CHARTWELL INVESTMENT PARTNERS

Chartwell Strategies Current Outlook

It is not true that people stop pursuing dreams because they grow old; they grow old because they stop pursuing dreams."

-Gabriel Garcia Marquez
(Nobel Prize novelist, 1927 -2014)

Summary

- *Despite additional Federal Reserve Board (FRB) interest rate hikes, stocks mounted a modest rally in the first quarter of 2023. The NASDAQ Index was the best performing Index, rising a surprising 17.2 percent. Nevertheless, many analysts remain skeptical that the markets have reached bottom.*

- *Gross Domestic Product (GDP) for the first quarter of 2023 rose a meager 1.1 percent year over year as the FRB attempted to reduce inflation, by raising short-term interest rates, without causing a recession. However, inflation remains well above the FRB's target of 2 percent, suggesting the need for more interest rate increases.*

- *The upcoming debate on raising the Federal debt ceiling and lingering concerns about the stability of regional banks weigh on investors' minds as sidelights to the central problems of fighting inflation and growing the economy.*

Background

The Federal Reserve Board (FRB) held center stage in the fist quarter of 2023 as investors attempted to determine how many more hikes in interest rates were being planned and if a recession is likely. Unfortunately, no clear answers were forthcoming, however, the equity markets were "oversold" enough at the end of 2022 to rally in the three-month period ending March. Last year's worst performing index, the NASDAQ, rebounded 17.2 percent in the first quarter after its 2022 annual decline of 31.2 percent. The Dow Jones Industrial Average, Standard & Poor's 500 (S&P 500) and Russell 2000 also gained in the first quarter, rising 0.9 percent, 7.5 percent, and 2.7 percent, respectively. So, at the end of the first quarter, some stock market indices had rallied off last year's lows but remained well below the highs reached in the November 2021 to January 2022 period. And Q1 was another case of a very "narrow" market advance, led primarily by large-cap Tech stocks. Value stocks were left behind, as seen by the larger-cap Russell 1000 Value's return of just 1% and the small-cap Russell 2000 Value Index's decline of 0.7%.

In our last letter, Fourth Quarter – 2022, three one-year charts of the major indices were shown, the S&P 500, the NASDAQ and Russell 2000. Each of these indices appears to have bottomed out last year in October, and these lows have not been penetrated since that time despite admonitions from most economists that a recession is imminent and that stocks are overvalued. Nevertheless, despite the modest first quarter rally, investors have remained cautious, choosing to invest in the safety and higher yields now available in Treasury bills.

A major reason for the anxiety of investors is the effect of rising short-term interest rates on several regional banks that came to light in March, most notably Silicon Valley Bank (SIVB) and First Republic Bank*. In the case of SVB, the bank was closed by regulators and the assets were sold to First Citizens Bank of North Carolina. First Republic Bank continues to struggle with deposit outflows and two other regional banks were declared insolvent due to their investments in cryptocurrencies. Although the problems experienced by these banks have not been systemic to the banking industry, the incompetence displayed by their management teams creates suspicion as to the effectiveness of the regulatory oversight process.

* Note: on 5/1/23, the FDIC announced that First Republic Bank was put into receivership and that JP Morgan agreed to assume the bank's ~$92 billion in deposits and substantially all of its assets

Past performance is no guarantee of future performance. All investing involves risk of loss. An investor cannot invest directly in an index. The Index returns provided throughout are an example of alternate return potential during the relevant time periods; however, indices may possess different investment attributes that may make comparisons difficult such as volatility, liquidity, market capitalization, and security types. This commentary is for informational purposes only. It is not an offer to buy or sell any security and should not be construed as investment advice. The views in this report were those of the Adviser at the time of writing this report and may not reflect our views on the date this report is first published or anytime thereafter.

CW23-0112 | EXP. 07/31/2023

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One concern for investors is the obvious tension between the policies of the Biden Administration and the FRB. The FRB is of the belief that the inflationary environment has been caused, at least in part, by the unprecedented amount of money being borrowed by the Treasury to fund the legislation passed by Congress. However, the Administration, specifically Treasury Secretary Janet Yellen, does not believe this to be the case. The absence of harmony in this regard is not comforting because the FRB's attempts to meet their inflation objective of 2 percent is taking longer than they anticipated; their frustration adds to the risk of even more interest rate hikes and the increased possibility of recession.

Whether or not a recession occurs in the near-term may be less important than the potential for an economic expansion later this year, or early next year. Figure 1 illustrates the annualized growth of the Nation's Gross Domestic Product (GDP) on a quarterly basis between 2010 and the present time. The numbers are adjusted for inflation and are presented in constant 2012 dollars. Over most of this period, growth has ranged between 1.5 and 4.0 percent, however, on average, economic growth has been lackluster. Examination of Figure 1 shows that economic growth peaked in the second quarter of 2021 at 12.5 percent annually when the economy expanded sharply following the economy's shutdown due to the COVID pandemic. Obviously, this was a unique situation that was unsustainable; predictably, the expansion has since lost momentum and in the last reported quarter ending December 2022, annualized growth was a disappointing 0.9 percent. Now, with the FRB continuing to raise interest rates to fight inflation, the growth trajectory is pointed down and economists are forecasting very modest growth for the next two years. A survey of economic forecasts, conducted by Trading Economics (a provider of economic data) predicts annualized growth for the United States of less than 1.0 percent for 2023 and 2024.

Quarterly Growth of GDP, Annualized, year over year, in chained 2012 Dollars

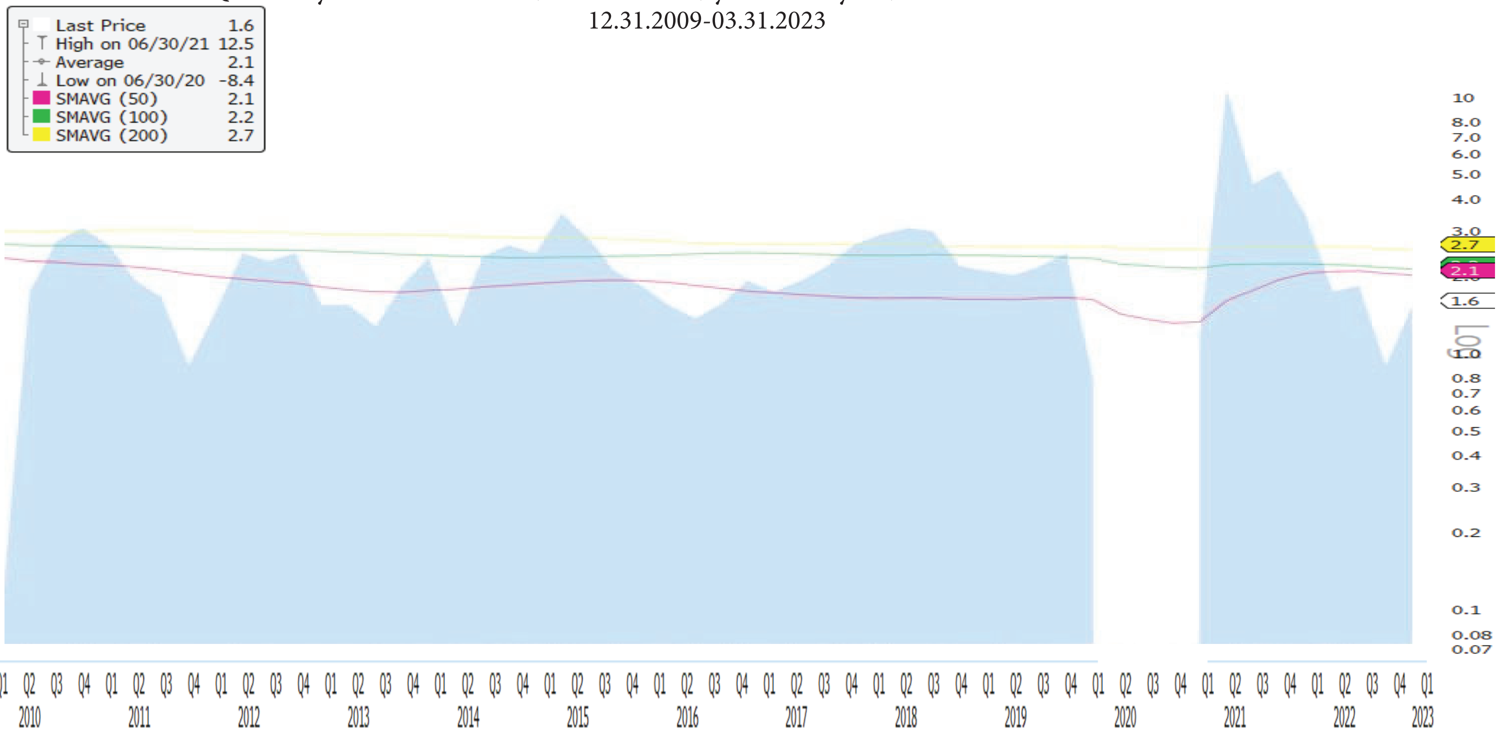

Figure 1. After a Robust Recovery from the COVID Shutdown, GDP Growth is Contracting towards Recession Levels..
Source: BLOOMBERG

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Of additional concern is the need for the Federal Government to raise the ceiling on the Federal debt limit. Figure 2 illustrates the rise in the Federal debt from 1922 to the present. The absolute level of the debt, which now comprises 130 percent of annual GDP, has risen hyperbolically since 2020 and coupled with higher interest rates, has become a major political issue. In the past, there was generally a negotiation between the President and Congress regarding the extent of the increase and it is not unusual for the negotiating sides to "go down to the wire" before an agreement is reached. However, this year to date, no negotiations have begun, raising the remote possibility of our country defaulting on its debt. Although this is unlikely to occur, the uncertainty of an agreement being made creates a higher risk environment that reduces the confidence of investors.

Finally, for those looking for reasons to be bullish, the mid-cap and small cap sectors of the equity markets are inexpensive, the peak in the rate of inflation has probably passed, investment sentiment is negative (typically a bullish sign) and there is substantial cash on the sidelines.

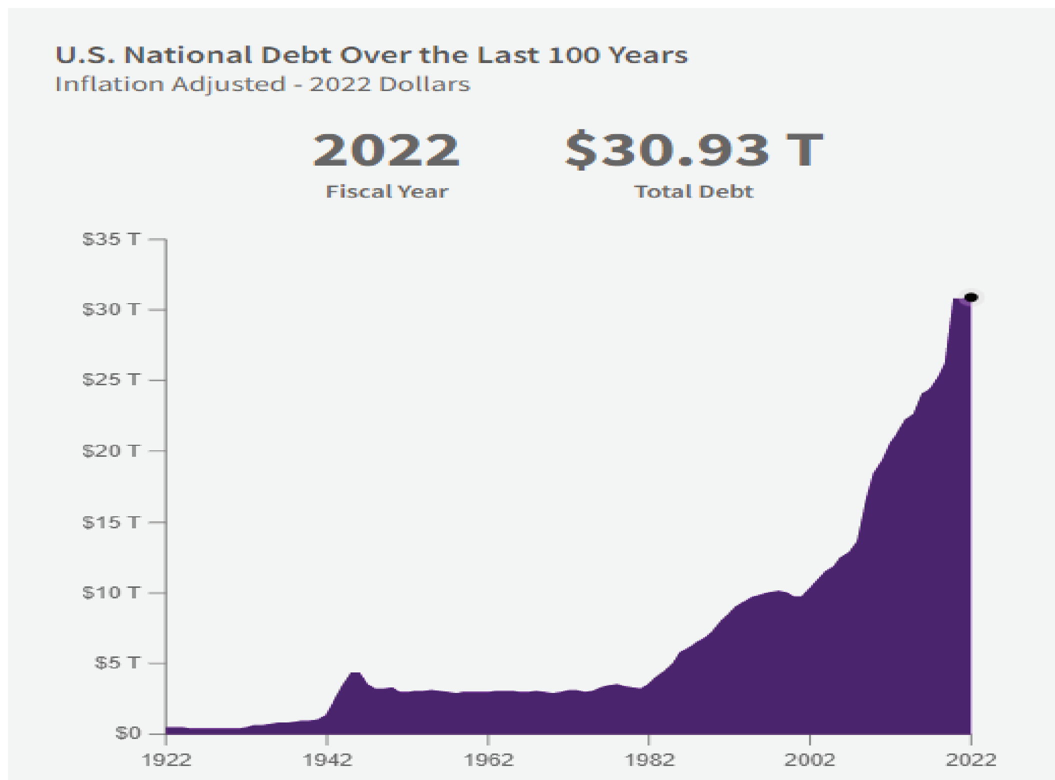

Figure 2. The Rise in the Federal Debt is now Rising at an Alarming Rate.
Source: Fiscaldata.treasury.gov/Americas-finance

In light of the market's rise in the first quarter (albeit narrowly led), and several risks still front-and-center, the risk/reward seems unbalanced to us. While inflation has come down from the 8-9% range to around 5%, the Fed just raised rates again on May 3, which continues to push the odds of a recession higher. The banking crisis that started with the collapse of Silicon Valley Bank, while now looking contained (and not systemic), has ramifications for tighter credit conditions and less loan creation, placing greater dampening effects on the economy. Geopolitical tensions with both China and Russia have increased, and "policy" risk (debt ceiling, etc.) in D.C. has also gone up a notch.

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These conditions warrant more caution, we believe, and this will be seen with incrementally more “defense” in investor portfolios – whether it be higher cash levels, reduction of some economically-sensitive positions, and/or the addition of more “recession-resistant” stocks. Having some dry powder seems like a good thing currently, as we await more clarity on the items noted above (or some opportunities created by a market pullback).

If you wish to receive additional information about the IMAP program please contact Chartwell at (610) 296-1400 or info@chartwellip.com.

Definitions:

Dow Jones Industrial Average: The DJIA or “The Dow” is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange (NYSE) and the NASDAQ.

The Nasdaq Composite Index is the market capitalization-weighted index of more than 2,500 common equities listed on the Nasdaq stock exchange.

Russell 2000 Index: London Stock Exchange Group plc and its group undertakings (collectively, the “LSE Group”). ©LSE Group 2023. FTSE Russell is a trading name of certain of the LSE Group companies. Russell® is a trade mark of the relevant LSE Group companies and is used by any other LSE Group company under license. All rights in the FTSE Russell indexes or data vest in the relevant LSE Group company which owns the index or the data. Neither LSE Group nor its licensors accept any liability for any errors or omissions in the indexes or data and no party may rely on any indexes or data contained in this communication. No further distribution of data from the LSE Group is permitted without the relevant LSE Group company’s express written consent. The LSE Group does not promote, sponsor or endorse the content of this communication.

S&P 500® Index: (registered trademark of The McGraw-Hill Companies, Inc.) is an unmanaged index of 500 common stocks primarily traded on the New York Stock Exchange, weighted by market capitalization. Index performance includes the reinvestment of dividends and capital gains.

Investors cannot invest directly in an Index.

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