DANN ASSET ADVISORS, LLC

First Quarter 2023 Update

April 12, 2023

1Q23 Highlights

- Stocks generate good returns, led by growth and especially large technology stocks
- Bonds fluctuate wildly in response to inflation, the Fed, and two large bank failures
- Assurances from the Fed and Treasury seem to alleviate broader concerns over the banks
- Inflation is moderating but remains high and unemployment remains low
- Despite strong employment, the bond market is signaling that recession is likely[(1)]

The table below summarizes the performance of some key indices during the first quarter:

Market Performance	
Index	% Ch. 1Q23
S&P 500	7.5
S&P Mid Cap 400	3.8
Russell 2000 (small cap)	2.7
MSCI All Country World ex US	6.9
US Aggregate Bond	3.0
High Yield Corp. Bond	3.7

Source: Morningstar, iShares

Equities. The S&P 500 index of large-company U.S. stocks had a good quarter, helped by technology stocks (broadly defined) and a strong last two weeks of the quarter. The favorable result masked lots of intra-quarter volatility, with the S&P 500 having been up nearly 9% in early February, just below breakeven by mid-March, and then up strongly into quarter end as interest rates fell and investors seemed to conclude that banks' balance sheet issues were not widespread.

Almost concurrent with the turning of the calendar, stock market leadership changed. The Russell 1000 Growth index (large-company growth stocks) returned 14.4% in the quarter compared with only 1.0% for the Russell 1000 Value index. For full year 2022, the reverse had occurred, with large value outperforming large growth by more than 21 percentage points. Also in contrast to 2022, small company stocks (indicated by the Russell 2000 index in the table) had been significantly outperforming larger company stocks until Silicon Valley Bank's failure. The Russell 2000 has a much larger exposure to banks than the S&P 500 (9.7% vs. 3.2%)[(2)] and this had an outsized negative impact on the small company index over the second half of March. International stocks came close to matching U.S. performance with developed non-U.S. markets stronger and emerging markets weaker.

Fixed income. In our opinion, the roller coaster ride in the treasury market was the big story during the quarter. The 10-year treasury yield began the quarter at 3.88%, fell as low as 3.38% in January, rose to 4.07% in early March due to higher than expected inflation numbers, fell back to 3.38% in mid-March as investors worried about banking issues' impact on the economy, and ended the quarter at 3.49%. The two-year treasury was even more volatile, beginning the quarter at 4.43%, rising to 5.07%, and then declining as low as 3.78% before rising again into quarter end and finishing at 4.06%.

Inflation data, comments by Fed chair Powell, and the collapse of Silicon Valley Bank and related bank-focused concerns drove the volatility. Given that short-term U.S. treasuries are considered to be among the safest investments, the volatility in the two-year note was remarkable. High-yield fixed income began the year strongly as stocks were rallying but fell in March as investors focused more on risk. Still, high-yield modestly outperformed the US Aggregate Bond index.

Market sectors[(3)]. The three best performing sectors during the quarter were technology (+21%), communications (+18%), and consumer discretionary (16%). We stated that technology broadly defined drove the first quarter's positive performance. To further illustrate this, we note that Alphabet and Meta (formerly Facebook) account for 22% and 14%, respectively, of the communications sector and that these stocks gained 18% and 73% during the quarter. Within consumer discretionary, Amazon and Tesla (both often considered technology companies) account for 20% and 13% of the sector, and they gained 21% and 59%, respectively.

We believe lower interest rates helped drive tech's performance during the quarter, with the stocks' multiples expanding as rates fell. We also note that the three above sectors were by far the worst performers in 2022, falling from 30% to 39%. With these types of losses (and based on what we saw in the market during the fourth quarter), we judge that late 2022 tax loss selling was particularly hard for these sectors, leading to an especially depressed base from which to begin 2023. Lastly, we've seen reports that investors are once again considering tech (with the largest tech companies mostly having very strong balance sheets) relative safe havens should a recession occur [(4)].

The quarter's worst performers were financials and energy (both down 5%) and healthcare, down 4%. With Silicon Valley, Signature, and First Republic banks heavily in the news, financials' performance is no surprise (the group had been up strongly early in the quarter). Energy stocks' decline likely stemmed from a modest fall in crude prices and fears of recession; the group had been the market's best sector by far in 2022 with a 63% gain. Finally, we note healthcare did relatively well in 2022's tough market. The only reason we can think of for the first quarter weakness is that greater price regulation for the industry was much in the news.

Portfolio Positioning

Most clients' fixed income portfolios remain 90% or more in investment grade mutual funds and 70% or more in short duration (which we define as three years or less) funds. With the six-month treasury yield having briefly moved above 5% during the quarter, for some clients we bought short-term treasuries. On equities, we sold a bank exchange traded fund (ETF) prior to Silicon Valley Bank news hitting the market, and part of a large cap, U.S. focused mutual fund. Proceeds were put into a dividend growth ETF and existing positions or left in cash.

Analysis and near-term outlook. We continue to believe the stock market will end 2023 higher than where it began but are more concerned about the next couple of quarters. Among the factors concerning us are:

- A recent Bespoke Investment Group report discussing yield curve inversions (periods when short term interest rates are higher than long term rates) and noting that, "… all seven of the points that have had a perfect track record of forecasting a recession [since 1970] are now inverted"[(5)].
- While inflation has moderated, it's still relatively high and may have a negative effect on company margins and earnings as sales growth slows post pandemic.

- Banks may be less likely to lend given concerns over deposits and unrealized losses in bond portfolios.
- The worst performing sectors of the market during the first quarter were primarily among the most economically sensitive, potentially indicating economic slowing to come.

Putting these factors together, we're more concerned about the economy and earnings for the next two quarters. Earnings estimates for 2023 for the S&P 500 have come down about 4% over the past three months (from $230 to $220)[6] but generally have held up better than expected. Our guess is that full-year estimates will decline further as first-quarter earnings are reported over the next several weeks, and this could lead to weakness for the market.

We also note that the Fed and the bond market are far apart, with the Fed, in their statements, substantially more hawkish on rates than the market. To the extent the Fed is right (their track record has been poor during the pandemic), any negative surprise on inflation could cause rates to spike up again, with further negative implications for stocks. Lastly, events over the past month have demonstrated again the impossibility of predicting near-term stock market moves – highlighting that our current concerns may be misplaced. Still, based on the above factors, we believe it's a time to be conservatively invested.

(1) The Bespoke Report, Bespoke Investment Group, March 24, 2023.
(2) The Bespoke Report, Bespoke Investment Group, March 17, 2023.
(3) Market sector performance numbers based on Vanguard sector ETFs.
(4) Morgan Stanley April 3, 2023, US Equity Strategy piece.
(5) The Bespoke Report, Bespoke Investment Group, March 17, 2023.
(6) Yardeni Research, Inc., S&P 500 Earnings Forecast, April 3, 2023.

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