2023 First Quarter Investment Report

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Were last year's market losses an illusion? We've now experienced two consecutive quarters of healthy market gains, the long-predicted recession hasn't materialized despite rising interest rates and the Fed reducing its balance sheet--and oil prices have stabilized. So why are investors still so worried?

The market gains in the first three months of the year were spread fairly evenly across all sectors. The Wilshire 5000 Total Market Index—the broadest measure of U.S. stocks—gained 7.26% in the first quarter. The comparable Russell 3000 index is up 7.18% so far this year.

Looking at large cap stocks, the Wilshire U.S. 2500 Large Cap index is up 7.40% in the first quarter. The Russell 1000 large-cap index has gained 7.46% so far this year, while the widely-quoted S&P 500 index of large company stocks gained 7.03% during the year’s first quarter.

Meanwhile, the Russell Midcap Index is up 4.06% in the first quarter.

As measured by the Wilshire U.S. Small-Cap index, investors in smaller companies received a 4.02% gain for the most recent quarter. The comparable Russell 2000 Small-Cap Index posted a 2.74% gain over the past three months. The technology-heavy Nasdaq Composite Index, the biggest loser in 2022, came roaring back in the first quarter, posting a 16.77% return.

Foreign markets moved in lock-step with the U.S. The broad-based EAFE index of companies in developed foreign economies gained 7.65% in the first quarter of 2023. In aggregate, European stocks were up 7.95% in the past three months, while EAFE’s Far East Index delivered a positive 7.08% performance. Emerging market stocks of less developed countries, as represented by the EAFE EM index, gained 3.54% in dollar terms in the first quarter.

Despite the rise in interest rates (and higher loan costs), real estate securities produced decent returns. The Wilshire U.S. REIT index posted a 3.25% gain in the first quarter of 2023. However, other alternative parts of a diversified portfolio were not so fortunate. The S&P GSCI index, which measures commodities returns, lost 5.91% of its value in the most recent three months. Utility stocks posted a 4.94% loss in the first quarter.

Bond rates rose dramatically last year, but that trend seems to have moderated. 30-year U.S. government bond yields are down slightly, from 3.96% at the end of last year to 3.65% currently. 10-year bonds are yielding 3.47% while, interestingly, 5-year government securities are yielding a higher 3.57%, 2-year Treasuries are yielding 4.03%, one-year government bonds are yielding 4.59% and 6-month securities are now yielding 4.86%. Whenever shorter-term bonds are paying bond investors more than their longer-term counterparts, it is called a yield curve inversion. Rarely will you see one as dramatic as this.

Municipal bonds are a bit less chaotic at the moment but there is still inversion going on; 30-year munis, on average, are yielding 3.38%, but the inversion can be seen in 10-year (2.28%), 5-year (2.23%), 2-year (2.41%) and 1-year (2.47%).

So... What about that recession that everybody keeps predicting? Are banks safe anymore? Will the war in Ukraine jump the borders and lead to something more dangerous? When will inflation finally moderate? Behind the nice returns, it's possible to find a world of uncertainty, and the narrative threads are undeniably complicated.

Start with the banking sector, where the run-on assets at Silicon Valley Bank were followed by problems at Signature Bank, First Republic Bank, Zions Bank, and Credit Suisse. This narrative is actually pretty simple; many lending institutions were sitting on unprecedented amounts of deposits due to the Fed's response to the Covid pandemic, and some of them parked that extra money in bonds. Since they weren't getting paid on short-term securities, they bought into the longer maturities, and then suddenly rates when up and their bond investments dropped in value. The Federal Reserve Board has taken extraordinary measures to make sure banks have access to capital when they need it, and all depositors are insured up to $250,000 per account. You may read about other banks with troubled balance sheets, but it appears that this is not the recession trigger that it was once feared to be.

One might think that banking woes would have zero impact on the inflation rate, but in fact, the two are connected. Inflation is running at a 5.4% rate over the past year and seemed to gain steam in January. These across-the-board price increases are well above the 2% rate that the U.S. central bank is targeting. In response, the Fed was expected to raise its lending window rate by half a percent, but decided, in light of the banking issues, to moderate the rise and in effect cut it in half. Its effort to fight inflation may be put on hold until the banking issues are straightened out.

Meanwhile, the 3.4% unemployment rate is the lowest we've seen since 1969. Labor markets are so tight that there are two jobs available for every unemployed worker right now--and workers are demanding, and receiving salary increases. This dynamic will push up inflation by raising production costs.

Finally, market watchers have noted the disparity between the Nasdaq returns and the market as a whole. Probing further, it has been noted that most of the gains posed by the U.S. indices are the result of a small number of stocks--Nvidia, Meta (Facebook), Tesla, Warner Brothers Discovery, and Advanced Micro Devices--showing outsized gains of between 50% and 87%.

Most of the rest of the market is actually about even (zero gains, zero losses) for the first quarter of the year.

What does this mean? The future is always unknown, but the view ahead today is unusually cloudy. Even so, the first quarter of the year might contain a hidden lesson. Economists have been predicting a recession for half a year now, and anyone who believed that those people with Ph. Ds on their resume possessed working crystal balls, and jumped out of the markets, would have missed two-quarters of nice returns. Long-term investors who don't jump at every prediction took their gains to the bank.

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