Maclura Investments

1Q23 Review - Uncertainty Abounds, but a Better Start to the New Year

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The market started off on better footing than last year's first quarter, returning 7.40% (Morningstar U.S. Markets index) for the first three months of 2023. The S&P 500 index was up 7.03% over the same time period. Even though this marked the second consecutive quarter of positive performance for the market, there were wide swings throughout the quarter, with nearly half of the first quarter's return being derived from the last week of the quarter.

Exhibit 1. Investment-Style Returns

	Morningstar Index Market Returns	2015	2016	2017	2018	2019	2020	2021	2022 1st Qtr.	2022 2nd Qtr.	2022 3rd Qtr.	2022 4th Qtr.	2022	2023 1st Qtr.
Growth	U.S. Growth	5.54%	3.16%	29.52%	0.78%	35.90%	44.65%	24.79%	-11.97%	-25.33%	-3.84%	0.15%	-36.70%	14.79%
	Large Growth	7.71%	1.79%	31.15%	2.94%	33.81%	38.86%	21.47%	-13.55%	-29.81%	-2.74%	1.06%	-40.36%	17.56%
	Mid Growth	-0.71%	6.46%	25.67%	-3.16%	36.01%	46.17%	14.97%	-16.01%	-21.33%	-2.37%	4.84%	-32.37%	9.71%
	Small Growth	-0.18%	9.61%	23.77%	-5.67%	27.60%	43.52%	-1.00%	-13.37%	-22.41%	-2.49%	1.75%	-33.13%	10.20%
	US Market	0.69%	12.44%	21.47%	-5.05%	31.22%	20.99%	25.78%	-5.33%	-16.85%	-4.56%	7.26%	-19.43%	7.40%
Value	U.S. Value	-2.16%	20.79%	14.23%	-7.51%	25.09%	-1.31%	23.98%	2.35%	-9.44%	-6.60%	14.68%	-0.72%	0.18%
	Large Value	-1.43%	18.91%	15.09%	-5.90%	25.70%	-0.62%	21.49%	1.63%	-8.16%	-7.09%	15.61%	0.26%	0.72%
	Mid Value	-2.57%	25.21%	13.02%	-10.63%	24.81%	-3.76%	29.02%	4.85%	-12.65%	-5.11%	12.31%	-2.39%	-1.28%
	Small Value	-8.65%	27.96%	8.40%	-16.61%	19.96%	1.01%	31.79%	1.80%	-12.78%	-5.14%	10.88%	-6.60%	-1.40%

Source: Morningstar

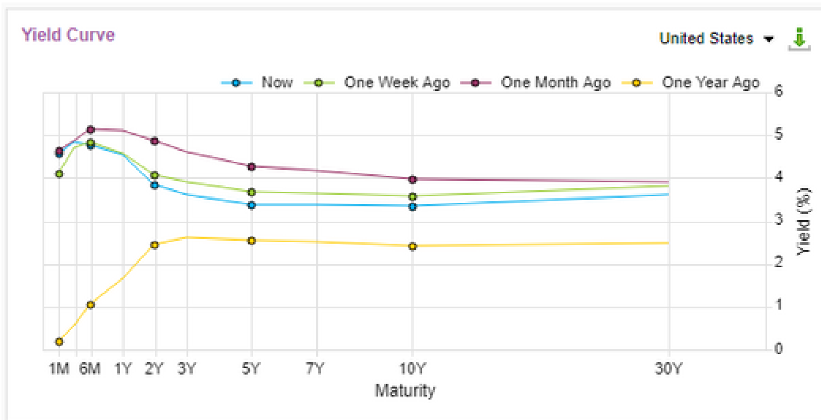
In January, the technology sector and growth stocks outperformed the general market as a disinflation narrative gained momentum and it was perceived that the Fed would start to slow the pace of rate hikes. After the significant underperformance of growth versus value stocks in 2023, some of this was due to the oversold conditions of the group. Regardless, this narrative found support as the Federal Reserve further slowed the pace of rate hikes to 25 basis points at its February FOMC meeting; though during Chairman Powell's press conference after the February meeting, he acknowledged that while the disinflation trend was welcomed, there was still work to be done to combat inflation.

It wasn't long after the Federal Reserve's February meeting that strong economic numbers confirmed the fears that the Federal Reserve would continue its relentless policy of increasing short-term rates in an effort to subdue inflation. The tight labor market and stubbornness of inflation to subside continued to be troubling to the Federal Reserve. Ironically, one would think that strong economic numbers would be what investors would prefer to drive the market higher, but at this point in the cycle, investors would prefer that the Federal Reserve halt its increases to let the economy digest the interest rate increases over the past 12 months.

At the beginning of March, odds increased that the Fed would have to raise interest rates faster than expected to slow the economy. But in mid-March, the banking sector turmoil grabbed headlines as the swift collapse of Silicon Valley Bank became the second largest bank failure in U.S. history. While pundits have offered a number of reasons why the bank collapsed, higher short-term interest rates have certainly not helped the situation, regardless of the mismanagement of the bank's portfolio.

Banks have faced a shift in their deposits, as depositors relocated their funds to pursue the recent interest rate increases. This leaves banks open to duration risk (the risk that the asset value will go down as interest rates rise), especially if they are invested in longer-term instruments. When interest rates were near zero, most investors desiring a return had limited options and plowed capital into real estate and stocks. As short-term interest rates peaked over 5%, investors started to reallocate capital to money markets and short-term bond funds that were yielding a significantly higher yield than could be achieved at most banks. In the digital age of rapid transfer of capital to the "highest yielding" alternative, cash can move very quickly and reenact a "George Bailey" moment on any financial institution.

Exhibit 2: U.S. Government Yield Curve



Questions and uncertainty remain regarding the health of the financial sector, and it wouldn't be too surprising if there were additional developments within the smaller regional banks. In an unprecedented move, the Federal Reserve, FDIC, and Treasury stepped in to backstop all depositors at Silicon Valley Bank and Signature Bank to help quell contagion fears, but it is uncertain how this new policy could be extended to other financial institutions, if at all.

There is a watchfulness in the market as investors' market opinions vacillate between the many economic data releases in hopes of gaining more clarity on the economic and monetary policy trajectory. At the March Federal Reserve meeting, the committee softened its statement language about possible future hikes after increasing rates a further 25 basis points. The committee continues to consistently communicate that it doesn't generally anticipate cutting rates this year.

This is in contrast to market pricing, which at the end of the quarter was anticipating one more Fed hike in May before pivoting to cuts as early as June. The second half of 2023 could be setting up to be an interesting one in the market with the reconciliation of the market's expectations that rates will come down and the Federal Reserve's resolve to keep short-term interest rates higher for longer.

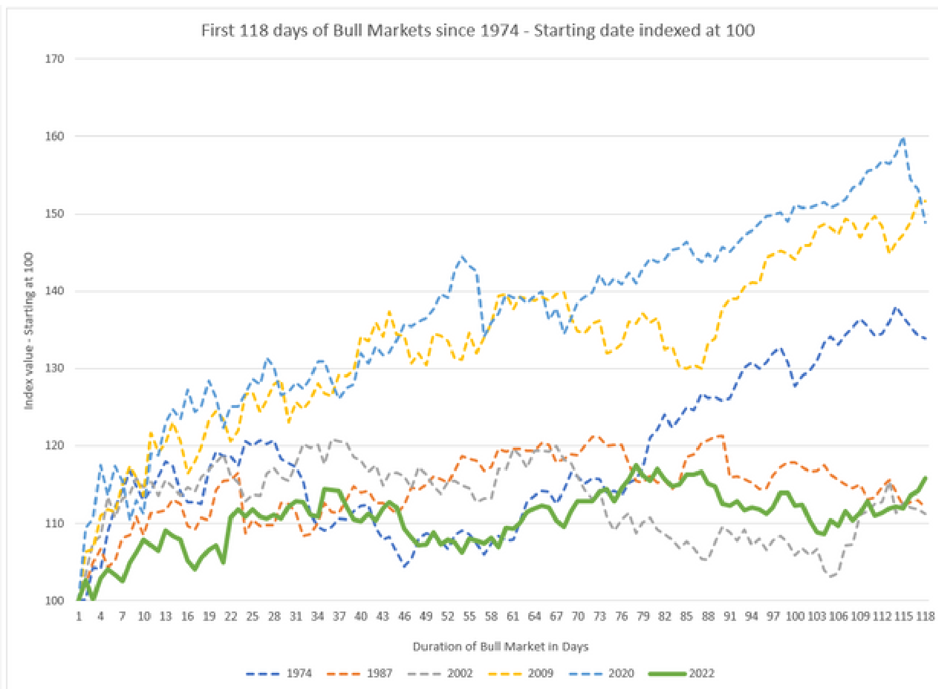
While there appears to be short-term challenges to the market from a top-down perspective, there continues to be some incredible investment opportunities for long-term investors. Though mainstream media sensationalizes generative artificial intelligence (A.I.) program, ChatGPT, developed by OpenAI, there are many generative A.I. platforms in existence. For years, companies have been incorporating machine learning and legacy artificial intelligence platforms in a wide spectrum of applications, from fixed income trading to helping to accelerate designing advanced semiconductor chips. Firms are just starting to understand how to take the generative artificial intelligence platform to unlock huge incremental value from their quality proprietary data sets. In order to fully utilize generative A.I., it will take a significant investment in additional data centers, semiconductors, cooling systems, and networking equipment which will provide multiple avenues for investors to capitalize.

Additionally, there is a bolus of economic stimulus in the fiscal policy pipeline that could have the same effect on certain industries as the previous easy monetary policies of the Federal Reserve. In July 2022, Congress passed the CHIPS Act of 2022 to strengthen domestic semiconductor manufacturing, design, and research in order to fortify the economy and national security and reinforce America's chip supply chains. Also, the Infrastructure Investment and Jobs Act on November 15, 2021, and the Inflation Reduction Act passed in August 2022 will invest nearly $700 billion in infrastructure projects.

Industrial and construction companies are still benefiting from the Cares Act that was passed in the spring of 2020 that allocated $22 billion to schools, universities, and other education customers to be used for upgrades to heating, ventilation, and air conditioning systems and other technology solutions, such as updating fire detection systems, to improve health and safety. Essentially, the baton of spending was passed from the Federal Reserve to Congress, and it will take years to spend what has already been committed through the bills passed.

While uncertainty abounds whether the economy is heading towards a hard, soft, and no landing, there are significant secular trends that will provide a tailwind for some sectors with the above catalysts. The market likely established a floor on October 12, 2022, when the S&P 500 closed at 3,577.03 and thus ended the bear market that started on January 3, 2022. Generally, the definition of the start of a bull market is determined after broad stock benchmarks have risen 20% from recent lows and ends when the market declines by 20% after a period of rising greater than 20%. Though the current market hasn't been confirmed a "bull market," since it has not risen greater than 20% from the October 12th low, it has come vanishingly close a number of times.

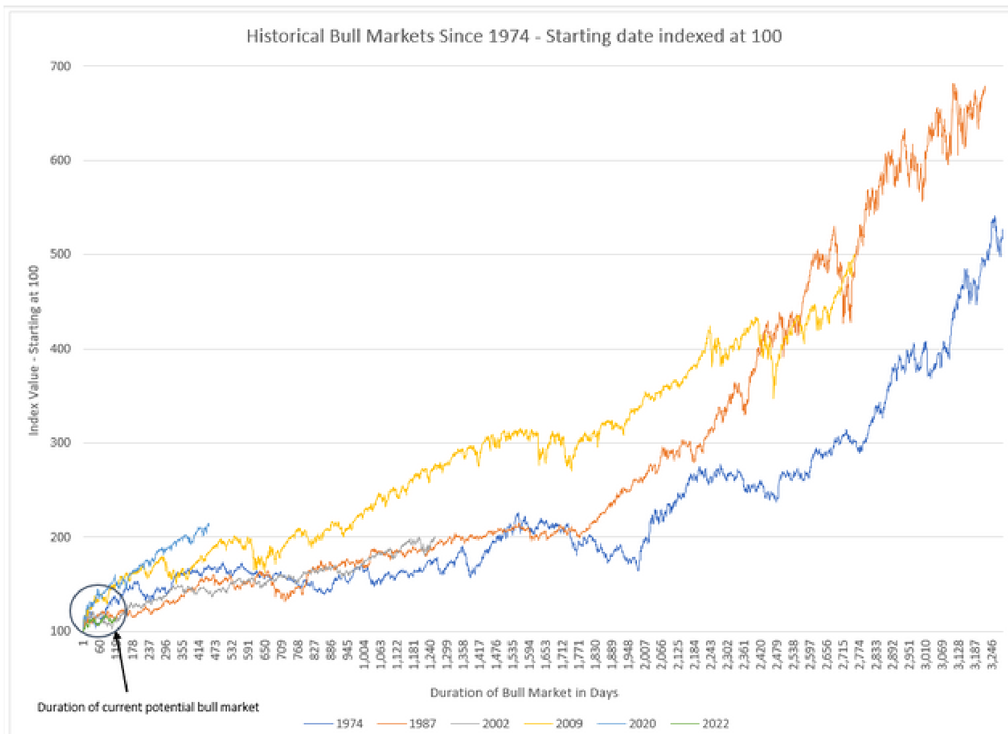
Exhibit 3: First 118 days of Bull Markets since 1974



Most investors would be perplexed to be told that the market currently could potentially be in a bull market, given the volatility over the past several months. Nonetheless, the recent market action isn't unusual when compared to the other bull markets since 1974 for the first 118 days of the bull market, which is the number of days from October 12 to the end of the first quarter. The solid green line is the current potential bull market that will be confirmed once the S&P 500 closes above 4,292.44. With the exception of the bull markets of 2009 and 2020 that were fueled by stimulus capital, it isn't unusual for the early stages of a bull market to have lackluster performance.

The bull market that started in 2020 has been the only upward sloping bull market from the initial start of the cycle. Investors need to understand that markets will fluctuate with the ebbs and flows of the economic flavor for the day, but there are numerous secular trends that should propel the market upward over the long-term.

Exhibit 4: Historical Bull Markets since 1974



The market will continue to be choppy, particularly as the banking sector turmoil and congressional debt ceiling debate get resolved. Having a well-diversified portfolio in companies that have strong balance sheets and solid competitive positioning should benefit investors when the market stabilizes. This is the type of companies sought by Maclura Investments to build client's individual portfolios. While the short-term markets will fluctuate, investing in the right companies for the long-term should get you to your wealth destination.

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