Graves Light Lenhart
Build. Protect. Thrive.

March 3, 2023

Graves Light Lenhart February '23 Market Commentary

What's Good for Economy is Bad for Markets

Market Overview:

Jitters returned in February, largely due to concerns over inflation and the resulting impact on interest rates. February's selloff was triggered by the release of January's largely stronger-than-expected economic indicators. The economic releases, paired with hotter than expected inflation stats, heightened fears of an inflationary "no-landing" scenario that would force Fed officials to conclude that the only way to bring inflation down is to continue raising interest rates *until* they cause either a recession or a significant slowdown in economic activity. This is where the current context of "good news for the economy being bad news for the markets" has become a stark reality. To this extent, recent minutes provided by the Federal Reserve confirmed that governors are more concerned about the risk of inflation staying elevated rather than the US economy tipping into a recession, with an overall sentiment that an insufficiently restrictive policy stance could stall recent progress on moderating price pressures.

Asset Performance:

In a reversal from January's strong performance, the S&P 500 finished down 2.4%. Fears of rising rates spread overseas as well, with the MSCI EAFE index – representing developed markets outside of the US and Canada – declining 2.1% and the S&P Emerging Market benchmark down 6%. The recent rebound in the US Dollar, which typically carries an inverse relationship with Emerging Market performance, is a major reason for the pullback in Emerging Markets.

Key US Index Returns	YTD '23	February '23
S&P 500	+3.7%	-2.4%
Nasdaq	+9.6%	-1.0%
Dow Jones Industrial Average	-1.1%	-3.9%

Relevant Fixed Income Yields	YE 2022	February '23
US 10-Year Treasury Note	3.88%	3.92%
Investment Grade Corp. (C0A0)	5.5%	5.6%
High Yield Corp. (H0A0)	9.0%	8.7%

Source: Factset as of 03/02/23

US fixed income performance was mostly negative as interest rates moved higher, irrespective of maturity. Notably, the shorter-end of the US Treasury curve rapidly adjusted to levels not observed since 2007, with the US 2-Year Treasury rate shifting higher by 0.54% to 4.80% at month-end. As we recently highlighted, the bond market has been pricing-in an optimistic path to lower inflation levels, as reflected

in the TIPS market (Treasury Inflation-Protected Securities). As a result of recent indicators, these implied inflation expectations adjusted higher accordingly. This has underpinned the Fed's reiterated stance to keep interest rates "higher for longer".

Summary Thoughts:

Aviation metaphors have become a very popular means to define prospective outcomes for the economy as well as the attendant market reactions. Most recently, economists are heavily debating whether the economy is headed for a "hard" or "soft" landing. Generally, a hard landing is characterized as a recession with significant economic weakness coupled with rising unemployment, while a soft landing is observed as a moderate slowdown followed by renewed expansion. We even hear about a "no-landing" outcome which is more or less a delayed version of a hard or soft landing. While we are not anchored to any specific landing scenario, what seems likely is that the Federal Reserve will continue its restrictive monetary policy which ultimately raises the risk of recession. As a result, we remain cautious about taking incremental risk for portfolios as we expect volatility to persist in the coming months. In previous cycles, when peak interest rate levels have been reached, yields tend to quickly decline thereafter as the markets readjust to a new path of inflation as well as Fed policy. Thus, high quality fixed income securities, carrying a shorter-term bias (example, up to 5-year maturity), continue to make sense for client portfolios.

Portfolio Management Corner: Know Your Index!

Interestingly, and perhaps underemphasized, is the impact that the recent reshuffling of index constituents has had on market valuations, and by extension, what is perceived as "Value" versus "Growth". After the close of trading on December 19th, Standard & Poor's released its new constituents for its various S&P Growth and Value indexes based on its annual recalculation of the growth and value scores for companies in the indexes. The commensurate scores determine which companies appears in the Growth and Value indexes, which appear in both indexes (in a market-weighted fashion), and which companies meet the stricter criteria for inclusion in the Pure Growth and Pure Value indexes. The scoring methodology is oft-debated, but irrespective, can have a material impact on funds which are passively tracking a style-based index. For example, at year-end 2021, S&P's criteria had seven of the Mega-Cap-8 (mostly "Big Tech" growth companies) in the top 10 market-cap spots in the S&P 500 Pure Growth index. Fast-forward to year-end 2022, and only Apple remains(!). Additionally, now four of the eight companies appear in *both* Growth & Value indexes. The net result? The relative multiples (valuations) between these respective Value and Growth indexes have reset drastically to multi-year lows. Moreover, while passive indexing has proliferated in recent decades, various index providers will use varying methodologies to add, remove or re-weight members and often at different times in the calendar year. In short, indexing isn't as straightforward as many would think.

While index reconstitution isn't the "topic du jour" at your typical social, this is something we are paying close attention to. Stay tuned for our upcoming quarterly where we deep dive on the subject.

Warm regards,

Ash Heatwole, CFA
Director of Wealth Management & Portfolio Manager

DISCLOSURE

Stocks offer long-term growth potential but may fluctuate more and provide less current income than other investments. An investment in the stock market should be made with an understanding of the risks associated with common stocks, including market fluctuations. Stock dividends are not guaranteed. Investments primarily concentrated in one sector may be more volatile than those that diversify across many industry sectors and companies. The technology industry can be significantly affected by obsolescence, short product cycles, falling prices and profits, and competition from new market participants. Global/International investing involves risks not typically associated with U.S. investing, including currency fluctuations, political instability, uncertain economic conditions, different accounting standards, and other risks not associated with domestic investments. Investments in emerging markets may be subject to additional volatility. Stocks of small and mid-cap companies may also be subject to greater risk than that of larger companies because they may lack the management expertise, financial resources, product diversification and competitive strengths to endure adverse economic conditions.

The value of fixed income securities will fluctuate with changes in interest rates, prepayment payment rates, exercise of call provisions, changes in the issuer's credit ratings, market conditions, and other variables such that they may be worth more or less than original cost if sold prior to maturity. There is also a risk that the issuer will be unable to make principal and/or interest payments. Although treasuries are considered free from credit risk they are subject to other types or risks. These risks include interest rate risk, which may cause the underlying value of the bond to fluctuate, and deflation risk, which may cause the principal to decline and treasury securities to underperform traditional securities.

The material has been prepared or is distributed solely for information purposes and is not a solicitation or an offer to buy any security or instrument or to participate in any trading strategy. Past performance is not indicative of future results and there is no assurance that any forecasts/targets mentioned in this report will be attained. The indices have been provided for information/comparison purposes only. Individual investors cannot directly invest in an Index.