Wealth Management Newsletter

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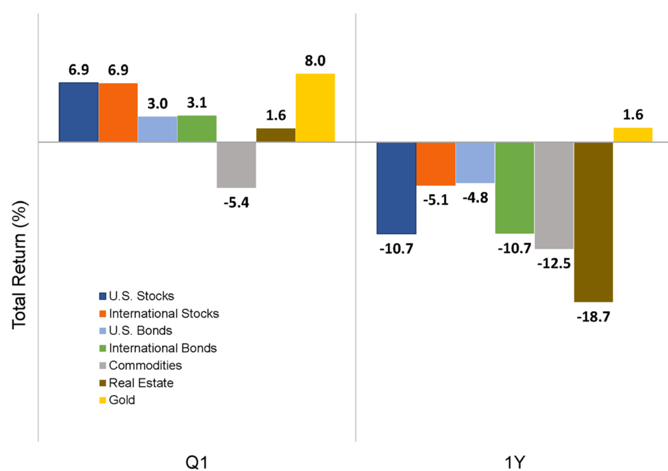
KEY POINTS

- With peak inflation likely behind us, bond yields may have also peaked
- Despite expectations of a recession, economic data proved more resilient than many anticipated
- The majority of asset classes experienced positive returns during the quarter despite increased financial market volatility as a result of stresses in the banking system
- The economic environment and financial markets remain challenging and therefore, we remain vigilant with respect to the current risks and continue to maintain a defensive investing posture overall

Q1 2023: BY THE NUMBERS

Despite continued concerns over elevated inflation, higher interest rates, lower profit margins, the risk of a recession, the collapse of Silicon Valley Bank (SVB) and the related stress in the banking system, the majority of asset classes finished the quarter solidly in positive territory (See figure 1).



The strong start to 2023 investment returns resulted from a surprisingly resilient U.S. economy, a reduction in the effects of the acute European energy crisis, and strong economic momentum following the easing of China's pandemic lockdowns.

With regards to U.S. Markets, the S&P 500 finished the quarter up 7.5% while mid-cap and small-cap stocks finished up 3.8% and 2.7% respectively. Beneath the surface, however, there was a wide dispersion among the various investment sectors with last year's most challenging sectors becoming this year's best performers and vice-versa. For instance, in the first quarter, the information technology sector finished up 22%, while the communication services and consumer discretionary sectors finished up 21% and 16%, respectively. Meanwhile, the energy sector which was the best performing sector last year was down 5% for the quarter.

With respect to investing style, in 2022, value outperformed growth for the first time since 2017. However, in the early innings of 2023, this trend has strongly reversed with large cap growth up 17% during the quarter and large cap value roughly flat, according to Morningstar data. The broader basket of U.S. stocks, as represented by the Wilshire 5000, finished the quarter up 6.9%.

Turning to international equities, the broader group delivered positive returns during the quarter of 6.9%. Developed international led the charge returning 8.5%, bolstered by attractive relative valuations, macro improvements in the Euro area, and U.S. dollar weakness. Emerging market equities also experienced gains, rising by 4%, driven by an earlier and swifter-than-expected China reopening.

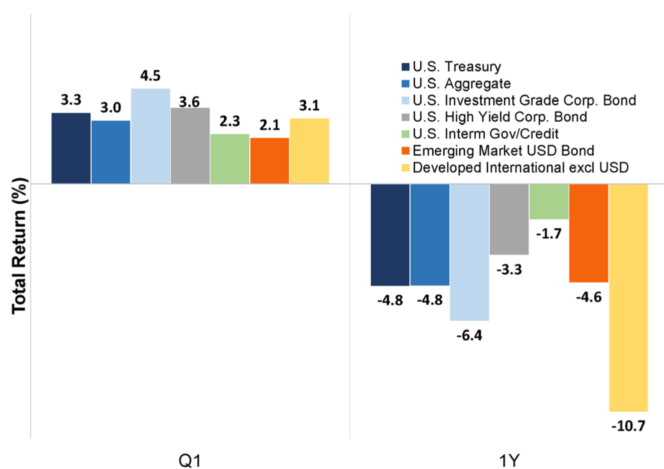
After an extremely challenging 2022, domestic and international bond markets delivered positive returns of 3% and 3.1%, respectively in the first quarter (See figure 1). Commodities fell by 5.4%, primarily due to lower energy prices. Real estate finished up 1.6%, supported by slight improvements in mortgage rates and modest declines in home prices. Gold rose 8%, driven by a potential pause in monetary tightening, a weaker U.S. dollar, and continued volatility as a result of financial market and geopolitical uncertainty.

INFLATION AND BOND YIELDS APPEAR TO HAVE PEAKED- WILL THE FED FUNDS RATE FOLLOW?

With peak inflation likely behind us and despite stresses in the banking system, the Federal Reserve (Fed) continued to increase interest rates in the first quarter. Federal funds rates were increased at a reduced 25 basis point pace at the FOMC meetings in both February and March, culminating in a 4.75-5% target rate which is up from 0% only one year ago. Undeterred by continued tighter interest rate policy from the Fed, fixed income markets posted their second straight positive quarterly return. Shorter-maturity bonds outperformed on the yield curve as markets shifted from pricing in continued rate hikes to now expecting

nearly a 100 basis point reduction in the Federal funds rate by the end of the year. Longer-dated yields peaked last fall and have since continued to decline along with inflation expectations. Across fixed income sectors, U.S. investment grade and high yield bonds were the best performers in the quarter as returns remained resilient despite increased market volatility.

While the Fed has tightened policy at an unprecedented rate over the past 12 months, much debate remains for the path of interest rates looking forward. Inflation peaked last summer and has steadily declined though it still remains well above the 2% target. Additionally, the U.S. labor market is historically strong and consumer spending remains robust. However, interest rate market expectations have shifted dramatically lower despite Fed rhetoric remaining steadfast with respect to their mandate of fighting inflation. Investors are looking for any signals of a Fed pause which would likely bolster asset returns across the investment universe, but rate cuts currently appear to be premature given the still elevated levels of inflation.



Data Sources: Bloomberg Financial LP, Bangor Savings Bank

THE ECONOMY

The U.S. economy was surprisingly resilient in Q1 as data came in stronger than consensus expectations. Although most economists have been predicting recession at some point in 2023 in response to ominous forward-looking economic indicators, domestic growth remained in positive territory. In that regard, the labor market remains the bright spot adding on average more than 300K jobs per month in Q1 and the unemployment rate hovering near all-time lows. Corporate earnings expectations have been revised lower, though at a lesser pace than most analysts expected. Inflation has dropped from 9% to 6% since the peak last summer, however, it is still well above the Federal Reserve's 2% target levels. Therefore, barring any exogenous events (continued banking stresses or geopolitical concerns, etc.) it will likely provide cover for the Fed to keep interest rates elevated in the near-to-medium term.

MARKET VIEW AND PORTFOLIO CHANGES

In the two years following COVID-19, the Fed bought $4.5 trillion of U.S. Treasuries and mortgage-backed securities, bringing its balance sheet to $9 trillion. More than 10 years of quantitative easing (QE) drove short-term interest rates essentially to zero, and the 10-year treasury yield to a low of 0.5%. This period of extraordinarily low interest rates and surging money supply undoubtedly buoyed asset prices across the board. As a result of interest rate normalization and the reversal of QE, 2022 marked a year of repricing to more normal monetary conditions. While 2022's market declines brought stock and bond valuations into less elevated territory, the S&P 500 forward price-to-earnings ratio of roughly 18.5 times today, is still above the long-term average of 16.5 times. Similarly, while bond market valuations are more attractive today than they once were, they are still challenged by the persistent elevated inflation levels that the Federal Reserve is working to contain.

As we look forward, the economic environment and investing landscape are still at a challenging juncture. While the strong labor market, buoyant consumer spending, inflation levels that appear to have peaked, and diminishing supply chain constraints are all very positive macroeconomic influences; conversely, the late stage of the current business cycle as well as restrictive monetary policy and tightening financial conditions remain a prevailing risk. Therefore, as noted previously, the evolution of global economic growth and inflation, as well as the corresponding monetary policy response to those variables remains paramount to our views of the investing landscape and overall portfolio construction.

While we've taken steps to express our defensive posture in overall portfolio construction at this time, as always, we remain most focused on generating strong long-term risk-adjusted returns in accordance with your strategic asset allocation objective by constructing high-quality and well-diversified portfolios. Moreover, history has shown repeatedly that the best defense against an uncertain investing landscape is having – and sticking with – a long-term financial plan. Therefore, please don't hesitate to reach out to our wealth management team to review your customized financial plan, and to ensure that your accounts are properly aligned with your investment goals and timeframe.

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