May
2023

FORGE
PRIVATE WEALTH

Portfolio Blueprint

Monthly Talking Points

Macro View

April continued the themes of 2023, which have been puzzling to both retail and professional investors. If one were just looking at the month-end market returns, the conclusion might be that we are in a period of solid economic growth, with interest rates falling, consumers spending at a solid rate, and corporate profits growing. In reality, economic indicators are telling us that, although the consumer is in fact spending, interest rates are probably not finished rising, corporate profits are slowing, and consensus earnings estimates seem too high. In addition to these issues, we could be close to the most anticipated recession of our careers.

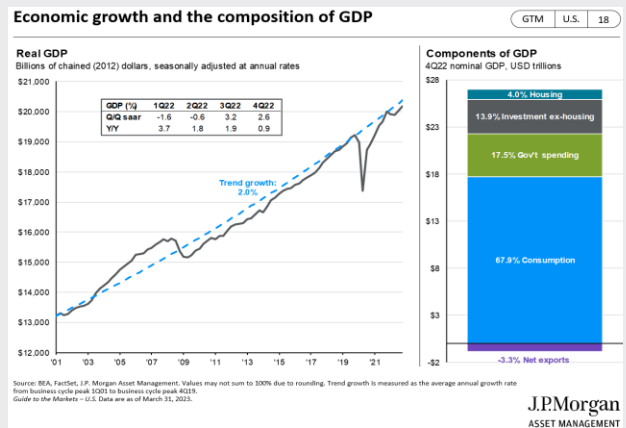

Chart Source: https://am.jpmorgan.com/us/en/asset-management/adv/insights/market-insights/guide-to-the-markets/economic-and-market-update/

For risk control reasons and as fiduciaries, we are always looking at worst-case scenarios. Our capitalist system, which has created unprecedented wealth and prosperity, does contain some drawbacks, of which cyclicality is one that emerges from time to time. Economies and markets both expand and contract, flushing out the inefficiencies when they appear and building businesses back up in times of expansion.

The National Bureau of Economic Research (NBER) defines a recession as "… a significant decline in economic activity spread across the economy, lasting more than a few months…"[1] This definition is not always directly relevant when it comes to investing, as economic slowdowns and contractions take many forms. We do know what the components of GDP are, and which of these are likely to lead both in times of recession and expansion. The chart below deconstructs the main inputs to economic growth, with the right side clearly showing that the largest component is consumer spending. A conclusion one could draw from this is that as goes the U.S. consumer, so goes the economy.

[1] http://www.nber.org/cycles/recessions.html

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Two things will drive the consumer: how much they are consuming and how willing they are to continue consuming. How much they are consuming is measurable through personal consumption data published by the Bureau of Labor Statistics. As of April of 2023, consumers continue to spend at a solid rate (see chart below).

However, spending is funded by reducing savings and income or by paying down balances on credit cards. As the chart shows, the use of credit cards to fund spending has risen post-pandemic.

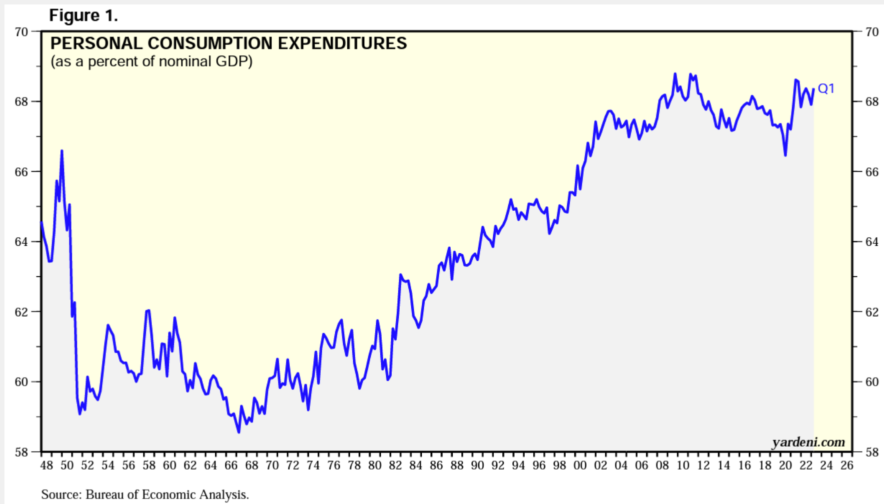

Chart Source: https://www.yardenibook.com/pub/ptmcctchap6conshouse.pdf

The second factor depends on sentiment, which is also measurable. Consumers, if they are confident, will be employed indefinitely and are more willing to make larger, more sporadic purchases. One way to measure the prospects of labor is the Jobs Opening and Labor Turnover Survey (JOLTS), which gives us an idea of employee-induced turnover. Generally, people do not quit their jobs unless they have better prospects. When the survey numbers are high, labor is generally thought as in a shortage status. As can be seen, going back to 1973, the survey numbers have been extremely high.

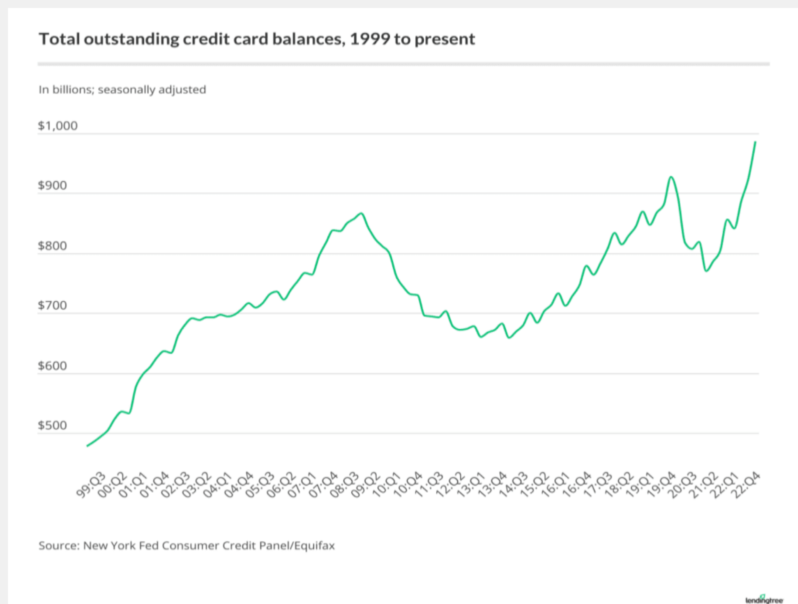

Chart Source: https://www.lendingtree.com/credit-cards/credit-card-debt-statistics/

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In the macro lens, Ashton Thomas does believe there is an above-average probability an official recession occurs within the next twelve months. However, given the propensity of consumers to spend and their prospects for employment, it is our opinion that, if and when a recession transpires, it will be shallow and relatively short.

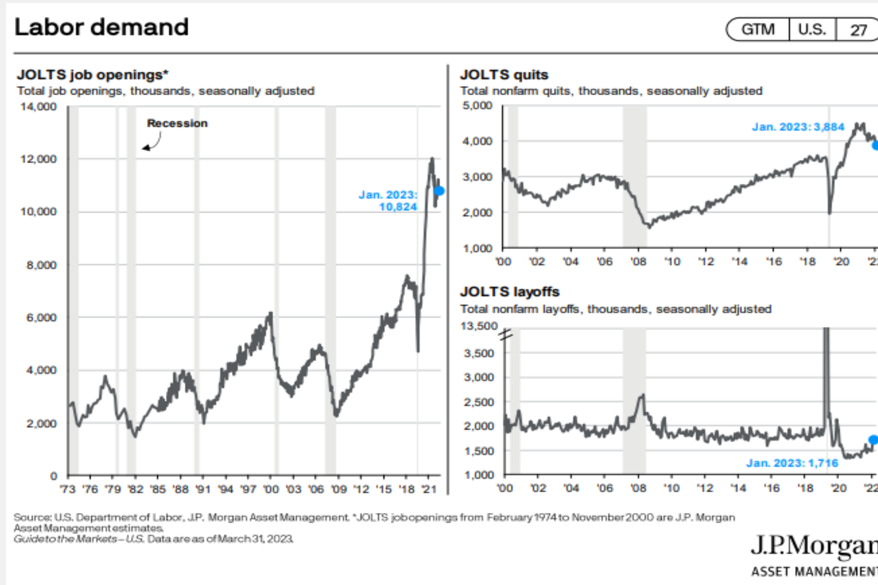

Chart Source: https://am.jpmorgan.com/us/en/asset-management/adv/insights/market-insights/guide-to-the-markets/

Equity Comments

Our macro comments cited the strength in U.S. markets and how just focusing on returns could make an observer conclude this may be a strong environment for stocks. At the risk of dousing enthusiasm, we need to bring readers back to reality. While some might consider the rally of 2023 the beginnings of a new bull market, we believe the U.S. stock market may have gotten ahead of itself to date. Certainly, investor sentiment is much higher than it had been at this time last year. But do U.S. equities warrant the valuations at which they are presently priced?

At this time, we are holding most equity positions at or slightly below target weightings. Interest rates are not rising as quickly and to the extent we have encountered previously and, presently, earnings are at somewhat of a standstill. Over market cycles, sentiment is certainly important, but earnings and interest rates are the foundation for stock prices.

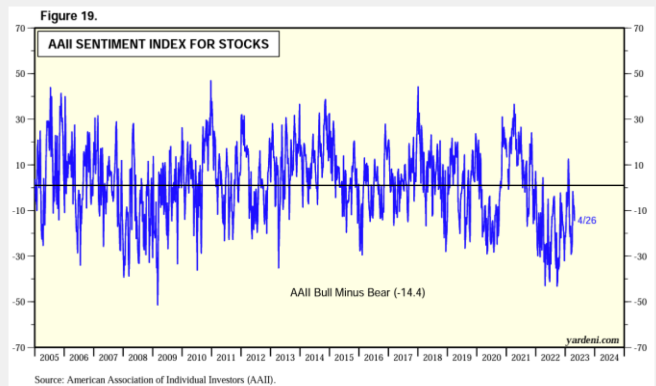

Chart Source: https://www.yardeni.com/pub/stmktbullbear.pdf

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We believe interest rates appear to be peaking at some point in 2023, at which point the focus will shift to corporate earnings. In the chart below, we can see that trailing 12-month earnings, as denoted by the yellow line, are in fact falling, telling us that reported earnings are coming down. The question is, are interest rates going to fall enough to support stock prices in a falling earnings environment? Our opinion is that, although perhaps earnings will recover in late 2023 or early 2024, we are likely to see some volatility throughout 2023.

Looking at volatility in past market cycles, we know now is the time to communicate with clients on the art of rebalancing. Rebalancing is one of the most important value-propositions an advisor can offer. This concept is somewhat contrarian: throughout volatile times, selling asset classes "on the margin" which have outperformed and are overvalued, while buying those which are underperforming and might be deemed undervalued, can lead to more favorable results over time. The exercise is sometimes difficult to do, as it goes against human emotions and the movement of crowds. Looking at the chart, we demonstrate potential the value of rebalancing.

Let's consider a scenario where an investor started in 1990 with only two asset classes (for sake of simplicity) and had two strategies. One strategy would be just to buy a portfolio of 60% stocks and 40% bonds and leave it untouched, only measuring growth as of the end of 2020. The other strategy would be to rebalance the same portfolio at the end of *each* year, putting the mix back to the original 60% stock/40% bond mix by selling the outperforming asset class and putting the proceeds into the underperforming asset class. In this simple two-asset class portfolio, the conclusion is the strategy which rebalanced annually had similar returns, less standard deviation, and a higher Sharpe ratio (measure of a risk adjusted return) due to rebalancing. Just as important, we should also note the actively managed, rebalanced portfolio exhibited lower risk (standard deviation) than the static portfolio.

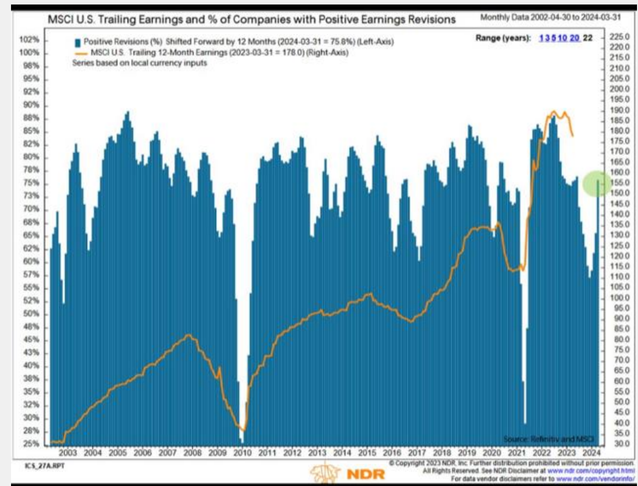

Chart Source: NDR Approval Email

Index	Month-to-Date	Year-to-Date
S&P 500	1.56%	9.17%
NASDAQ	0.52%	21.40%
Russell 2000	-1.86%	0.44%
Russell 1000 Growth	0.99%	15.49%
Russell 1000 Value	1.51%	2.53%
S&P 600 Small Cap	-2.78%	-0.28%
EAFE (USD)	-2.82%	11.53%
Bloomberg Agg. Bond	0.61%	3.59%
DJIATR	2.57%	3.53%

Chart Source: Bloomberg LP (via subscription)

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Our conclusion for the equity markets is that, in the medium-term, we believe earnings fluctuations and increased interest rate unpredictability will *not* be enough to smoothly buoy stock prices to higher levels until earnings recover. However, in this time of volatility, investors should be rebalancing into volatility in order to add value and decrease portfolio risk over the market cycle.

Rebalancing frequency	Weighting as of 12/31/2022	Jan. 1990 – Dec. 2022 return (%)	Jan. 1990 – Dec. 2022 standard deviation (%)	Jan. 1990 – Dec. 2022 Sharpe ratio
Annual rebalancing	60% S&P 500 Index 40% Bloomberg U.S. Aggregate Bond Index	8.27	9.23	0.62
No rebalancing	86% S&P 500 Index 14% Bloomberg U.S. Aggregate Bond Index	8.55	10.96	0.57

Sources: © 2023 Morningstar Direct[1] and Wells Fargo Investment Institute. Monthly data from January 1, 1990, to December 31, 2022. ***Index return information is provided for illustrative purposes only***. Index returns do not represent investment performance or the results of actual trading. Index returns reflect general market results; assume the reinvestment of dividends and other distributions; and generally do not reflect deductions for fees, expenses, or taxes applicable to an actual investment. The S&P 500 Index is a market-capitalization-weighted index composed of 500 stocks generally considered representative of the U.S. stock market. The Bloomberg U.S. Aggregate Bond Index is a broad-based index that measures the investment-grade, U.S.-dollar-denominated, fixed-rate taxable bond market. An index is unmanaged and not available for direct investment. **Past performance does not guarantee future results.**

Sector Allocation

Our present views which are unchanged from the last month, with the exception of commercial real estate, which moves from overweight to underweight:

Overweight

Energy – We see this as the most "controversial" of all sector recommendations, as higher capital expenditure and weaker global growth have caused the sector to underperform YTD. We have taken profits, but believe that all of the factors—such as earnings, free cash flow, and attractive valuations—are still present. This is a sector which historically has shown high volatility and needs to be actively managed.

Consumer Staples – This sector has historically offered attractive performance in slow to recessionary environments and tends to do well at "peak inflation."

Healthcare – Demographics are positive and favor this sector, and it also has "defensive" characteristics.

Materials – The reversal of "Zero COVID" policies has increased demand for commodities. We believe industrial demand, especially driven by green initiatives, is promising, as many of the inputs needed are materials based.

Neutral weight

Industrials – The rise of the U.S. dollar is generally negative for this sector, as a high percentage of sales are abroad. However, the trend is reversing. There may also be additional margin erosion.

Utilities – Somewhat of a "bond substitute," the sector is looking more attractive now that rates may have peaked.

Underweight:

Technology – Less than average and even falling revenue growth is presently forecasted. Although the sector has done well year-to-date, it is tough to justify when looking at the fundamentals and high valuations.

Communications – As with technology, price recovery is more liquidity-driven than fundamentals-driven. We expect social media will come under additional government scrutiny.

Discretionary – The pandemic induced more online shopping. Wage gains are hurting margins.

Financials – We recently sold off all small banks. Current holdings are focused on large banks and non-lending entities. Too much uncertainty remains, although select companies will emerge unscathed and could be rewarded in exceptional stock performance.

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Real Estate – We believe this sector demands the most discerning judgement. Commercial (office buildings) still have too many questions to answer about repurposing and how they will meet debt service. Significant financing risk remains, as most real estate is financed by small banks.

Fixed Income - Monthly

The month of April saw continued volatility in the fixed income markets. Much of the action in fixed income was dominated by economic news and headline news regarding regional banks and their stability, as well as inflation and economic growth.

Inflation worries seemed to subside a bit, as both the Consumer Price Index (CPI) and Producer Price Index (PPI) printed below expectations. Although both figures showed inflation sliding back, it was not enough to convince the fixed income market that at least another 25 basis-point rate hike could be avoided, and the market began to slowly price in that possibility.

With additional data coming in showing slight inflationary pressures in the manufacturing and services sector later in the month, the Fed was provided all the ammo needed to raise rates in May without surprising the markets. As a result, rate hike odds began to increase, topping out at over 90% by the end of the month: in other words, the market expects 25 basis points in May. It's safe to say the statement from the Federal Open Market Committee (FOMC), along with Chairman Powell's corresponding Q&A, will be the most closely watched of 2023 so far.

Most interestingly, the GDP data released in April began to point to the very real possibility of Stagflation (which is simply defined as persistently high inflation coupled with low growth). We believe Stagflation would put the Fed between a rock and a hard place, so to speak. If they continue to raise rates to battle inflation, especially since the "sticky" components such as wages, rents, and services are starting to contribute more and more to each CPI reading, they run the risk of causing a potentially severe recession. If the Fed pauses or even cuts rates, they run the risk of inflation printing higher, thereby eventually forcing future rate hikes, but reviving the economy out of recession. We believe this is exactly where the Fed and Chairman Powell did *not* want to find themselves.

Let's end by focusing on the continuing drama in the small and mid-sized regional banking sector. The end of April saw First Republic being shut down and taken over by the Federal Deposit Insurance Corporation (FDIC) and, by the end of the weekend, sold to JP Morgan Chase, with the FDIC absorbing the most toxic of the bank's assets.[1] This is the third regional bank failure so far, with Silicon Valley Bank and Signature Bank being the first two, and it may not be the last. As many banks have reported earnings so far, most are also reporting tremendous outflows of deposits to either large national banks (think JP Morgan Chase, Bank of America, and Wells Fargo) or to money market funds, which are essentially short-term Treasury proxies. In addition, almost all have tightened lending standards to levels not seen since the Great Financial Crisis of 2008-2009. This has had the effect of slowing money supply growth (fewer loans) and forcing borrowers to move toward private lenders, typically paying higher rates for the same loan. From a fixed income perspective, we are watching bonds with lower ratings to see the impact on credit ratings and the financial stability of these corporate borrowers which have to refinance at higher rates. At the moment, we do not see this ending well.

1 JPMorgan Chase takes over First Republic after biggest U.S. bank failure since 2008

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Take Aways:

- Corporates – Spreads are a tell-tale sign that a firm is in trouble before the rating agencies can downgrade and we are watching several sectors, including Banking and lower-rated consumer discretionary names that need financing. We are actively staying away from commercial real estate exposure, as it is the most-shorted segment of the market right now.[2]
- Treasuries – We see friction from the upcoming federal debt ceiling battle. We believe that, unless tax receipts from the April filing deadline far exceed estimates, a June debt ceiling deadline is the most likely scenario, with the hope of avoiding a significant government shut-down or a technical default.
- Munis – We favor quality names and extending duration into the 3-year to 10-year space. We believe there are attractive opportunities there to pick up yield, especially with continued volatility across the curve.

2 https://in.investing.com/news/short-sellers-step-up-bets-against-office-owners-on-bank-turmoil-3573849

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Inspiring You To Live Your Ideal Financial Life

The Gross Domestic Product (GDP) is a comprehensive measure of U.S. economic activity. GDP measures the value of the final goods and services produced in the United States (without double counting the intermediate goods and services used up to produce them). Changes in GDP are the most popular indicator of the nation's overall economic health.

All indexes referenced are unmanaged. The volatility of indexes could be materially different from that of a client's portfolio. Unmanaged index returns do not reflect fees, expenses, or sales charges. Index performance is not indicative of the performance of any investment. You cannot invest directly in an index. Consult your financial professional before making any investment decision.

The Standard & Poor's (S&P) 500 Index tracks the performance of 500 widely held, large-capitalization U.S. stocks.

The MSCI EAFE Index is an equity index which captures large and mid cap representation across 21 Developed Markets countries* around the world, excluding the US and Canada. With 799 constituents, the index covers approximately 85% of the free float- adjusted market capitalization in each country.

The Consumer Price Indexes (CPI) program produces monthly data on changes in the prices paid by urban consumers for a representative basket of goods and services (Source: U.S. Department of Labor).

The Producer Price Index (PPI) program measures the average change over time in the selling prices received by domestic producers for their output. The prices included in the PPI are from the first commercial transaction for many products and some services.

The NASDAQ Composite Index is a market capitalization price-only index that tracks the performance of domestic common stocks traded on the regular NASDAQ market as well as National Market System-traded foreign common stocks and American Depository Receipts.

The Russell 2000 Index measures the performance of the 2,000 smallest companies in the Russell 3000 Index, which represents approximately 8% of the total market capitalization of the Russell 3000 Index.

The Russell 1000 Growth Index measures the performance of those Russell 1000 Index companies with higher price-to-book ratios and higher forecasted growth values.

The Russell 1000 Value Index measures the performance of those Russell 1000 Index companies with lower price-to-book ratios and lower forecasted growth values.

The S&P SmallCap 600 Index is a stock market index established by Standard & Poor's. It covers roughly the small-cap range of American stocks, using a capitalization-weighted index. To be included in the index, a stock must have a total market capitalization that ranges from $750 million to $4.6 billion.

The Bloomberg Barclays U.S. Aggregate Bond Index is a broad-based fixed-income index used by bond traders and the managers of mutual funds and exchange-traded funds (ETFs) as a benchmark to measure their relative performance.

The Dow Jones Industrial Average, or simply the Dow, is a stock market index that indicates the value of 30 large, publicly owned companies based in the United States, and how they have traded in the stock market during various periods of time.

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