STRAIGHT TALK

1st Quarter 2023

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2023
Market Returns

Domestic Large
S&P 500
7.50%

Domestic Small
Russell 2000
2.74%

Intl Developed
MSCI EAFE
8.62%

Emerging Markets
MSCI EM
4.02%

Fixed Income
Bloomberg US
Aggregate Bond
2.96%

**Returns are from YCharts, with dividends reinvested, and are through 3/31/23*

Everything, everywhere, all at once. It is not just an Oscar-winning film, it perfectly describes the investment environment of the moment. Quarter after quarter it seems like we see headlines that one might assume are taken from a movie, or in some cases are even too strange for Hollywood. The first quarter of this year was no different. Who could have imagined that we would have been so captivated by some of the first clear applications of AI, Chinese spy balloons, or an old-fashioned run on the banks? These continue to be interesting times, and for every concern or moment of strangeness, we see tremendous opportunities for investors.

The year started with a bang, as markets were notably higher in January. The following two months saw more mixed trading, with a bit of a pullback in February, and then gains in March. Overall, markets have been well-behaved to start 2023 and the gains are both a welcome sight after last year's selling, and in our view, a possible sign of things to come. The S&P 500 has been largely rangebound for the better part of the last six months, something we will gladly take given the circumstances. We do eventually see the index breaking out higher, but volatility is likely to remain elevated in the near term as overall risk and uncertainty remain more prominent than usual.

The coming months will likely bring some renewed focus on a couple of key areas that we are watching. Last year's rapid rise in interest rates are now starting to be felt in the economy, and while a slowdown of some sort is very much baked into expectations, the degree of pain is far from certain. It feels as though we have been on recession watch for a year now, and every time it seems near, the economy shows its resiliency and continues to persist at higher levels. Unfortunately, nothing that happened in the first quarter cleared up that picture. Q1 GDP is likely to be fairly good (1-2% growth) and we will have to wait and see what earnings reveal in the coming months.

All is not perfect though, the collapse of Silicon Valley Bank (SVB) and the subsequent banking fears are an ongoing concern. Human nature had regulators fighting the last fight, and while credit risk is lower, interest rate risk has crept into the system. Consistently low interest rates over the last decade-plus allowed banks to pay virtually nothing on deposits while lending at historically low rates. All of that has changed. The Fed's focus is now on containing inflation, and they have raised short-term rates to near 5%. Now consumers can invest in money market funds and short-term treasuries paying near that level. However, banks have resisted increasing deposit rates in kind, mainly because they cannot afford to do so. Paying 4-5% on deposits while they have loans on their books earning the same rate, or in many cases lower, is a quick path to insolvency. Making matters worse is the fact that consumers can, with a few clicks of a button, move their money wherever they choose, and now they are rightfully choosing to move away from savings accounts and into higher-yielding instruments. As terrible as it is, in some ways the fall of SVB may prove to have some good side effects. It has alerted bank executives and regulators to rate risks, and while worries remain, the fact that the problems are known can help lead to workable solutions that prevent things from getting meaningfully worse.

Elsewhere in the ongoing saga of governmental actions, the debt ceiling fight is in full swing. While we expect a last-minute summer deal to avoid chaos, we cannot rule out some turmoil. The summer months will also likely bring a renewed focus on the war in Ukraine. After the winter lull, both sides are gearing up for fresh offensives. It is believed that Russia is planning to send upwards of 500,000 troops to the front lines in an effort to overwhelm Ukrainian defenses. Meanwhile, Ukraine continues to hold its own and is gearing up with fresh deliveries of tanks and jets from Western allies. As the weather warms and the ground hardens, the fighting in the region is likely to escalate. The brutal war will likely boil down to Russia's manpower versus Ukraine's weapons and operational advantages.

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If things are not going well for Russia, they may lash out in different ways, not the least of which would be suspending the brokered grains export deal. Russia has been allowing Ukraine to export some agriculture products, with the deal being extended every 120 days. However, the deal was recently extended for just 60 days, lining up with the spring offensive. If the remaining agriculture exports are cut off, some food prices will increase. We are also concerned about Russian oil exports. Western oil servicing firms have left Russia, and it is not clear if, and for how long, Russia can service those needs on its own. Due to sanctions, Russia has limited avenues to sell its oil, but if production starts to wane, the few countries they do sell to will have to look elsewhere. With limited excess capacity globally, oil prices would easily rise in this scenario. This is not an immediate concern, but it is perhaps an underappreciated risk in markets, and highlights why we continue to view the natural resource space constructively from an investment standpoint.

Meanwhile, China is ruffling feathers in different ways. They gifted us one very public spy balloon, which raises all kinds of questions as to what is going on there. The timing, just before US and Chinese officials were set to meet, and the seemingly surprised initial reaction leads us to believe that it was not intended to happen. While much has been made of the move away from the failed Zero Covid policy, and how the economy should rebound, this does little to solve the bigger issues. The Chinese economy is facing a future of serious structural and demographic issues. Many projections show their population declining by as much as half by the end of this century due to low birth rates, a generally aging citizenry and severe restrictions on immigration. Also, it can be argued that no country benefited from decades of globalization more than China, and now that things are moving in the opposite direction, perhaps no one stands to lose more. China is in a race against the clock. They need to advance their economy to be on par with other developed nations before demographic decline turns into stagnation. The math, however, is simply not in their favor. Although there are some opportunities both in and outside of China, we continue to be cautious towards emerging markets right now. We prefer to focus on areas where we have more visibility on the potential risks and rewards of investing.

This brings us to the other news of note in the quarter. Few things simultaneously conjure images of idealistic futures and dystopian nightmares like the idea of artificial intelligence. AI came into focus during the quarter as OpenAI's ChatGPT hit the mainstream. In basic terms, this is the next evolution in virtual assistants and the simple internet search. We can ask more complex questions, get better targeted responses, and in some cases use the technology to directly solve problems. There have been numerous stories of programmers using ChatGPT to write code for them, or students using it to write papers. In a very real-world example, we have used it at StraightLine to create complex Excel formulas which will improve several of our internal processes. This is just the beginning, as the application of AI could eventually spread across all sectors. There are of course concerns and many guardrails will need to be put in place to control things, but if we can manage to avoid the robot uprising, both the economic and investment implications are incredibly exciting.

So far this year, investors have been rewarded for holding steady, and as we continue to climb the wall of worry there may be more rewards ahead. Certainly, the long-term picture has us excited on many fronts, even as the short-term outlook might be a bit more cloudy. Right now the negatives are more clearly defined, and this is reflected in various measures of sentiment and the tremendous amount of money that has moved to cash and treasuries. There is no hotter trade than to buy T-Bills and sit back to collect your 4-5% without much worry. We have been doing the same for many of our clients, but that does not mean it is the only opportunity. Stocks remain an excellent long-term play both for growth and for protection from inflation, and in most cases should continue to be a part of any investment portfolio. Sometimes the best time to own stocks is when there are seemingly many reasons not to, and while we expect volatility to remain elevated, this past quarter has shown why you cannot time markets. In this environment you do not want to take big bets in any one area. Instead, you have to invest for the most likely outcomes, and this is something we continue to strive for across the accounts we manage. We take the trust our clients have in us very seriously, and if you have any questions, we encourage you to reach out anytime.

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