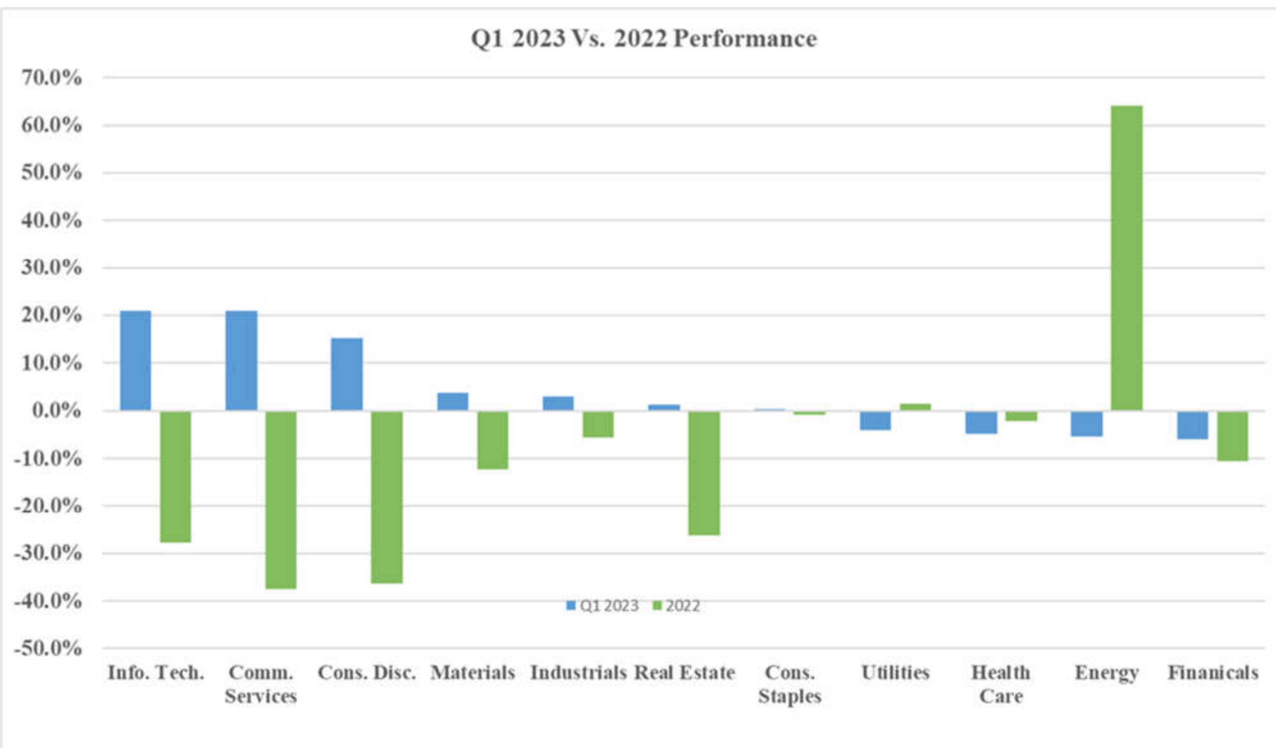
2023 Second Quarter Investment Outlook

We entered 2023 with low expectations, and not solely due to the battering the stock and bond markets had endured in 2022. The Federal Reserve imposed 0.25% rate increases to its target rate at both its February and March meetings following a series of seven rate hikes that began in March of 2022, thereby elevating the Fed funds rate above the yield on every Treasury obligation at every maturity. The Fed's motto has become "higher for longer", and any positive economic or market surprises which could be interpreted as an easing of financial conditions have been met by further warnings from the Fed that their mission was far from being accomplished.

As so often happens in such circumstances, the capital markets rose contrary to all expectations or logic. The Bloomberg Aggregate Bond Index rose 2.96% in the quarter, as the 10-year Treasury rate fell from 3.88% to 3.48% during the quarter. The bond yield rose to as high as 4.08% in early March, then fell in the wake of Silicon Valley Bank's collapse, presumably reflecting the hope that the Fed might pause in its course to prevent the "banking crisis" from spreading.

Equity investors cast aside their inflation/recession/stagflation concerns, at least for now. The Standard and Poor's 500 Index rose 7.1% in the first quarter, generating a total return of 7.5% including dividends. Even the afore mentioned failure of SVB and growing fears of possible contagion to the rest of the banking system failed to deter equity investors from adding risk into their portfolios. The index rose nearly 5% from the date of the bank's collapse to the end of the quarter, and has continued its rise in April.

Interestingly, the worst performing sectors in 2022 have been the best performers so far in 2023. The Technology, Communication Services and Consumer Discretionary sectors, which suffered the deepest



losses last year, generated the best returns during the quarter – and by a wide margin. It's not mere coincidence that the so-called FANG stocks reside exclusively in these sectors, but more on that in the next section. The more defensive sectors, staples, utilities and health care, trailed the market for the quarter, having been among the best (least worst?) sectors in 2022. And energy, which soared last year in a down year for the market, was the second-worst performing sector in the first quarter. Financial stocks were the market's worst performers, for obvious reasons.

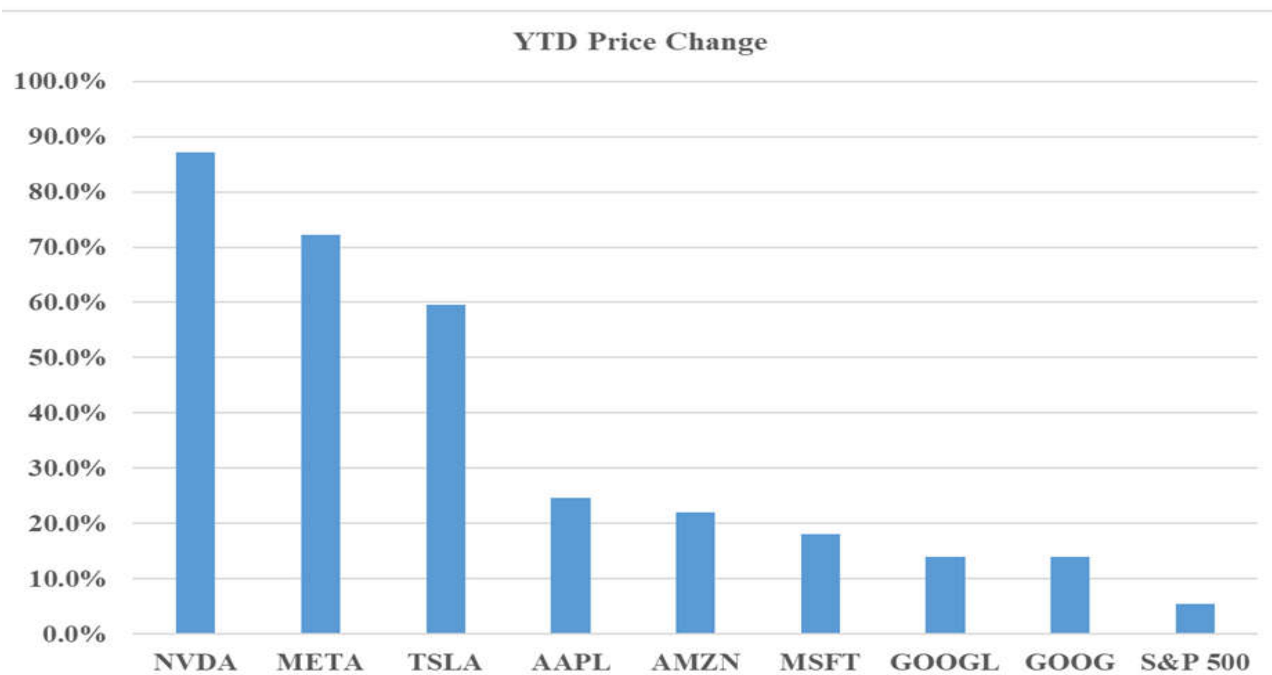
The FANG Stocks – 2021 Redux

Impressive as the market's performance was in the first quarter in the face of its many headwinds, it was actually not as strong as it appeared. In one respect, the current market resembles the market we experienced coming out of the pandemic.

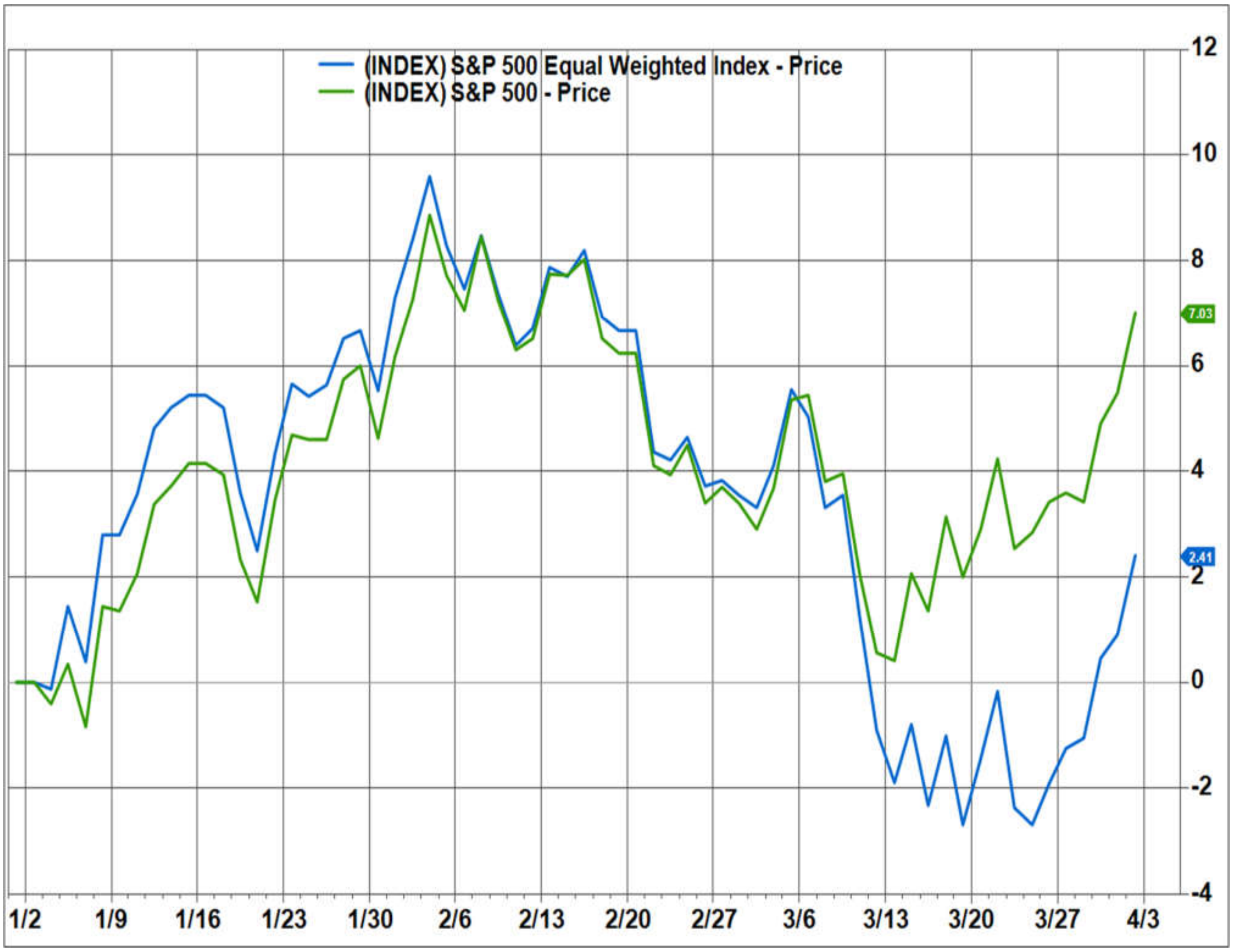
From the bottom of the 2020 bear market to the end of 2021, the S&P 500 index rose 75%, driven primarily by the performance of a handful of large growth stocks with very high price/earnings multiples – if they had any earnings at all. They came to be known collectively as the FANG stocks, a name derived from the original 4 members (Facebook-Amazon-Netflix-Google), and though the composition of the group has changed from then to now, the acronym survives.

During that same 2020-21 period, Nvidia rose 235%, Google 135%, Apple 179%, and Tesla 500%! These stocks, along with Microsoft, Amazon, and Facebook have outperformed the broader market to such a degree that they have come to represent almost 25% of the total capitalization of the S&P 500 index. For better or worse, the performance of the market index has become increasingly dependent on investors' demand for shares in these few companies, and is often less indicative of market's performance as a whole.

In the first quarter, five of the seven FANG stocks rose 20% or more, and three of them were up more than 60%. As a group, they rose by a weighted average of 31%, more than four times greater than the S&P 500's price increase of 7.1%, and they accounted for 7.5% of the S&P's total return of, yes, 7.5% - in other words, all of it. That doesn't mean that there weren't returns to be generated in the rest of the market, it's just that the other 492 stocks, as a group, were virtually flat for the quarter.



The equal-weighted price performance for the S&P 500 in the first quarter showed a rise of just 2.4%, barely a third of the index's price only rise of 7.1%, illustrating the outsized effect the performance of those few mega-cap stocks have on the index.



Silicon Valley Bank

Silicon Valley Bank collapsed suddenly and in dramatic fashion over the course of several days in early March, but the confluence of events leading up to its failure had been brewing for several years.

SVB was regarded as the premier bank for catering to the start-up and venture capital firms that found a home in Southern California, and benefited from the rapid growth that these firms realized, largely as a result of the monetary and fiscal stimulus measures enacted during the COVID recession. The bank's deposits doubled over the course of a year starting in March 2020, increasing by around $62 billion. The bank used this influx of deposits to purchase longer-term government bonds in an attempt to generate a higher rate of return than what was offered on short-term maturities. Unfortunately, long-term bonds bring with them a much higher level of interest rate risk, which more than offsets the meager incremental income they generate.

As interest rates rose dramatically throughout 2022 in response to rising inflation and the Federal Reserve's tightening of financial conditions, SVB's bond portfolio suffered significant losses. The complicating factor stemmed from the bank's accounting treatment of its securities portfolio. More than $91-billion of SVB's $117 billion portfolio was accounted for as "held-to-maturity." This accounting treatment meant that the unrealized losses were essentially hidden, and did not pass through the bank's income statement or on to shareholders equity. The justification for this treatment is that bonds classified in this manner are not intended to be sold, thus their face value will ultimately be received. The large, unrealized losses in the bank's securities portfolio remained hidden in the notes to the financial statements, and over looked by many.

As 2022 progressed and the SVB's securities portfolio continued to lose value due to the increase in interest rates, the economic outlook for start-up companies became bleaker. The low interest rate environment that fueled the growth of start-up companies receded and credit availability began to evaporate. The start-ups and other institutional investors began drawing on their large deposit balances with SVB, which then had to begin selling securities at losses to meet the withdrawals. Once the public and several large depositors realized that Silicon Valley Bank was having trouble meeting the growing demand for the withdrawal of deposits, a classic run on the bank ensued. Almost comically, management floated the idea of raising equity capital in the midst of the panic, and the next day almost 25% of the bank's remaining deposits were withdrawn. That was also SVB's last day.

<u>**Banking Crisis – Not!**</u>

The media loves to attach the word, crisis, to any situation that is in any way concerning. It's sexy and it draws the readers' (or the viewers') attention, but there is no evidence that supports the notion that the banking sector is "in crisis."

What happened to Silicon Valley Bank, and the unrelated FDIC takeover of Signature Bank, has led to repeated references to the current banking crisis by analysts, when enumerating the growing list of concerns facing the markets. There are indeed many challenges and concerns facing the banking sector today, but they are unrelated to the demise of SVB.

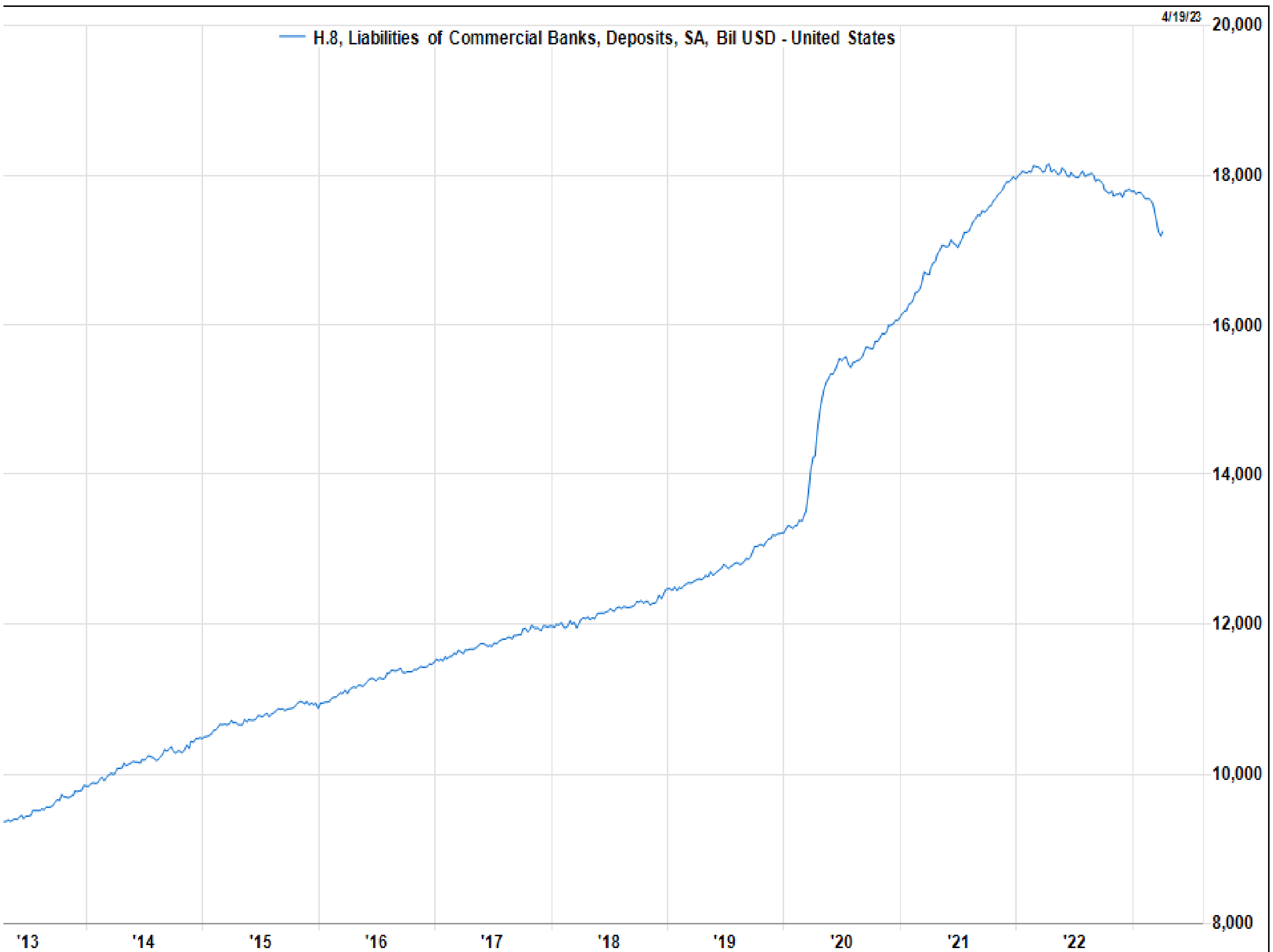
The collapse of Silicon Valley Bank represented a failure by both management and regulators. Management failed to adequately manage the duration gap between the assets and liabilities of the bank, and did not maintain enough liquidity. And, as we mentioned earlier, by focusing on long duration bonds in search of greater yield – at a time when long term interest rates were low by historical norms – management introduced an unnecessary level of interest rate risk to the bank's balance sheet that was far greater than any incremental return it could have realized in shorter-term instruments. This additional risk, and the resulting subsequent losses, were masked due to the lack of transparency for held-to-maturity securities.

Questions have also arisen regarding the role that regulators should have played. The Federal Reserve has the responsibility of supervising banks and making sure they are maintaining adequate reserves to avoid scenarios precisely like what unfolded in Silicon Valley. As early as 2021, the Fed noted deficiencies in Silicon Valley Bank's risk mitigation processes and in mid-2022 placed them under a more substantial review. Many have argued that the Fed should have stepped in sooner, but regulations for banks with assets under $250 billion in assets were scaled back in 2018. The ultimate result will likely be increasing scrutiny of the Federal Reserve's oversight processes, as well a review of the accounting treatment for held-to-maturity securities.

It should be noted that Silicon Valley Bank was, if not unique, at least unusual in many respects. It was reported that nearly 90% of the bank's deposits were uninsured by FDIC, meaning that they were above the $250,000 deposit insurance limit. This lack of insurance for the majority of SVB's depositors intensified the outflows. Finally, according to the latest FDIC report, investment securities account for 25.9% of the average commercial bank's total assets; for SVB, that number was 56.7%.

There are a growing number of challenges facing the banking sector today, but they are cyclical and are far more the product of the Federal Reserve's relentless efforts to rein in inflation than they are in any way related to the isolated collapse of Silicon Valley Bank. And those challenges are to earnings, not solvency.

There is, first, the reality that deposit outflows are accelerating for reasons totally unrelated to any fear of widening bank failures. It is simply that deposit interest rates have increased at a much slower pace than short term Treasury or money-market rates. At some point, banks will have to pay more for deposits to become competitive, compressing interest rate margins and penalizing earnings.

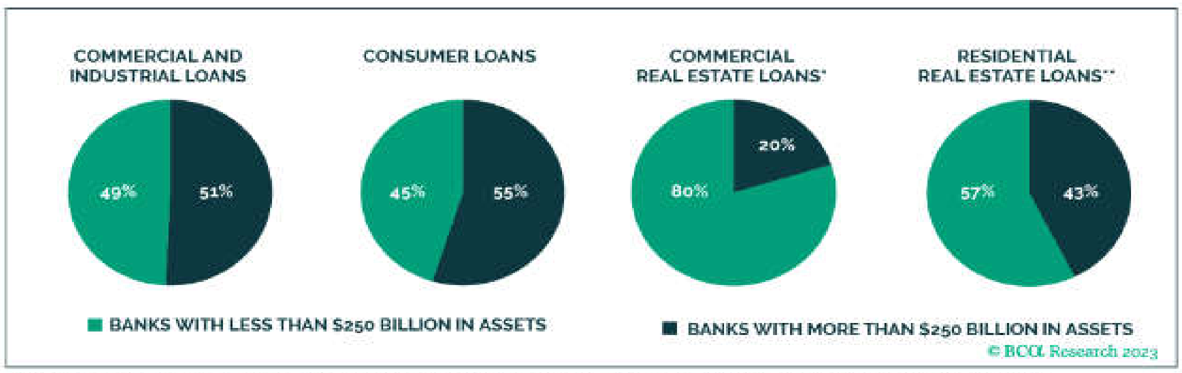


Another challenge is that a weakening economy will likely result in increasing levels of delinquencies in loan payoffs and increases to loan loss reserves, creating still more headwinds for earnings. System-wide data on loan loss reserves is difficult to come by after 2020, but a review of the largest banks is a mixed bag, at best. J.P. Morgan increased its allowance for loan losses substantially in 2022 vs 2021, both nominally and as a percent of loans outstanding, suggesting that it is reserving for more difficult times ahead. Bank of America and Wells Fargo, however, have reported significant increases in loan balances, while leaving loan loss reserves substantially unchanged.

The larger concern in this regard, however, lies with midsize and smaller banks. Almost half of all deposits reside in banks with less than $250-billion in assets, and the vast majority of these banks are not subject to the strict capital and liquidity requirements that larger, so-called Systemically Important Financial Institutions (SIFIs) are subject to. It should also be noted that the more stringent level of regulatory oversight for SIFIs has itself become a source of systemic risk in the post Silicon Valley Bank environment, as it has arguably been a catalyst for increasing deposit flows from smaller banks to larger ones, who are perceived to be better regulated, "safer" and too big to fail.

But while smaller banks (under $250-billion) hold a proportional share of outstanding commercial, industrial and consumer loans relative to their deposit share, their exposure to commercial and residential real estate loans is far greater than their larger competitors. Commercial real estate, which includes offices, apartment complexes, warehouses and malls, has come under substantial pressure.

Economically, Small Banks Tend To Punch Above Their Weight



* INCLUDES COMMERCIAL, MULTI-FAMILY RESIDENTIAL, CONSTRUCTION & LAND DEVELOPMENT, AND FARMLAND REAL ESTATE LOANS.
** INCLUDES SINGLE-FAMILY REAL ESTATE LOANS.
NOTE: DATA AS OF Q4 2022. INCLUDES ALL FDIC-INSURED INSTITUTIONS (COMMERCIAL BANKS AND SAVINGS INSTITUTIONS).
SOURCE: BCA CALCULATIONS BASED ON FEDERAL DEPOSIT INSURANCE CORPORATION (FDIC) DATA.

The rapid increase in interest rates over the last year has been painful, as purchases of commercial buildings are generally financed with large loans. Prices of commercial properties are down 15% from their peak. Occupancy rates of office properties in the country's 10 largest cities are barely half of what they were prior to the pandemic, as the trend toward hybrid work and work-at-home shows no sign of abating. About $270-billion in commercial real estate loans held by banks will come due in the next year, and nearly one-third of that total are office properties. Higher rates and plummeting valuations will make refinancing difficult, as banks are likely to request the owners to put up more equity. An increasing number of property owners – especially owners of less desirable properties – might well decide to hand over the keys, given the challenging market conditions, leaving banks in the position of owning depreciating properties. This is the view of Jones Lang LaSalle (JLL), a premier global commercial real estate services company with offices in 80 countries.

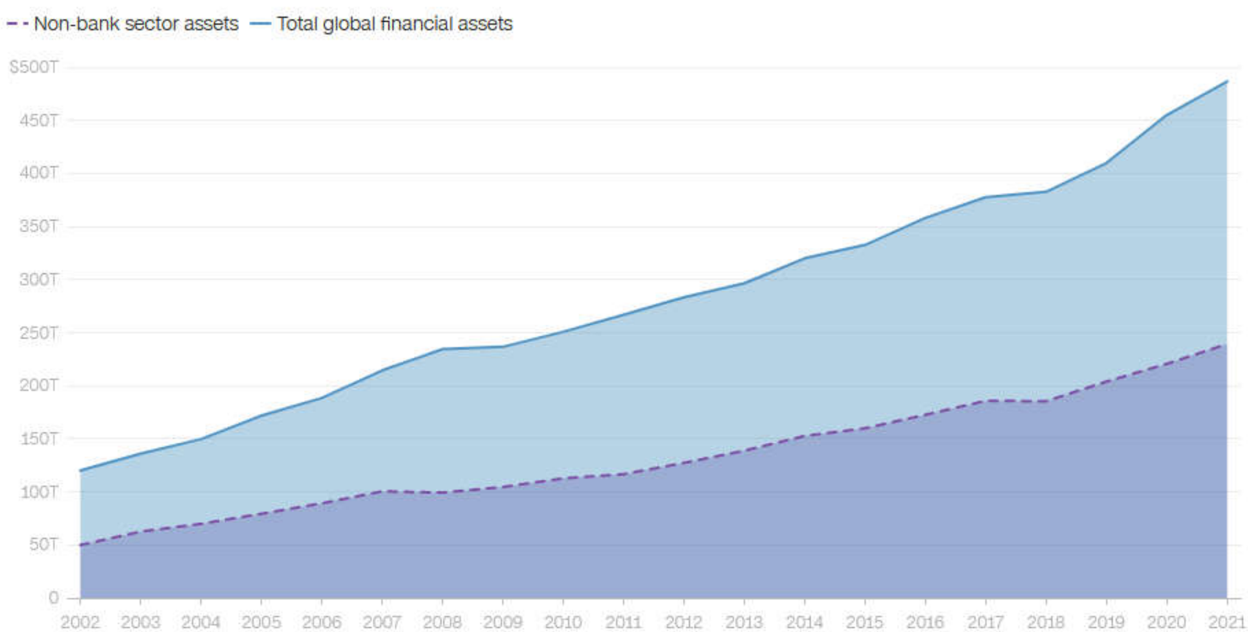
As onerous as this all sounds, a descending spiral of foreclosures, defaults and bank failures is not the consensus expectation. Even JLL's CEO, Christian Ulbrich, has said that he "expects that things will play out in a digestible way." U.S. bank loan portfolios are well diversified for the most part, and loans on office properties account for less than 5% of total bank loans. Banks have maintained greater capital requirements and tightened lending standards since the 2008 financial crisis, and have in fact accelerated the tightening of lending standards since the SVB collapse. There will almost certainly be an uptick in delinquencies and defaults, and loan losses in general will begin to negatively impact bank earnings. For this reason, we have moved to reduce our exposure to the traditional banking sector due to the worsening near term outlook. But this is a cyclical storm that well capitalized and well managed banks will weather in time.

“Shadow” Banks – An Under-reported Risk

If crisis is too strong a word to describe the condition of the banking sector today, there is another potential source of stress to the financial system that is perhaps receiving too little attention from analysts and the media.

The International Monetary Fund (IMF) recently warned of “vulnerabilities” among so-called non-bank financial institutions, saying that global financial stability could hinge on their resilience. The Bank of England called attention to the same concern in March. Global investors surveyed by the Bank of America in the wake of Silicon Valley Bank’s collapse, cited U.S. non-banks – rather than traditional lenders such as SVB – as the more likely source of a credit crisis.

Non-banks are financial firms, other than banks, that provide all manner of financial services, including lending to households and businesses. Non-banks include everything from pension funds and insurance companies to mutual funds and hedge funds. The sector is large, with about $239-trillion in assets on their books at the end of 2021, accounting for just under 50% of the world’s total financial assets. That’s up from 42% in 2008, at the peak of the global financial crisis.



Source: Financial Stability Board
Graphic: Anna Cooban, CNN

The sector has grown rapidly over the last 15 years. As interest rates have fallen throughout the last decade, many savers have turned to non-banks providing higher deposit rates. And as regulators imposed more restrictions on bank lending following the 2008-09 crisis, riskier borrowers have increasingly sought out non-banks for loans. Non-banks that provide credit have come to be referred to as shadow banks, and it is this type of institution that is worrying the institutional investors polled by Bank of America. Shadow banks now control about 14% of the world’s financial assets, and they operate without anything close the level of regulatory oversight and transparency as banks.

Rising interest rates and an increasingly uncertain economic outlook have made funding for shadow banks more expensive and harder to come by. Shadow banks are exempt from the strict capital and liquidity requirements imposed on banks, cannot access emergency central bank funding in times of stress, and governments may be less likely to use taxpayers' funds to rescue or recapitalize a failed shadow bank.

Trouble in the non-bank sector would potentially spill over to traditional lenders, because non-banks both lend to and borrow from banks, and they invest in the same assets as their traditional counterparts. A notorious example of this was the collapse of Archegos Capital Management in 2021, which caused about $10-billion in losses across the banking sector. More than half of those losses were sustained by Credit Suisse compounding its decades long string of compliance failures, which ultimately led to Credit Suisse's demise and an emergency takeover by rival UBS Group AG.

Simultaneous fire-sales of government bonds by distressed non-banks would lead to losses for the bonds' other holders, including banks. This is what happened last fall when U.K. pension funds had to sell U.K. government bonds, which were crashing in the wake of then-Prime Minister Liz Truss's budget plans. The circumstances created a vicious, downward spiral in the country's bond market that, in a report issued by the Bank of England, "nearly toppled the UK financial system."

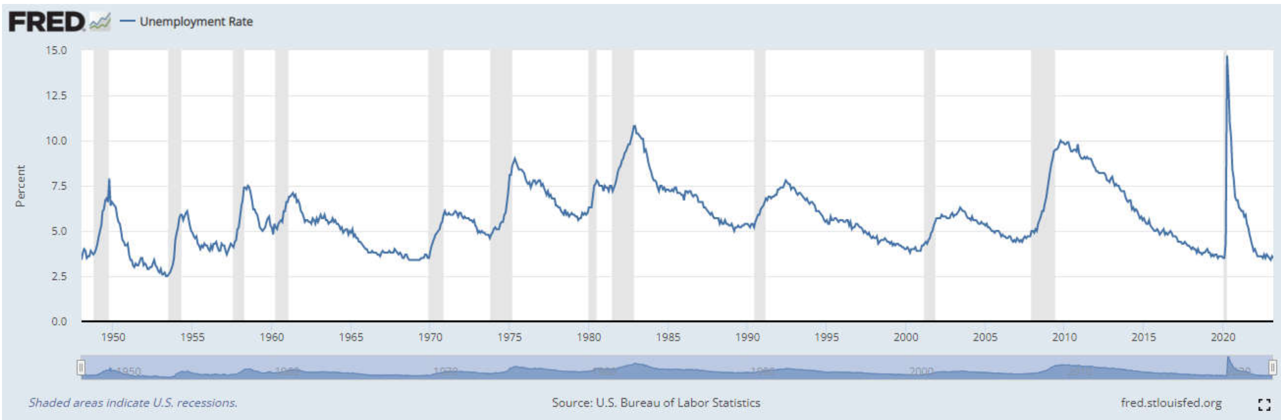
The direct and indirect links between banks and non-banks are not the only sources of risk; confidence matters greatly in banking. The mere perception that the banking sector might be connected to a struggling non-bank risks a broader financial crisis. S&P Global said in a recent report, "This form of contagion risk – via perceived proximity or reputational risk – should not be underestimated."

In response, regulators are beginning to play a more active role. The Bank of England is implementing procedures to stress-test the UK financial system in a manner that would include non-banks. And U.S. and European policy makers are considering proposals to discourage runs on non-bank assets, as well as imposing stricter rules on non-banks' capital and liquidity requirements.

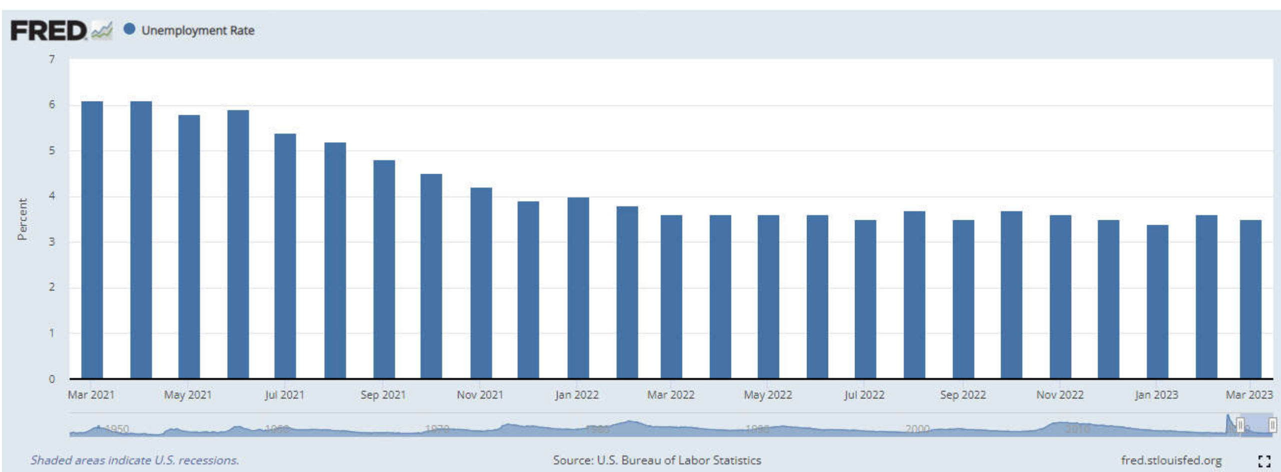
Labor Market Still Hot, but Cooling

The labor market remains tight, but is showing early signs of cooling off. Non-farm payrolls rose 236,000 in March, very close to consensus expectations for a gain of 239,000 jobs. It was the first jobs report in twelve months that came in below expectations, and represented the lowest number of jobs gains since the economy lost jobs in December 2020.

The unemployment rate dropped to 3.5%, and remains at or near levels not seen since the mid-1960s, but there are indications that the Fed's efforts to slow the pace of new job creation is beginning to bear fruit. The number of job openings has dropped from 10.8-million in January to 9.9-million in March, and there are now 1.7 open jobs for every unemployed worker, down from 1.9 at the beginning of the year. The pace of cooling is agonizingly slow, but the direction is what the Fed wants to see.

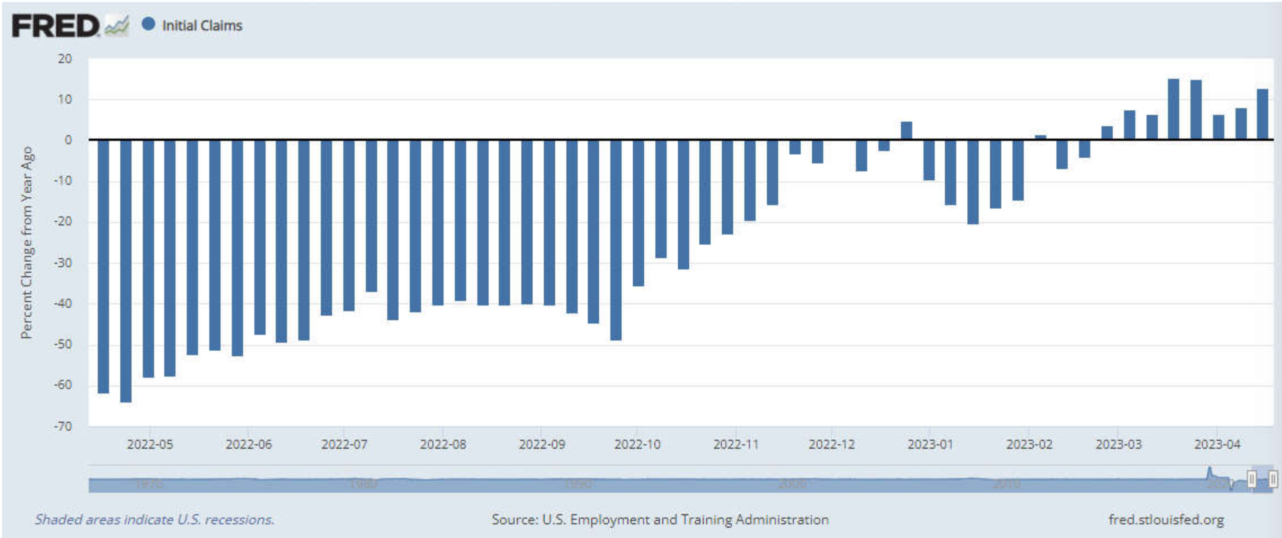


The unemployment rate has been in a narrow range of 3.4% to 3.7% for the last year, and it bears watching as the pace of new job openings begins to slow. Historically, peaks in the economic cycle peaks have generally been accompanied by an unemployment rate that moves higher after it has plateaued for a sustained period of time. Throughout the post-World War II period, every increase in the unemployment rate

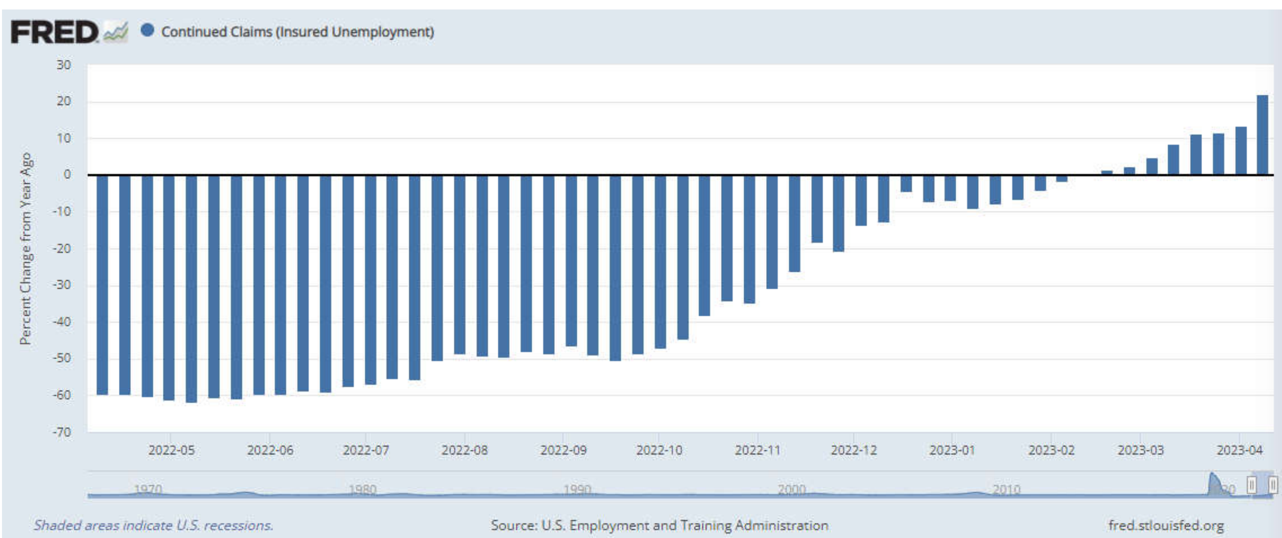


of 0.5% or more from year earlier levels has signified the onset of a recession. So if the unemployment rate were to rise up to the 4% range in the foreseeable future, that would be a strong signal that the economy has either entered a recession, or is on the verge of one.

Jobless claims are considered to be a leading indicator of the economy, and are, in fact, a component of the Conference Board's Index of Leading Economic Indicators. The number of initial claims began to rise above year earlier levels in March, and they are now more than 10% above levels of a year ago (chart, following).

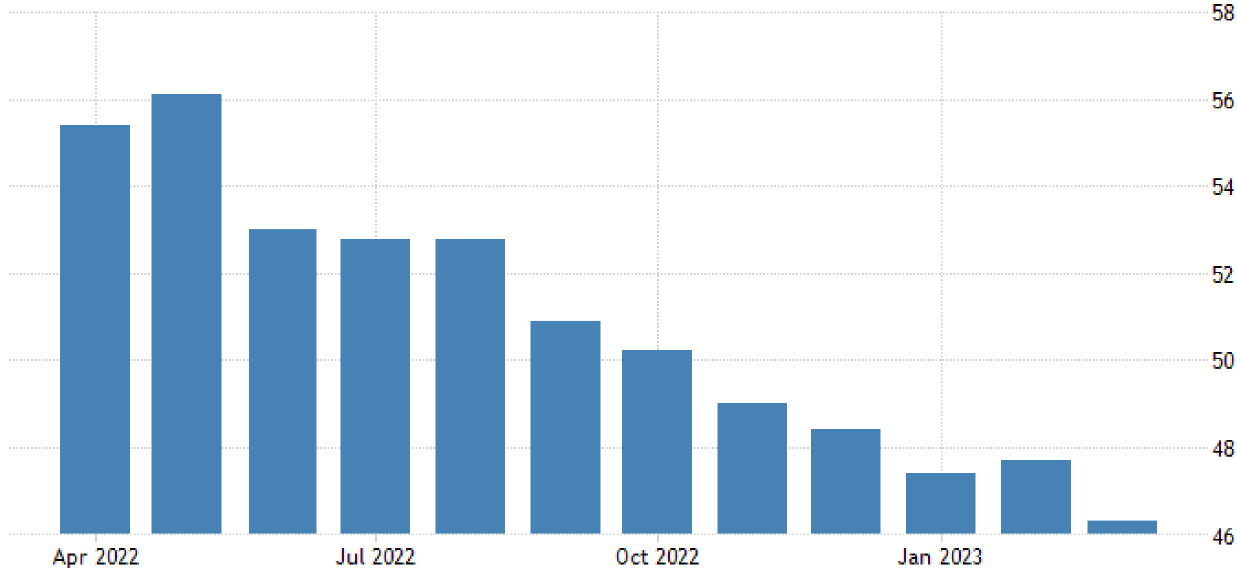


However, *continuing* claims have been found to be a more reliable gauge than initial claims, and a rise of 10% or more in continuing claims over the prior year's level has never occurred outside of a recession, or just prior to one. The most recent reading indicates that continuing claims are 22% above the levels of April 2022, and the Conference Board's Employment Trends Index, which includes jobless claims and six other indicators, fell in March by a magnitude which has always preceded an eventual fall in employment.



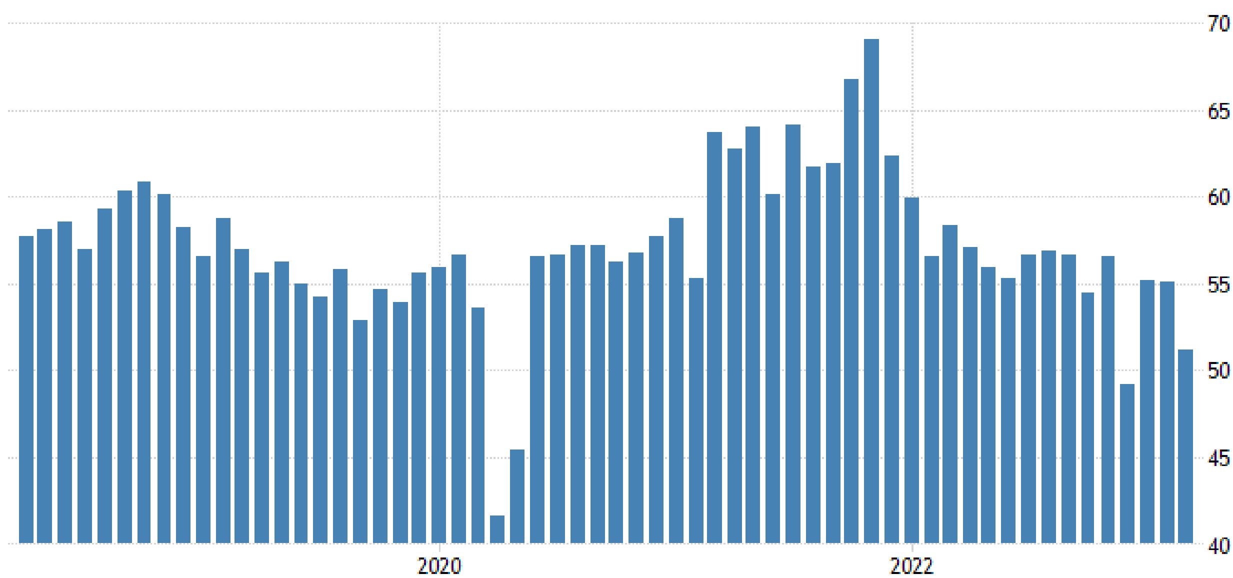
<u>The Manufacturing Sector</u>

Economic activity in the manufacturing sector contracted for the fifth consecutive month in March, and at a faster pace than in previous months. The March Manufacturing Purchasing Managers Index (PMI) came in at 46.3, below consensus expectations for a reading of 47.5 and down from February's report of 47.7. The manufacturing PMI is at its lowest level since May 2020, in the depths of the COVID recession, when it registered 43.5. A reading below 50 is evidence of a sector that is contracting (chart, following).



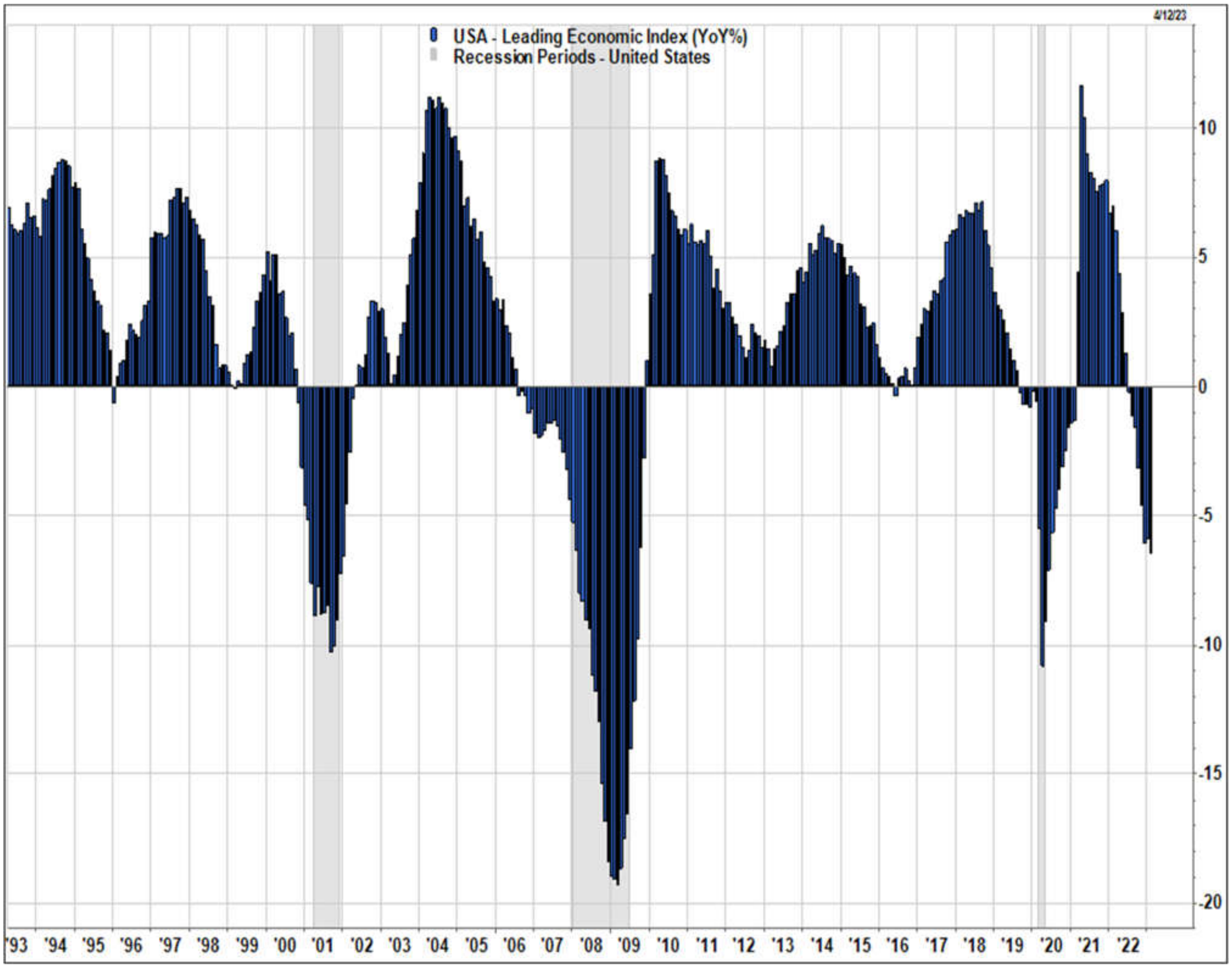
The forward looking New Orders Index remained in contraction territory at 44.5, and all other components of this index - Production, Prices, Backlog, Employment, Supplier Deliveries, Inventories, and Exports are all contracting with levels below 50.

Manufacturing represents a smaller share of the country's GDP and employment than has been the case historically, and evidence of a sector contracting is not necessarily indicative of an economy in recession. But based on historical data, recent readings for this index are consistent with an economy heading into recession. The question is how long it will take for the cyclical "turn" in manufacturing to bleed into the services sectors, which still accounts for two-thirds of spending, and four-fifths of employment. The ISM Services PMI (below) remains in positive territory (above 50), but the latest reading of 51.2 was well below the consensus forecast of 54.5. It is too early to place much credence on a single monthly report, especially since business confidence remains high among the survey participants in most industries. But the trend, if one develops, bears watching.



LEI is Approaching Recession Levels

The Conference Board's Index of Leading Economic Indicators (LEI), which includes data on manufacturing activity and employment, as well as building permits, sales, credit, interest rates, stock prices and sentiment, fell by 1.2% in March following a 0.5% decline in February. The LEI is now down 4.5% over the last 6 months, a steeper rate of decline than its 3.5% decline during the prior 6 months, and it is approaching levels that have accompanied past recessions.



The Conference Board's narrative that accompanied the March report read as follows:

"The U.S. LEI fell to its lowest level since November 2020, consistent with worsening economic conditions ahead. The weaknesses among the index's components were widespread in March and have been so over the last six months. The Conference Board forecasts that economic weakness will intensify and spread more widely throughout the U.S. economy over the coming months, leading to a recession starting in mid-2023."

The Inflation News Is Mixed, but Encouraging

Inflation continues to trend lower as the lag effect of the Fed's rate hikes on demand continues to take hold. The Consumer Price Index rose 0.1% in March on a seasonally adjusted basis, following a 0.4% increase in

February. The CPI is up 5.0% over the last 12 months, down substantially from 9.1% recorded last June but still a long way from the Fed's 2% target. Energy costs have declined 17% on a year-over-year basis, while food costs have risen 8.5%. The core CPI (ex. food & energy) remains elevated at 5.6%, and actually rose slightly in March (chart, below).

The Fed's preferred measure of inflation is not the CPI, but the Personal Consumption Expenditures (PCE) index. The CPI is a narrower index, measuring only out-of-pocket expenditures by primarily urban consumers. The PCE considers expenditures made by both urban and rural consumers, and includes expenditures made on their behalf by third parties – such as medical expenses paid by insurance companies, Medicare and Medicaid. The March PCE report won't be delivered until April 28th, but previous months' reports have shown steady improvement, similar to the monthly declines in the CPI.

Inflation expectations for the next 1-3 years have fallen noticeably in recent months, according to surveys by the Federal Reserve Bank of New York and longer term inflation forecasts are coming down close to the Fed's target rate of 2%. Whether or not that target can be achieved in the absence of a recession is still very much the question.

Corporate Earnings

The pace of corporate earnings reports for the first quarter is beginning to quicken, and FactSet data suggests that Q1 earnings for the S&P 500 will decline by 6.5%, year-over-year. That would mark the second quarterly earnings decline in a row, and the largest quarterly earnings decline for the index since the second quarter of 2020. But as a Bank of America strategist recently pointed out, "Q1 isn't about Q1." Instead, analysts and investors are far more interested in future guidance, fearing that the worst is yet to come.

We have repeatedly emphasized in recent *Outlooks* that consensus earnings expectations for this year and next are too high, particularly as the recession risks were increasing. BlackRock analysts wrote recently that, "We don't think (earnings estimates) reflect the coming damage yet. Corporate earnings expectations have yet to fully reflect even a modest recession."

Earnings estimates for 2023 and 2024 have come down steadily in recent months, but they still do not reflect the impact of a recession which is becoming more likely. The 2023 consensus earnings estimate for the S&P 500 of $220 is 8% below where the consensus was 6 months ago, but it still represents a 2% increase over 2022 earnings. If earnings are expected to decline by more than 6% in the first quarter, then earnings would have to accelerate over the next 3 quarters to make even a modest 2% increase for the year achievable – hardly realistic given the macro outlook.

Recession	EPS Degradation	P/E Compression	S&P 500 Drawdown
Aug 1957 – Apr 1958	-12.1%	-18.5%	-21.6%
Apr 1960 - Feb 1961	-12.4%	-22.1%	-5.2%
Dec 1969 – Nov 1970	-17.0%	-21.8%	-36.1%
Nov 1973 – Mar 1975	18.4%	-61.9%	-48.2%
Jan 1980 – Jul 1980	7.1%	-26.8%	-17.1%
Jul 1981 – Nov 1982	-11.8%	-19.7%	-27.1%
Jul 1990 – Mar 1991	-39.7%	-7.7%	-19.9%
Mar 2001 – Nov 2001	-25.9%	-27.7%	-49.1%
Dec 2007 – Jun 2009	-50.1%	-38.0%	-56.8%
Feb 2020 – Apr 2020	-20.3%	-15.5%	-33.9%
Mean	***-16.4%***	***-26.0%***	***-31.5%***
Median	***-14.7%***	***-22.0%***	***-30.5%***

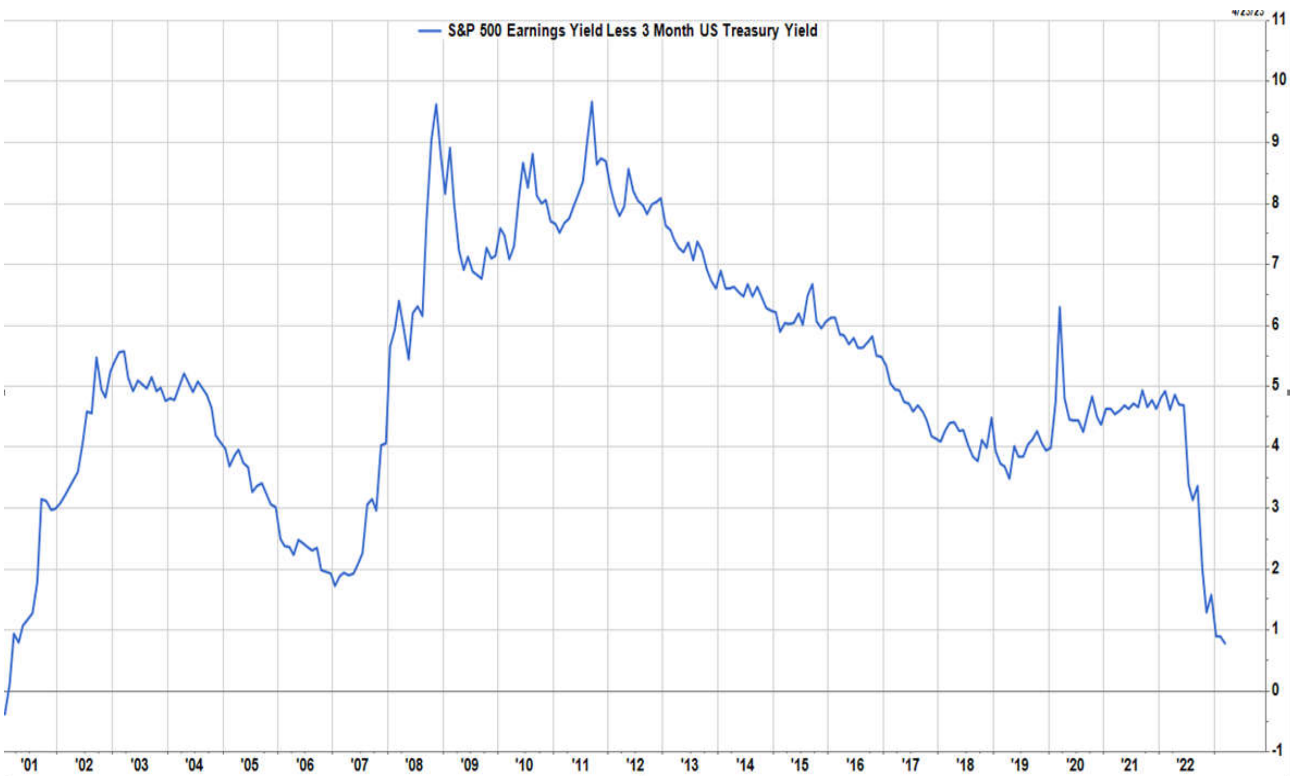
Sources: Bloomberg, NBER.

The 2024 consensus of $247 is 12% above 2023's (too high) estimate. Intuitively, one would expect earnings to decline, not grow, if the economy contracts or goes into recession, but even those lacking the gift of intuition could discern from the above chart of earnings declines over the last 10 recessions that current earnings expectations for 2023 and 2024 are wildly unrealistic. If earnings were to decline by just the average rate of 16.4% from last year's level, that would imply 2024 S&P earnings of $185, not $247 – 25% below current expectations. And note that the earnings declines over the last 4 recessions have been even more severe, averaging 34%.

Where We Stand

While most of the attention of the financial media has been focused on concerns over the banking sector and prospects for a hard landing (or soft landing/no landing), it shouldn't escape anyone's attention that the stock market's rise in the face of a worsening macro environment has stretched valuations, as well. Goldman Sachs points out that the S&P 500's current forward price/earnings multiple of 18.7 ranks in the 82nd percentile of observations since 1980. This means that only 18% of the time has the S&P 500 traded at richer valuation levels than today. The market's forward P/E is higher than it was a year ago, but Treasury rates were 65 basis points lower then, and earnings estimates were higher.

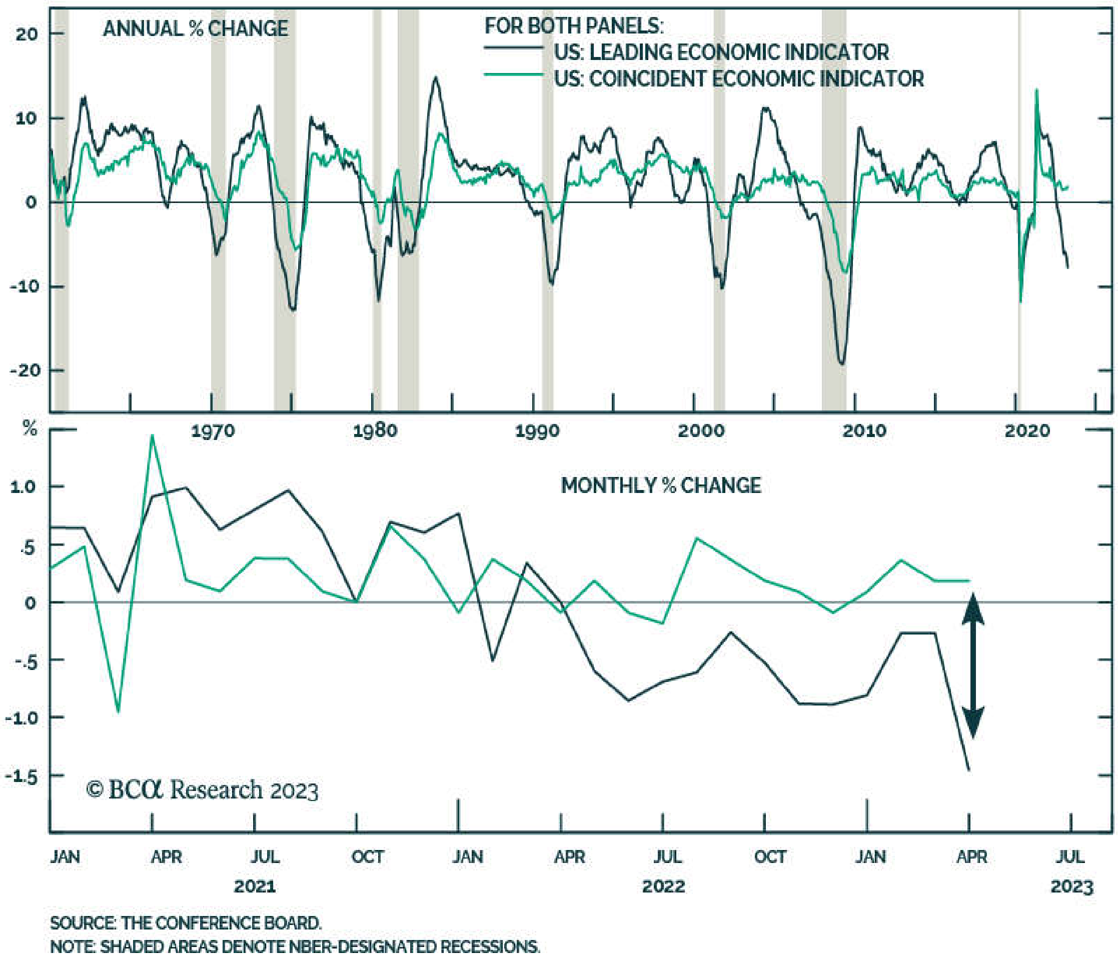
The S&P's current earnings yield (the inversion of the P/E) is just 96 basis points above the 3-month U.S. Treasury Bill yield – the narrowest spread since 2001. In other words**, stocks are expensive compared to the risk-free alternative,** and even more so when you consider that valuations are based on forward earnings assumptions that are too optimistic, and will inevitably be revised downward – probably dramatically.



Bond yields have ticked up in April after falling through the second half of March. The 10-year Treasury rate is up to 3.57% from its low of 3.30%, offering a reasonable balance of current income and risk mitigation, and potentially greater returns if a recession materializes and long term rates drop. A Bank of America survey of money managers shows that they are currently more over-weight bonds compared to equities than at any time since the global financial crisis of 2008-09.

There are still many who doubt that a recession is inevitable, or even likely, and all cite continued strength in the economy and jobs as the reason for their optimism. Even St. Louis Fed President James Bullard recently downplayed the risk of recession, arguing for the Fed to keep raising rates. His entire argument was based on strength in coincident or lagging indicators.

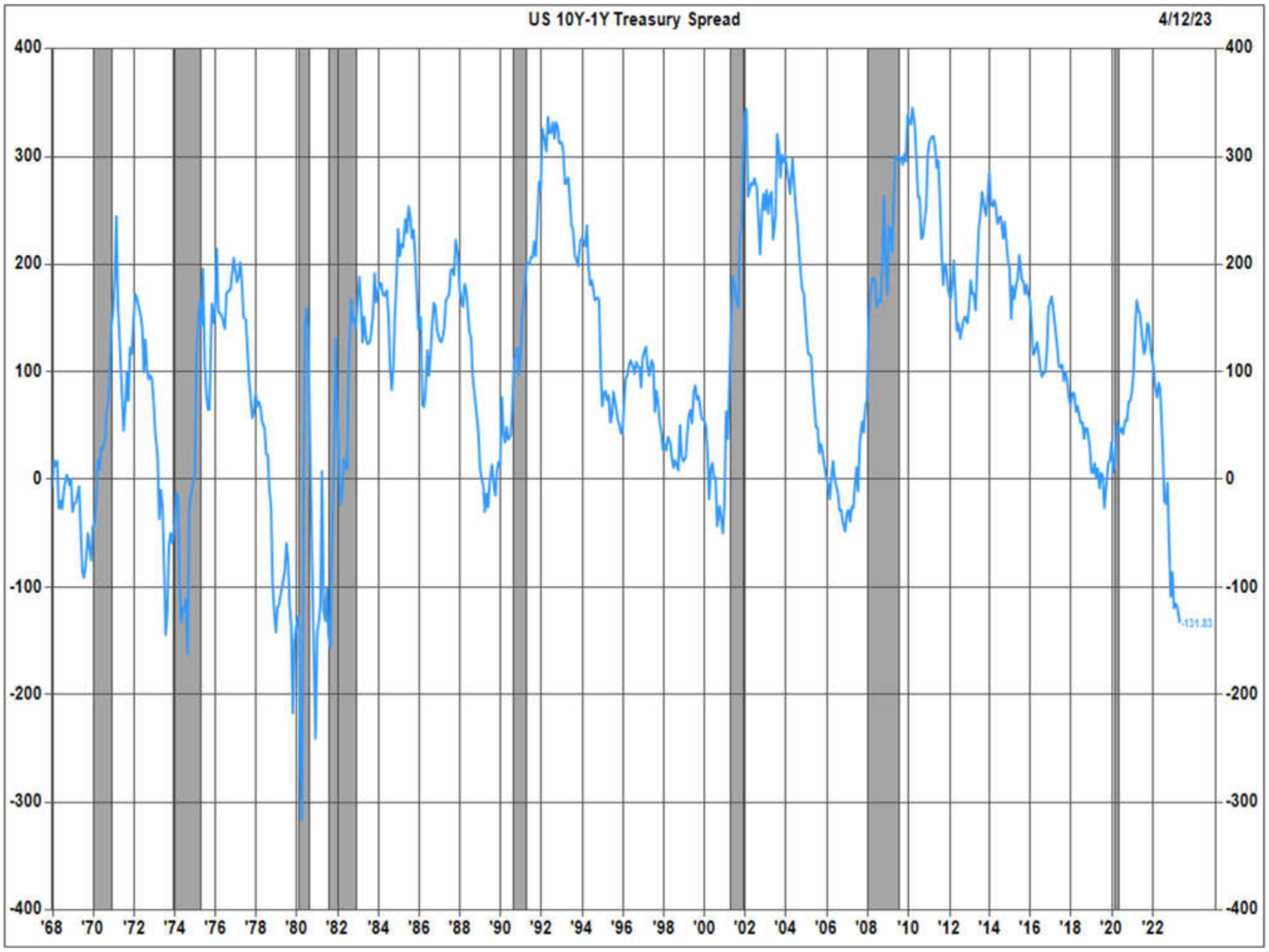
Well, when the optimist says "this is as good as it gets," the realist fears that this is true.



It stands to reason that, at the peak of a cycle, lagging indicators are strong and coincident indicators are mixed. This is clearly shown by the readings of the Conference Board's Coincident Indicators (top chart, green) and Leading Indicators (black), prior to past recessions. Lagging and coincident indicators always point to a soft landing – until they don't. Leading indicators, especially those that have been the most reliable in the past, are evidencing an economy that, while not yet on the cusp of a recession, is steadily sliding into one (bottom chart, above).

An inversion of the yield curve – when long-term interest rates are lower than short-term interest rates - is a leading indicator of a recession that hasn't been wrong over the last 8 recessions spanning a period of 55 years. **And over that time, the S&P 500 index has never bottomed before a recession, but always during – or even after – a recession.**

The yield curve inverted in July of last year, and the typical lag between the initial inversion and the onset of a recession has been 12-14 months. We have no intention of casting aside this indicator just 9 months after the curve inverted, particularly when other leading indicators such as rising jobless claims, contracting PMI, tightening bank lending standards and shrinking money supply are also flashing red – not yellow.



The S&P 500 is higher now than it was when the yield curve first inverted last year. It's not unusual for stocks to rally after an inversion (by an average of 11%). But in every case, post-inversion rallies in the equity market have been more than fully reversed in the recession that inevitably followed. The average market decline from the initial inversion to the trough of the recession has been 23%, which would imply a potential S&P downside of 3,100, or 25% below its current level, but the range of possible outcomes is far wider than any single point forecast could capture.

Stocks could continue to rise in the short term, driven by momentum as well as the tendency to use coincident or lagging indicators in an attempt to invalidate leading indicators. But chasing short term profits seems to us to be a fool's errand. Missing the bottom on the way up costs nothing, it's missing the top on the way down that's expensive.

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