First Quarter 2023 Investor Letter

The S&P 500 rose 7.5% in the first quarter as financial markets continued to rebound from the sharp decline in the first half of 2022. Growth stocks, which lagged in 2022, rose 14.4% in the period, compared to a rise of 1% for Value stocks. The technology and communication sectors both rose over 20% in the quarter. Sectors which held up well last year were weak during the quarter, with utilities, financials, and energy all down for the period.

Financial markets continued to be preoccupied with inflation during the quarter. Markets rose in January on relatively benign inflation numbers, and then retreated in February when it looked like the Fed might reaccelerate its rate hikes.

The biggest news event of the quarter for investors was the collapse of Silicon Valley Bank. The problem at SVB began when the fast-growing bank purchased large positions in intermediate and long-term US bonds. When interest rates rose last year, the value of these bonds dropped dramatically. (For those who are interested, our third quarter 2022 letter discusses the increased interest rate risk inherent in long-term bonds.) When SVB attempted to raise additional funds to shore up its capital base, its tech-savvy clients used their phones and computers to set off an old-fashioned bank run. This run led to a rescue by the FDIC.

As with any financial crisis there are fears of contagion or additional fallout. While several other banks with similar profiles to SVB have come under pressure and one other bank required a bailout, at this point it does not appear that SVB's failure will set off a large-scale banking crisis. For more on this topic, please see the special letter we sent in late March.

What if there is a recession?

Investors reasonably may wonder what would happen if the U.S. economy were to go into recession, and how it would impact their investment strategy. While this may seem like a simple question, there are a few important aspects to consider.

First, what exactly is meant by a recession and who decides when one has occurred? Economists generally define a recession as two consecutive quarters of negative economic growth. That seems straightforward enough, but two negative quarters do not always mean a recession is declared. For example, last year the US economy had two consecutive quarters of negative growth, but it was not considered a recession because the cause of the two negative quarters had to do with dislocations resulting from the rapid restart of the US economy following the pandemic.

A recession is officially declared by the National Bureau of Economic Research, which is a non-profit organization made up of leading economists. Unfortunately, they take their time doing in making their determination. On average for the past six recessions, it has taken 234 days (about eight months) after the start of a recession for them to announce that it has started.

This creates a dilemma for investors: It takes 8 months on average for a recession to be declared. A standard recession might last three quarters (9 months), so the recession may easily be almost over by the time the NBER

says the economy is in a recession. Furthermore, the stock market will generally anticipate an economic recovery at least 6 months before it occurs, just like it anticipates recessions (see 2022). So, the market may start to recover around the time the economy goes into recession. You can see why timing the market is so difficult.

We have invested client portfolios in a way that we believe will hold up relatively well should a recession occur, while also allowing clients to participate in the subsequent recovery. For the most part, asset allocation reflects neither our nor anyone else's economic forecasts, but rather factors which are specific to clients: age, resources, risk tolerance, years until retirement or retirement needs, and any other items we may have discussed. These are the primary things we consider when selecting client investments. We can't predict the future, but we can use our experience to guide client portfolios through economic cycles which will continue to occur as they always have.

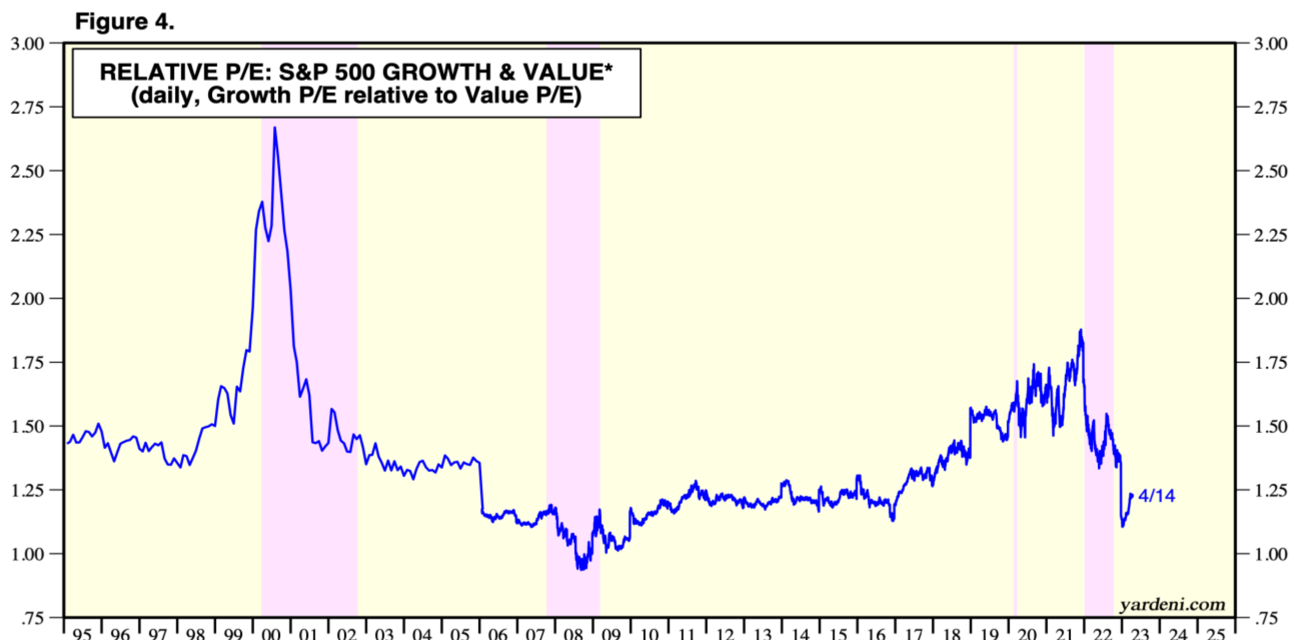
All that said, while we do not make investment decisions based on economic forecasts, we do make them based on important valuation parameters. In our experience, valuation levels are significantly more reliable investment metrics than economic or market forecasts. One such parameter we monitor is the relative valuation of growth stocks and value stocks. For more on this, see below:

Valuation Update: Growth vs. Value

A year ago in this letter we showed a chart which compared the valuation of growth stocks to value stocks. At the time, the multiple of earnings for growth shares was over 30, up substantially from around 15 a decade earlier. The multiple of earnings for value shares was 16, up from 12 a decade before. Our conclusion at the time was that the valuation bubble which was widely discussed was mostly confined to fast growing companies, along with some other asset classes such cryptocurrency.

Since then, the valuation of growth shares has declined dramatically. As can be seen in the chart below from Yardeni Research, the P/E for growth relative to value is back to its historical level. This indicates to us that growth stocks are no longer substantially overvalued compared to value shares.

Figure 4.



* Price divided by 12-month (52-week) forward consensus expected operating earnings per share. Monthly data through December 2005, then daily.
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.

Recessions and Fed Policy

Ever since the Fed started raising interest rates 15 months ago economists have been predicting a recession. It has not happened yet. Two quarters ago we asked whether the Fed's rate strategy had failed. At that time, we said it was too early to say for sure. It is important to ask again why it has taken the Fed so long to slow the economy and whether they are on the right path.

To recap, the reason the Fed started raising interest rates was because of high inflation. Economics teaches us there are two ways the government can lower inflation—monetary policy (raising interest rates) or fiscal policy (reducing government spending). For various reasons, fiscal policy is essentially off the table for now, which leaves monetary policy as the only alternative. The theory for using monetary policy is that by raising interest rates, businesses and consumers will borrow less which will lead to less overall demand and eventually less inflation. It's a simple concept and has generally worked well over time. The downside is that it often causes recession. In fact, from 1934 to 1980, a significant rate increase by the Fed caused a recession about 75% of the time. In recent years, however, the experience has been different. From 1980 to the present time, Fed rate increases have only caused a recession about half the time.

Has the economy become less interest rate sensitive, and if so, why? More importantly, if the economy is less rate sensitive, what can be done to lower inflation? There are several recent research papers by the Fed which address this issue.

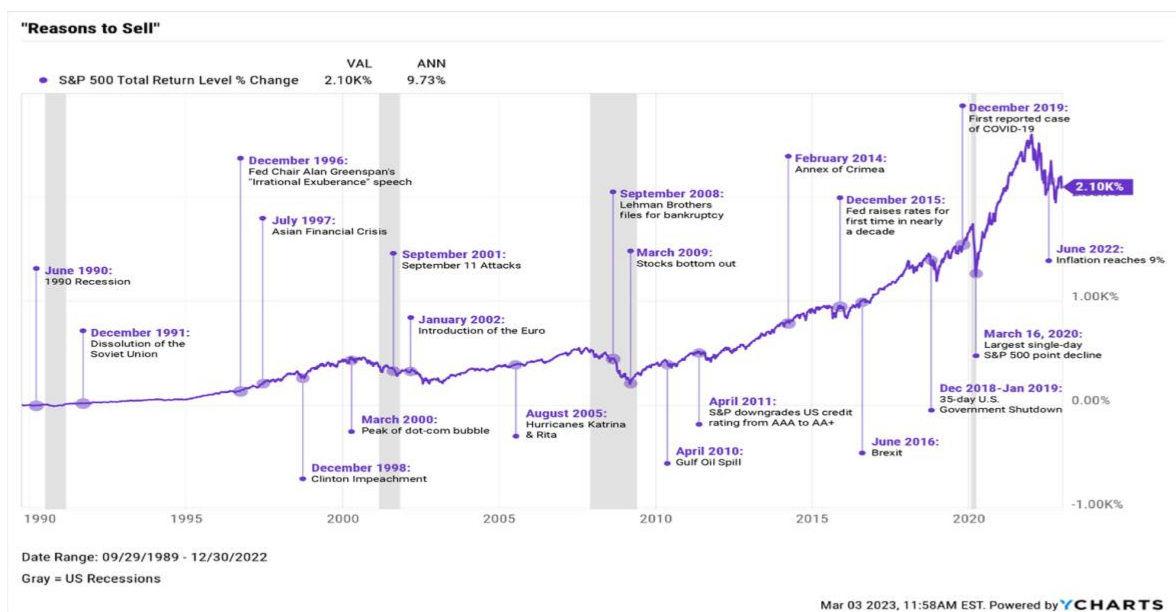
One possible explanation is that the economy has changed dramatically in recent decades, and many of the areas that have grown the ost are not, or are minimally, impacted by interest rates. For example, government expenditures (federal, state, and local) are about a third of the US economy and are not directly impacted by interest rates. Healthcare is another huge part of the US economy and is also not particularly rate sensitive. Consumer staples are also minimally impacted, as are many service sector businesses. Mortgage payments used to be interest rate sensitive as many consumers had variable rate mortgages. But since the real estate crisis in 2008, the percentage of variable rate mortgages has fallen dramatically, for 40% to only 10%.

If interest rates only have a direct impact on a few economic sectors, the Fed's ability to fine tune the economy would be severely limited. The Fed would be left with the prospect of achieving a minor slowing of the economy by decimating the relatively few parts of it which are rate sensitive. For obvious reasons, this would put the Fed in a very difficult position.

Market Rises over Time, Despite Bad News

There is no shortage of bad news currently. Between economic concerns, geopolitical worries and other issues, investors could be forgiven for wanting to buy just buy gold or to keep their money under their mattress. If history is any guide, however, this would be a mistake.

The chart below reminds us that there have always been serious issues facing the world, but that over time, equity markets have been good places to invest. This is not just a coincidence. An investment in equities represents ownership in an enterprise which (usually) allocates capital effectively, invests in research to develop new products, and manufactures products in a cost-effective manner. Most importantly, a company's products must compete with other companies in the marketplace, or it will not be successful. This effort over many decades is what the stock market ultimately rewards. The headlines of the day may impact the market in the short run, but they don't determine its ultimate value.



Thank you as always for being a client. Please feel free to reach out to Roger or me should you wish to discuss any topic.

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