, austerity and budget reforms are probable.

S&P 500 Index (Large Cap / U.S. Stocks): A representative sample of 500 leading companies in leading industries of the U.S. economy. These are equity securities of large capitalization (generally $7 billion plus market cap) companies having growth and value characteristics. ● **Russell 2000® Index (Small Cap / Small Core):** Measures the performance of the 2,000 smallest companies in the Russell 3000® Index, which represent approximately 10% of the total market capitalization of the Russell 3000® Index. These are equity of small capitalization. ● **MSCI EAFE Index Net (International / Developed Markets):** A free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the US & Canada. As of May 27, 2010 the MSCI EAFE Index consisted of the following 22 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, and the United Kingdom. ● **BBgBarc Aggregate Bond Index (Taxable Bonds / Bonds):** Comprised of approximately 6,000 publicly traded bonds, including U.S. Government, mortgage-backed, corporate, and Yankee bonds with an average maturity of approximately 10 years. ● **BBgBarc Muni Bond Index (Municipal Bonds):** Bonds must have a minimum credit rating of at least Baa, an outstanding par value of at least $3 million, part of a transaction of at least $50 million, issued after December 31, 1990 and have a year or longer remaining maturity ● **FTSE 3-month T-bill Index (Cash):** This index measures monthly return equivalents of yield averages that are not marked to market. It consists of the last one-month and three-month Treasury bill issues, respectively. ● **Bloomberg Commodity Index (Commodities):** Composed of commodities traded on U.S. exchanges, with the exception of aluminum, nickel and zinc, which trade on the London Metal Exchange (LME). Subindices include Petroleum, Grains, Industrial Metals, Livestock, Precious Metals, and Softs.

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