STOKES CAPITAL ADVISORS, LLC

Market Commentary
March 31, 2023

Quarterly Market Review

Global markets started the new year on a positive note with bonds and equities posting gains for Q1. A welcome reprieve from the sharp declines in both bonds and stocks last year.

The decline in bond yields and a possible end to the Federal Reserve raising interest rates were a key catalyst to the gains in equities and bonds for Q1. Indeed, the policy sensitive 2-Year Treasury yield dropped from 5.0% to 4.0% during the month of March and with Fed Funds at 5.0%, bond investors are pricing in interest rate cuts over the next two years.

In addition, the labor market remains strong, wage inflation is slowing, and the U.S. economy is not flagging recession warning signs, at least for the moment. Markets do indeed “climb a wall of worry”.

The reversal in Technology stocks during the quarter was quite surprising given the sector’s dramatic decline in 2022 and the concerns over valuations, slowing economic growth, rising interest rates and the expected decline in year over year earnings. The tech heavy NASDAQ Composite posted an impressive +17% gain for the quarter compared to the dramatic decline of over -32% for 2022.

If you take a closer look at the S&P 500 for Q1, you will find the leadership in this rally is very narrow. For example, if you strip out the top 5 stocks in the S&P 500 (AAPL, MSFT, AMZN, NVDA, TSLA) the index return for Q1 was just 1.3%.

Symbol	**Description**	**% of Net Assets**	**YTD 3.31.23**
AAPL	Apple Inc	6.6%	27.1%
MSFT	Microsoft Corp	5.6%	20.5%
AMZN	Amazon.com Inc	2.5%	23.0%
NVDA	NVIDIA Corp	1.7%	90.1%
TSLA	Tesla Inc	1.7%	68.4%
Total Performance Attribution			**6.2%**
S&P 500 Index Total Return			**7.5%**
S&P 500 Index Less Top Five Holdings			**1.3%**

Bond markets recovered during the quarter as well with the Barclays Aggregate Bond Index positing a total return of +2.9% for Q1. However, Bond investors remain in negative territory after the -13% decline in 2022, the worst on record.

Looking at commodities and currencies for the quarter, gold was the big winner. The yellow metal hit $2,000 at quarter end, just shy of the all-time high of $2,074 put in back in August of 2020. Concerns over runaway inflation and a declining US dollar were tailwinds for the precious metal.

Brent crude arrested the decline during quarter when Saudi Arabia announced a surprise production cut of more than 3.5 million bpd. Brent reached a low of $70 per barrel but finished the quarter at $80. However, demand for crude oil is expected to increase for 2023 as it has for every year on record except during the 2008-2009 financial crisis and the 2020 COVID pandemic.

Investment Strategy & Outlook

If markets climb a wall of worry, they have a wall the size of El Capitan to conquer! My conversations with clients in recent months have revealed an exhaustive (and exhausting) list of items to worry about: Possible conflict with China, collapse of the U.S. Dollar, bank failures, the looming global recession, and there is always the obligatory political target(s).

I have spent the better part of my 25-year career in this industry “talking people off the ledge”. Indeed, when I travel and asked what I do for a living I respond with “Financial Psychotherapy” and there is an awkward pause and curious look on their face until I reveal the truth.

I must say with the arrival of social media, 24-hour news, and the media constantly spewing misinformation, my job has become 100 times harder. Indeed, it has made it difficult for everyone to separate signal from noise.

Let's focus on signal, noise is for the media and for those seeking attention. The bond market signal is currently at odds with the stock market and investors should be paying close attention. First, as mentioned above the linkage between the 2-Year Treasury Yield and the Fed Funds Rate has been highly correlated throughout history. We think the Federal Reserve tightening cycle is ending and the terminal rate for Fed Funds will be around 5.0% to 5.25%. The 2-Year Treasury yield at 4.0% is suggesting the Fed will cut interest rates in the not-too-distant future as the economy slows and inflation comes down. Furthermore, the inverted yield curve, specifically the spread between the 10-year at 3.4% and 2-year notes at 4.0% remains negative which has presaged every recession going back to 1990. We think a contraction in U.S. economic growth will occur in the back half of 2023 and into Q1 2024, but the depth and duration of this recession will likely be mild given the strength in the labor market and the overall health of the consumer.

The equity market has a somewhat different view of how the next 12 months might unfold. Currently, equity investors assume only a mild contraction in economic growth and the subsequent slowdown in earnings to be shallow and short lived. In addition, the Fed cutting interest rates will serve as a turbo charger which will aid in multiple expansion and ultimately lead to higher stock prices. Essentially, equity markets are dismissing the near-term challenges and betting on a rapid return to growth and a more accommodative Fed.

Let's put some numbers behind this. We can take current analyst earnings estimates for the S&P 500 for 2023 and 2024 and arrive at simplified price targets and ranges for the next 12 months. Using an earnings multiple or PE of 18 times (the 10 year average), and 2023/2024 analyst earnings estimates of $219 and $246 respectively, we have a range of 3,942 to 4,428 for the S&P 500 (Q1 close was 4,109). Not exactly a raging bull market but not a recession either.

Unfortunately, we think earnings estimates are simply too high and must come down. We believe the bond market is a more accurate reflection of the challenges that lie ahead for the US economy over the next 12 months. Furthermore, the Federal Reserve is attempting to correct a huge policy mistake of leaving interest rates too low for too long and now has an inflation problem that will likely prove to be much more difficult to solve than markets anticipate.

We see the earnings contraction witnessed in Q4 (-5.7%) continuing into Q1 (-6.6%) and into Q2 along-side a contraction in the U.S. economy. This would likely bring earnings estimates down -5% to -10% from current analyst projections. In addition, we expect the Federal Reserve to leave interest rates elevated for an extended period as they have in prior tightening cycles which will limit multiple expansion. Taken together, we see fair value for the S&P 500 around 3,700 to 3,500 or approximately -10% to -14% lower from current levels.

Furthermore, cash yields at 4.5% and investment-grade corporate bonds now providing 5% to 6% yields are attractive alternatives to equities. These alternatives did not exist over the last decade thanks to the Federal Reserve keeping interest rates artificially low.

So, while the investment outlook looks challenging over the near-term, we do see opportunities for long-term investors. In terms of bonds, short term investment-grade corporates and US Treasury securities are attractive for income-oriented investors. As a portfolio manager this is a welcome change and nice to have this "tool back in our toolbox".

For equities, it is a question of what to own not whether you should own them. In our view companies that have a long history of growing dividends will provide investors with superior risk adjusted returns. Unlike bonds, equities have always been and will continue to be an excellent inflation hedge, a critical hurdle for all investors.

Capital Markets Scorecard

Benchmark Description	Q1	1 Year	2022
U.S. Treasury 3 Month T-Bill	1.1%	2.6%	1.5%
Barclays Aggregate Bond Index	2.9%	-4.8%	-13.0%
Bloomberg US High Yield Bond	3.6%	-3.3%	-11.2%
S&P 500 Index Total Return	7.5%	-7.7%	-18.1%
NASDAQ Composite Total Return	17.0%	-13.3%	-32.5%
NASDAQ Dividend Achievers TR	1.9%	-3.0%	-9.8%
Russell 2000 Index Total Return	2.7%	-11.6%	-20.4%
Alerian MLP Index Total Return	4.1%	14.7%	30.9%
MSCI Emerging Markets Index	3.8%	-6.2%	-15.2%
China SCI 300 Index LC	4.5%	-1.5%	-19.8%
U.K. FTSE 100 Index LC	3.5%	5.4%	4.7%
Japan Nikkei 225 Index LC	8.5%	3.1%	-7.3%