Where's the Recession?

"Games are won by players who focus on the playing field – not by those whose eyes are glued to the scoreboard" – **Warren Buffet**

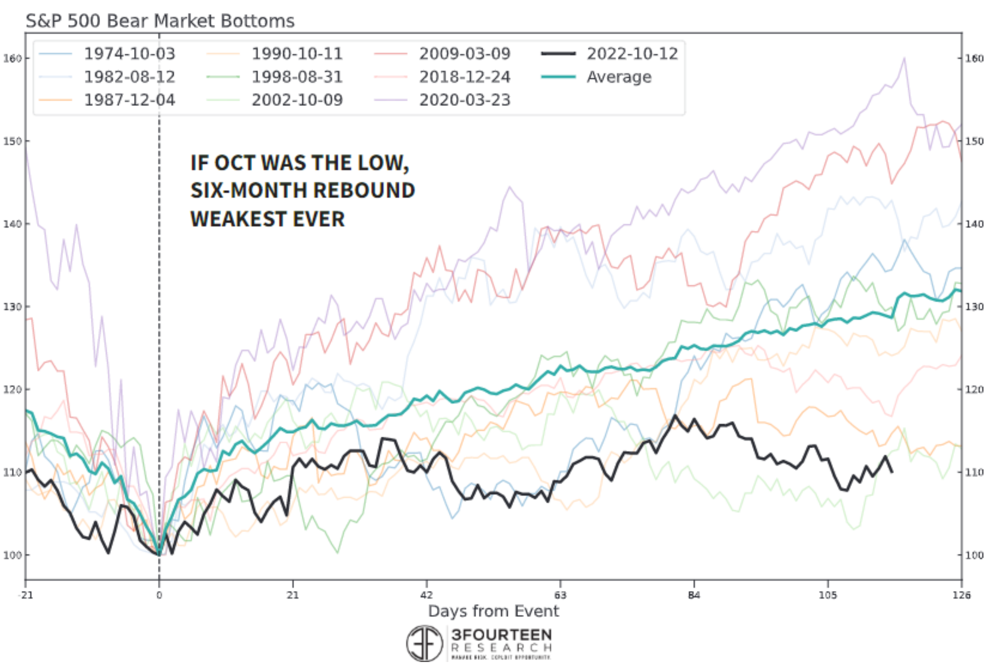
In the face of significant uncertainty, markets proved to be more resilient to start the year than many investors thought possible. The quarter started off largely upbeat as inflation seemed to be subsiding and many believed that would lead the Fed to stop raising rates or even contemplate cutting rates. In February, economic numbers came in hotter than expected and the Fed's rhetoric quickly reinforced further rate increases. Many professionals have been predicting that the significant rise in rates would eventually cause something to break. In March, the cracks started to emerge as Silicon Valley Bank & Signature Bank quickly were shut down by regulators within a few days of each other.

Despite the whirlwind of negative news, the market (S&P 500) was up 7% for the quarter. Ten stocks accounted for 95% of the returns of the S&P 500, led by Apple and Microsoft. Growth oriented stocks, which were by far the hardest hit in 2022, rebounded by 20% as measured by the Nasdaq 100. Bonds were also positive by 3% after a tumultuous 2022.

Moving forward, there remains a mountain of worries facing investors. Below we discuss our thoughts on the sustainability of this recent rally, the key indicators we are watching and potential outcomes.

Bear Market Rally or All Clear?

Although we didn't get a Santa Claus rally at the end of the year, we did see a rally to start 2023 and despite many lingering issues, we persevered through the quarter leaving investors to wonder if the October lows would be THE lows for this cycle. Based on the accompanying chart, which shows every major market bottom back to the early 70s, this would be the weakest 6-month rebound on record. Typically, market bottoms have fast and sharp rallies. We are also facing headwinds from the dramatic, sharp rise in rates and a Federal Reserve that is still in the process of raising rates and unwinding its balance sheet. Historically, markets rally after the



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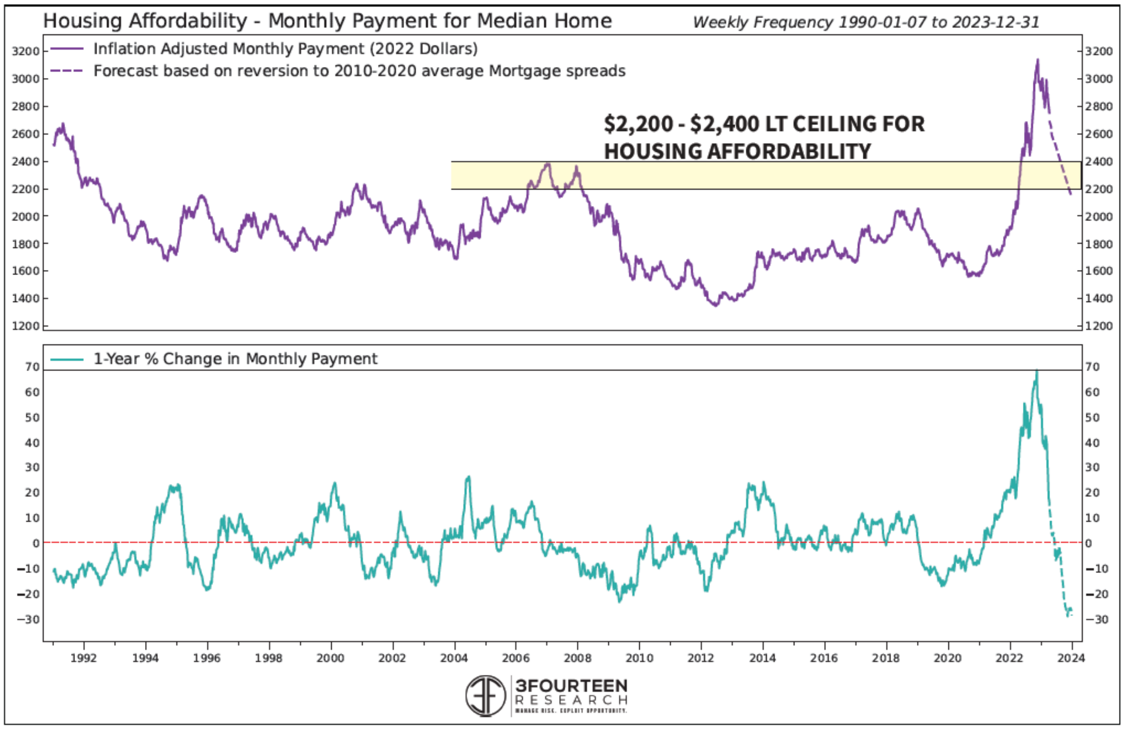
hikes have ended, not while they are still rising. We also have a number of yield curve inversions such as the 2-year vs the 10-year (short term rates are higher than long term rates), which have been very predictive of recessions.

What signals do we need?

We are now one year into the bear market, and we are looking at several key indicators to determine if we have further to go or if we are through the worst of it. In our view, one of the most important drivers of the economy is housing and today the Housing Affordability Index is at an all-time low. This is a combination of home prices seeing massive gains following COVID, new inventory at all-time lows, and mortgage rates rising dramatically last year to over 7% at their peak. Average monthly payments reached nearly $3,200/month last year, which is simply unsustainable, taking more than 1/3 of new purchasers' discretionary income. Luckily, most mortgage holders are locked in at much lower rates, but the longer that rates stay high, the more challenges the housing market will face. We would like to see the affordability numbers normalize, which would require some combination of housing prices and mortgage rate declines.



The second indicator we are watching is Household Savings, which have remained very high as a result of the massive stimulus packages from COVID. Household excess savings, which generally floats around zero (Americans like to spend) peaked at $2.5 trillion in late 2021 and has since declined to around $1.5 trillion. Many economists see this number declining substantially towards the back half of 2023. If the excess savings number does go away, defaults would certainly rise, and a recession may be inevitable.

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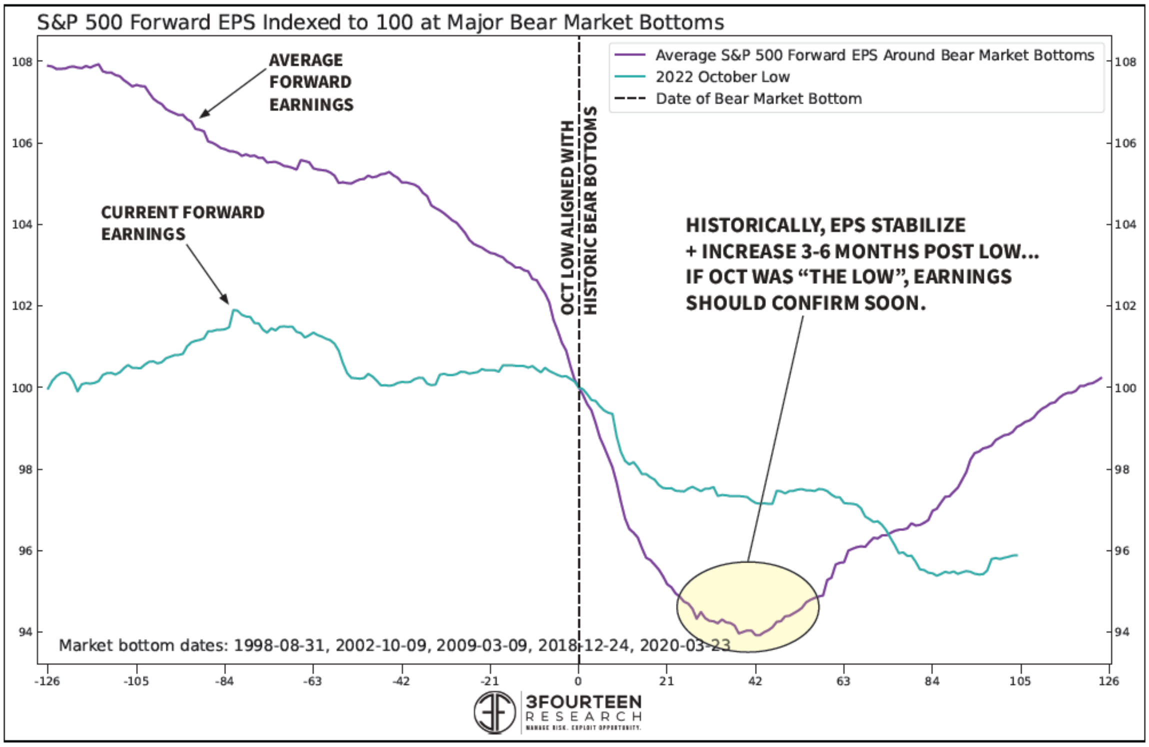
The third variable and arguably the most important is corporate earnings, which are just beginning for 1Q 2023. Continuing inflation and a slowing economy are expected to put continued pressure on earnings, which most analysts don't see recovering until 2024. Historically declining earnings have not been favorable for stocks. The good news is that stocks typically bottom 3-6 months before earnings bottom. Based on the below chart, if the October low was the LOW, we would need earnings to stabilize this quarter.



Potential Outcomes?

In our view, the path forward all depends on the potential recession. If the Fed is able to orchestrate a soft landing and there is no recession, then we are probably out of the woods. Non-recessionary bear markets are typically short lived and shallower in declines. At over a year in length and a 25% peak to trough decline, this would suggest there may be good times ahead.

The problem with the soft-landing scenario is that it is possible but not probable, and there could be more cracks to come. The most obvious crack is an acceleration of issues in the banking sector. Commercial loans offered by banks are seeing stricter lending standards and increased rates. As real estate and business loans mature, borrowers are now faced with terms and rates that they haven't seen in over a decade. This may cause both apartment and housing construction to slow, which would in turn impact labor across the housing sector. Although Facebook and Google are in the headlines when they have large corporate layoffs, the numbers pale in comparison to the labor force in housing across the country. Large job losses in the real estate sector would most likely trigger a recession and we are keeping a close eye on payrolls and wages in the sector.

It feels like we have been talking about this recession for a long time. The reason it is so important is that declines in recessions are deeper and longer and would suggest we have another 6-12 months of volatility. The good news is that unlike a year ago, bonds have already corrected and as a result of the spike in interest rates we can earn 4.5%-5% in very safe short-term U.S. Treasuries. The benefits of diversification should be much more normal as compared to 2022.

Conclusion

Thank you for taking the time to read this letter. As always, please let us know if you have any questions related to your investments, taxes, or general planning or if there have been any changes to your overall plan or risk tolerance. This is a great time to set up a review meeting.

Also, one important reminder. The Schwab and TD Ameritrade merger announced in 2021 will be taking place for our clients this year. You will begin receiving correspondence over the summer and all Canal Capital accounts will transition to Schwab over Labor Day weekend. The transition of assets, bank account information, etc will all take place on a “negative consent” basis. This means that nothing needs to be done by clients outside of setting up a new Schwab portal, if desired. We will be providing further information and instructions on establishing the new Schwab portal in the coming months.

Sincerely,

Canal Capital Management