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MAY 2023 MARKET COMMENTARY

EQUITY & FIXED INCOME MARKETS COMMENTARY

The trend of mega-cap growth stock outperformance continued in May, as evidenced by the NASDAQ Composite Index posting a gain of 5.9%, while other indices struggled. The S&P 500 was up 0.4% (helped by those mega-cap stocks) and the Blended Equity benchmark was down by -1.1% for the month, as the Mid-Cap S&P 400 and the Small-Cap S&P 600 Indices fell -3.2% and -1.8%, respectively. International stock indices were also down, with developed markets down -6.3% and emerging markets down -2.7% in May.

HONEY, I SHRUNK THE MONEY SUPPLY

In our ***July 2022 Market Commentary: Money Supply & Inflation***, we discussed how the year-over-year (YoY) growth in M2* money supply was declining and how we believed that meant the rate of inflation was almost certain to fall. So far, so good in that prognostication. What has changed since then is that the YoY growth in M2 has actually ***gone negative***, something never seen in the history of M2 that goes back to 1959, as seen in the chart below – and thus the title of this month's market commentary. The explanation for how this can happen is too lengthy to delve into in this short commentary but suffice it to say it means that there is less money sloshing around in the economy than there was a year ago.

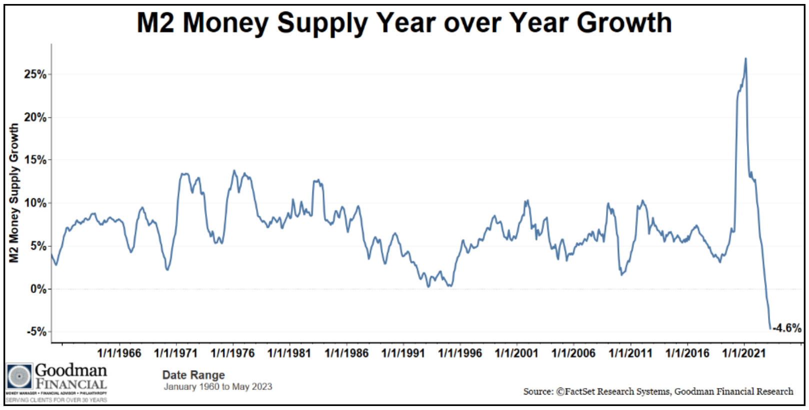
Since we are breaking new ground here, there is no history to guide us on what the ramifications are of a declining M2, but we can make some educated guesses as to what they might be:

- First, we can have increased confidence that the inflation dragon has been slayed. This will take a year or more to play out since changes in money supply growth come with long and variable lags, but unless something drastic changes, we have increasing conviction in such a prediction. If true, the Federal Reserve (Fed) will almost certainly begin to lower the overnight Fed Funds rate that they control, which will likely lead to lower overall interest rates on the short-term part of the bond maturity spectrum (generally out to 5 years or so). If that is right, then it would make sense for fixed income investors to consider building out a bond maturity ladder that locks in today's likely higher rates rather than putting cash into short-term treasuries or money markets where today's deceptively high overnight interest rates will be headed ever lower over the coming years.
- Next, there will be some risk that the economy could actually experience ***deflation***, something the U.S. hasn't seen since the 1930's. This is not a prediction mind you, but just highlighting a potential risk of falling money supply – a risk we would characterize as very low at this time. Deflation leads to lower asset prices broadly - something that is toxic for borrowers and generally causes wealth destruction. Under this scenario, the best way to manage this risk is to be cautious in borrowing money.
- Finally, falling money supply further increases the odds of the U.S. economy entering a recession over the coming year, something we have increasingly come to expect and have talked about on numerous occasions. While M2 only goes back to 1959, Deutsche Bank has prepared an M2 proxy that goes back to 1831. Their data shows several instances of negative YoY growth in money supply prior to 1959 and all of them were followed by an economic recession.

<u>About the Debt Ceiling</u>

In our January 2023 Market Commentary, we wrote about the debt ceiling and the ever-present drama around the process to raise it. This time around did not disappoint in providing the expected drama. At the time of this writing, the House of Representatives (House) and the White House have come to an agreement for a spending package that simultaneously increases the limit on outstanding U.S. debt. That agreement was passed in a bill by the House, and will now move to the Senate for approval, so default has once again been averted, but not without the inevitable drama!

**M2 includes cash, checking and savings deposits, and other assets and accounts that can be easily converted to cash in relatively short order.*



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S&P 500 – market capitalization weighted index of 500 leading publicly traded companies in the U.S.
S&P Midcap 400 – index of 400 companies that broadly represent companies with a midrange market capitalization between $3.6 billion and $13.1 billion.
S&P Smallcap 600 – index of small-sized companies that meet specific liquidity and stability requirements defined by Standard & Poor's.