NORTH STAR
Resource Group

MARKET UPDATE
QUARTER 1, 2023

Inflation Ensues and Banking Has a Crisis

One of the best Warren Buffett quotes is "only when the tide goes out do you learn who has been swimming naked."

Well, we found out what banks have been swimming without their trunks. The economic failure of two US banks and a large, historical credit prone Swiss bank captured all the headlines for the first quarter of the new year. In the US, we had the failure of two commercial banks, Silicon Valley Bank and Signature Bank. Both banks cater to start-up companies and small business, one located in New York the other San Jose, better known as Silicon Valley.

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The reason the two US banks, Signature and Silicon Valley Bank, failed can be attributed to the mismanagement of their capital reserves. By the nature of their business, these banks have very large deposits that are in constant motion, from venture capital deals to the funding of new companies. The banks bought long dated US Treasury bonds to back these large highly volatile cash flows. When the Fed started raising interest rates, it caused the value of these long-term bonds to go down in value, affecting the solvency / liquidity of the bank. When Silicon Valley bank warned of this liquidity concern on their earnings call, it created a run on the bank's assets, the large cash accounts of the start-up companies that need the money for funding payroll and committed growth.

In the case of Credit Suisse, they have been swimming in high tide for years without trunks. The tide finally caught up to them. The Swiss government was forced to broker a deal for the assets to be taken over by another Swiss bank, UBS. These bank "failures" are currently viewed as isolated events, not the beginning of larger banking problem. Since the financial crisis in 2008, and again with COVID in 2020, the banking systems globally called for higher deposit rates and more reserve holdings. The banking system in the US is the strongest it has ever been from a capitalization perspective[2].

Inflation, as measured by the Consumer Price Index, CPI, continued to trend above expectations during the first quarter of the year.

The February number of 6%, came in as the lowest number since September of 2021, but still higher than expectations, and well above the Fed's Target of 2%. The stock market started the year with a strong January run over the expectation that inflation was slowing, and the Fed would slow or stop raising interest rates. The surprise higher than expected February CPI number saw the Fed to continue the pace of rate increases, causing the markets to sell off the latter portion of the quarter.

The early quarter run of stocks has been tamed but markets did manage to finish with positive returns to begin the year.

The US Large Cap Index, the S&P 500, was up for the quarter 7.50%, the small caps of the Russell 2000 index were up 2.74%, and the international MSCI EAFE index continues to be the best performer, being up 8.47%1. The fixed income markets and the Barclay's Aggregate Bond Index bounced up 2.96%, based on expectations the Fed may have to cut rates later in the year. More on this further in update.

The Fed began the process of increasing interest rates one year ago. This is reflected in the 1-year return numbers: they are off -7.73%, -11.61%, -1.38% and -4.78%[1], respectfully, for the S&P500, Russell 2000, MSCI EAFA and Barclay's Aggregate indexes. Interestingly, the 3-year return numbers now reflect the beginning of the initial COVID worries for the markets. Following the same order, led by the S&P 500, the 3 Year returns are 18.6%, 17.51%, 12.99% and down -2.77% for the Barclay's US Aggregate Bond Index1. It is crazy to think the beginning of the COVID pandemic is already 3 years past.

Economists feel that corporate earnings will be the next wall of worry for the stock market.

As corporate earnings play themselves out over the next couple of quarters, those companies with strong balance sheets and earnings growth should be rewarded the most. Value oriented stocks continue to be cheap compared to growth stocks across both the large and small cap space. Large cap growth stocks are still expensive at 127% to their 20-year PE ratio, whereas large cap value stocks are 103%. On the small cap side, that is, respectfully, 118% to 93% growth to value on the 20-year PE ratio2. Large cap stocks are still at a PE premium to their small cap counterparts. A PE ratio over 100% would be considered expensive to average, whereas a number under 100% would be considered cheap.

A final statistic regarding quality relates to interest rate coverage ratios. Large cap companies are 9.8 times covered (compared to 25-year average of 6.3 times), whereas small cap companies are 2.6x covered to their 25-year average of 2.2x2. This is a testament to corporate financial prudence as a result of COVID. An interest rate coverage ratio is EBIT (earnings before interest and taxes) divided by the interest expense on their outstanding debt.

Sector wise, Technology, Communication Services and Consumer Discretion lead sector performance, up 21.8%, 20.5% and 16.1%, respectively1. Technology consists of multiple, very large, earnings driven companies. Currently, two large tech companies, Microsoft and Apple are the top holdings that make up 13.3% of the cap weighted S&P500 Index. Historically the largest weighting for any two companies given the index is made up of the 500 largest companies in the US. Ironically, the three sector gainers were the three that lagged the most in 2022, all down more than 28%. The sectors that lagged for the first quarter were Financials, down -5.6%, Energy, down -4.7%, Healthcare, down -4.3%, and Utilities, down -3.2%[1].

Over the last year only 3 sectors are up: Energy, 13.6%, Consumer Staples, 1.22%, and Industrials, 0.2%.

The 1-year lagging sectors have been Real Estate, down -19.7%, Consumer Discretion, down -19.6% and Communications, down -17.7%. The only constant to sector investing, given the wild swings and rotations among the sectors, has been to be in a diversified portfolio.

Internationally, after lagging the US markets for 14.2 years[2], the international stocks have posted better performance both for the quarter and 1-year time frame. Since 1971 the average of one market outperforming the other has averaged 5.1 years. Historically, this has been seen as a long-time difference. The MSCI EAFA index returned 8.4% for the quarter outperforming the US by almost 1% on large cap and almost 6% to small cap stocks. This begs the question: is this the start of a new cycle where international stocks will begin to outperform their US counterparts?

All the indicators are pointing to potential advantages of a new cycle rotation.

A prospect of a weakening US dollar, higher inflation in the US, pace of interest rate increased in the US and cheapness of international stocks are all strong cases for a possible rotation. International price to earnings, PE, valuations continue to remain very cheap to the US, a 29% discount, or almost 2 standard deviations to averages, the dividend yield continues to be 1.6% higher than the US rate2. Developed International and Emerging Markets will garner investor and economist attention for the reasons above. Geo-political risks remain a wild card, but as the US has shown, we are not above geo-political risks ourselves. Either way, an allocation to international stocks remains an important portion of a client portfolio.

Two long-term trends continue to be important drivers for Emerging Market economies. The case for a weakening US Dollar and continued growth of the middle class. The former is relatively new as the speed of US interest rate increases and growing US debt to GDP ratio should begin to weigh on strength of the US dollar. The demographic trend of middle-class growth will increase the consumption of goods and services, which is a key driver of a country's GDP, or Gross Domestic Product. Over 95% of the growth between now and 2030 is expected from Asia, Middle East, and Africa. India, China, and Indonesia will account for the vast majority of this growth2. Economists are predicting an economic expansion in China after their COVID re-opening and recent cuts in key interest rates. China is stimulating its economy while the rest of the world is restricting with rate increases. Like International, an allocation to emerging markets may finally prove to be a very important portion of a client portfolio.

The volatility of the first quarter was especially felt within the fixed-income markets.

The whipsaw effect of inflation and Fed decision to continue increasing interest rates, saw the yield curve become more inverted, the long end of the curve shrank while the short end increased. Both the stock and bond markets were trading as though the Fed would decrease interest rates later in 2023. Now, most Fed governors and economists are not expecting that until mid-2024, as inflation has remained stickier than expected2. An interesting observation was that the Silicon Valley Bank collapse happened the week prior to the Federal Reserve meeting, setting up drama around how the Fed would react. The Fed actions to continuing raising interest rates, signaled they are more concerned about combating inflation, than yielding to economic or corporate woes.

Fixed Income continued to rebound from the historic lows of 2022 to post a return just shy of 3% for the start of the new year. The fixed income benchmark index, Barclays US Aggregate Bond, was down -17%[2] at its peak in Q3 2022. The pace of interest rate increases, coupled with historic low yields, has essentially mitigated ten years' worth of fixed income returns. The one-year return is off by -4.78%, the 3yr annualized returns are down -2.77%, the 5yr only 0.91% and 10yr up only 1.36%[1]. To further understand the severity of the Fed actions to the yield curve, make note of the JPMorgan chart below. This shows the yield curve from the end of 2021 to inverted yield curve at the end of 2022 to the further first quarter 2023 inversion.

Yield curve

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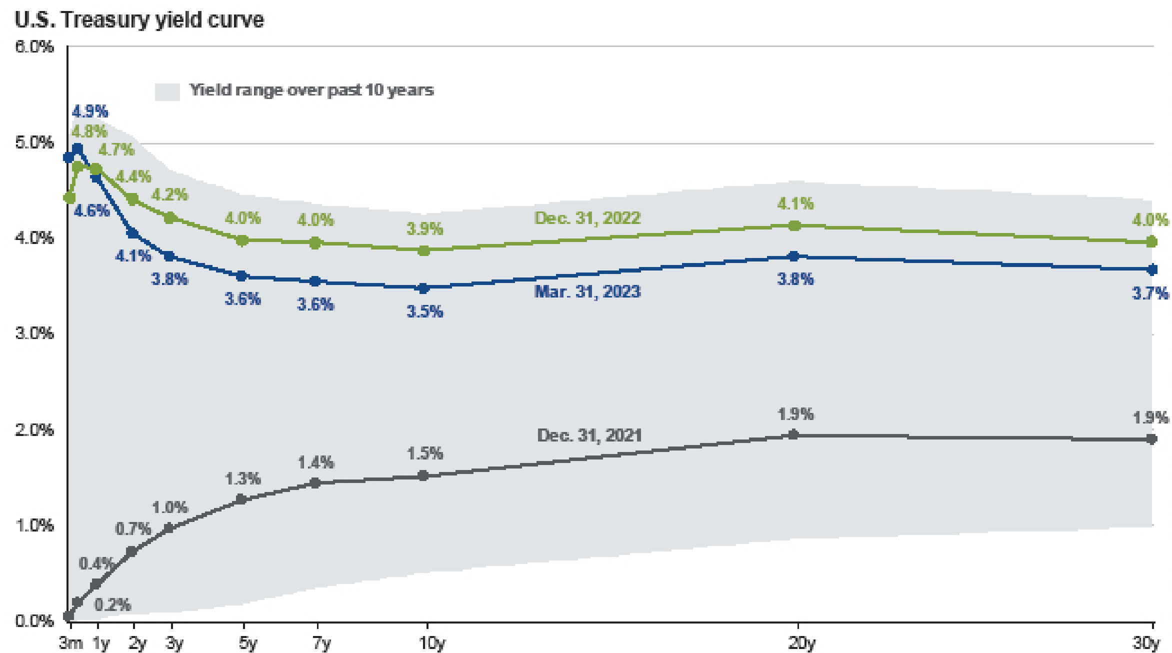
Fixed Income



Source: FactSet, Federal Reserve, J.P. Morgan Asset Management.
Guide to the Markets – U.S. Data are as of March 31, 2023.

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Fixed Income Opportunities

The immediate opportunity for fixed income is on the short end of yield curve. Short duration bond funds, US Treasury Bills and Notes and Brokered CD's, all with maturities under two years, continue to have very attractive yields. Apart from high yield bonds, the fixed income markets continue to be relatively cheap compared to the last 20 years. Municipal bonds also continue to be attractive for clients in the higher tax brackets. Unlike the inverted taxable bond yield curve, the taxable equivalent yield curve is relatively steep. The opportunity to extend duration and buy longer maturity bonds will present itself as the yield curve returns to its normal shape.

Economists feel there may be moderate recession hanging over the markets in late summer to early fall of this year. Corporate earnings and earnings growth are the new wall of worry, given the Fed's commitment to combatting inflation over corporate or economic concerns. Markets will be anxiously awaiting another round of quarterly earnings releases from companies.

Behavioral Aspect of Investing

We hear repeatedly about the importance of staying invested at times like these. Fixed income is the perfect example, as markets are down at levels not seen in well over 50years, now could be the worst time to sell your fixed income holdings. Conversely, it may also prove to be a great opportunity to purchase bonds. As with any period of time, a fully diversified portfolio is the best way to achieve consistent returns and discipline to hold those assets classes that are out of favor. Markets are cyclical and markets rotate, stay invested!

"The Investors chief problem – and his worst enemy – is likely to be himself. In the end, how much your investments behave is much less important than how you behave." **-Benjamin Graham**

Taking the long-term view at North Star Investment Resource Center, we continue to believe diversified portfolios and disciplined investment strategies continue to provide the best opportunities for those investors seeking growth.

We welcome investment discussions, should you have any questions or concerns, or if there is a change in your investment time horizon or financial circumstances, please feel free to contact us at your convenience.

Written by North Star Investment Resource Center

Average Annual Returns chart on next page

Sources of Information: 1Morningstar Direct, 2JPMorgan – Guides to the Market

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This material represents an assessment of the market environment at a specific point in time and is not intended to be a forecast of future events, or a guarantee of future results. This information should not be relied upon by the reader as research or investment advice regarding any funds or stocks in particular, nor should it be construed as a recommendation to purchase or sell a security. Investments will fluctuate and when redeemed may be worth more or less than when originally invested.

Investments that focus in one sector may involve a greater degree of risk and volatility than an investment with greater diversification.

AVERAGE ANNUAL RETURNS FOR PERIODS ENDING 12/31/2022						
INDEX	**1ST Q**	**YTD**	**1 YR**	**3 YRS**	**5 YRS**	**10 YRS**
S&P 500	7.50%	7.50%	-7.73%	18.60%	11.19%	12.24%
Russell 2000	2.74%	2.74%	-11.61%	17.51%	4.71%	8.04%
MSCI EAFE (U.S. dollars)	8.47%	8.47%	-1.38%	12.99%	3.52%	5.00%
Barclays US Aggregate Bond	2.96%	2.96%	-4.78%	-2.77%	0.91%	1.36%
BENCHMARK COMPOSITES	**1ST Q**	**YTD**	**1 YR**	**3 YRS**	**5 YRS**	**10 YRS**
Aggressive Growth	6.73%	6.73%	-6.19%	17.44%	7.93%	9.55%
Growth	6.04%	6.04%	-5.56%	13.36%	6.76%	8.04%
Conservative Growth	5.55%	5.55%	-4.89%	9.25%	5.70%	6.60%
Income and Growth	4.80%	4.80%	-4.55%	5.14%	4.20%	4.88%
Income	3.98%	3.98%	-4.68%	1.27%	2.92%	3.40%
USD VS LCL	**1ST Q**	**YTD**	**1 YR**	**3 YRS**	**5 YRS**	**10 YRS**
MSCI EAFE NR USD	8.47%	8.47%	-1.38%	12.99%	3.52%	5.00%
MSCI EAFE NR LCL	7.49%	7.49%	3.84%	14.63%	6.25%	7.34%

S&P 500 - The S&P 500 Index is an unmanaged index of 500 stocks that is generally representative of the performance of larger companies in the U.S. Please note an investor cannot invest directly in an index.

Russell 2000 - Russell 2000 Index is an equity index that measures the performance of the 2,000 smallest companies in the Russell 3000 Index, which is made up of 3,000 of the biggest U.S. stocks. Please note an investor cannot invest directly in an index.

MSCI EAFE - The MSCI EAFE Index is the Morgan Stanley Capital International Index and is designed to measure the total return of the developed stock markets of Europe, Australia and the Far East. Investment risks associated with international investing, in addition to other risks, include currency fluctuations, political and economic instability and differences in accounting standards when investing in foreign markets. Please note an investor cannot invest directly in an index.

Barclays US Agg Bond - The Barclays U.S. Aggregate Bond Index is a broad-based bond index comprised of government, corporate, mortgage and asset-backed issues, rated investment grade or higher, and having at least one year to maturity. Please note an investor cannot invest directly in an index.

The Benchmark Composite returns are a weighted average of index data comprised in the following manner. Aggressive Growth is 45% S&P 500, 25% Russell 2000 and 30% MSCI EAFE. Growth is 35% S&P 500, 20% Russell 2000, 25% MSCI EAFE and 20% Barclays US Aggregate Bond. Conservative Growth is 30% S&P 500, 10% Russell 2000, 20% MSCI EAFE and 40% Barclays US Aggregate Bond. Income and Growth is 20% S&P 500, 5% Russell 2000, 15% MSCI EAFE and 60% Barclays US Aggregate Bond. Income is 15% S&P 500, 5% MSCI EAFE and 80% Barclays US Aggregate Bond.

MSCI ACWIxUS - The MSCI ACWI ex US Index is a market capitalization weighted index was designed to provide a broad measure of equity-market performance throughout the world. It is comprised of stocks from 22 of 23 developed countries (excluding the US) and 25 emerging markets. Please note an investor cannot invest directly in an index.

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