Hughes Investment Advisory Service LLC

April 1, 2023

Dear Clients and Investors,

Spring has arrived here in the Northeast, but we are still waiting for warmer temperatures. The first quarter has passed but the excitement in the equity and bond markets have not.

In a bi-furcated Q1 market the DJIA was up just .4% while the S&P 500 rose 7%. After the worst year on record last year, the Barclays US Aggregate Bond Index, or AGG, rose 2.5%. Gold closed up 8.5% at $1,978 near an all-time high.

So where do we stand as we head into Q2 2023? The interplay between Federal Reserve policy, inflation, economic growth, and earnings is driving the markets in 2023. The Federal Reserve's battle to tame inflation is proving arduous. Personal Consumption Expenditures (PCE) Price Index, the gauge of inflation most closely watched by the central bank, is still much too strong. Despite inflation likely being past its peak, the question remains how fast will it fall and to what level? This is probably the most important variable to consider and yet one of the most difficult to forecast.

The Fed was one of the last major institutions to realize inflation was a persistent problem that needed addressing. Its response was ultimately aggressive but late, requiring more drastic measures. This comes as questions persist as to whether the full effects of the most restrictive monetary policy course in 40 years have been seen. The labor market has held up well in the face of Fed tightening and less business investment, but there are signs of stress in manufacturing and housing, February mortgage applications were 44% lower than the prior year for example.

The Fed continues to hold its inflation target of 2%, which is unrealistic. Inflation is likely to prove sticky as labor supply challenges lead to wage inflation and services demand remains strong. In this context, I believe that markets and the Fed will likely need to gain comfort with inflation closer to 3% or more likely 4%, compared to the sub 2% we have experienced since 2010.

On March 19th I sent out a mid-quarter update to clients regarding the current banking crisis surrounding SVB and Signature banks and subsequent closing of Credit Suisse in Europe. Is the crisis over? Hopefully the near-term crisis is past but the problems that caused these latest bank failures are still very much present. Fears of further systemic financial problems have roiled markets, even as the Fed and Swiss authorities have responded swiftly to instill confidence. Assuming the latest bank failures remain contained, the key question for investors is, what measures will the Fed take next? The losses that caused the problems for the above mentioned banks rest on the balance sheets of virtually all financial institutions and must be recognized one way or another.

The Fed's aggressive monetary tightening is what has put stress on the financial system. This tightening to date has been reasonably well accepted, going forward that seems less likely, and the markets have started to predict interest rate cuts before year-end however I now believe that the Fed will, by necessity, remain vigilant on inflation and expectations of rate cuts are now probably premature.

As a result of the above economic and monetary policy complexity, a wide range of equity and bond market outcomes lies ahead for the remainder of 2023, and flexibility will be paramount to navigate this volatility. How will the current stress in the US banking system play out? Will the US enter a recession? Will the Fed accept an inflation target above 2%? What level of earnings will the S&P 500 achieve in 2023?

Earnings expectations for S&P 500 companies have dropped from last year's 2023 estimate of $250 per share to $225 per share now, a number that I agree with. So, it will be critical to own the companies that prove resilient in their earnings power. Despite the uncertainty, it remains possible to find pockets of growth, especially in areas of the market with idiosyncratic opportunities. Areas we have liked and continue to like are health care, defense, infrastructure, utilities, and energy. Success will be determined by the ability to find companies with better fundamentals than currently appreciated.

In the near term, volatility is expected to reign as inflation and earnings pressures persist. However, we will pay attention to the data as the year progresses because if the Fed accomplishes its mission to tame inflation, we need to be ready for the upside, if not, it will be stormy seas ahead. Either way, the winds can change quickly.

Specifically, given the above concerns where do I find attractive investments today? Gold has been hitting new all-time highs and finally providing a hedge against inflation. T-Bills are providing 4-5% returns. In equities the Cloud buildout continues, Large Tech, Defense, Medical/Pharma/Biotechnology, Consumer Staples, Farming and Energy including clean energy such as Nuclear and Hydrogen. These are the growth areas where the US is playing the leading role for the future.

Overall, I continue to favor large-cap, dividend paying, US based multi-national companies with strong balance sheets. We love businesses with irreplaceable brand names, wide moats, high margins, grow their dividends, and have modest debt. Risk/reward now slightly favors equities over fixed income – Utilities, MLP's and specialized bond/income funds provide steady income. I believe that our portfolios are well positioned to produce consistently attractive long-term risk adjusted returns while preserving capital. Please do not hesitate to give me a call to discuss the above analysis.

Sincerely,

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