Wellington Shields

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Quarterly Market Strategy Report

A Year of Volatility

The first quarter of the year closed with a gain of 7.0% in the S&P 500 index and a smaller 0.4% rise in the Dow Jones Industrial Average. Yet these numbers do not accurately reflect the market's action in the first three months of 2023. The year started off with a bang as the S&P 500 soared 6.2% in January, but this quickly reversed to a swoon of 2.6% in February and this was followed by a 3.5% rebound in March. It was an extremely volatile quarter with nearly half the individual trading sessions generating gains or losses in the S&P 500 of 1% or more. January 6 posted outsized gains of over 2% in all three indices while the February 21 session posted a loss of 2% or more in all three indices.

But the quarter's best price action was concentrated in stocks that had been the biggest losers in 2022. The worst sector performances last year were communications services (down 40%), consumer discretionary (down 38%), and technology (down 29%). However, it is important to note that the communications service sector includes not only companies like Verizon Communications Inc. (VZ - $38.89), but also familiar tech-like names such as Meta Platforms Inc. (META - $211.94), Alphabet Inc. Cl A (GOOGL - $103.73), Alphabet Inc. Cl C (GOOG - $104.00); and Netflix (NFLX - $345.48). The consumer discretionary sector includes large capitalization favorites like Amazon.com, Inc. (AMZN - $103.29) and Tesla, Inc. (TSLA - $207.46). The technology sector includes Microsoft Corp. (MSFT - $288.30); Apple Inc. (AAPL - $164.90), and Nvidia Corp. (NVDA - $277.77).

In other words, the early part of 2023 was a time of bottom fishing for investors. A trading strategy of buying the losers and selling the winners is what drove performance early in the year. As a result, the Nasdaq Composite index, home of many of the beaten down "large capitalization growth stocks" rose nearly 17% in the first quarter, outpacing all the other indices. However, we are not convinced that the first quarter represented the beginning of a new bull market move. First, it did not have the participation of the financial sector. Second, value usually outperforms growth during a period of rising interest rates because higher interest rates will limit speculative activity and goes hand in hand with lower PE multiples.

Summary

History shows there is a strong relationship between the Fed increasing its balance sheet (adding liquidity to the banking system) and rising stock prices.

Therefore, equity prices could rise in the near term. But we would not be in favor of chasing rising prices since we believe equities will be rangebound for most, if not all, of 2023. This range is best seen in the Russell 2000 index between support at 1650 and resistance near 2000.

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Financial stocks did not do well in the early part of the year. In fact, the first quarter of 2023 will go down in the history books because it contained two of the three largest bank failures in US history. Silicon Valley Bank, a regional bank in California, the second largest bank failure on record, was taken over by regulators on March 10, 2023, and Signature Bank, a New York-based regional bank, and the third largest bank failure in the US, closed on March 12, 2023. This led to ripples of uneasiness throughout the regional banking industry. Banking angst also increased on March 19, when Swiss regulators orchestrated a $3.25 billion takeover of Credit Suisse Group AG ADR(CS - $0.89), the second largest bank in Switzerland, by UBS Group AG (UBS - $21.34), the largest of Switzerland's banks.

Some Swiss financial leaders are already criticizing this shotgun deal for reasons including the fact that the total value of exotic securities – like options or futures contracts – held by the combined merged bank could be worth 40 times Switzerland's total economic output. The Swiss Parliament indicated it will quickly organize a special session to discuss the takeover, including "too big to fail" legislation and possible penalties against Credit Suisse managers. All in all, the global banking system was on edge in the first quarter, and it remains under pressure. Still, none of this is surprising in view of the fact that the Federal Reserve had just increased interest rates by 450 basis points in less than 11 months. The rise in short-term interest rates puts pressure on the balance sheets of most banks, and also leads customers to shift money from checking accounts into money market funds and other higher interest rate paying investments. The second quarter will continue to be a tricky time for bankers.

We remain defensive and look to protect portfolios as much as possible from the possibility of a recession. This means having above-average cash levels and emphasizing areas of the stock market with recession-proof revenue growth and earnings such as energy, staples, utilities, aerospace/defense, and stocks in any sector with the best predictability of sustained earnings power.

PAUSE, RAISE, OR PIVOT

Nevertheless, as expected, the Federal Reserve increased the fed funds interest rate by 25 basis points on March 22, lifting the range to 4.75% to 5.00%. Some forecasters thought the Fed might pause or reverse its tightening policy due to the instability in the global banking sector. And though we agree that recent bank failures will result in tougher credit conditions for households and businesses, and this will have an impact on the economy similar to higher interest rates, we do not think the Fed's job in terms of fighting inflation is over. It will, however, make the central bank's task trickier.

The banking crisis forced the Federal Reserve to reverse its quantitative tightening policy. It moved quickly to add reserves to the banking system in order to calm the markets; and to date, the Fed's balance sheet has expanded by more than $366 billion dollars. The quick response from the Fed appears to have assuaged depositors and the crisis seems halted for the moment. However, it also neutralized the Fed's tightening policy.

Nevertheless, history shows that there has been a strong relationship between the Fed increasing its balance sheet (adding liquidity to the banking system) and rising stock prices. In sum, equity prices could rise in the near term. But we would not be complacent about a near-term rally.

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In our opinion, the Federal Reserve will take every opportunity to raise rates again in the future.

Federal Reserve Chairman Jerome Powell has stated that fighting inflation is a key priority and to do this the real fed funds rate needs to shift to positive, i.e., the fed funds rate needs to be measurably above the rate of inflation. Yet even after February's personal consumption expenditure deflator (the Fed's preferred measure of inflation) declined from 5.3% to 5% in February and the March rate hike lifted the top of the fed funds range to 5%, the real fed funds rate only "improved" from negative 60 basis points to zero. This means the Fed needs to see more improvement in inflation data and even so, is likely to raise interest rates at every opportunity in the coming months.

We do not expect to see a Fed pivot in 2023 unless the economic or financial backdrop becomes extremely unstable and such an event would not be good for equities. In sum, the bullish camp looking for a pause or a pivot may be disappointed in upcoming months, and this means the volatility seen in the first quarter is likely to continue.

Rangebound

The March expansion in the Fed's balance sheet is apt to be a positive for the equity market in the near term. However, history suggests that whenever inflation reaches more than one standard deviation above the norm, or above 6.5%, the US economy experiences a series of rolling recessions; therefore, we would not be in favor of chasing rising prices because we believe the market will be rangebound for most, if not all, of 2023. This range is best seen in the Russell 2000 index between support at 1650 and resistance near the 2000 level.

In terms of recessions, the first in a series could have been the two consecutive quarters of negative GDP recorded in the first half of 2022. It would not be surprising to see another mild recession in the next twelve months. If so, the current earnings estimates for the S&P 500 companies are far too optimistic. We remain defensive and would protect portfolios as much as possible early in 2023. This means emphasizing areas of the stock market with recession-proof revenue growth and predictable earnings streams such as that seen in many energy, staples, utilities, aerospace & defense stocks.

*Stock prices are as of March 31, 2023 close

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We believe the market will be rangebound for most, if not all, of 2023. This range is best seen in the Russell 2000 index between support at 1650 and resistance near 2000.

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