HUDSON ADVISOR SERVICES, INC

OUR VIEW OF THE MARKET

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Three months ago we said the economy would need time to sort itself out before the stock market could have sustained recovery. We retain that viewpoint despite the market's positive performance in the first quarter. Some people describe the market in recent months as resilient. We think bipolar is a better description.

Yes, the S&P 500 gained 7% for the quarter. But that increase was largely concentrated in the technology sector which grew over 20%. Some investors assumed or hoped the Federal Reserve was done with interest rate increases. They chose to favor technology which had perceived value after its pummeling in 2022. But most S&P 500 sectors were flat or negative. Absent the technology blip, the broader market is uncertain and unsettled.

At Hudson Advisors, we feel more cautious than optimistic about the immediate period ahead. We do not assume the Fed is done with rate increases. We accept their pledge to do what it takes to beat down inflation. We are not overly concerned that broad problems exist in the banking system. But we think credit will tighten further for small business and consumers. We think the outlook for corporate earnings is weakening. We think the probability of a recession this year – or what some are calling a "hard landing" – is fairly strong. The market will pause rather than move further ahead in this period.

MARKET TRENDS

Longer term, of course, we are inherently the optimists. We counsel patience and perspective. We expect the economy to normalize in 2024 and subsequent years after the peculiarities of the pandemic and its aftermath. We are looking for stocks that will rebound in the future. The accompanying chart summarizes stock and bond market trends in the first quarter of 2023. Both markets were volatile but positive amidst the various economic uncertainties.

Equity Market: Many investors began the year feeling largely upbeat. Inflation appeared to be subsiding and many believed the Fed would switch from raising interest rates to cutting them. This sentiment was challenged somewhat as data showed the fight against inflation would not be easily won. The biggest shock to the market came in March when Signature Bank and Silicon Valley Bank collapsed. Stocks swung around daily, but by March 31 the market showed itself to be resilient and overall positive.

As stated, the S&P 500 concluded the fourth quarter ahead 7.5%. This result was driven by Information Technology with a gain of 21.82% and Communications Services with a gain of 20.50%. Other sectors showed modest gains or declines. The interests in technology was also evident in the Nasdaq Composite Index which was ahead 17.05%. The Russell 2000 index was positive by 2.74%. Perhaps the best indicator of actual market performance was the Dow Jones Composite Average which moved ahead only 0.93%.

Fixed Income Market: The bond market also was buoyed by a seeming belief that the worst economic news was in the past. The yield on the 10-year U.S. Treasury note – which moves inversely to prices – fell to 3.491% from 3.826% at the end of 2022. It was the biggest rally in Government bond prices since 2020.

MAJOR MARKET INDEXES

	2023 YTD Return
Dow Jones Composite Average TR	0.93
S&P 500 Index TR	7.50
Russell 2000 Index TR	2.74
NASDAQ Composite TR	17.05
EAFE Index NR	8.47
Bloomberg Aggregate Bond Treasury TR	3.01

Source: Morningstar® as of March 31, 2023

THE OUTLOOK

The Economy: We agree with a recent economic analysis by the U.S. Conference Board. They predict a mild recession in the second half of the year. Here is their rationale:

The U.S. economy is still strong at the moment. Annualized GDP for the first quarter is estimated at 1%. Both employment and consumer spending are healthy. The March CPI headline number rose 5% year over year, slowing a full percentage point from a rise of 6% in February. As a result, the Fed could possibly raise rates

another 25 basis points at its next meeting. It is possible that additional rate hikes will be needed.

Then we have the problems in the banking system. The Conference Board does not see widespread bank failures. But managing balance sheets in the face of higher interest rates will lead to tighter credit for small businesses and consumers which will dampen the economy.

The Board forecasts the economy slipping into recession during the second half of the year. However, because the labor market is still vibrant, the recession will be mild. Looking to 2024, the volatility that has dominated the U.S. economy over the pandemic period will diminish. Overall GDP growth should return to the 2% range of 2019 and previous years. Inflation will drift down to the 2-3% level and the Fed will cut rates back to below 4%.

The Market: Given the probability of recession, corporate earnings will be challenged for the remainder of 2023. Analysts have lowered their average estimate of earnings per share in the S&P 500 companies. The bottom-up EPS estimate for full-year 2023 is a decline of 3.8% -- to $221.50 from $230.33 last year. Several months ago many analysts were still predicting profit growth in 2023.

We always look carefully at the Price/Earnings ratio for the S&P 500. The forward 12-month P/E ratio is now 17.8 – much higher than the 100 year average of 15. The ratio grew from 16.7 on December 31 because of the positive market performance in the first quarter. The effect of lower corporate earnings may push the ratio even higher in the months ahead. So, yes, many stocks are richly priced.

Given the economic and earnings outlook for the remainder of 2023, we expect the market will be range bound for the rest of this year. As stated, the first quarter was a bit erratic. We expect the market will pause until the forces of inflation and recession play themselves out. If the Conference Board is correct about 2024, we might then see a sustained market recovery take hold.

As always, there is the 'black swan" of unexpected geo-political events. The tensions with Russia and China and the actions of OPEC are on the top of this list at the present time and we will be watching the news carefully.

OUR STRATEGIES

Asset Allocation: Most clients should stick to portfolio strategies previously identified. We advise against an increased allocation to equities at this time. For new clients, we will recommend a 60% allocation to equities to be phased in over a 12- to -18- month period. The other 40% of assets will be short to intermediate term bonds, cash, and alternative investments.

Preferred Equities: As always, despite market conditions, we look for long-term equity opportunities. Our focus is on companies that can weather both the short-term period and flourish in a longer time frame. We want fundamentally sound companies with reasonable valuations and that pay dividends. In that context, we are looking at these sectors which are similar to last quarter.

HEALTH CARE: This sector has proven to be economically resilient and has provided good returns historically.

ENERGY: Companies in this sector are undervalued at present and we are especially interested in pipeline companies.

UTILITIES: Companies in this sector have provided consistent earnings and good dividends.

CONSUMER STAPLES: Some of these companies can do well in uncertain times where consumers stick to basics like food and household items.

FINANCIALS: Higher interest rates can improve banking net interest income and we are interested in certain regional banks.

Other Assets: Our aversion to long-term bonds remains and is reinforced by the inflationary situation. We like bond maturities under two years which now have higher rate returns than previous years. We like laddering investments with a mix of U.S. Government, municipal, and high-quality corporate bonds. We also like the new better-paying opportunities in money market funds.

Also, for some clients, we look at alternative investments through Broadly Syndicated Loan vehicles and Collateralized Loan Obligations which can provide investors with greater security through collateral, yields, and a hedge against inflation through floating rate structures.

Dow Jones U.S. Sectors Total Return
(Percent Change for YTD, Ending March 31, 2023)
Source: Morningstar®

Oil & Gas	**-4.61**	**Consumer Services**	**10.43**
Basic Materials	**5.86**	**Telecommunications**	**2.78**
Industrials	**4.11**	**Utilities**	**-3.12**
Consumer Goods	**9.83**	**Financials**	**-2.27**
Health Care	**-3.79**	**Technology**	**24.75**

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