MARKET UPDATE

Economic Market Update – First Quarter, 2023

April 14, 2023

Despite a barrage of negative headlines and continued tightening from the Fed, markets posted solid returns in Q1.

- **While solid cross-asset returns in Q1 2023 were a welcome development after a painful 2022 for investors, underneath the surface, markets are not as healthy as they may first appear.**
- **Despite concerns about the stability in the banking system that popped up in Q1, the Fed remains laser-focused on their battle against inflation.**
- **Fed members have signaled a high hurdle to shift away from the current planned path of policy; investors expecting rate cuts in the back half of 2023 are likely to be disappointed.**

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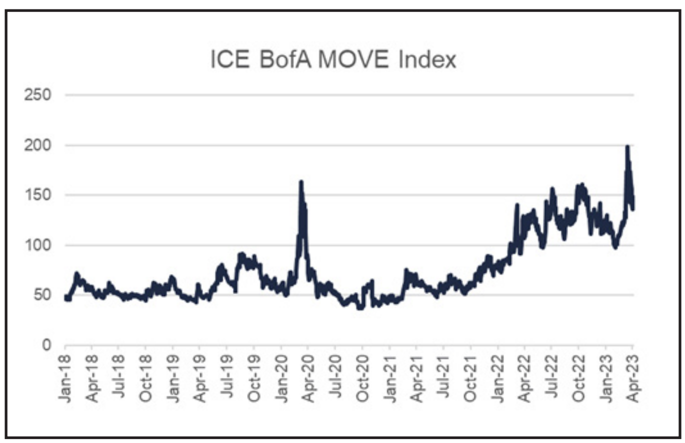
Despite the fact that the first quarter of 2023 was filled with surprises, as the quarter began, all eyes remained focused on inflation. When the year kicked off, the consensus among economists was that a recession was highly likely at some point in 2023. When the economic data bucked that trend, the focus became higher-for-longer Fed policy. Then March brought the second and third largest bank failures in U.S. history. Despite a deluge of negative headlines, nearly all major markets finished the first quarter in positive territory. After experiencing one of the worst years on record in 2022, diversified investors have much to smile about when taking stock of markets after the first quarter of 2023.

Looking underneath the surface, however, things may not be as rosy as they appear. The S&P 500 returned 7.0% on a price basis for the first 3 months of 2023. Nearly all of that performance, however, was driven entirely by just a few firms with the heaviest weights in the index. Strong rallies in Apple and NVIDIA contributed 1.8 and 1.4 points, respectively. Microsoft (1.2), Tesla (0.9), Meta (0.8), Amazon (0.6), and Alphabet (0.6) rounded out the top contributors. Combined, these seven stocks provided 7.3% of performance in Q1, meaning the other 493 stocks in the index actually reduced performance by 0.3%. This type of top-heavy performance, also known as low market breadth, has typically not been an indication of a healthy market environment. The Tech and Telecommunications sectors drove the market, both up more than 20% in the first three months of the year. Most concerning, the climb higher was not driven by earnings growth, but rather by multiple expansion, with the forward price-to-earnings (P/E) ratio of the Tech sector expanding by 25% year-to-date. Tech now trades at a 38% premium to the S&P 500 on a P/E basis as of the end of March, a level even higher than the peak hit in 2021 as the pandemic sent the sector soaring to new heights. This multiple expansion has largely been driven by lower interest rates and the prospect for easier monetary policy from the Federal Reserve. While a strong quarter in equity markets is a welcome respite for investors after an abysmal 2022, the question from here is whether the rally is sustainable in the face of the most uncertain macroeconomic environment in decades.

Given that the rally appears to be predicated on expectations for the path of Federal Reserve policy going forward, monetary policy is likely to be in the driver's seat from here. The Fed is currently attempting to engineer a soft landing for the economy – the goal is to return inflation back to the long-term target of 2% without tipping the economy into recession, a task that historically has proven difficult. The events of the first quarter have investors wrestling with the possibility that the U.S. economy may be facing too much resistance from the combination of higher rates and stress in the regional banking system. This dynamic has led to a significant increase in bond volatility, with the ICE BofA MOVE Index, a closely monitored proxy of expected swings in the Treasury market, more than doubling from a near-term low in January to hit levels not seen since 2008. The year began with heightened expectations that the U.S. economy would fall into recession at some point during the year.

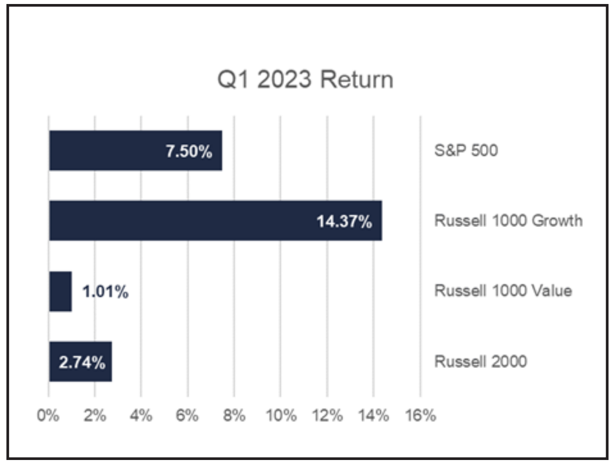


Economic forecasters surveyed by the WSJ in January signaled the chance of a U.S. recession in the next 12 months was 65%. As economic data came in stronger than expected, however, recession fears faded and hopes for a soft landing rose. These hopes shifted to a ”no” landing scenario by early March, as strength in the labor market and persistently hot inflation data led to expectations that the Fed would need to continue to tighten monetary policy through the summer. Expectations for more rate hikes led the yield on the 2-year U.S. Treasury to rise over 100 basis points through early March, with the yield peaking at 5.08% on March 7 after Fed Chair Powell stated the Federal Open Market Committee was willing to accelerate the pace of tightening if necessary during Congressional testimony. The failure of Silicon Valley Bank (SVB) the next day, however, sent yields plunging. The 2-year yield fell by 60 basis points in a single session as concerns over systemic risk in the regional banking system led investors to seek out safe havens. The 2-year yield bottomed out at 3.55% on March 24, then rallied into the end of the quarter to finish at 4.03%. Market expectations for Fed moves, derived from swaps pricing, also gyrated wildly during the quarter. As February turned to March, markets were pricing in 3 additional rate hikes over the course of the year. In the days that followed SVB's failure, however, these anticipated hikes swiftly became expected cuts. Market expectations for the Fed Funds Rate in January 2024 fell by nearly 2% in a week as investors began pricing in a belief that the Fed would need to cut rates in the back half of 2023. The market misjudged the Fed during the fastest rate hiking cycle in history, consistently expecting looser monetary policy than the Fed delivered. Is it possible that market participants are continuing to misjudge the Fed today? Could the economic cracks that began to show in the first quarter, coupled with the concerns over the stability of the financial system, be enough to get the Fed to change course?

The Fed cares about one thing and one thing only in the current environment – inflation. While the Fed will be keeping a close eye on the banking sector, recent public comments indicate that members believe the emergency measures implemented in the wake of the SVB collapse have stabilized the financial system, allowing policy makers to maintain a laser-like focus on the fight to bring down inflation from levels not seen since the early 1980s. Markets may be pricing in rate cuts in the back half of the year, but the Fed has firmly stated that no such cuts will be in the offing. Based on the Summary of Economic Projections released after the March meeting, the current Fed baseline suggests one more rate increase, likely at the May meeting, followed by a long pause, maintaining a target rate of 5.00-5.25% through the end of 2023. Thus far, Fed officials have taken great pains to signal policy decisions in advance during this tightening cycle. That suggests that investors banking on easier monetary policy in the second half of 2023 are likely in for an unpleasant surprise.

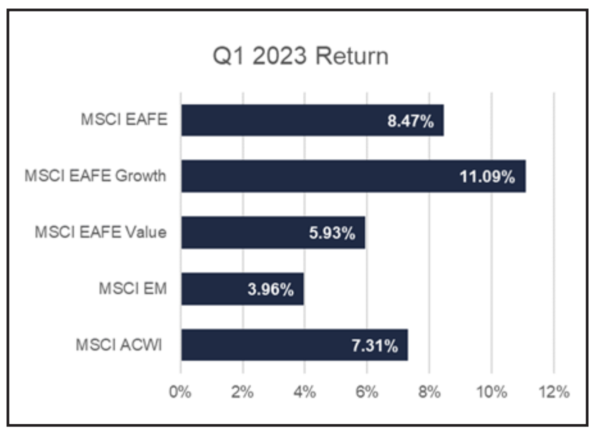
What lies in store for the remainder of 2023 after such an unusual start? A review of market history provides positive news. Looking back at history since 1950, the third year of every Presidential cycle has been strong for markets. For the S&P 500, the year after midterm elections has delivered a 33% return on average, with every third year of the four-year Presidential cycle seeing positive performance since the Chicago Daily Tribune mistakenly printed the headline “Dewey Defeats Truman” in 1948. A review of market performance following a significant down year like we experienced in 2022 is equally rosy. History provides 11 previous cases where the S&P 500 experienced a significant decline in the previous calendar year followed by a Q1 rally. In all 11 cases, the remainder of the year delivered positive performance 100% of the time, returning an additional 14.6% on average. A similar outcome would be welcome relief for investors after the pain markets delivered in 2022.

U.S. Equity Markets

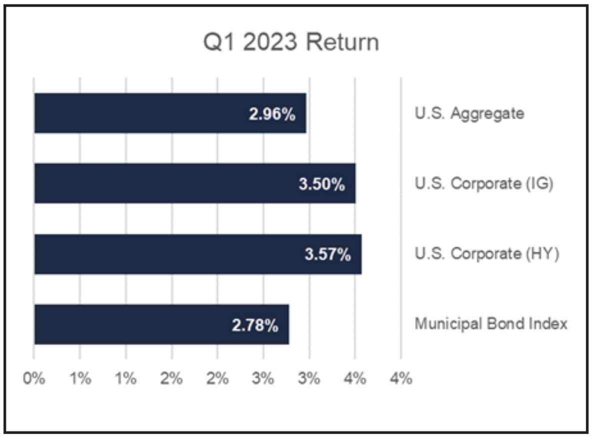


Despite all the seemingly negative headlines during the first quarter, the S&P 500, the bellwether for U.S. stock returns, finished the quarter up 7.50% . Small-cap stocks underperformed their large-cap peers, with the Russell 2000 Index up 2.74% for the quarter. This pattern breaks with historical trends, as small-cap stocks tend to outperform in positive market environments. A key driver of this divergence from the norm is the underlying sector and industry makeup of the two indices. The weight of the Financial Services sector in the Russell 2000 is 15.84%, compared to the sector's 12.84% weight in the S&P 500, and the Russell 2000 also includes the small- to medium-sized banks that saw significant share price declines in the aftermath of the SVB failure. U.S. equity performance varied widely by style during the first quarter as well, though the patterns were a near perfect inversion of the previous twelve months. The Russell 1000 Growth Index, which is comprised of both large- and mid-cap firms, was up 14.37% for the quarter vs. the 1.01% return of the Russell 1000 Value Index, returning to leadership after trailing significantly in 2022. The growth style led in small-cap as well – albeit by a narrower margin – with the Russell 2000 Growth Index returning 6.07% vs. the Russell 2000 Value Index's return of -0.66% on the quarter. As expected when the divergence between growth and value is so wide, performance varied widely across sectors and industries in the Q1 as well. Growth stocks came back into favor, with firms whose valuation is mostly comprised of cash flows expected far out into the future benefiting from a decline in longer-term rates. This decline lowers the discount rate applied to those future cash flows, increasing their value in the present. Tech stocks were the best performers, followed by Telecommunications stocks, gaining 21.49% and 20.18%, respectively. Consumer Discretionary was the only other sector with a return greater than the S&P 500 Index overall, gaining 15.76% on the quarter. Financial Services stocks were the worst performers, down -6.05% in Q1. Energy stocks also struggled in the first quarter after being the overwhelming leader in 2022, finishing March down -5.57% year-to-date.

International Equity Markets



International equities also performed well in Q1 2023, with developed markets outperforming U.S. large-cap and emerging markets outperforming U.S. small-cap. The MSCI EAFE Index of major developed international equity markets was up 8.47% for the quarter in U.S. dollar terms, besting the S&P 500 by nearly a full percentage point. The growth/value trend was present internationally as well, with the MSCI EAFE Growth Index gaining 11.09% vs. a gain of 5.93% for the MSCI EAFE Value Index. Europe was the top region, with Ireland (18.6%), the Netherlands (14.5%), and Spain (13.4) delivering the best performance. The countries with the largest weights in the regional index, Germany and France, also delivered strong performance, with each rising 12.4% on the quarter. In emerging markets, tech heavy economies performed best. The biggest contributors to index performance were Taiwan and South Korea. On the other side of the equation, India was the biggest laggard. China, the biggest country in the MSCI EM Index at 41.25%, rebounded as the country reopened following the abandonment of their zero-COVID policy to finish the quarter up 5.04%. **Summing up equity markets globally for the quarter, the MSCI ACWI Index, a proxy for the global stock market, finished Q1 2023 up 7.31%.**

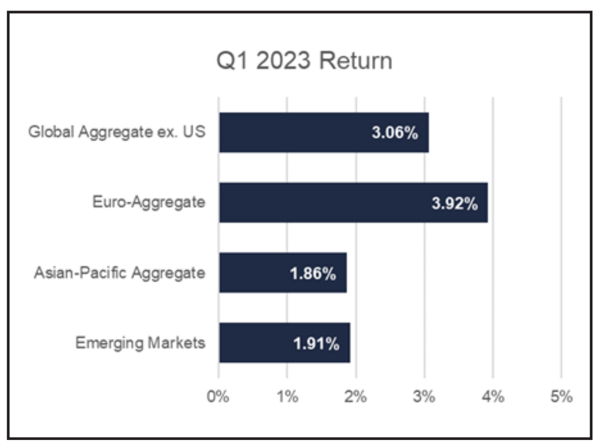


U.S. Fixed Income Markets

U.S. fixed income returns were the strongest of the post-COVID era in Q1, with a decline in rates leading to rallies in most major indices. The yield on the 10-year U.S. Treasury, which began the year at 3.87%, finished the quarter at 3.47%. The yield on the 2-year U.S. Treasury experienced a similar decline, starting the quarter at 4.43% and finishing the quarter at 4.03%. The broad decrease in rates across the various tenors of the yield curve when comparing yields at the start of the year to where they finished the first quarter belies the true path of rates over the first three months of 2023. Rates increased significantly on the front end of the curve, with the 6-month Treasury Bill peaking above 5% in early March before declining in the aftermath of the SVB failure. Despite the volatility, the decline in yields was a positive for fixed income investors, with all major areas of the fixed income market in the black for the first quarter after experiencing one of the worst years on record in 2022. The Bloomberg U.S. Aggregate Bond Index, a broad measure of the performance of investment-grade fixed income markets in the U.S., finished the quarter up 2.96%. Investment-grade corporate bonds fared even better, finishing the quarter up 3.45%. Despite a widening of credit spreads in the aftermath of banking stress in March, high yield corporate bonds also performed well, with the riskier part of the corporate bond market finishing the quarter up 3.57%. Despite softening inflation prints, TIPS also had a strong quarter, with the Bloomberg U.S. Treasury Inflation Protection Notes Index up 3.34% in Q1. Municipal bonds trailed slightly, with the Bloomberg Municipal Bond Index up 2.78% on the quarter. Floating rate bonds, which have interest payments that adjust to the prevailing interest rate environment, continued to perform well, with the Credit Suisse Leveraged Loan Index gaining 3.11% for Q1.

International Fixed Income Markets

International fixed income performance broadly lagged the U.S. on the quarter, but also turned positive after a difficult 2022. The Bloomberg Global Aggregate ex. U.S. Bond Index, a proxy for the global investment-grade credit universe outside of the United States, finished Q1 up 3.06%. Regionally Asia-Pacific outperformed, gaining 2.75% on the quarter. Europe was the laggard, up 2.09% for the quarter. Emerging market bonds, which are predominantly issued



in U.S. dollars, also lagged. The JPMorgan Global Core Emerging Market Bond Index returned 1.91% on the quarter. **Summing up fixed income markets globally for the quarter, the Bloomberg Global Aggregate Bond Index, a proxy for the global bond market, finished Q1 2023 up 3.01%.**

Solid Q1, but Caution Still Warranted

After historically poor cross-asset performance in 2022, rallies in nearly all major asset classes were a welcome relief for investors in the first three months of 2023. While history would suggest that the equity market may continue to rally from here, we believe that the heightened level of uncertainty in the current macroeconomic environment makes a cautious approach prudent. The stocks and bonds of high-quality companies with strong balance sheets will perform well relative to those of lower quality companies should economic and market conditions deteriorate but also deliver solid risk-adjusted returns in a more risk-on market environment.

We remain committed to focusing on your long-term financial goals and priorities by constructing portfolios designed to reach those goals while minimizing risk. As always, our clients' interests always come first, and our goal is to continue to separate the signal from the noise and focus on what truly matters in the economy and markets to help you achieve your investment goals. Should you wish to have a more in-depth conversation about the current environment and its impact on your portfolio and long-term financial plan, please reach out to your Fulton team.

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Matthew is a portfolio manager and leads the investment strategy group for Fulton Private Bank and Fulton Financial Advisors. He was a National Merit Scholar at the University of Chicago, where he graduated with a B.A. in Political Science. He is a Chartered Financial Analyst (CFA®) charterholder and is a member of the CFA® Institute and the CFA® Society of Philadelphia.

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