2 KNIGHTS
WEALTH MANAGEMENT

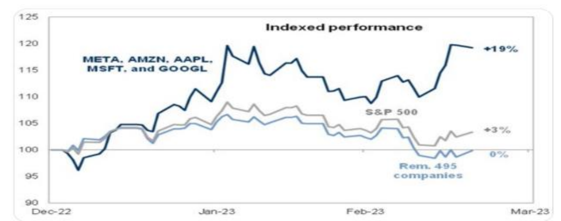
Market outlook as of April 2023

The late Marty Zweig is credited with the saying 'Don't Fight the Fed'. In his book 'Winning on Wall Street', which was published in 1970, he writes "indeed, the monetary climate - primarily the trend in interest rates and Federal Reserve policy - is the dominant factor in determining the stock market's major direction'. Aligning with the Fed means you should invest aggressively when rates are low, and conservatively when rates are high. When the Fed sets low rates, it helps the economy expand, which lets corporations and consumers borrow money more cheaply.

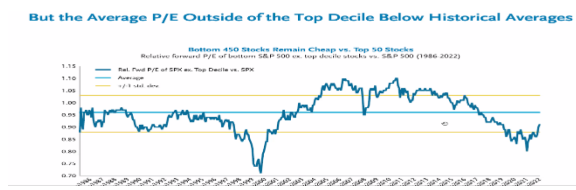
So far, this year economic indicators have shown a global economy that is growing more robustly and suffering from stickier inflation than previously thought. The maxim is that central banks (The Federal Reserve) will tighten monetary policy till something breaks. We certainly heard a "snap" with the rapid implosion of two Silicon Valley Banks but sense that they were isolated cases, and a result of poor management rather than industry "systemic" risk. We think that the US banking sector overall is in much better shape than the global crises of 2008, due to much stronger balance sheets and risk controls.

The US economy is being sustained by a robust labor market and strong consumer spending. Service sector inflation is showing itself to be a lot more persistent, forcing the Fed to remain hawkish. The banking crises may even be helpful to the Fed as banks are tightening lending standards which will further throttle the economy.

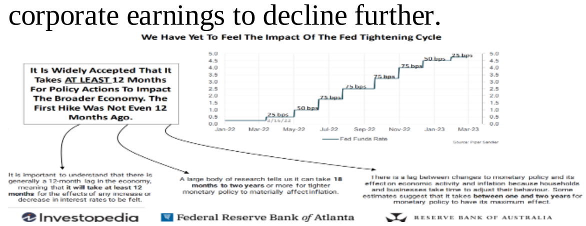
Looking at the markets returns this year, one would think that a new bull market was starting. However the performance was very narrow, completely dominated by a hand full of stocks (see below).



The remainder of the market looks more than fairly valued.(see below)



We think the Fed will not raise rates much more as they have already raised 8 times since March 2022. Interest rate hikes which have yet to hit the economy are much like torpedoes in the water, they will have a delayed effect. We think one must be prepared for interest rates to stay higher for longer due to stickier wage inflation…causing corporate earnings to decline further.

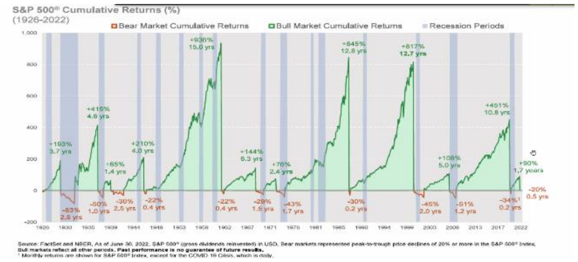


Historically, it has taken 18 months to two years after the Fed's initial rate hike for a recession to commence. The first hike in this cycle was in March 2022. The Fed, by their own words, has unequivocally stated that they will only back off from a restrictive stance when it is confident that the labor market has cooled enough to bring wage inflation into line with its 2% target for consumer price inflation. Most wage measures are running at around 5-6% annual growth. The Fed would prefer wage inflation to be below 4%. The unemployment rate most recent reading even dropped from 3.6% to 3.5% last week and is the lowest since the 1960s.

We think it's way too early to sound the "all clear" for several reasons. Continued Fed vigilance against wage inflation, higher interest rates taking their toll on all aspects of the US consumer and the economy, banks tightening standards, spiking oil prices and the upcoming U.S. debt ceiling debt debate all argue for a more cautious/defensive approach until there is more clarity on the economy and the Feds stance. Additionally, we believe the next shoe to drop is from companies' lower guidance toward economic weakness and uncertainty ahead. We expect S&P 500 forward earnings estimates to continue to trend lower this fiscal year, but we do believe that they will be higher further out over the next 12 to 18 months as investors begin to discount the eventual recovery.

Based on prior studies once unemployment rates start to rise, they get a life of their own and continue to accelerate due to recessionary concerns. Households respond by cutting back on excess spending. Corporations cut back on capital and investment spending. Both leading to even higher unemployment and less spending. Over the post-World War II period, the U.S. economy has experienced a recession every time the three-month moving average of the unemployment rate has risen by more than a third of a percent. History suggests that a soft landing will be difficult to accomplish.

From a long-term perspective, bear markets are part of the investment landscape. While we are more cautious in the nearer term, once housing bottoms and the Fed is done raising rates, markets will take off and a new Bull will take the reins. From the chart below, one can clearly see that markets are in a bullish mode most of the time, punctuated by relatively brief bouts of selling, so it's important to stick with a long-term investment plan.



As stewards of our clients' portfolios, we view our job as finding and maintaining 30 great companies to invest in for our dividend focused strategy. Dividend stocks tend to be more defensive during recessions because companies that have an established dividend policy are much more stable businesses with strong franchises, pricing power and balance sheets to weather markets. While dividends are also taxed at a lower rate (20% max) than short-term stock gains, they also offer lower risk with reduced volatility. Bonds are now starting to provide an alternative to stocks, especially for low-risk investors or with shorter time horizons.

April 2023