POST OAK PRIVATE WEALTH ADVISORS
ADVISORY, CONSULTING & INVESTMENT MANAGEMENT

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Monthly Market Commentary

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After starting 2023 on a good foot in January, stocks stumbled through February with the S&P 500 Index sliding 2.4% for the month. Looking back over the past two months, you could say that stocks borrowed from some of their strong January returns from February; even with last month's loss the S&P 500 is up 3.6% for the year-to-date, which qualifies as a good start to the year. We'll see how the rest of the 1st Quarter plays out. It's not uncommon to see stocks give back a little momentum after a strong run. Even still, some disappointment is understandable following the market's steady rally since the lows of last October.

On the other hand, the recent strong economic numbers should be cause for celebration. U.S. Gross Domestic Product grew at a 2.9% annual rate in the 4th Quarter, a small dip in its current form but a good pace of growth nonetheless. Employment markets continued to shine with over a half-million new jobs added in January and a 50-year low in the unemployment rate (reported at 3.4% in the monthly report.) There was even some good news on inflation, which continued to show improvement last month, even if the easing of consumer price increases has moderated since the start of the year.

But in reality—and what investors came to realize in February—is that this positive news was a double-edged sword. Ongoing strength in the economy means the Federal Reserve is likely to maintain a tighter monetary policy for the foreseeable future. An expanding economy, strong labor market and sustained retail spending all make the case for "higher for longer" interest rates from the Fed. That realization lowered investors' risk appetite, along with stock prices, in February.

The price we pay

The hopes that many investors had for a Fed pivot in the first half of this year seem dashed at this point. As I wrote last month, I did not believe the Fed would change direction and lower interest rates anytime soon, despite what the Fed futures markets were projecting at the time. In my view, inflation was--and still is--too high to warrant a shift to looser monetary policy. We still hold to our thesis that the Fed won't alter course on rates anytime this year. We may see a pause in the current rate-hike campaign in the second half of 2023, but a rate cut is probably not on the table (unless we experience a dramatic shift in the economy.)

The latest economic data appears to reinforce this position. The personal consumption index (PCE), which is the Fed's preferred inflation gauge, ticked higher in January over the previous month. An annual increase of 5.4% last month and 4.7% for the core PCE reading are both way off from the Fed's 2.0% inflation target. The Federal Reserve claims to be "data dependent" in setting monetary policy and making interest rate decisions. The quarter-point increase at the FOMC's February 1 meeting seems justified now in light of the recent economic data. As of this writing, the market is expecting three more quarter-point hikes from the Fed through the first half of 2023, which would raise the target rate to a 5.25-5.50% range by June.

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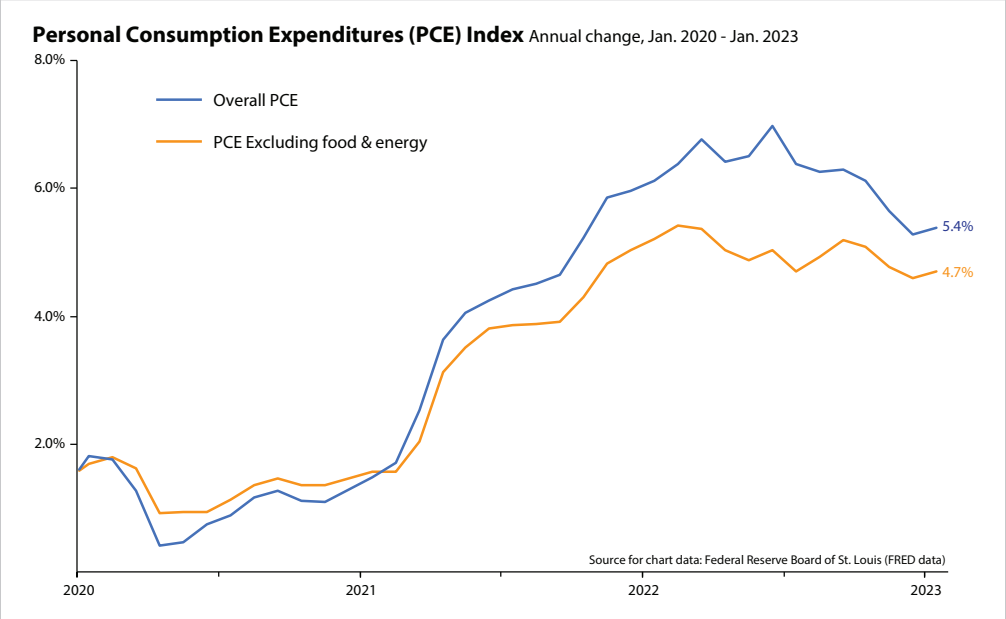

If the Fed is said to be data dependent, it can also be said that investors have been "data reactive" as of late, not just this year but going back to Q4 of last year. For example, January's rise in stock prices can be attributed to investor exuberance over Fed Chair Jerome Powell's comments last month about possible easing inflation. In contrast, February's positive economic data on jobs, wages and consumer spending growth revised this narrative, soured the mood on Wall Street and dragged stock prices down.

Even this latest market reaction may prove to be temporary. Although short-term drops in the market aren't fun to watch, this kind of market noise is not consequential in context of your long-term investment plan. What is important are the portfolio allocation decisions we make now, taking your time horizon, your risk tolerance and your income needs in perspective. It's widely recognized that most investors, even those in retirement, need some exposure to equities as long-term growth is necessary to keep pace with inflation. This requires investors to stomach market gyrations in the short term, but doesn't impact their long-term plans. This is a roundabout way of saying that market volatility is the price we pay for higher returns in the long run.

Value, growth or both?

That's not to say investors should stick their heads in the sand when it comes to news in the markets and economy. It's important to be aware of shifts in the economic cycle when and where they take place. Patterns of growth, contraction and recession do impact companies' financial performance, which ultimately drives investment performance. For example, a climate of higher-for-longer interest rates will present significant constraints for the "go-go" growth companies that investors have favored over the last decade. The lack of free and easy money in the capital markets will make it more expensive for many younger, growth-oriented firms (particularly in the tech sector) to fund their growth initiatives. Higher costs for debt servicing will likely compress their margins as well, even as many of these companies strive for profitability.

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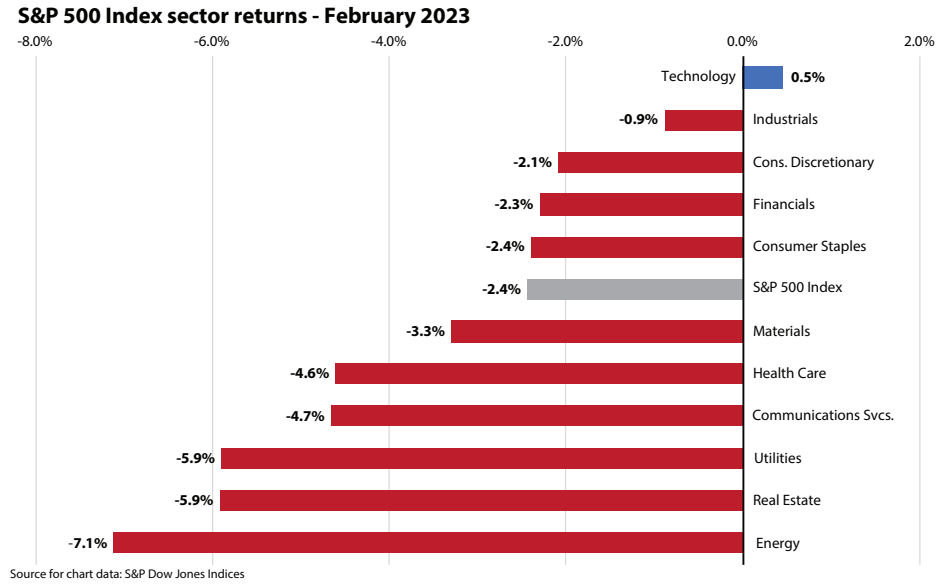
Does this mean investors should abandon growth companies and focus on value? I believe this is the wrong narrative. The key is to own quality companies. There are many high-quality firms that fall in the growth category based on their higher price/earnings ratios. Likewise, many high-quality firms are labeled as value because they have generated consistent earnings.

There can be a place in your investment plan for higher-risk investments, but they shouldn't be the foundation for a long-term portfolio. Companies that can produce solid earnings, dominate their chosen markets and generate the cash flow to withstand different economic environments will generally offer the best opportunities for return in the long run. Quality and market dominance does not preclude innovation. In fact, some of the greatest product and service innovations that have come to market in recent years emerged from our largest companies. I think many of these firms will continue to innovate and succeed.

A word about earnings

From a sector perspective, energy companies continue to stand out in reporting positive earnings performance for Q4, but the industrials and real estate sectors have also turned in good results. Earnings growth for utilities and consumer staples firms was mostly flat but outperformed the market as a whole. Declines in earnings brought down the communications, materials and consumer discretionary sectors. These announcements tended to have an inverse effect on stock performance for the month. Energy and Real Estate were the two worst-performing sectors, but the Communications and Utilities sectors suffered as well. Technology was the only positive sector in February, with a return of just 0.6%. Industrials, Consumer Discretionary and Financials saw smaller declines relative to other sectors but outperformed the overall market for the month.



Nearly all S&P 500 firms have reported Q4 earnings by now and it appears that earnings growth for the quarter will be negative, as many analysts have expected. However, earnings season has not been terrible; 68% of S&P 500 companies have outperformed expectations, although these expectations had been gradually reduced for several months in anticipation of a slowing economy.

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In many of the Q4 reports, companies offered uncertain guidance for future earnings because of the many unknowns about the economy going forward. Some analysts believe uncertainty and ongoing earnings revisions haven't been priced into the market yet. There may be some truth to those assertions, and in the coming weeks stock valuations may come down from current levels. But investors shouldn't lose sight of the fact that the stock market is very efficient in pricing securities based on future expectations.

Minding the market's emotions

While financial markets are remarkably efficient, investors are human and bring the range of human emotions to their experience in the markets, as evidenced by the immediate reaction to minute-by-minute economic data. Emotional reactions to economic or financial news are natural. At times, investors can be their own worst enemies, following the crowd in chasing the market up or down, jumping in and out of investments depending on good or bad news. This is short-term noise that distorts the historical rule that stocks have gone up over the long run. We should recognize the market's emotions in the moments when they occur, but tune out the short-term noise and focus on the historical record—that stocks have gone up and beaten inflation in the long-term.

Please feel free to reach out our team if you would like to discuss your investment plan or the results of your portfolio. As a comprehensive investment management and financial advisory firm, allow us to be your resource for sound financial guidance.

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