Market Bulletin

John Workman, Managing Director

April 2023

Solid returns in the first quarter of 2023 will be celebrated by equity and bond investors alike. As we look ahead to the second quarter, let's consider what may support further economic growth. The U.S. labor market continues to be one of the strongest pillars of the global economy. After avoiding an energy catastrophe this winter, the European manufacturing sector is showing renewed signs of life, as indicated by the headline S&P Global Flash Germany PMI Composite Output Index, which rose to 52.6 in March from 50.7 in February. Chinese economic activity is recovering now that Covid restrictions have been lifted: Manufacturing PMI data shows three straight months of expansion, and Non-manufacturing PMI came in at 58.2 in March, marking the highest level in recent years (National Bureau of Statistics). Also, the easing interest rates and greater funding support for the real estate market in China are providing a boost to the housing market there.

The counterbalance to this economic activity is inflation. Rates of inflation have been coming down worldwide but are still considered too high by most central banks. Therefore, interest rates continue to get pushed higher around the world. Higher interest rates make borrowing more costly, thereby slowing down the real estate market and weighing on corporate activity by increasing the cost of borrowing. Additionally, those higher interest rates provide an alternative to investors weighing trade-offs in risk and return for their capital.

What we are witnessing is an economic tug-of-war, a David vs. Goliath battle, where the brute force of global economic growth tries to overcome the efforts of central banks to tamp down inflation by slowing economic activity with higher interest rates. This struggle raises the question of what caused inflation in the first place and what must be done to quell it now. If the root cause was simply issues with supply chains, availability of workers, or scarcity of energy, that would be one thing. However, if inflation was really driven more by expansionary fiscal and monetary policy, then it may take longer to drain that stimulus from the economy. Central bankers' efforts to do so are sure to slow economic growth, and the question we all wrestle with is whether it is feasible to bring down inflation without causing a recession.

Questions remain on the overall health of the banking sector, which was marred by the recent failures of Silicon Valley and Signature banks and the subsequent fears that pushed Credit Suisse into the arms of UBS. While the Federal Reserve stepped in with measures to support bank liquidity to meet depositors' demands, we can still expect that many banks, particularly regional and local banks, are likely to pull back on lending. We will be watching developments in the commercial real estate sector as these regional banks have played a very prominent role in lending to local developers and owners of such properties.

What do market participants make of the possible scenarios from here? The Bulls expect that declining inflation and recent hiccups in the banking sector will permit central banks to end the rate hiking cycle and begin to lower rates sooner rather than later. They are hopeful that inflation continues to ease as the impact of the pandemic on businesses subsides. The Bears anticipate that inflation will take longer to get down to a comfortable level, meaning interest rates will stay high for longer and central banks won't be inclined to unwind their restrictive monetary policy anytime soon unless something serious breaks.

We believe the preponderance of data indicates we are in the latter stages of this economic cycle: 1) Recent data on layoffs and initial and continuing unemployment claims suggest labor market strength is waning; 2) Market breadth has weakened (limited number of stocks leading the market higher); 3) Money supply (M2) is shrinking; 4) Recent Purchasing Managers Index (PMI) survey data points to slowing orders; 5) Banks are tightening lending standards; and 6) Corporate profits are declining.

Adding it all up, we remain in the cautious camp near term. We continue to believe that the risk of a recession is elevated. We will be convening our Strategy Committee shortly to review our positioning and will review our many tools - Market Cycle Dashboards, Stress Test Scenario Analysis, and forward-looking Capital Market Assumptions - to refine our portfolio recommendations which will follow in our Tactical memo later this month.

Disclosure

This communication and its content are for informational and educational purposes only and should not be used as the basis for any investment decision. The information contained herein is based on publicly available sources believed to be reliable but is not a representation, expressed or implied, as to its accuracy, completeness or correctness. No information available through this communication is intended or should be construed as any advice, recommendation or endorsement from us as to any legal, tax, investment or other matters, nor shall be considered a solicitation or offer to buy or sell any security, future, option or other financial instrument or to offer or provide any investment advice or service to any person in any jurisdiction. Nothing contained in this communication constitutes investment advice or offers any opinion with respect to the suitability of any security, and this communication has no regard to the specific investment objectives, financial situation and particular needs of any specific recipient. Past performance is no guarantee of future results.

Additional information and disclosure on Pathstone is available via our Form ADV, Part 2A, which is available upon request or at www.adviserinfo.sec.gov.

Any tax advice contained herein, including attachments, is not intended or written to be used, and cannot be used, by a taxpayer for the purpose of (i) avoiding tax penalties that may be imposed on the taxpayer or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein.