PENDLETON STREET
BUSINESS ADVISORS

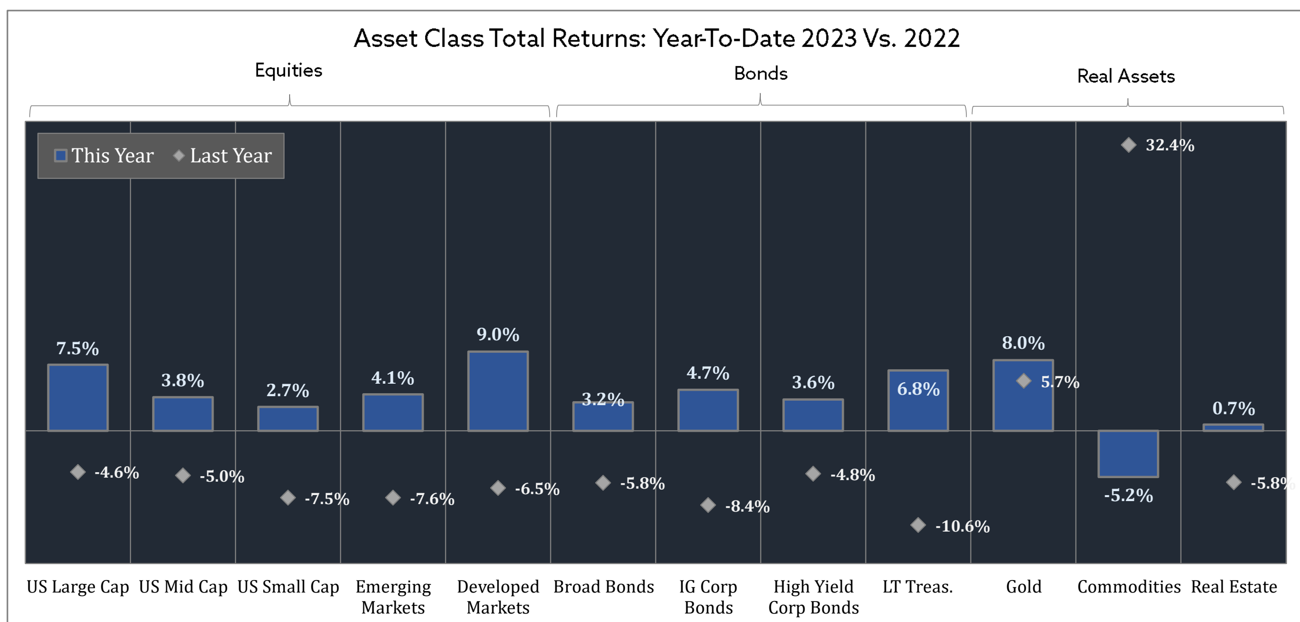
Pendleton Street Advisors
1st Quarter 2023 Investment Commentary
April 14th, 2023

Index Returns	1st Quarter	Trailing Twelve Months
S&P 500 US Large Cap Stock Index	7.5%	-7.7%
Russell 2000 Small Cap Stock Index	2.7%	-11.6%
MSCI All Country World Ex-USA Stock Index	6.9%	-5.1%
Barclays Capital US Aggregate Bond Index	3.0%	-4.8%
US Core Consumer Price Index - (Inflation)	1.3%	5.5%

It might be difficult to guess by the tone of daily financial news flow over the first quarter, but during that time markets continued a recovery that began in the 4th quarter of last year. Most notably, it appears that the financial system may have narrowly escaped a wide-spread run on community and regional banks that entered crisis mode with the failure of Silicon Valley Bank. While the crisis seems to have abated, the underlying factors that led to the situation are still alive and reach farther than that isolated case.

As we look ahead, the most pressing issues remain largely unchanged: above-target inflation; rising interest rates; and fears of an imminent economic recession. More specific to the 2nd quarter, we expect the debt ceiling debate to heat up as the Treasury is expected to run out of extraordinary funding measures late in the quarter. **For client portfolios, we continue to focus on positioning for the risk of more frequent bouts of high market volatility while also identifying and moving quickly on opportunities to add high-quality yet undervalued securities when markets are dominated by fear.**

Market Overview: US stocks as measured by the S&P 500 index returned 7.5% (including dividends) during the quarter, slightly lower than the 7.6% achieved during the prior quarter. Bonds also experienced a strong quarter, with the Barclays US Aggregate Bond Index returning 3% for the quarter vs 1.9% during the prior quarter. Of major asset classes, commodities – as measured by the Bloomberg Commodities Index - fared the worst, declining by 6.5% as natural gas and industrial metals components dragged the overall index lower.

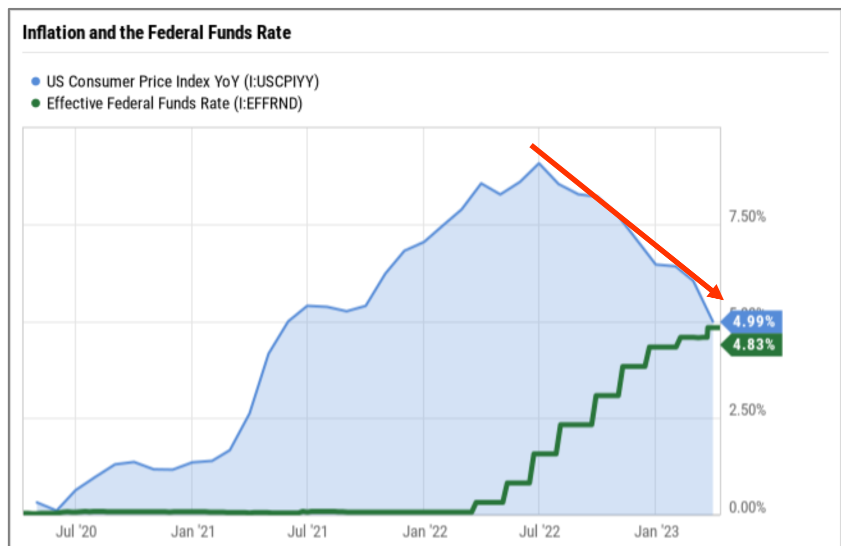


Market Drivers:

In early 2022 we outlined our view that three foundational drivers of value (inflation, interest rates, and growth) were beginning to shift in a direction that could result in a difficult environment for markets and the underlying economy. While we could not have anticipated the invasion of Ukraine by Russia, or the beginning of a rate hike cycle with unprecedented speed by the Fed, those catalysts pushed the shift in market drivers into overdrive. Currently, core market drivers are sending mixed signals.

	Indicator Levels As Of...					
	5-Year Average	2020 Year-End	2021 Year-End	2022 Year-End	Most-Recent	Expected in 2023
Inflation (CPI Year-Over-Year %-Change)	**3.7%**	**1.4%**	**7.0%**	**6.5%**	**6.0%**	***3.30%***
Source: Bureau of Labor Statistics		*12/31/20*	*12/31/21*	*12/31/22*	***2/28/23***	
Effective Federal Funds Rate	**1.39%**	**0.09%**	**0.07%**	**4.33%**	**4.83%**	***5.10%***
Source: Federal Reserve		*12/31/20*	*12/31/21*	*12/31/22*	***3/31/23***	
Actual Real GDP Growth (Yr-Over-Yr-%)	**2.22%**	**-1.52%**	**5.72%**	**0.88%**	**0.88%**	***0.40%***
Source: Federal Reserve		*12/31/20*	*12/31/21*	*12/31/22*	***12/31/22***	

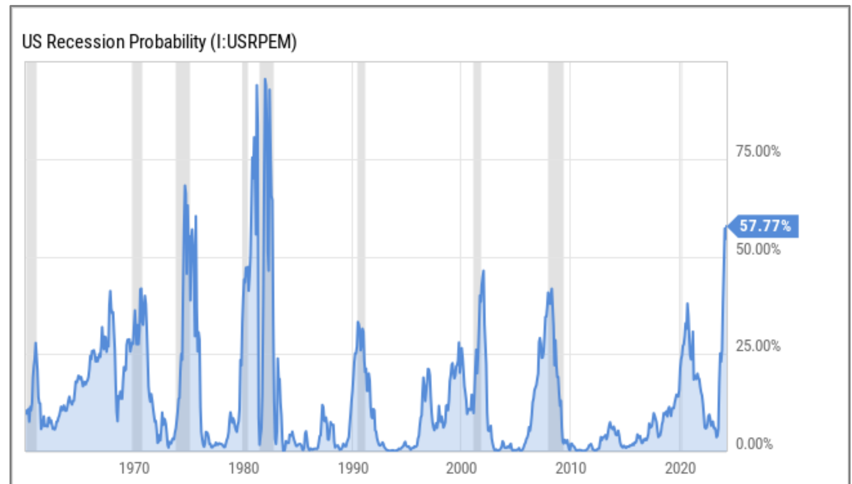
- **Inflation appears to have peaked in June, 2022** at a little over 9%, and has since declined to 5.0% as of March. This level of inflation is still above the long-term average of 3.7% and the Fed's inflation target of around 2%. But, the gradual decline tells markets and - more importantly, right now - policy makers that prices for consumer goods and services are moving in the right direction. **We see the continuation of moderately declining inflation as a positive influence on the markets going forward.**

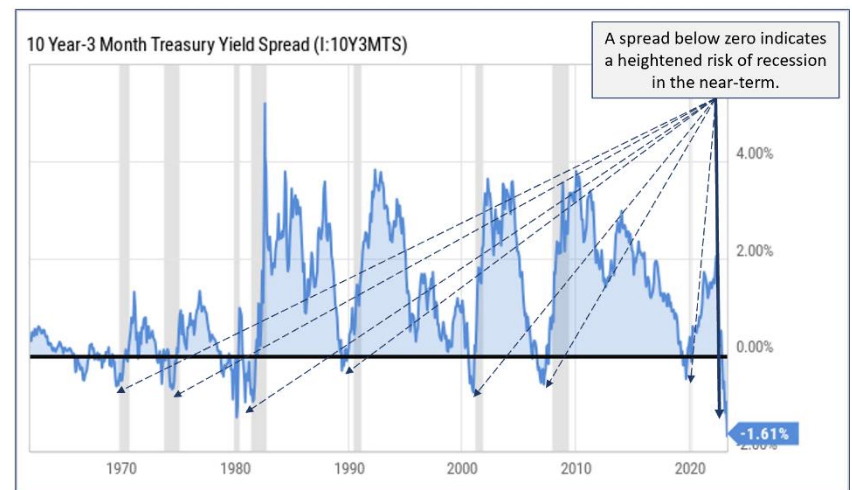


- **Interest rates** The Federal Funds Rate, the Fed's primary interest rate policy tool, has increased from nearly 0% at the end of 2021, to nearly 5% currently. An increase in the Federal Funds Rate typically results in a similar rise in interest rates across the economy: from corporate bond yields to mortgage rates. The most direct impact for investors has been the reduction in bond prices, which during 2022 drove returns on bonds in aggregate down by more than any other year beginning in 1976.

  The latest Summary Economic Projection – *a survey of the Federal Open Market Committee members* – from March suggests that the Fed will raise the Fed Funds Rate to 5.1% by the end of 2023. But, as we've seen from 2022 it is not only the magnitude of rate increases that matters, but also the speed. Some committee members have suggested that rate hikes will be slower and may even end this year. But, without significant improvement in inflation or a debilitating recession we are not convinced that the Fed will be satisfied with a job-well-done. **We see the committee's uncertainty regarding magnitude and pace of hikes going forward as a strong driver of continued market volatility.**

- **Economic growth** is expected to approach 0.4% by year-end, as measured by US Real GDP - down from 0.5% at year-end and down from the 30-year average of 2.56%. The risk of recession has risen significantly since the summer, as the impacts of inflation and the rise in interest rates meant to fight it have begun to build. **We see expectations for an economic slowdown and increasing risks of an actual recession as another primary driver of continued market volatility.**





Portfolios: We have been focused since early in 2022 on reducing risk in portfolios by replacing exposure to longer-dated fixed-rate bonds with short-term and floating rate bonds; as well as selectively selling overvalued and/or fundamentally deteriorating positions; maintaining relatively higher cash levels; and adding high quality undervalued positions as opportunities arise.

We believe it is important to recognize markets routinely swing too far - both above and below - what is reasonable pricing based on underlying fundamentals; especially when underlying drivers of the fundamentals are significantly changing course as they have been over the last 15 months. **Our challenge as managers is to navigate both the hazards AND opportunities that arise when prices are dislocated from fundamentals.** The Fed's actions to raise rates and reduce the size of its balance sheet in an effort to combat inflation have resulted in markets scrambling to reshape around a moving target.

Additionally, as yields have risen and bank savings rates have remained depressed we have focused extensively on optimizing returns on cash holdings which are above our long-term target allocation. As a result, during the last quarter, we shifted cash holdings in portfolios away from the default money market sweep account that was yielding approximately 0.45% on an annualized basis into a money market mutual fund that currently yields close to 4.5%.

Our firm values frequent communication with you to discuss changing conditions and to ensure that we understand and stay updated on your objectives. We appreciate your patience and we do not take your choice to be a client of the firm lightly. Our client-service staff will be reaching out to you as usual to schedule a meeting. If you would like to set up a meeting sooner, please contact us at your convenience. We look forward to hearing from you.

Contact: Matt Morley, CIO
Pendleton Street Advisors, LLC