



ECONOMIC NEWSLETTER

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QUARTERLY ECONOMIC UPDATE



Bearish Outlook In Spite of Market Resilience

While the S&P 500 ended the first quarter of 2023 with solid gains, its counterpart the Dow Jones Industrial Average was little more than flat.

The markets were, and still are, hoping for an economic soft landing and for the Fed to signal that their historic rate hike campaign is coming to an end.

For now these hopes, whether realistic or not, helped to offset two rate increases and the biggest bank failures since the financial crisis of 2008.

Markets started 2023 with gains in January, which were primarily driven by a continued decline in widely followed inflation indicators.

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That decline in price pressures was coupled with resilient numbers in the labor market. These forces combined to increase investors' hopes that the Fed could deliver an economic soft landing, whereby the economy slows but avoids a painful recession, while inflation moves close to the Fed's target.

On the other hand, the idea of a soft landing was looked at with some skepticism by a number of investors considering corporate earnings declined in the fourth quarter by a negative 4.6%.

This is the first time the index has reported a year over year decline since quarter three of 2020, during the COVID lockdown.

What also concerns a number of analysts, as well as investors, is the estimate by Factset of a -6.6% earnings decline for the first quarter of 2023. If this occurs it will be the worst decline in earnings, other than the COVID year, since the great recession of 2008.

In February, growing optimism for an economic soft landing was delivered a setback, as economic data implied a still very tight labor market while the decline in inflation stalled. The January jobs report, released in early February, showed a massive gain in jobs, implying that the labor market will remain extremely tight (something the Fed believes is contributing to inflation). Later in the month, widely followed inflation metrics such as CPI and the Core PCE Price Index showed minimal further price declines, implying that the drop in inflation that had powered the gains in stocks was ending.

The strong economic data and a leveling off of inflation metrics led investors to price in substantially higher interest rates in the coming months, and that weighed on both stocks and bonds in February. The S&P 500 finished with a modest loss on the month, falling just over 2%.



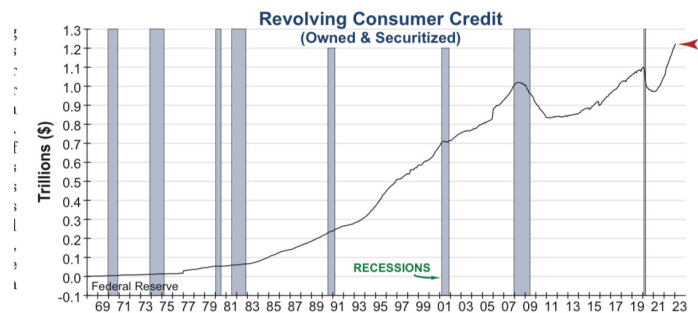
The final month of the first quarter began with investors still focused on inflation and potential interest rate hikes, but the sudden failure of Silicon Valley Bank, at the time the 16th largest bank in the United States, shifted investor focus to a potentially growing banking crisis. Signature Bank of New York failed just days later, and concerns about a regional banking crisis surged.



In response, the Federal Reserve and the Treasury Department created new lending programs aimed at shoring up regional banks and preventing bank runs, but concerns about the health of the financial system persisted and those fears weighed on markets through the middle of March.

However, while the Federal Reserve hiked interest rates again at the March meeting, policy makers hinted that they may be close to ending the current rate hike campaign. That hope, combined with no additional large bank failures, eased concerns about a growing banking crisis, and the S&P 500 was able to rally during the final two weeks of March to finish the month with a small gain.

In sum, markets were surprisingly resilient in the first quarter in light of inflation that while declining, is still well above the Fed's 2% target, a looming recession, regional bank failures that still may not be out of the woods yet, and revolving consumer credit at an all time high.



First Quarter Performance Review

The first quarter of 2023 saw the Nasdaq (which badly underperformed in 2022) handily outperformed in the first quarter and finished with impressive returns. That outperformance was driven by a decline in bond yields (which makes growth-oriented tech and consumer companies more attractive to investors) and as mega-cap tech companies such as Apple, Alphabet, Amazon and others were viewed as "safe havens" amidst the late-quarter banking stress.

The S&P 500, with its heavy weighting to tech, finished the quarter with a solidly positive return while the Dow Industrials and Russell 2000 logged very modest, but still positive returns through the first three months of the year.

By market capitalization, large caps outperformed small caps, as they did throughout 2022. Concerns about funding sources, should the banking crisis worsen, and higher interest rates weighed on small caps as smaller companies are historically more dependent on financing to maintain operations and fuel growth.

From an investment style standpoint, growth outperformed value which is a sharp reversal from 2022. Tech-heavy growth funds benefited from the aforementioned decline in bond yields and a late-quarter "flight to safety" amidst the regional banking crisis.

Value funds, which have larger weightings towards financials, were weighed down by concerns about a potential broader banking crisis.

Internationally, foreign markets largely traded in line with the S&P 500 in the first quarter and realized positive returns. Foreign developed markets outperformed the S&P 500 through the first three months of the year as economic data in Europe was better than expected and European banks were viewed as mostly insulated from the U.S. regional bank crisis. Emerging markets logged slightly positive returns through March but underperformed the S&P 500 thanks to still-elevated geopolitical stress, as U.S.-China tensions rose following the Chinese spy balloon affair.

Switching to fixed income markets, the leading benchmark for bonds (Bloomberg Barclays US Aggregate Bond Index) realized a positive return for the first quarter of 2023, after experiencing the worst return ever in 2022. Although bonds were volatile to start the year. The Fed signaling a possible end to rate hikes combined with concerns that the regional banking crisis would raise the odds of a recession, caused bond prices to make modest gains in the first quarter.

Looking deeper into the fixed income markets, longer-duration bonds outperformed those with shorter durations in the first quarter, as bond investors welcomed further declines in inflation and reached for long-term yield amidst an uncertain outlook for future economic growth.

Turning to the corporate bond market, higher-quality investment grade bonds and higher-yielding, "junk" rated corporate debt registered similarly positive returns in the first quarter. Investors moved to both types of corporate debt following declines in inflation and as corporate earnings results were largely better than feared.

The True Indicator of Banking Stress

Markets began the new quarter facing multiple sources of uncertainty including the path of inflation, future economic growth, the number of remaining Fed rate hikes, and whether the regional banking crisis is truly contained.

Starting with the regional bank crisis there are currently two loan programs from the Fed that are specifically designed to help regional banks that are experiencing liquidity issues. The first is the Fed discount window, where banks can pledge U.S. Treasuries to access liquidity. It's been around for a long time, although it's likely very few people have paid attention to it since the financial crisis of '08 (when all of us were paying attention to it!).

The second program is new, the Bank Term Funding Program, which the Fed just created to alleviate the liquidity issues that brought down Silicon Valley Bank.

Think of these two programs as "bridge loans" the Fed extends to banks who need cash.

These are not facilities that banks use regularly, and just like a company (or person) needs a bridge loan to "stay afloat," there's stigma in the banking industry attached to using these facilities. Put simply, if a bank is using them, it's a sign they are in trouble, which can make the problem substantially worse.

How much these two facilities are used is updated once a week – and we literally can see how many banks are using both of these programs, and just like any emergency loan program, the higher the usage, the worse the problem! So how bad is it?

- Since the start of March, the usage of the Fed's discount window has spiked from about \$4 billion (prior to the crisis) to \$110 billion by the end of March.
- Since the creation of the "Bank Term Funding Program", use has surged from \$0 (because it didn't exist) to \$12 billion in early March, to \$53 billion by the end of March.

Between the two programs the Fed has had to lend \$160 billion in emergency loans to banks so far through the end of March. And that \$160 billion dwarfs what was needed during the pandemic, and actually equals what was needed in 2008 during the financial crisis!

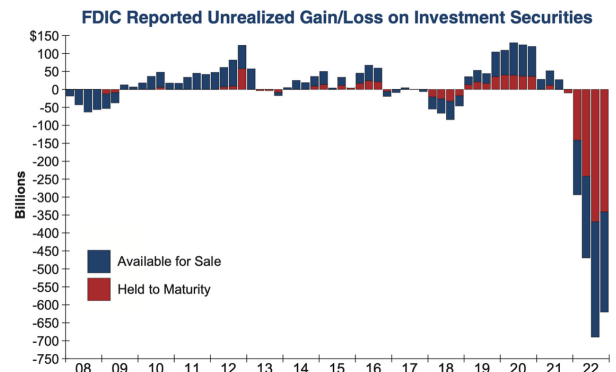
Bottom line, as the old saying goes, "Put your money where your mouth is." So far, banks' money, and their mouths, are telling us that the regional bank crisis is not over, and if anything may be getting worse under the surface.

Bank Losses

In fact, the recent bank failures have us thinking about lurking icebergs. The unrealized gains and losses on investment securities at banks (graph below) shows the striking increase in unrealized losses in 2022 when interest rates soared.

Specifically, in the case of Silicon Valley Bank (SVB), the bank invested their deposits in longer-term securities that were inevitably tied to interest rates. The combination of large client withdrawals and substantial unrealized losses in investment securities proved to be too much and the bank was seized by regulators.

SVB is not the only bank in this situation, and similar less-capitalized institutions could be at risk. While the failure of a bank is a disturbing development, the Federal Reserve Board has agreed to make additional funding available to eligible depository institutions to help assure banks have the ability to meet the needs of all their depositors, even those that are uninsured. This should reduce the risk of additional "bank runs," but longer-term risks still remain, and we can't help but wonder how big these icebergs are beneath the water's surface.

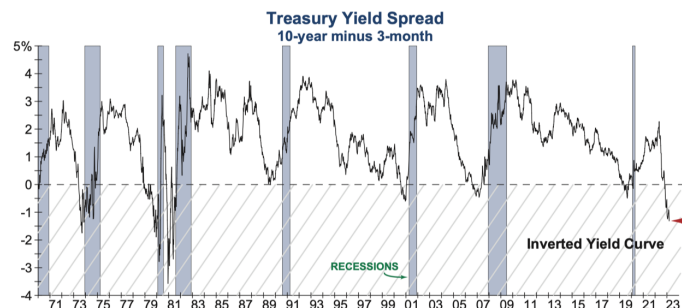


Also, remember even if banks are not failing, the fact they are in trouble means it will be harder for those banks to provide loans to businesses and consumers; meaning an even bigger slowdown/recession is likely.

The Treasury Yield Spread

The problems surrounding less capitalized banks are compounded by the recession risk that is reflected in the Treasury Yield Spread. Traditionally, the yield spread measures the difference between 10-year and 3-month Treasuries and is the most classic of monetary warning flags. In the past, when the spread has dropped to the current level, well below zero, it has always led to a recession.

This degree of inversion is very reminiscent of the inflationary late 1970s, and this indicator has its recession warning sirens on high alert. The yield spread is also the primary component of the Fed's recession probability model, which currently shows a 54.5% chance of recession in the next twelve months.



Inflation

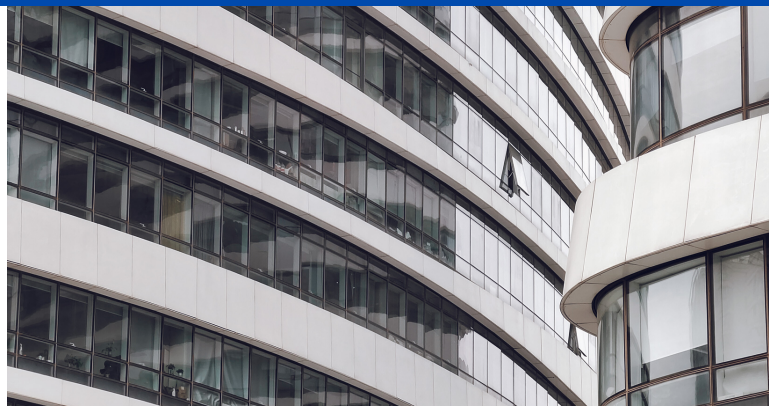
Looking past the regional bank crisis, headline inflation moderated in March, coming in below consensus expectations and pushing the twelve-month comparison down a full percentage point to 5.0%. However, a look at the details of the report show inflation was more of a problem than the headline suggests.

Overall consumer prices were held down by the energy sector, which decreased 3.5% in March. Stripping out energy and its other often volatile counterpart – food prices (unchanged in March) – “core” prices rose 0.4%, matching consensus expectations, and pushing the twelve-month comparison up to 5.6% from 5.5% in February. The main driver within the core categories was once again housing rents, which rose 0.5% in March,

We expect rents to continue to generate high inflation for some time as they catch up to home prices, which skyrocketed in 2020–21. Meanwhile, a subset category of inflation that the Fed is watching closely – known as the “Super Core” – which excludes food, energy, other goods, and housing rents, continued to rise at an outsized clip, increasing 0.4% in March. This measure is up at a 5.2% annualized rate in the first quarter of 2023. Unfortunately for the Fed, even after stripping out nearly every category they’ve blamed this high inflation on, it does nothing to improve the picture. Putting this altogether, inflation is still a problem in the US economy. Expect Powell and Co. to keep monetary policy tight in the months to come.

Office Building Crisis

After the banking crisis, could the next domino be all those empty office buildings in your downtown?



This sector has been hit hard for years now with the shift to remote work bringing about rising vacancy rates and falling property values. Lisa Shalett, the chief investment officer for Morgan Stanley Wealth Management, sees a “huge hurdle” ahead. And she had some frightening figures.

“More than 50% of the \$2.9 trillion in commercial mortgages will need to be renegotiated in the next 24 months when new lending rates are likely to be up by 350 to 450 basis points.”

Alarmingly, Shalett notes that regional banks accounted for 70% to 80% of all new loan originations in the past cycle, with all eyes already on the sector after the historic implosions of Silicon Valley Bank and Signature Bank last month. And she now sees a wipeout with vacancy rates close to a 20-year high: “MS & Co. analysts forecast a peak-to-trough CRE price decline of as much as 40%, worse than in the Great Financial Crisis.”

Tighter lending standards for the commercial real estate market are also now likely. In fact, stricter lending standards were already in place with the Federal Reserve raising interest rates in its attempt to lower inflation, and the banking crisis will only exacerbate the existing lack of liquidity. That in turn will increase the risk of defaults, distress, and delinquencies, as the CRE industry is largely built on debt.

Distress on this scale, Shalett says, will hurt landlords and the bankers who lend to them, trickling down to business communities, private capital funders, and owners of underlying securities.

And what of the wider impact on the economy? The odds of a soft landing are decreasing in light of these coming problems in CRE.

Money Supply Contraction

According to Brian Wesbury, Chief Economist of First Trust, an even greater threat to stocks than earnings declines is the money supply now down –2.47% year over year. That’s the largest 12 month decline on record with data going back to 1959.

The economy is still absorbing and responding to the 40% surge in the M2 measure of the money supply during COVID. Think of that enormous surge in the money supply as installing a furnace built for a 10,000 square foot mansion into a home that’s only 2,000 square feet, and then running it full blast.

Even when you have finally turned the furnace off – like the Federal Reserve did with the money supply in the past year, with the largest drop since the Great Depression – that 2,000 square foot home doesn't immediately get cold. It takes time for the home to gradually cool off and eventually get cold. Given the drop in the money supply, we are headed for a much colder economy; we're just not there yet.

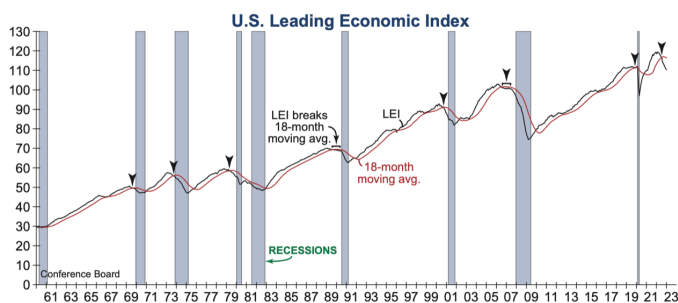
And when the US economy cools off, we expect profits, which were artificially boosted by easy money and government handouts to fall. At present, the stock market seems priced for both multiple expansion (the price-to-earnings ratio moving up) as well as higher profits. This is unlikely. The Fed and federal banking regulators have ring-fenced the banking system to prevent losses for depositors. In turn, because the Fed feels like rate hikes won't break things, future rate hikes will likely exceed current expectations and long-term interest rates will move higher too.

The sudden decline in the M2 measure of money will likely hit the economy soon...and just like so many times in history, the drop in activity will take many businesses and investors by surprise. That means more layoffs, lower profits, and lower stock prices.

The Slowing LEI Index

Another important and historically reliable overall leading indicator is the Conference Board's Leading Economic Index (LEI). Currently, this is one of the strongest signs that the US is already in a recession. Almost every time the LEI has crossed below its 18-month moving-average, a recession has followed (except in 1995).

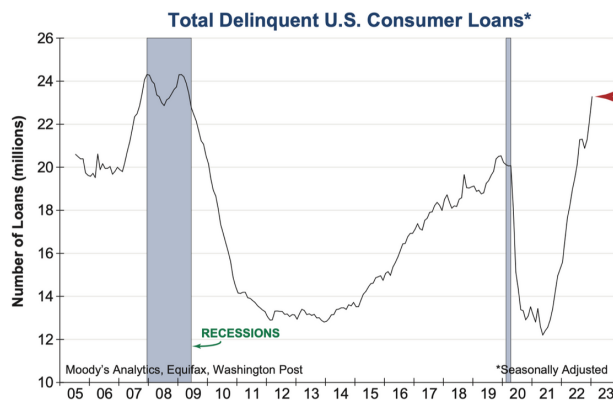
Never in history has this indicator declined so rapidly and drastically outside of a recession. The steepness of this drop is almost unprecedented – the only times the LEI has plummeted in a similar manner were during the 2008 Financial Crisis and the COVID shutdowns in 2020.



Delinquent Consumer Loans

Many market pundits and economists have argued throughout this bear market that the strength of the U.S. consumer will help pave the way for a soft landing. While consumers have been remarkably resilient in the face of 40-year high inflation, we are concerned that the U.S. economy could soon lose this stronghold.

As shown in the graph on the top right, over 23 million consumer loans are now delinquent, the highest amount since 2009 and almost 50% more than were delinquent a year ago! With excess savings dwindling and inflation still outpacing wage growth, we are concerned that consumer spending could soon collapse and drag the economy into recession.



Wall Street Forecasts

Of course, this year one might find comfort in the many Wall Street forecasts of "no or mild recession" and stable-to-higher stock prices. It appears to be a "can't lose" scenario for investors...

That is until one steps back to 2008 at the start of the Great Financial Crisis. Shown in the following chart is a table of forecasts published in Business Week in January of that year. All but two were forecasting nice gains in the market (mostly double-digit) and only two expected mild single-digit losses. Of course, 2008 turned out to be the worst loss since 1937 with the S&P 500 losing -38% on its way to even bigger losses before the eventual March 2009 bottom.

Business Week 2008 Forecasts	
Firm	S&P 500
Garzarelli Capital (Elaine Garzarelli)	1,780
Birinyi Associates (Laszlo Birinyi)	1,700
Schaeffer's (Bernie Schaeffer)	1,700
UBS (David Bianco)	1,700
Strategas (Jason Trennert)	1,680
Citigroup (Tobias Levkovich)	1,675
BNY Mellon (Leo Grohowski)	1,675
Banc of America (Thomas McManus)	1,625
AG Edwards (Stuart Freeman)	1,575
NY Institute of Finance (Ralph Acampora)	1,530
UMB Financial (William Greiner)	1,520
GMO (Ben Inker)	1,440
Research Affiliates (Robert Arnott)	1,350
Average: 1,612	
2007 Year-end Value: 1,468	
Forecast Return for 2008: 9.2%	

Conclusion

Ering on the side of caution (yes, that IS a strategy!), we've remained skeptical of this market's post-October bounce as we've waited for additional evidence to develop.

Currently, that evidence is mostly developing to the negative side, with an increasing probability of a prolonged bear market ahead. We continue to advise patience and a watchful eye as Wall Street attempts to navigate these iceberg-laden waters...

IT'S NOT TOO LATE TO JOIN OUR CLIENT AMBASSADOR PROGRAM

Thank you to those who have already joined our new Client Ambassador Program, but if you haven't yet, it's not too late to be a part! Here's how it works:

To become a member all you need to do is refer us to a friend, colleague or family member who might qualify for our Gold Medal Services.

To thank and celebrate those clients who are awarded Client Ambassador status because they have encouraged others to let Piershale Financial help in their financial goals, we will host a special, one-of-a-kind event to celebrate and appreciate your partnership in helping Piershale Financial grow our firm!

To participate, scan the code to the right or call Noeleen Neubauer at 847-713-8070.



TEAM MEMBER SPOTLIGHT: MATT & TRISH NADEAU



Trish has been an integral part of the team for over 11 years now. She is currently the office manager and a strategic and supportive partner for each of our clients. Her focus is on helping clients every step of the way. She successfully provides a positive customer experience and creates long-term positive working relationships. Trish has also earned the FPQP designation, requiring a rigorous examination that covers all aspects of financial planning, from securities analysis to retirement planning. Prior to her current position Trish spent seven years as the Marketing Coordinator.

Matt is a Wealth Advisor at Piershale Financial Group and has been with the company 15 years.

He has experience overseeing dynamic portfolio management for a variety of investors. Matt prepares and develops in-depth trading strategies and provides investment insight. He regularly works with pre-retirees and retirees to create and implement in-depth retirement plans, including Social Security and income planning. Matt has been called upon by national media outlets for his insight. Also, he has completed the rigorous process to earn the Chartered Financial Analyst designation which is designed to demonstrate a strong foundation in advanced investment analysis and portfolio management, accompanied with a strict emphasis in ethical practice.

Trish and Matt not only have found a rewarding career with Piershale Financial, they also met each other while working here too. They now live in Geneva, each with 2 kids and a total of 4 grandkids.



THE MONEY HOUR RADIO

Tune in and listen to the Piershale Financial team each week on The Money Hour Radio where they give sound insights on the markets, retirement, investing and more. Catch them on the stations and times below or wherever you listen to podcasts.



Saturdays 3-4 PM



Sundays 10-11 AM



ANIMALS ARE GOOD FOR THE SOUL! MEET OUR FAVORITE FURRY FRIENDS



Mike:
Rufus (right) & Simon (left)
Rufus is the cool big brother & Simon
is the mischievous, younger sibling.



Ben:
Cassius Clay the Boxer
He's very sweet & energetic. He likes
to play fetch & find the treats



Eric:
Daisy (right) & Chloe (left)
Chloe goes to school. She knows sit,
stay, shake, down, and "watch me"



Noeleen:
Durban the Doodle
He is named after Noeleen's
hometown in South Africa



Laureen:
Guinness the Labrador
He loves hiking & fetching, but also
enjoys relaxing in the family pool



Deirdre:
Marley the Golden Retriever
She loves to dress up for our tradition
of chopping down a Christmas tree

WHAT'S COMING UP

Client Appreciation Event – June 9 at 6PM



You're invited to join at Concorde Banquets, June 9th at 6PM for our annual appreciation dinner. This year will feature music from The Four C Notes the Midwest's ONLY tribute dedicated to recreating the music of Frankie Valli and The Four Seasons. Call Noeleen at 847-713-8070 to RSVP.



- May 29th – Office Closed
- June 19th – Office Closed