# HORAN Capital Advisors

# Quarterly Investor Letter

**Spring 2023**

***"It is better to be roughly right than precisely wrong."***
*- John Maynard Keynes*

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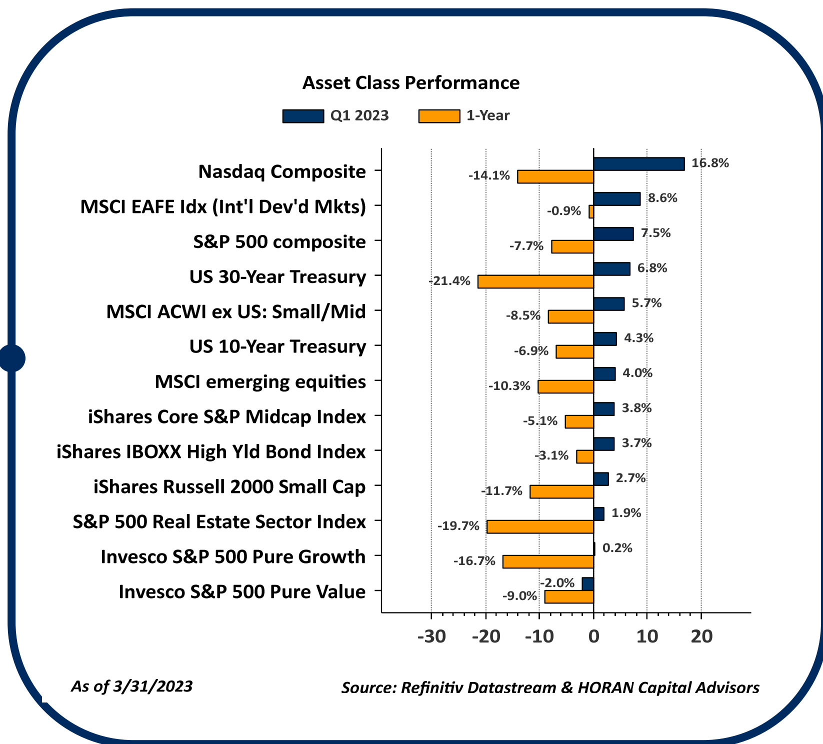
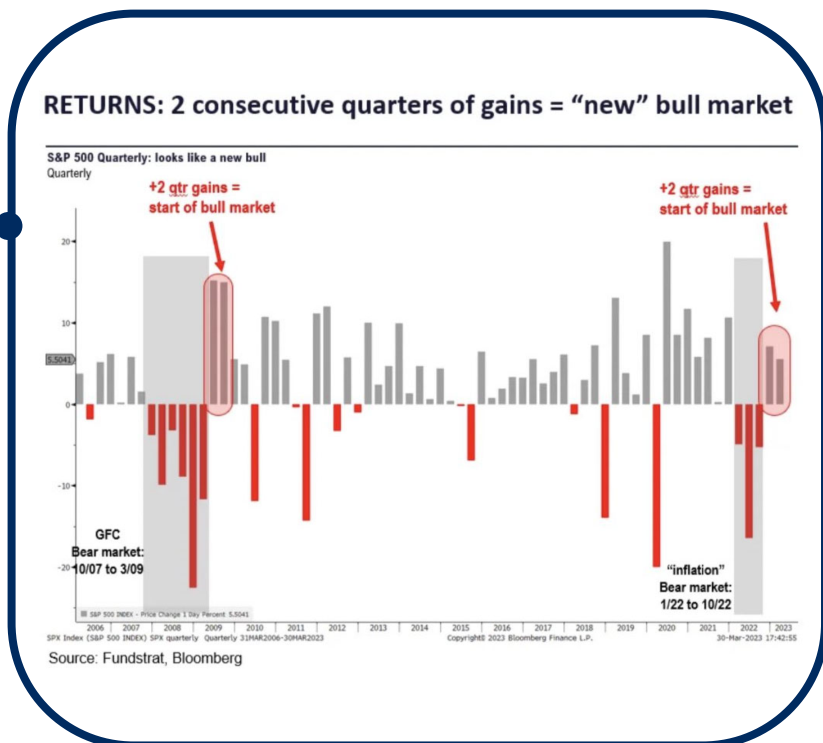
## Stock Rebound Continues

Without a doubt 2022 was a tough year for investment returns with 105 out of 112 asset classes generating a negative return, according to Morningstar data. However, many asset classes rebounded and finished with positive returns in the fourth quarter. This favorable trend carried over into the first quarter of this year as seen in the near chart. According to the research firm Fundstrat, "The S&P 500 has now posted two consecutive quarters of gains a pattern not seen in any bear market over the past 50 years. [This] solidifies our view that 10/12/22 was the bear market low and we are 6 months into a bull [market]."

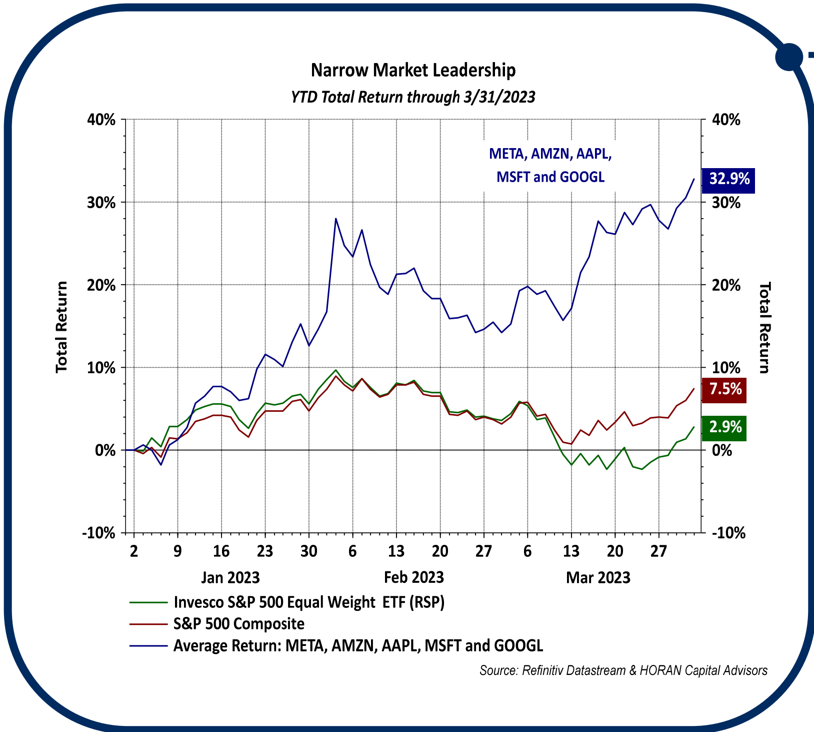



In 2022, the Nasdaq Composite Index was one of the worst performing indexes, down -33.5% but this reversed in the first quarter with the Nasdaq Index up 16.8%. Even bond returns are once again providing positive support in investors' portfolios with the 10-year U.S. Treasury up 4.0% after being down -16.9% in 2022. Positive bond returns are a result of intermediate to longer term interest rates declining, a sign the bond market believes the Federal Reserve is winning the fight on inflation and nearing a pause in the rate increase cycle.




## Narrow Leadership

A favorable characteristic of sustainable bull markets is a majority of stocks and equity asset classes participating in the positive performance. With respect to the market this year, a handful of large capitalization stocks are driving equity



market returns. The near chart shows five stocks, Meta Platforms (META), Amazon (AMZN), Apple (AAPL), Microsoft (MSFT) and Alphabet (GOOGL) have far outpaced the broader S&P 500 Index as well as the Invesco Equal Weighted S&P 500 Index (RSP). The equal weighted index return is up 2.9%, representing the performance of the average stock in the market. In the fourth quarter last year the average return for the same five stocks was down -9.5%.

Another measure of market breadth is comparing the percentage of stocks in the S&P 500 Index whose current price is trading above its 150-day moving average. The red line in the below chart shows the percentage at the beginning of the year was about 37% and has improved to 59%. The black line is the S&P 500 Index. Wide breadth occurs when 70% or more of stocks are trading above their moving average.

## Inflation and Stock Valuation

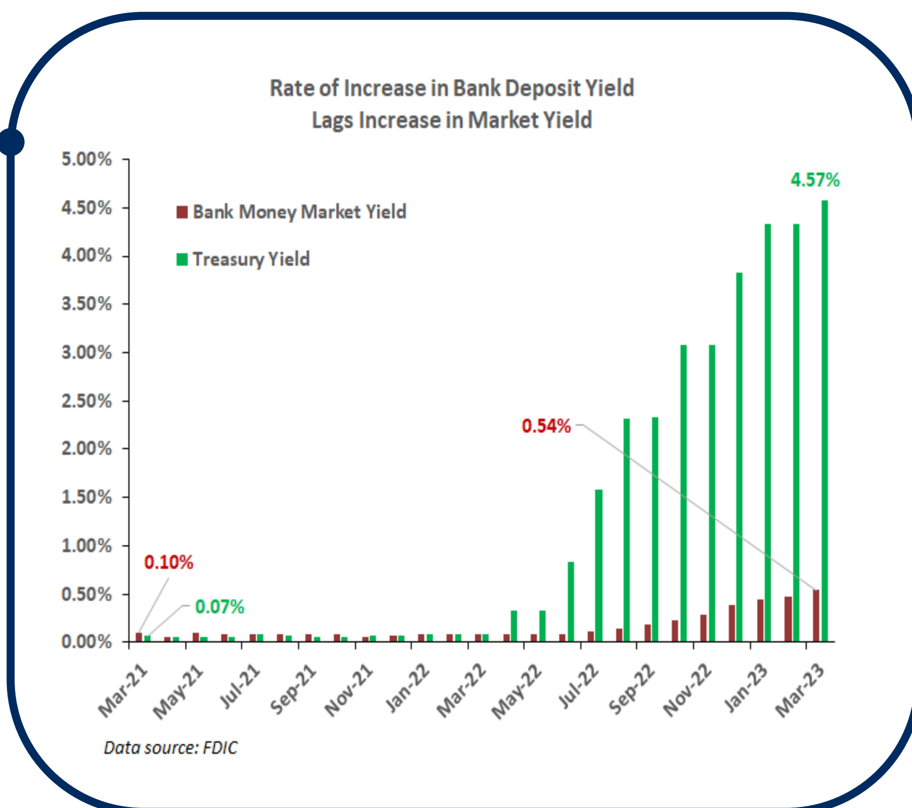
The handful of stocks leading the market this year are classified as growth stocks. Growth stocks tend to trade at higher valuations, i.e., higher price to earnings ratio, higher price to book value, etc. With the Federal Reserve's aggressive pace of hiking short term interest rates, in an effort to slow the pace of inflation, the higher rates impact how stocks are valued by investors. At the end of 2020 the inflation rate in the U.S was about 1.4% and reached a forty year high of 9.1% in June last year.

A common method of valuing stocks uses a discount rate to discount a company's future cash flow to the present. For growth stocks,

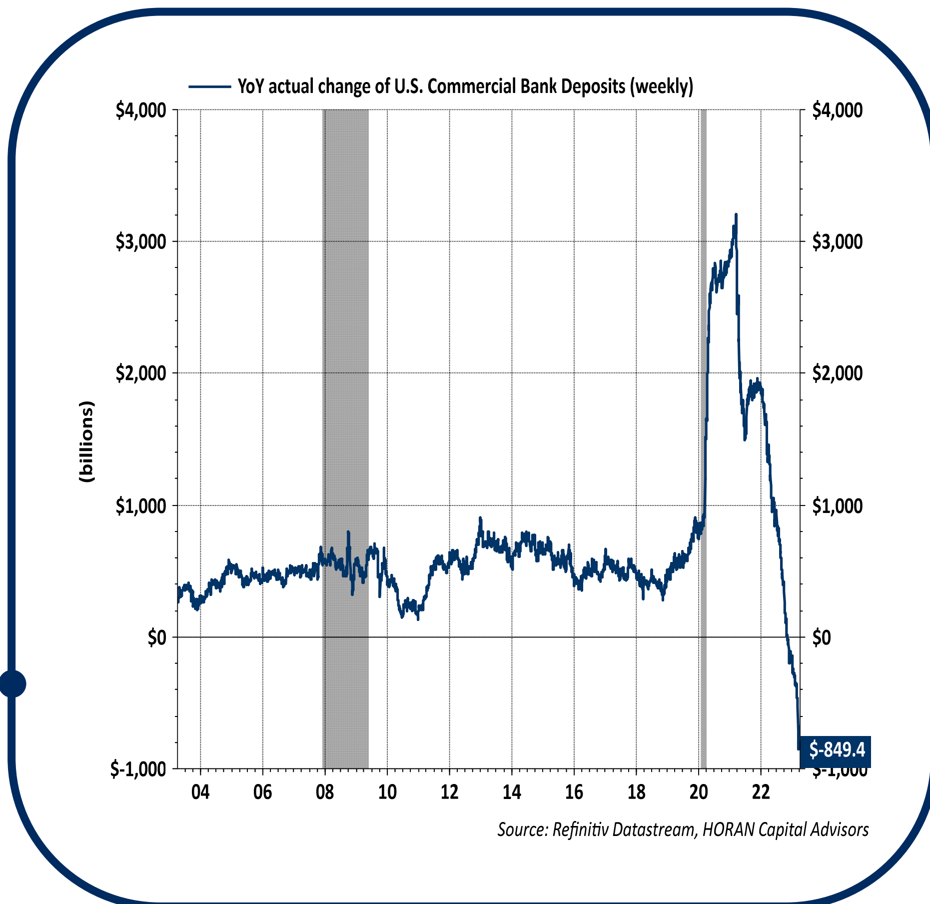
those future earnings end up being worth less in a higher inflation and higher interest rate environment. In 2022 this served as a headwind for growth stocks and the performance of value stocks outpaced growth. Fast forward to 2023 and inflation appears to be gradually falling. This has translated to falling interest rates and an inflation environment that benefits growth stocks. In the second half of this year comparisons to the prior year will be against lower inflation numbers, potentially resulting in inflation spiking in the back half of the year and creating a headwind for growth stocks. As a result, value stocks may return to outperforming their growth counterparts.

## The Fed Nearing A Pause with Stress In The System, i.e., the Banks

At the time of this writing, intermediate and longer-term market interest rates have been declining with the 2-Year U.S. Treasury yield falling from a yield of 5.08% in early March to a yield of 4.05% in early April. A catalyst for the decline is partially attributable to the bank solvency issues that have surfaced over the last few months. Three banks have failed over the last month or so – Silvergate Capital failed in early March, a week later Signature Bank and SVB Financial Group (SIVB) failed. These are not small bank failures, as SVB Financial Group was a top 20 bank in the U.S. with assets of $209 billion. The three U.S. banks that failed were not involved in what most would consider typical lending activities. Both Signature Bank and Silvergate Capital were involved with companies in the crypto currency industry. SVB Financial Group and its Silicon Valley Bank dedicated a large percentage of its commercial loan activity lending to startup companies. A recent Wall Street Journal editorial noted SIVB had a willingness to lend to unprofitable startups. A tech entrepreneur quoted in the article stated, “They’re basically subprime business loans. You’re talking about companies that have no credit profile, they’re burning cash and are unlikely to raise the same type of capital because of interest rates.... It was basically social credit.” At the end of the day the pandemic that began in 2020 and the monetary and fiscal response by the U.S. government far exceeded what was needed. The government injected unprecedented amounts of money into the system. Both individuals and businesses accumulated significant amounts of cash. Too much cash in the economy not only led to higher inflation, but to balance sheet issues for banks.



Specific to the banks was the fact they ended up holding too much customer cash and what was not lent to borrowers was invested in U.S. government bonds. Therein was the trap, customer bank deposits were short term instruments and the bonds were in some cases long-term in comparison. As the Fed aggressively raised interest rates, the longer-term bond investments declined in value. As short-term interest rates rose, the rate banks paid on bank money market accounts was substantially below what one could earn on a U.S. Treasury as seen on the chart on the previous page. Bank depositors took note and began to move money out.



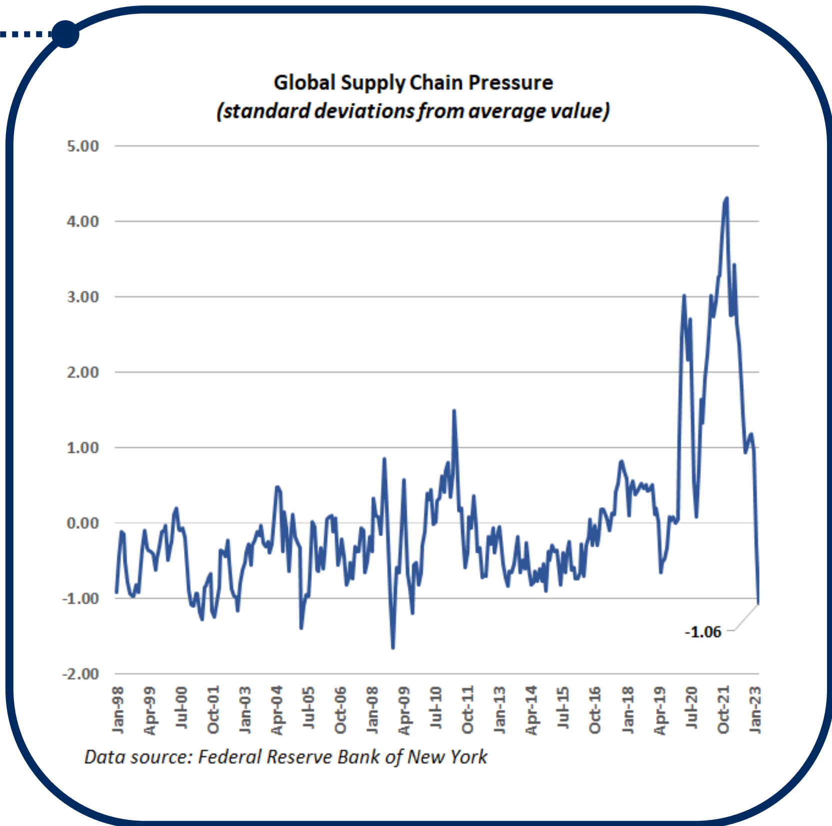

## Commercial Real Estate Issues

Real estate issues are once again beginning to make the headlines, not unlike in the 2008/2009 financial crisis. The issues this time now appear centered in the commercial real estate market, largely Type “A” downtown office buildings versus the single-family home segment. The pandemic has created a ‘work from home’ labor force that represents about 30% of workers; thus, firms do not require as large a space to accommodate their employees. The net effect is firms are reducing square footage at lease renewal. The other factor is regional banks were often the lenders for some of the office properties and bank balance sheet issues are resulting in tighter lending standards.

## Mixed Data

The pandemic has created an environment that makes it difficult to ascertain the strength of the economy. Some of the strength and inflation pressures are due to a demand spike for goods and services resulting from consumers and businesses satisfying pent up demand. Noted earlier is the fact too much stimulus was pushed into the economy and this created excess savings. This excess savings is being spent down and the economy just might be getting back to a more normal operating structure.

As the near chart shows, supply chain pressures have eased globally, individuals are re-entering the workforce as the labor force participation rate has increased to 62.6% versus the pandemic low of 60.8% and wage, or average hourly earnings, growth has slowed to 5.1% versus nearly 7% in March of 2022. Conversely, the U.S. Conference Board's Leading Economic Indicators Index is a steeply negative -6.46%. A negative LEI historically has coincided with recessions. Purchasing Managers' Index for Manufacturing is below 50% which indicates manufacturing is contracting. On the other hand, the services PMI remains above 50, indicating an expanding services sector.




Many other economic variables remain mixed. With stresses appearing in the economy and mixed data following the largest increase in interest rates in more than four decades, maintaining a balanced investment portfolio approach is advisable and prudent. Focusing on higher quality investments with strong dividends and/or cash flow should provide some stability in a potentially volatile market.

Thank you for your continued confidence and support in HORAN Capital Advisors and we are always available to answer your questions and discuss our outlook further. Please be sure to visit us for company news, reports, and our blog at https://horanassoc.com/insights/market-commentary-blog.

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