Q1 Review & Outlook

April 11, 2023

ELEMENT	TREND	COMMENTS
VALUATION	Neutral	Equity valuations moved away from lows but remain well below peak levels.
INTEREST RATES	Positive	Rates have risen significantly, though hikes appear to be slowing.
INFLATION	Positive	Inflation is stubbornly high but may have crested.
VOLATILITY	Positive	Volatility remains elevated, which tends to be bullish going forward.
MONETARY POLICY	Neutral	Monetary tightening likely to have reined in near-term economic growth.
DOMESTIC POLICY	Negative	Banking system under some pressure, and debt battle looms.
GEOPOLITICAL	Neutral	Ukraine war persists in Europe; rising energy inputs pose challenge.

"That Will Play All Day."

There is practically an endless supply of overused expressions that can be used to describe various situations that may occur on the golf course. Some are more apt than others, and of course, many are unprintable. Some are so hackneyed that they are only used in jest or to be ironic. Even so, this is Masters week, and with azaleas and green fairways on the brain while writing this market letter about the first quarter of 2023, I could not help but think "there are no photographs on the scorecard."

Yes, it would be difficult to conclude from looking at the first quarter scorecard that we had experienced three bank failures in the United States and seen the forced marriage of two large Swiss banks. The safety of the banking system was called into question, yet here we are with the S&P 500 up 7.5 percent for the quarter. The tech-centric NASDAQ was up 17 percent for the quarter, and the DJIA ended net positive. If Mr. Market were a golfer, he hooked his drive into the woods on the left, but his ball ricocheted off a tree back into the fairway. He then proceeded to skull his second shot thin into a bunker. However, on the third shot, Mr. Market, now breathing heavily and beginning to perspire, catches the ball thin again, and the ball comes screaming out of the sand headed for the pond. From there, it hits the flag and somehow drops in the hole for a birdie. That's pretty much what we just saw in the markets.

Major Indices Total Returns (%)

	December	4Q2022	2022	January	February	March	1Q2023
S&P 500	-5.8	7.5	-18.1	6.3	-2.4	3.7	7.5
DJIA	-4.1	16.0	-6.9	2.9	-3.9	2.1	0.9
NASDAQ	-8.7	-0.8	-32.5	10.7	-1.0	6.8	17.0
Russell 3000	-5.9	7.2	-19.2	6.9	-2.3	2.7	7.2
Russell 3000 Value	-4.2	12.2	-8.0	5.4	-3.5	2.7	0.9
Russell 3000 Growth	-7.6	2.3	-29.0	8.4	-1.2	6.2	13.8
Value - Growth	3.4	9.9	21.0	-3.0	-2.3	-3.6	-13.0

Source: Bloomberg, Trust Company of the South

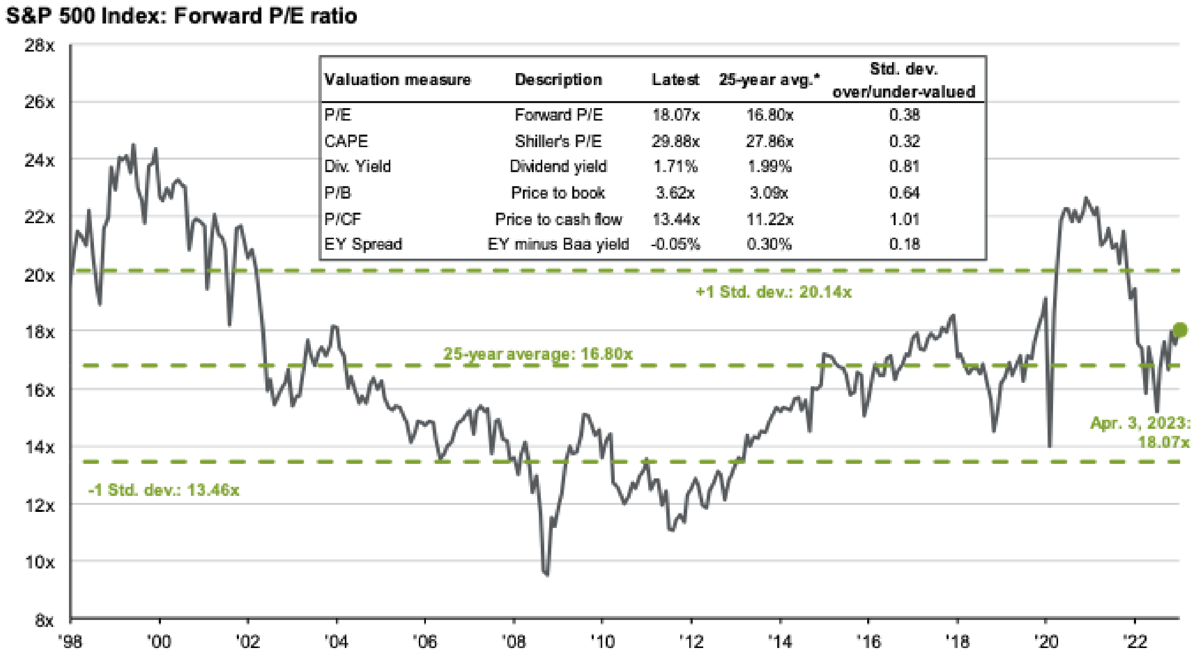
Now, of course, this round can still go a lot of different ways. Good fortune is a wonderful thing, and this golfer now has a nice story to tell. He can finish his round as the net beneficiary of some good luck. On the other hand, another quite logical conclusion given what we've seen, is that this fellow isn't a very good golfer, and his luck will eventually run out.

Even so, there is one major difference between the journey of a golfer and the journey of Mr. Market. Golfers may have benevolent monkeys in the trees looking out for them, but Mr. Market has the Federal Reserve. The Fed can be quite an effective caddy.

“We brother-in-law-ed it pretty well.”

Equity valuations are still well off their late 2021 highs, but they crept back up again during the quarter and are now slightly above long-term averages. The price/earnings ratio on the S&P 500 has exceeded 18x forward earnings estimates, above the 25-year average of 16.8x. Because this environment tends to draw comparisons to the early 2000s, with the economy trying to shake off an easy-money hangover, it’s worth noting that 18x is comfortably below where the market was during its three-year swoon from 2000 through 2002.

Figure 1: S&P 500 Valuation Measures



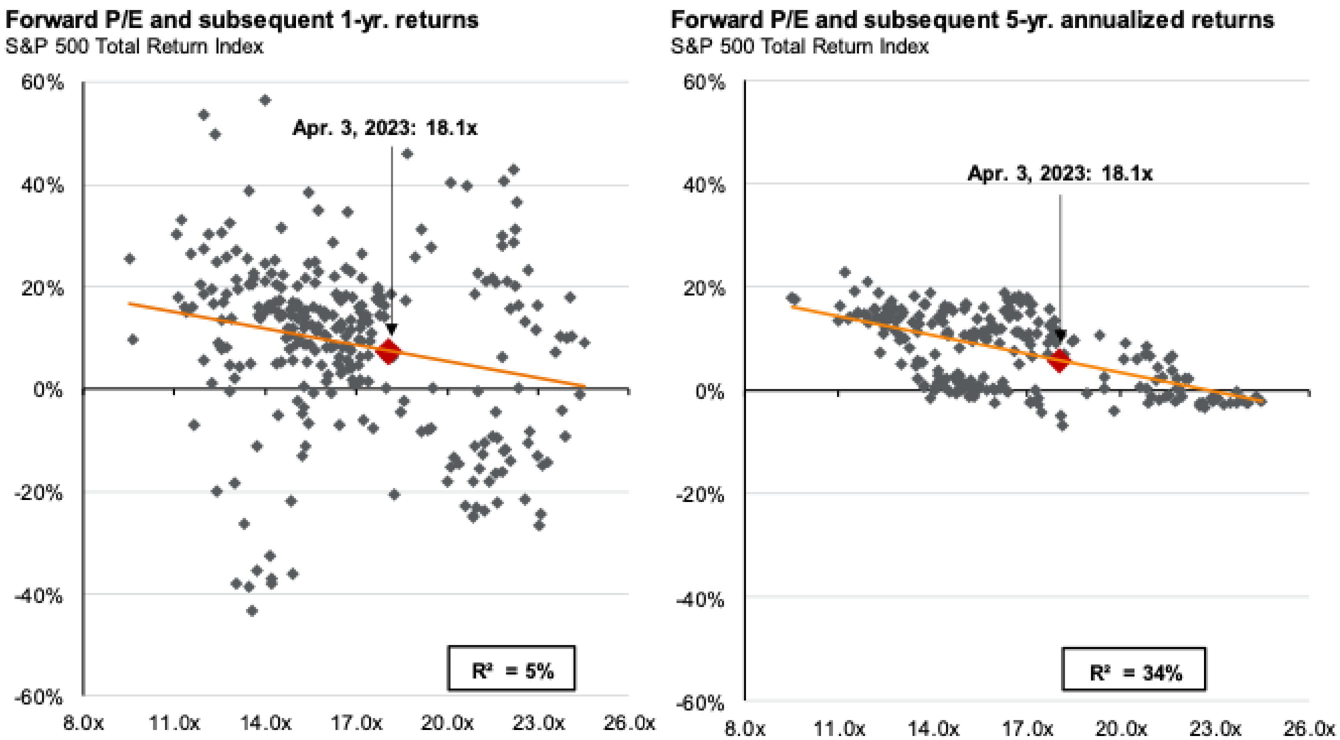
Source: FactSet, FRB, Refinitiv Datastream, Robert Shiller, Standard & Poor’s, Thomson Reuters, J.P. Morgan Asset Management.

Price-to-earnings is price divided by consensus analyst estimates of earnings per share for the next 12 months as provided by IBES since December 1997 and by FactSet since January 2022. Current next 12-months consensus earnings estimates are $231. Average P/E and standard deviations are calculated using 25 years of history. Shiller’s P/E uses trailing 10-years of inflation-adjusted earnings as reported by companies. Dividend yield is calculated as the next 12-months consensus dividend divided by most recent price. Price-to-book ratio is the price divided by book value per share. Price-to-cash flow is price divided by NTM cash flow. EY minus Baa yield is the forward earnings yield (consensus analyst estimates of EPS over the next 12 months divided by price) minus the Moody’s Baa seasoned corporate bond yield. Std. dev. over-/under-valued is calculated using the average and standard deviation over 25 years for each measure. *P/CF is a 20-year average due to cash flow availability.

Guide to the Markets – U.S. Data are as of April 3, 2023.

Even so, higher valuations mathematically pose a hindrance to future returns. While the relationship between valuation and subsequent returns is not necessarily obvious over a one-year period, as the chart below shows, it is visible over a five-year period. Five-year annualized returns from these levels ought to be positive, but perhaps not historically powerful.

Figure 2: Price/Earnings Ratios and Equity Returns



Source: FactSet, Refinitiv Datastream, Standard & Poor's, Thomson Reuters, J.P. Morgan Asset Management.

Returns are 12-month and 60-month annualized total returns, measured monthly, beginning 11/30/97. R^2 represents the percent of total variation in total returns that can be explained by forward price-to-earnings ratios. Price-to-earnings is price divided by consensus analyst estimates of earnings per share for the next 12 months as provided by IBES since February 1998 and by FactSet since January 2022.

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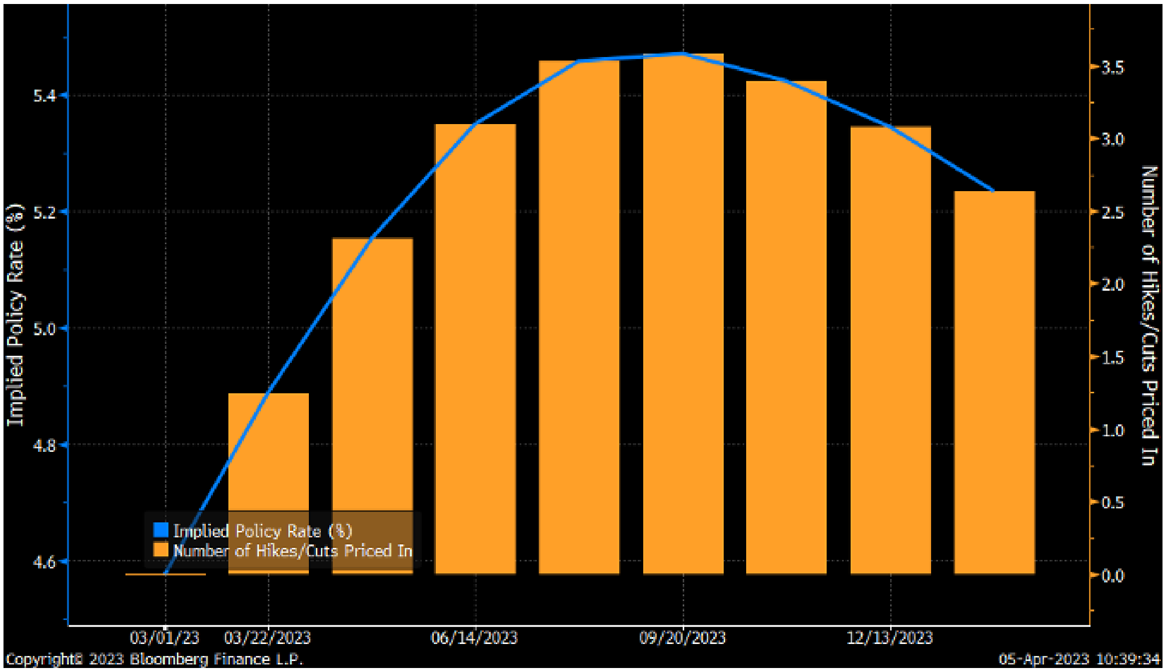
The first is this—based on history, not to mention logic, investors experience better future So, why are valuations rising even as clouds of uncertainty gather on the economic horizon? From our perspective, the market's expectations about the future Fed actions are key. The Fed might not be able to throw a golf ball back into the fairway, but, like a good "brother-in-law," it can be a powerful partner, carding a par, or at least a net par, when one's own ball is at the bottom of the pond or lost in woods.

Prior to this most recent financial unpleasantness, the futures market for the Fed funds rate had predicted that interest rates would continue to move higher throughout the year, even into next year, owing to persistent inflation and supported by strong economic growth data.

The chart below illustrates what the market was expecting on March 1, including four more rate hikes and the implied Fed funds rate topping out at about 5.5 percent:

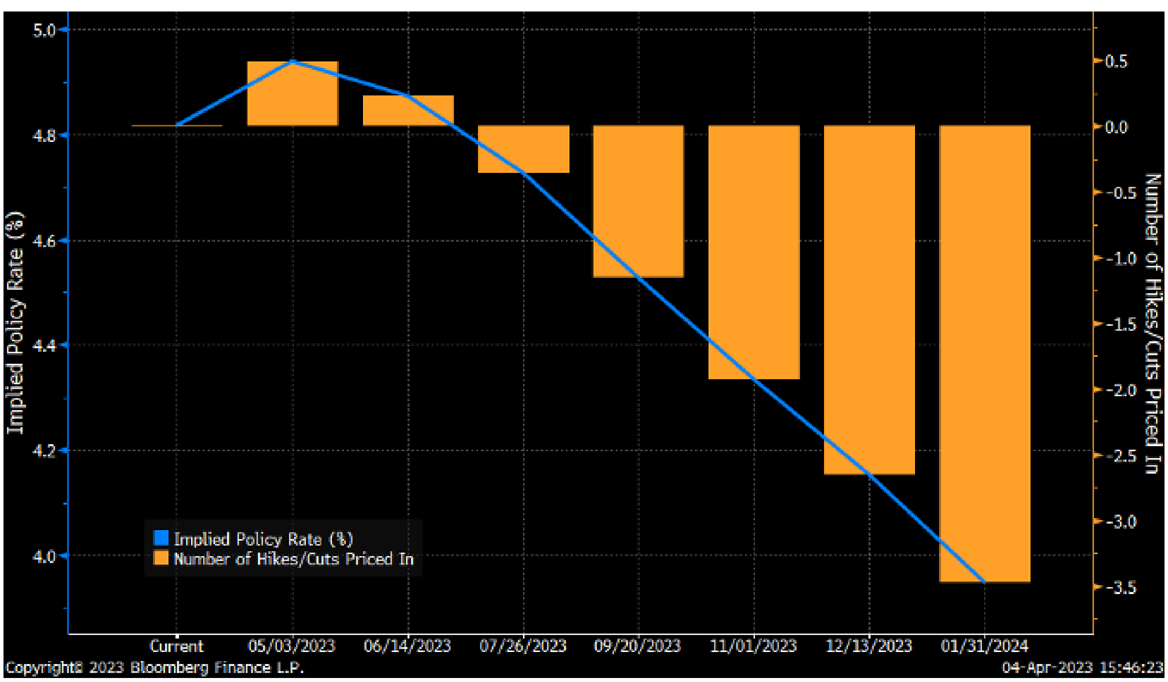
Figure 3: Fed Funds Futures Curve, March 1, 2023



Source: Bloomberg, Trust Company of the South

Save one errant swing and the whole round in danger of becoming a true calamity, the market immediately looked to Jay "Tiger" Powell to come in and save the day. This is what the Fed futures curve looks like this week:

Figure 4: Fed Funds Futures Curve, April 4, 2023



Source: Bloomberg, Trust Company of the South

The market is now predicting that there is less than a 50 percent chance the Fed will raise rates even 25 basis points more. Suddenly, it seems, the Fed may be a lot more market-friendly – a good caddy, indeed.

"Winter Rules."

This certainly does not mean that the market's prospects are guaranteed to be rosy. After all, this newly accommodative stance merely reflects that the tighter financial conditions that Fed has been trying to engineer for more than a year have finally arrived. Regrettably, the shareholders of Silicon Valley Bank, Silvergate Capital and Signature Bank can each attest to that. The playing conditions have become more difficult for most companies, and there will almost certainly be additional bouts of credit concerns, Broadly speaking, the Fed is again allowing investors to "lift, clean and place."

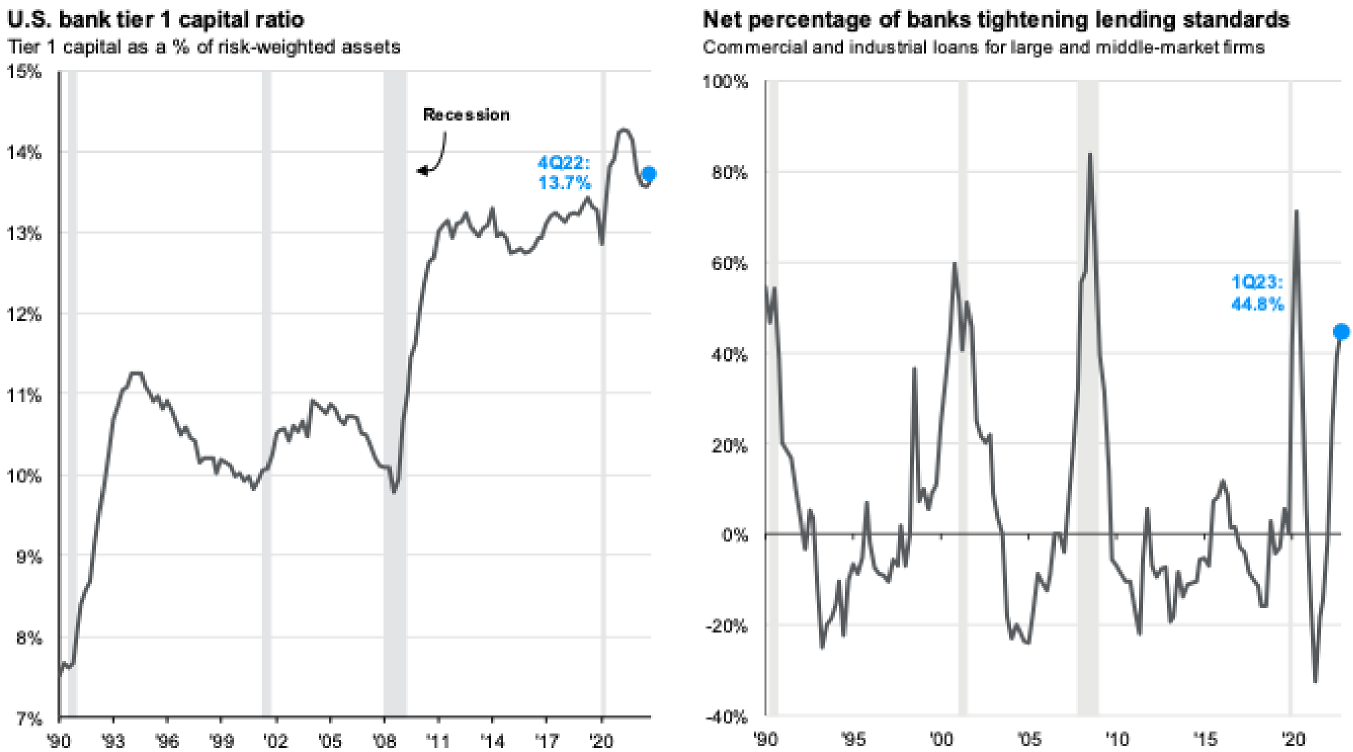
"Green has a false front."

In golf, there's a particularly maddening phenomenon known as a green with a false front. Due to a diabolical combination of topography and groundskeeping, a golfer – doomed, wretched soul that he is – is led to believe he has hit a great shot onto the front of the green, only to watch the ball slowly, then with gathering speed, roll off the green and deposit itself into the fairway. There is a case to be made that this first quarter rally is a false front. This is because the lion's share of the rally was in the largest stocks. One study (by Strategas Research) indicated that ten stocks accounted for 90 percent of the rally in the S&P 500, which is market-weighted. These mega-cap stocks have meaningfully outperformed the broader markets, perhaps as investors sought the perceived relative safety of these companies, which have lower debt and above-average growth prospects. With such a narrow rally, we should likely not start counting our score before we get to the turn, and stay cognizant of the hazards on the course.

The sudden convulsions seen in the banking system seemed to stem from several sources. Yes, SVB could be accused of having a portfolio with a huge duration mismatch, but after years of low interest rates, many banks do, which is the problem. In a world where investors can move vast sums of money even from mobile devices, perhaps spooked by something they've read on social media, it's clear that insolvency is a greater risk than regulators had understood. Compounding the danger is the apparent phenomenon that many depositors, in the process of checking the safety of their deposits, figured out just how much they were giving up. They had been keeping cash in safe, but technically uninsured, accounts and not just buying treasuries, which were both safer and higher-yielding. Finally, there's the matter of what was going on among the SVB customer base. From appearances, the giant spigot of cash that had flooded the venture capital market with cash for years has been turned off. Part of SVB's problem was that the bank's customers were simply drawing down their cash balances, not originally because they had the least bit of concern about SVB, but because they simply needed the dough to make payroll. It doesn't take a great deal of imagination to contemplate an economy in which there will be customers of other banks who will soon find themselves short of cash. This would perhaps be the result of loans coming due and being unable to refinance at higher interest rates. Under these circumstances, why would anyone willingly expose themselves to smaller, regional banks unless there was some additional level of insurance, explicit or implicit, provided? Well, there historically hasn't been, which is why the deposit backstop created by the Fed and the Treasury proved necessary.

The good news is that overall bank capital is historically strong. This is a far cry from 2008. The bad news is that depositors don't care about capital ratios if they feel like their deposits are in danger for any reason. Whether newly-tightened lending standards, as the next chart illustrates, are good news or bad news is perhaps a matter of perspective.

Figure 5: Bank Capitalization and Lending Sentiment



Source: Bloomberg, FDIC, Federal Reserve, J.P. Morgan Asset Management. The tier 1 capital ratio is the ratio of a bank's core tier 1 capital (equity capital and disclosed reserves) to its total risk-weighted assets. It is a key measure of a bank's financial strength that has been adopted as part of the Basel III Accord on bank regulation.

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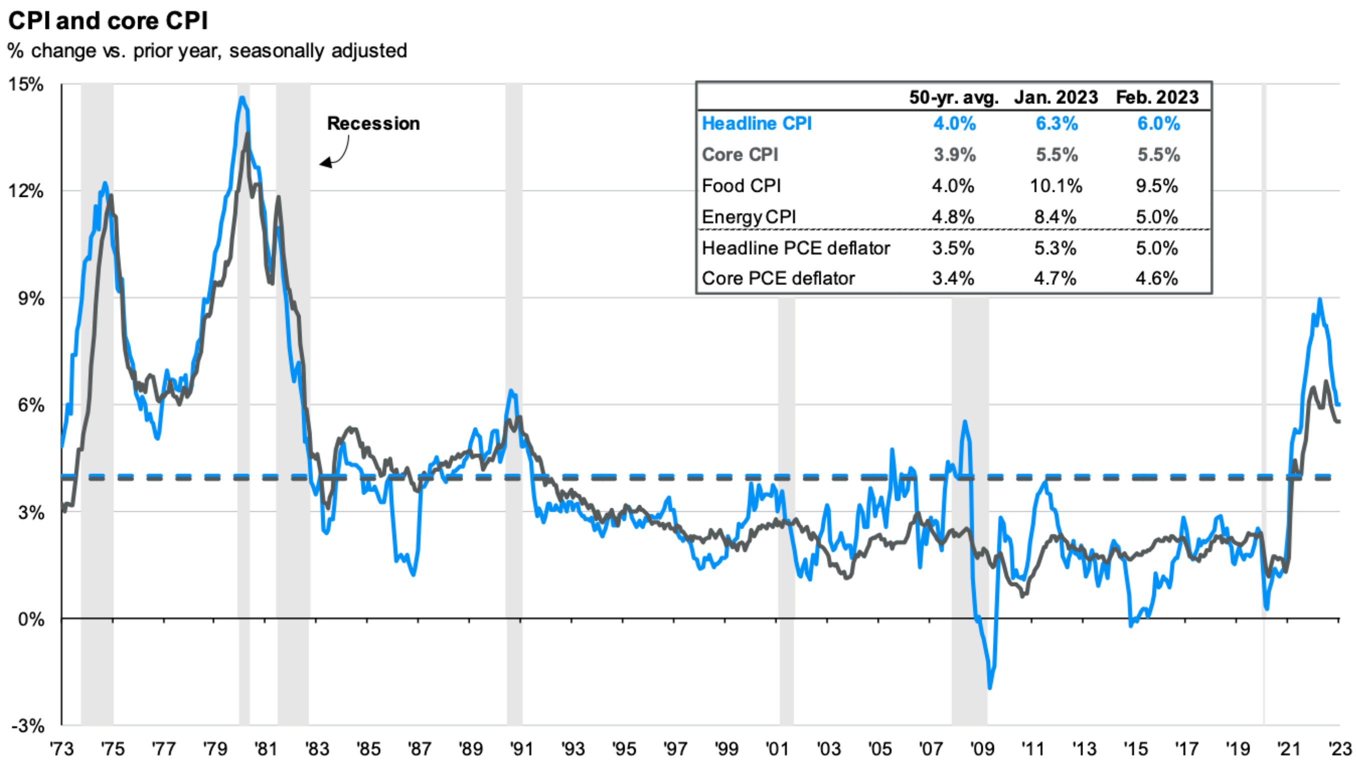
“There’s a lot of golf left to play.”

On the other hand, the market remains efficient – not perfectly efficient, but reasonably so over the long-term. Inflation first started showing signs of cooling late last fall which is when the market bottomed. Falling inflation is good news for everyone, and the Dow seemed to sniff it out first, rallying 16% during the fourth quarter.

Figure 6: Inflation



Source: BLS, FactSet, J.P. Morgan Asset Management.

CPI used is CPI-U and values shown are % change vs. one year ago. Core CPI is defined as CPI excluding food and energy prices. The Personal Consumption Expenditure (PCE) deflator employs an evolving chain-weighted basket of consumer expenditures instead of the fixed-weight basket used in CPI calculations.

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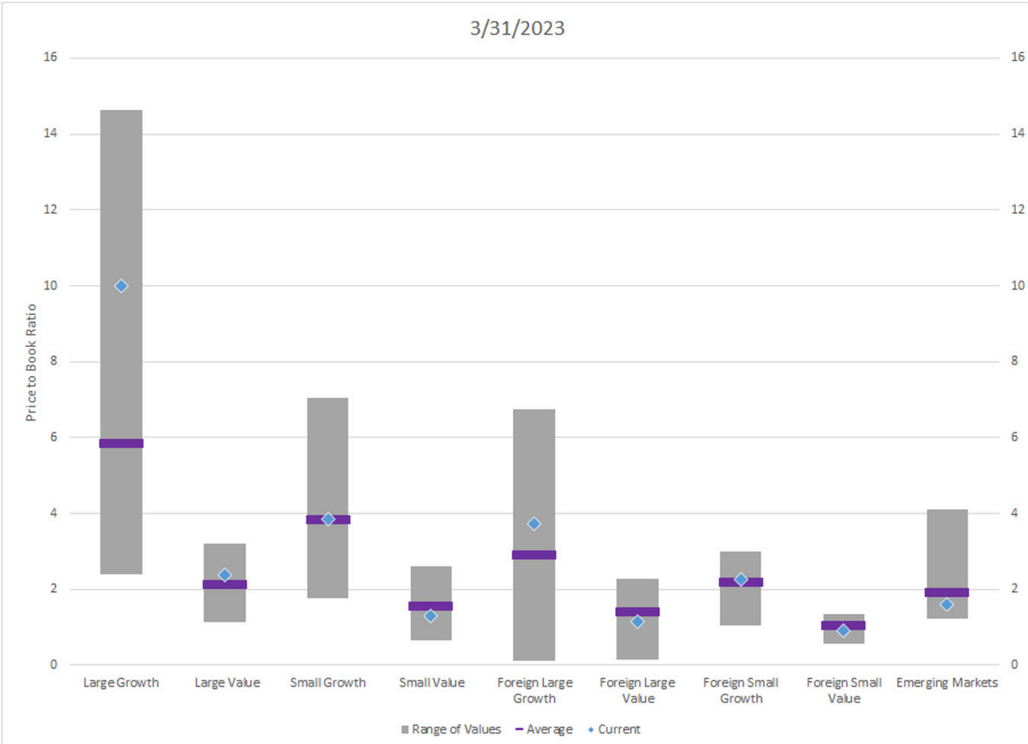
This past quarter, it was tech’s turn. The mega-cap names doing well so far this year are the same ones that were left for dead last year. Perhaps it’s not so strange for some of the largest companies in the world to see their stock prices outperform during periods of financial duress because of their low leverage. That said, we remain of the view that these mega-cap stocks that fuel returns in large-cap funds and strategies are still priced well north of historical averages. They will probably be less likely to reward investors over the long term versus other opportunities.

Figure 7: Historical Price-to-Book Ratios Across Various Equity Asset Classes



Source: Trust Company of the South

Range of values calculated monthly beginning in January, 1995.

"You're pressed."

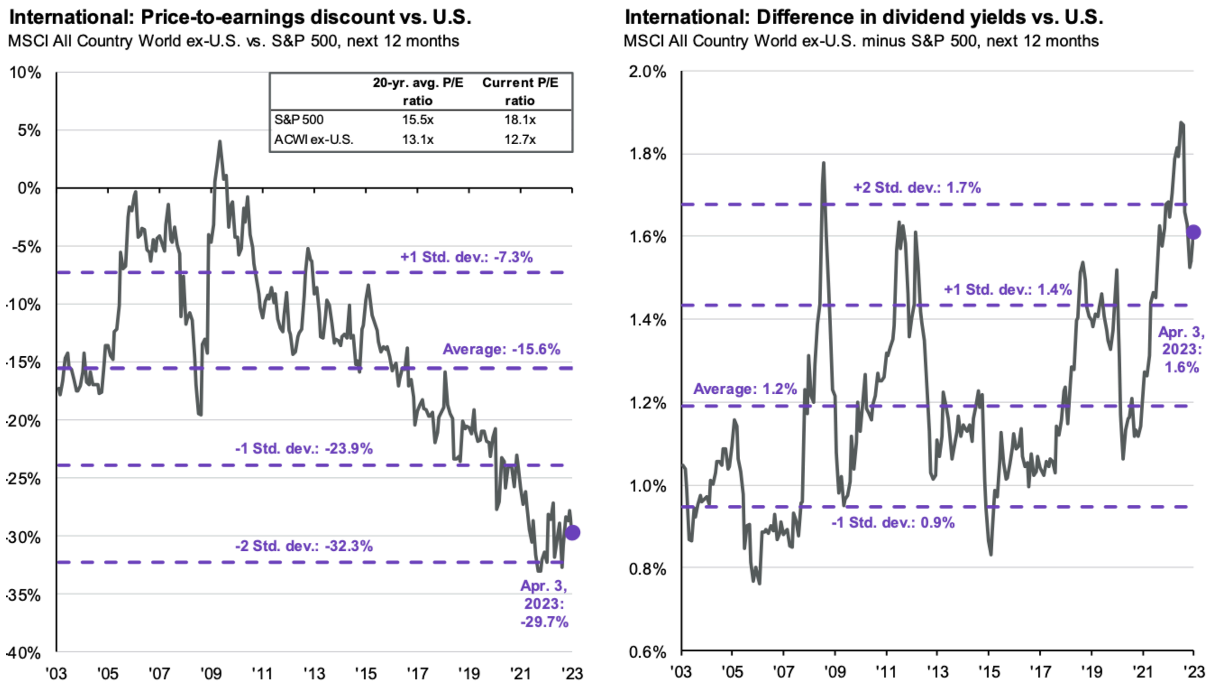
For the first time since last summer, before the Fed really made clear its willingness to ratchet up interest rates to levels unseen in years, growth outperformed value during the quarter. Moreover, growth outperformed by quite a lot. The Russell 3000 Growth Index outperformed its value counterpart by 1,300 basis points. However, the outperformance was mainly among the tech names. Comparing the Russell 2000 growth and value indices, which do not include the 1,000 largest stocks, growth's outperformance was only 660 basis points. This proved to still be strong, but it does suggest there was a flight-to-safety component to this rally. Safety and long-term returns belong on opposite ends of the spectrum. Over the long-term, the evidence suggests that having a value tilt is a good way to bet.

Ryder Cup

Outside of the Masters, the Ryder Cup, when a team of U.S. golfers takes on a team of European golfers, is perhaps golf's most exciting event. Held only biennially, the stakes are high. One side or another can hold the cup for long periods of time.

Similarly, last year marked the end of 14 years of U.S. dominance over the rest of the world in equity returns. A strong finish to the year, boosted by falling long-term interest rates in the U.S., was a factor, but the real attraction of continuing to allocate to international is valuation. Valuations abroad remain at historically attractive levels compared to U.S. stocks. International returns are again outpacing U.S. returns year-to-date. With the market now expecting rates to fall this year, which typically means a weaker USD, perhaps the international team is the way to bet again.

Figure 8: International Valuations and Dividend Yields



Source: FactSet, MSCI, Standard & Poor's, J.P. Morgan Asset Management.

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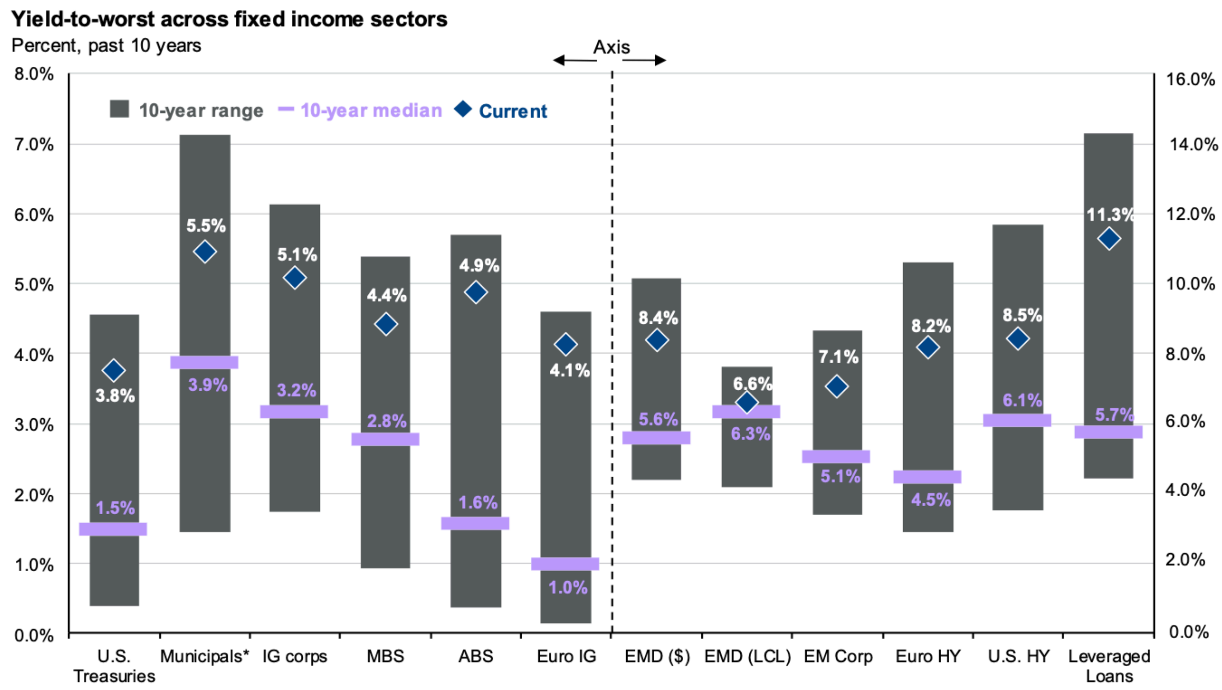
"In the leather."

For years, fixed-income returns have been anemic due to the extremely accommodative stance among central banks. Investors were seemingly forced into riskier assets to earn acceptable economic returns. Rising interest rates have made bonds more attractive, and though many fixed-income investors are sitting on mark-to-market losses from last year, new investments in extremely short-term securities are earning positive real returns.

Figure 9: Fixed Income Yields vs. Historical Averages



Source: Bloomberg, FactSet, J.P. Morgan Credit Research, J.P. Morgan Asset Management. Indices used are Bloomberg except for emerging market debt and leveraged loans: EMD ($): J.P. Morgan EMIGLOBAL Diversified Index; EMD (LCL): J.P. Morgan GBI-EM Global Diversified Index; EM Corp.: J.P. Morgan CEMBI Broad Diversified; Leveraged loans: JPM Leveraged Loan Index; Euro IG: Bloomberg Euro Aggregate Corporate Index; Euro HY: Bloomberg Pan-European High Yield Index. Yield-to-worst is the lowest possible yield that can be received on a bond apart from the company defaulting. All sectors shown are yield-to-worst except for Municipals, which is based on the tax-equivalent yield-to-worst assuming a top-income tax bracket rate of 37% plus a Medicare tax rate of 3.8%.

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"What's the yardage? What's the wind doing? Can you give me a read?"

These course conditions seem challenging indeed. We have crosswinds in the form of a hopefully, newly-supportive Fed amid a cooling economy. Inflation may have decelerated, however this is no time to decelerate attempting a new swing. This is perhaps the most anticipated economic slowdown in modern history, and that does not mean there won't be surprises, as the events of the first quarter make clear. We know what the evidence suggests about where to find premiums in the markets over the long term, and that's how we'll continue play the course.

> ***"If nothing is so useless as an ivory tower academic theory that goes unused, nothing is so very practical as the theory that works."***
>
> ***— David Swensen***

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