46 PEAKS
INVESTMENT ADVISORY GROUP

It's Complicated.

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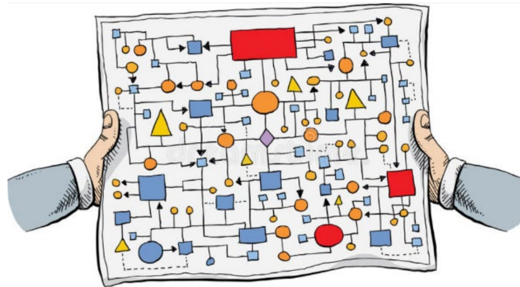


When choosing a label for your current social status, some social media apps let you describe your situation not only as "*Single*" or "*In a Relationship*", but another choice is "*It's Complicated*". I can't think of a better description of the state of the economy and the markets as we reflect on an uncomfortable yet profitable first quarter and look ahead to an uncertain remainder of the year. It's complicated indeed.

In the face of persistent bad news, including the 2nd and 3rd largest bank failures in U.S. history in March, Stocks and Bonds both posted handsome gains for the first quarter - The S&P 500 rallied over 7% while falling intermediate and long-term bond yields propelled Core Bonds to a strong total return of 3.2%.

	1st Qtr 2023	2022
Stocks (S&P 500)	7.5%	-18.1%
Non-U.S. Stocks (EAFE)	8.6%	-14.0%
Bonds (Aggregate Bond)	3.0%	-13.0%
Technology Stocks (IYW ETF)	24.7%	-34.8%
Energy Stocks (IYE ETF)	-5.0%	60.3%
Commodities (GSG ETF)	-5.2%	24.1%

This table highlights the performance of some major asset classes and categories for the first quarter and contrasts them with last year. An obvious observation - The first quarter was marked by several "reversals". Technology stocks went from worst (in 2022) to first (in 2023). Energy and Commodities suffered from the opposite pattern. Swapping places, non-U.S. stocks beat U.S. stocks in the first quarter. In fact, **non-U.S. stocks recently reached a 52-week high** – a level that U.S. stocks cannot claim.

Alternative Investments were "team players" last year, lending a helping hand to their liquid and core Stock and Bond teammates. This year, many Private Investments have posted flat or negative returns in the first quarter. Much of this is due to the time lag on which their values are updated. Additionally, due to a handful of sharp reversals in trends during the first quarter, especially in interest rates, most Trend-Following strategies posted modest losses in the first quarter. Since these strategies carried portfolios on their back last year with handsome gains, and having non-correlated investments is the whole idea behind portfolio diversification, we'll cut them some slack.

Shrugging off continued calls for an inevitable recession by a large chorus of analysts, the U.S. (and Global) economy continues to grow. And employment in the U.S. remains tight. Yes, there are some early signs in the labor market that the job market is no longer as hot as it was last year, but these trends seem isolated to a few industries, and **unemployment is near record low levels**.

However, looking forward and around the corner, the Leading Economic Indicators (LEI) are in negative territory. While an LEI index crossing from positive territory to below zero typically warns of a future recession, today's LEI level is deeply negative – at a level consistent with an economy that is *already* contracting. Yet, that's clearly not the case. While the current situation is certainly… complicated…it also seems that something, somewhere is confused – Either the leading indicators used to predict the economy, the tools used to measure current economic growth, or the popular definition of a recession.

Interest rates are in a strange spot too. You may have heard that the yield curve is "inverted". That means that short-term rates are yielding more than long-term rates.

Most of the time, longer-term interest rates are higher than short-term, and that relationship is important to a well-functioning financial system and the economy. To put some numbers to it, here are U.S. Treasury yields on 3/31/23. Also illustrated are yields on 12/31/21 - a time when yields were abnormally low but reflected a "normal" relationship of yields increasing with maturities.

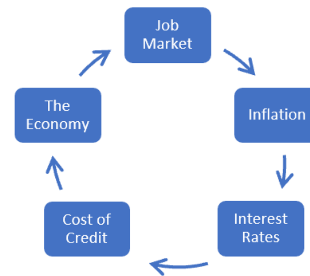
	3/31/2023	12/31/2021
1 Year	4.6%	0.4%
3 Year	3.8%	1.0%
5 Year	3.6%	1.3%
10 Year	3.5%	1.5%
20 Year	3.8%	1.9%

A yield pattern like this, where 1-year T-Bills yield 4.6% and 10-year Bonds yield 3.5%, is the market saying to Fed Chairman Powell…"*You may want to keep rates higher, but you won't be able to. You will have to lower rates.*"

We all know now that inflation is forcing the Fed to raise short-term rates to this awkward position. If inflation comes down, then so can interest rates. If it remains "sticky", then rates will likely stay higher. So where is inflation now, more than a year after it became the topic du jour? For the last twelve months through March, the CPI index is up 5.0% - high for sure, but much less than 8-9%. The good news is that in the month of March, the Consumer Price Index (CPI) rose only 0.1% (an annualized rate of 1.2%). **The trend is our friend.** If we annualize the CPI for the past six months, it's only 3.6%!

But the inflation picture is nuanced. There are many ways to look at it and the Fed likes to look at a version called "Core" inflation. Under this lens, inflation is higher than the widely reported headline CPI – up 0.4% last month, 4.7% annualized for the past six months, and 5.6% over the past year. At the end of the day, you can make a good case that inflation is improving and will continue to do so. Or if you're so inclined, you can argue that it's still too high and it's premature to declare victory.

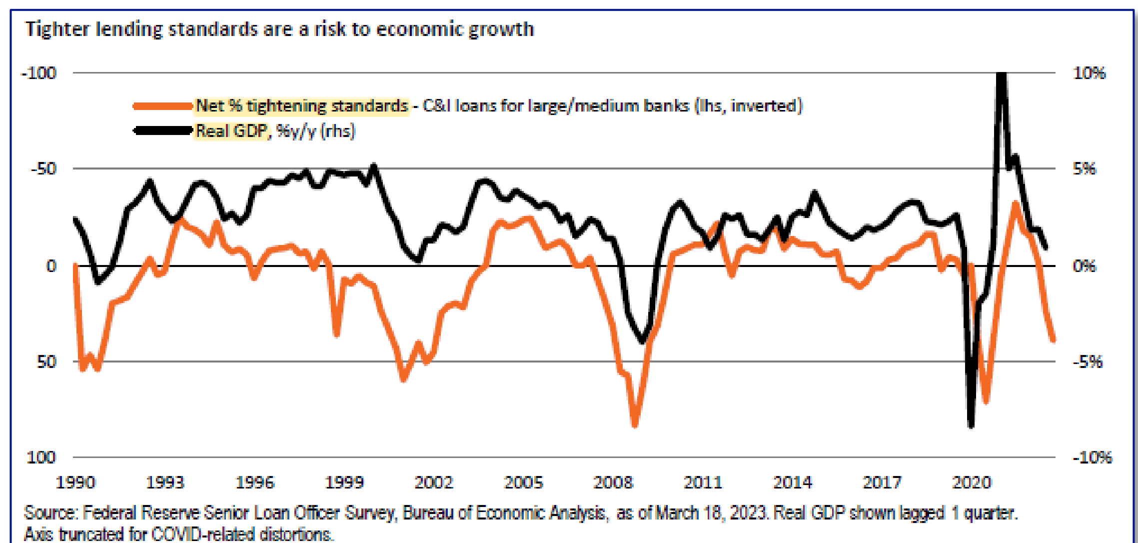
The Fed believes that its success at reeling in inflation is linked to its ability to cool off the job market, and the way it cools off the job market is to hurt the economy. And the way it hurts the economy is through higher rates, that increase the cost of credit. This circular relationship looks something like this:



The Fed may get help from somewhere else in its goal to tighten credit. We wrote a few weeks ago about the banking "crisis" associated with the collapse of Silicon Valley Bank and a couple of other banks, so we won't go into detail on it here. While the news on that front has calmed down since, it would be unwise to bank on that issue being completely in the rear-view mirror. Even if there are no more crisis-level flare ups, it seems highly likely that bank lending and the availability of credit will dry up going forward.

It's happening already - Following the banking crisis in March, the U.S banking system experienced its **largest 2 week decline in lending since at least the early 1970's**. I don't need to tell you how important credit is to the U.S. economy. Without it, who's buying a car? Buying a house? Building new apartments or storage centers?

For picture "proof" of this, see this chart which graphs inflation adjusted GDP (in black) and the percentage of lenders that are tightening credit standards (orange line), lagged by three months. You can see how the orange and black lines dance the tango – easier credit fuels economic growth. Tighter lending standards hurt growth. Looks like a high probability of slower growth this summer.



Another issue making headlines lately is the Office sector of the Commercial Real Estate market. While the Apartment, Single-Family, Storage, and Industrial real estate sectors seem to be on pretty firm footing, the Office market is clearly stressed. Three years after Covid hit, Office vacancies are still elevated, and it's clear that traditional Office demand is unlikely to ever return to pre-Covid levels. The problem is that a large amount of loans on Office buildings are adjustable rate, with interest rate resets coming in the next year or two. With vacancies up sharply, there's a risk that many office building owners will not be able to afford to refinance their debt at higher interest rates. Will they turn the keys over to their banks? This bears watching, as it could further hurt lending.

With stubborn inflation, heated geopolitics, higher interest rates, and newfound concerns about the banking sector, it sure feels like we're swimming in bad news. Yet, the market has been strong. **Real strong**. Strong enough to suggest that a new bull market is underway. Here's some fuel for that argument.

- Since the 1950's, when the S&P500 gained 7% or more in the first quarter, it has only declined over the next three quarters once. (And that was 1987 when it gained 20% in the first quarter, much more than this year.)
- The political cycle suggests a good year for stocks in 2023. Since 1950, there have been 8 mid-term election years with declines in the S&P 500. (Last year was the ninth.) The next year? Stocks gained an average of 24.6% and were positive all eight times.
- A measure of market strength known as the Zweig Breadth Thrust just triggered a rare "buy" signal. It has only happened 14 other times since 1950 and the S&P 500 was higher a year later. **Every. Single. Time**. Up more than 23% on average a year later.
- The most robust and our most favored U.S. stock market model from Ned Davis Research, just this week triggered a BUY signal on U.S. Large Cap Stocks – its first since flashing a SELL signal in January 2022.

We think the market's optimism of the first quarter is based largely on the fact that we are getting closer to the end of this Fed tightening cycle. What does history teach us on this subject? Well, the answer is either "*it's complicated*" or "*it depends*". Here are the results of the S&P 500 for the 6 months and 12 months following the end of Fed tightening cycles going back to 1929.

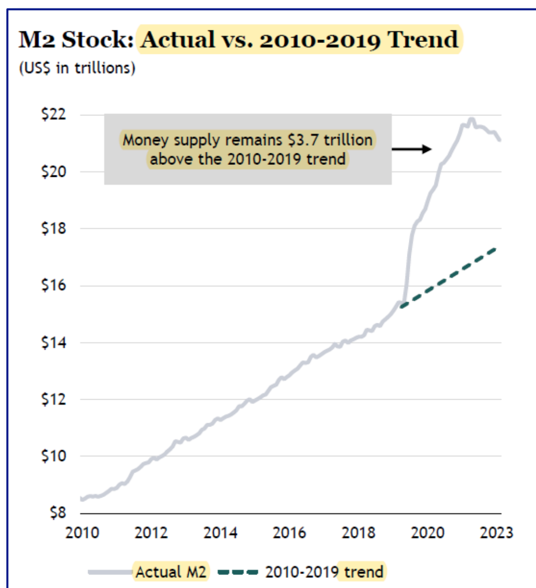
Fed Tightening End Dates*	S&P 500 Change 126 Days Later	S&P 500 Change 252 Days Later
08/09/1929	-24.24	-29.21
01/16/1953	-7.07	-1.31
08/23/1957	-8.67	7.23
09/11/1959	-5.38	-2.86
12/06/1965	-5.71	-11.43
04/03/1969	-7.44	-11.84
04/25/1974	-20.70	-3.94
02/15/1980	8.93	10.74
05/05/1981	-4.70	-9.87
02/24/1989	22.43	12.89
02/01/1995	18.79	35.21
05/16/2000	-7.83	-12.35
06/29/2006	11.93	19.37
12/19/2018	17.69	27.86

If I want to make a bearish case, I'd point out that following the end of Fed tightening cycles, stocks dropped 9 of 14 times over the next six months and 8 of 14 times over the next 12 months. But if I wanted to make a bullish case, I'd emphasize the more recent (and more relevant?) period since 1980 (in the box) when declines were less common and stocks rallied 5 of 7 times over the next 12 months, averaging 12% gains overall while advancing over 10% in all 5 bullish scenarios.

If you are feeling the tension in the room, know that **we are as well**. The complications of today's environment have us conflicted. We respect and can sympathize with the arguments made by both the bulls and the bears. If "forced" to pick a side, we would pick the bullish side. Why? Because 30+ years of experience has taught us many valuable lessons – One of which is…"*Don't fight the market.*" If forced to choose between trying to be smart enough to decipher all the complexities of the markets and the economy, or simply observing the (currently bullish) evidence of the market, choose the market. Another thing we've learned is that most of the time "*If it's obvious, it's obviously wrong*." And today, there's near unanimity that a recession and more downside is coming.

But if axioms and technical strength aren't enough and you're looking for something in the fundamentals to help explain why things seem so odd, and perhaps why we can

avoid a recession, I'd look at this chart.



The grey line shows the U.S. Money Supply (M2). The green dashed line simply shows the trajectory that the Money Supply was on – where it would be if our government did not print Trillions of Dollars following Covid. According to this chart (from Blackstone), there is currently $3.7 TRILLION more dollars in circulation today than there would likely be without Covid-related stimulus. We don't KNOW if this explains everything. Time will tell. But this money is still out there, sloshing around, buying cars and houses, vacations, boats, restaurant dinners, and Taylor Swift concert tickets. Are historical LEI's, rules of thumb, and inverted yield curves useful indicators when there's $3.7 Trillion dollars of "extra" cash out there?

Returning to portfolio design, thankfully, we don't have to choose sides. We're maintaining a **balanced stance**. Our overweight to trend-following strategies takes the bull/bear decision out of our hands and puts it into the computers – these algorithm-based-strategies increase or decrease exposure to stocks, bonds, commodities, and currencies depending on if they are going up or down.

Earlier this year we allocated to a hedged Emerging Markets ETF with downside protection. The risk/reward profile of this strategy has improved significantly over the past year due to higher volatility and interest rates.

We're also working to increase Government Bond exposure in our portfolios through the efficient and prudent use of leverage. This way we can add Government Bonds without reducing our Equity or Alternatives allocations. This is an advanced technique used by institutions for decades, but we previously avoided it due to low yields. To us, it's more attractive now that yields are higher. If a recession and lower stock prices are in the cards, then both Trend-Following strategies and Government Bonds should prove quite helpful. In a bull market, we would not expect these exposures to hurt our portfolios.

Looking at Alternatives, the **double-digit** yields on esoteric assets like Reinsurance securities and Private Credit could be a source of both robust returns and important diversification. Within Private Equity and the Venture Capital Markets, there could be good opportunities on the secondary markets this year as institutional investors are forced to sell positions (at discounted prices) to rebalance their portfolios. And volatility within Real Estate could beget attractive buying opportunities if existing investors can't make the numbers work when their adjustable-rate mortgages reset to higher rates over the next year or two. For investors with dry powder, bad news is often good news.

The current environment has us challenging ourselves and traditional portfolio design, seeking strategies that offer attractive risk and return opportunities in a variety of economic regimes. The result are portfolios **heavy on Alternative strategies but also light on their feet**. We think this sophisticated approach has our portfolios well positioned for today's uncertain environment, even if they are a bit, well, complicated.

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