Retirement Market RECAP Q1 2023

HANYS Benefit Services

March madness for investors

After a dismal 2022 when equity and fixed income struggled simultaneously, investors were optimistic that 2023 would be more stable and recession fears would abate. However, while asset prices have gained back some of the losses seen in 2022, looming recession fears remain top of mind. Concerns over the inverted yield curve, heightened U.S./China tensions and more frequent "black swan" events continue to make investors cautious. While there is an undeniable feeling of uncertainty in the air, 2023 may shape up to be very unlike 2022.

While 2022 overall was poor for equity markets, the fourth quarter provided some much-needed relief and Q1 2023 continued that trend. January was a particularly strong month for U.S. equity markets, with the S&P 500 gaining 6.18%, capitalizing on the 7.56% gain it saw the quarter prior. However, volatility through February and March gave back some of January's gains. Through Q1 2023, the S&P 500 saw a gain of 7.50%. The NASDAQ Composite saw an even larger gain of 16.77%. The NASDAQ's "growthier" technology emphasis has proven to be a tailwind this year, with growth leading the muted rally.

Markets outside the U.S. were mixed in Q1. The MSCI EAFE Index, focusing on developed international equity, outpaced domestic equity with a gain of 8.47%. European markets in particular have been a bright spot in portfolios. Better than expected economic data with higher GDP growth, coupled with a sharp decline in natural gas prices, have allowed European markets to flourish — that's during a period for which, just a year ago, recession was a stark concern.

The outperformance has been substantial. From September 2022 to February 2023, "European market benchmarks have risen by 20 percentage points more than Wall Street — the largest outperformance seen in a four-month period in the past 30 years."[1]

Emerging markets struggled relative to other equities, gaining 3.96% in Q1. However, emerging markets may be disproportionate beneficiaries as China continues to reopen and consumer demand begins to normalize to pre-pandemic levels.

Fixed income faced a disproportionately difficult 2022 due to unexpected inflation and rapid interest rate hikes, not providing the downside protection investors had hoped. In Q1, fixed income continued to face restrained returns, measured by the Bloomberg U.S. Aggregate Bond Index, gaining 2.96%. Fixed income continues to offer negative indications of the economy's path. This was seen on March 7, as the inverted yield curve between the two-year and 10-year Treasury yield reached its deepest inversion since 1981. This inversion saw a two-year yield of 5.015% and a 10-year yield of 3.698%, a difference of -31.7 basis points.

An inverted yield curve is a state of fixed income in which shorter-dated Treasuries, such as the two-year, offer higher yields than longer-dated Treasuries, such as the 10-year. It is generally viewed as a bearish indicator for the economy, signaling that "while investors expect interest rates to rise in the near term, they believe that higher borrowing costs will eventually hurt the economy, forcing [the Federal Reserve] to later ease monetary policy."[2]

While equity markets overall saw positive gains in Q1, certain sectors have faced abnormally strong pressure. The S&P 500 Financials Sector Index saw a loss of 6.05% in Q1. Instability within the banking sector has been the focus of financial headlines, spearheaded by the collapse of Silicon Valley Bank, Signature Bank and Silvergate Capital, all within the span of five days.

While these collapses have been contained and are primarily due to idiosyncratic factors, there appears to be a renewed public fear and distrust of financial institutions. A recent survey by the *Associated Press* and NORC Center for Public Affairs Research at the University of Chicago found only 10% of respondents said they have a "great deal" of confidence in banking and financial institutions — down from the 22% who said they did in a 2020 poll.[3]

CONTINUED

[1] Anna Cooban (Feb. 1, 2023) Europe grew faster than the US last year. Its markets are outperforming too. *CNN*. https://www.cnn.com/2023/02/01/investing/euro-vs-us-stock-performance/index.html

[2] David Randall and Davide Barbuscia (March 7, 2023) Explainer: U.S. yield curve reaches deepest inversion since 1981: What is it telling us? *Reuters*. https://www.reuters.com/markets/us/several-parts-us-yield-curve-are-inverted-what-does-it-tell-us-2022-11-01

[3] Jared Gans (March 22, 2023) Following recent collapses, Americans' trust in banking industry sharply declines: poll. *The Hill*. https://www.yahoo.com/lifestyle/following-recent-collapses-americans-trust-015507936.html

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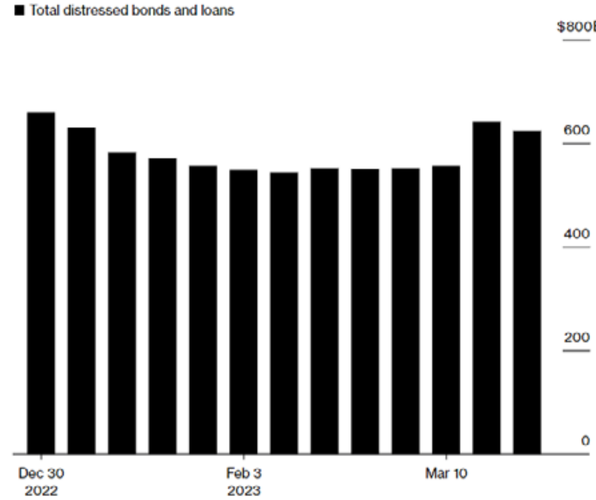
This distrust was magnified by the potential collapse of Credit Suisse, a deemed "systemically important" bank. The firm saw a substantial share price decline when Saudi National Bank, the largest investor of Credit Suisse, said it would not provide more assistance to the firm. This created a crisis, with credit default swaps skyrocketing. The firm then received a $50 billion Swiss Francs ($53.7 billion USD) loan from the Swiss National Bank to continue operations. Finally, UBS Group AG, the largest private bank in the world, purchased Credit Suisse for $3.25 billion USD in an all-stock deal pending review, effectively ending the crisis.

While the causes of these events appear to be idiosyncratic "black swan" events, rather than broader market collapses, the events have affected the financial system. In the final two weeks of March, "the amount of corporate debt in distress has shot up to $624 billion globally."[4] (See chart.)

If recessionary concerns materialize, this may lead to an even more severe uptick in the corporate default rate. The perceived distress within this sector also creates unwanted pressure for the Federal Reserve (the Fed).

As the Fed continues to weigh whether to raise rates, a new consideration has been added — the impact of rates on lenders. While the Fed did raise rates 25 basis points in line with expectations on March 22, there was a noticeably more dovish tone to Jerome Powell's comments. Whether additional banking distress will lead to looser monetary policy is yet to be seen.

The Global Distressed Debt Pile is Growing



Source: Data compiled by Bloomberg
Distressed bonds defined as those with prices below 80% of face value and yield spreads wider than 1,000 basis points. Distressed loans are those with prices below 80.

As investors move through the March Madness of the financial sector, there is an undeniable desire to return to normalized markets. After three years of COVID-19, 18 months of sticky inflation, 13 months of geopolitical tension and 12 months of interest rate hikes, investors are becoming increasingly weary of headlines and looking forward to turning the corner. With the end of the federal rate-hiking cycle potentially in sight, investors may get their wish in 2023.

[4] Amelia Pollard (March 28, 0223) After SVB and Credit Suisse, a $624 Billion Pile of Distress. Bloomberg. https://www.bloomberg.com/news/newsletters/2023-03-28/svb-credit-suisse-crises-trigger-distressed-debt-increase

EQUITY AND RETIREMENT INDICES	3 MO	1 YR	3 YR	5 YR	10 YR
S&P 500 TR USD	7.50%	-7.73%	18.60%	11.19%	12.24%
Russell 3000 TR USD (Broad Market)	7.18%	-8.58%	18.48%	10.45%	11.73%
Russell 1000 TR USD (Large Cap)	7.24%	-19.13%	7.35%	9.13%	12.37%
Russell Midcap TR USD	4.06%	-8.78%	19.20%	8.05%	10.05%
Russell 2000 TR USD (Small Cap)	2.74%	-11.61%	17.51%	4.71%	8.04%
MSCI EAFE NR USD (Int'l Equity)	8.47%	-1.38%	12.99%	3.52%	5.00%
MSCI Emerging Markets NR USD (E.M. Equity)	3.96%	-10.70%	7.83%	-0.91%	2.00%
S&P United States REIT TR USD (Real Estate)	2.72%	-19.08%	12.03%	6.03%	5.83%
Morningstar Lifetime Mod. TR 2020	4.32%	-7.95%	6.03%	4.07%	5.09%
Morningstar Lifetime Mod. TR 2040	5.31%	-7.81%	12.51%	5.62%	7.31%

FIXED INCOME INDICES	3 MO	1 YR	3 YR	5 YR	10 YR
ICE BofA 3M US Trsy Note TR USD	1.14%	2.60%	0.93%	1.47%	0.90%
ICE BofA 1-3YR US Trsy TR USD	1.55%	0.20%	-0.81%	1.11%	0.81%
BBgBarclays Long Term US Trsy TR USD	6.17%	-16.00%	-11.33%	-0.35%	1.45%
BBgBarclays US Aggregate Bond TR USD	2.96%	-4.78%	-2.77%	0.91%	1.36%
BBgBarclays US Treasury US TIPS TR USD	2.19%	-0.32%	3.47%	2.97%	1.55%
BBgBarclays High Yield Corp TR USD	3.57%	-3.34%	5.91%	3.21%	4.10%
BBgBarclays Global Aggregate TR USD (Global Bond)	3.01%	-8.07%	-3.43%	-1.34%	0.07%

ICE BofAML – Intercontinental Exchange Bank of America Merrill Lynch; BBgBarc – Bloomberg Barclays; S&P 500 – Standard & Poors; MSCI – Morgan Stanley Capital International
Sources: Morningstar as of March 31, 2023

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