RICE HALL JAMES
& ASSOCIATES, LLC

Market Review
First Quarter 2023

In the first quarter of 2023, stocks were either resilient or chaotic, depending on your vantage point. The result was a huge dispersion in returns.

During the period, the S&P 500 Index gained 7.50% versus 2.74% for the Russell 2000 Index. Growth trounced Value on both ends of the market capitalization spectrum. However, the most significant disparity was between the Nasdaq Composite, which increased 16.77%, and the Dow Jones Industrial Average, which returned 0.93%. In each case, the performance gap became more pronounced in March due to the outperformance of *Information Technology* and underperformance of *Financials*.

The new year began with a sudden rally, propelled by several indications of lessening inflationary pressure. This included a continued decline in the December ISM Manufacturing Price Index, as well as benign CPI and PPI reports. The disinflationary trend also meant that the subsequent strong consumer activity and data was well received, increasing hopes for an improbable "soft landing". The result was a strong, broad-based advance in January; the S&P 500, Russell 2000, and Nasdaq Composite gained 6.28%, 9.75%, and 10.68%, respectively.

Investor sentiment, however, soured shortly thereafter. The trigger was a strong January employment report that more than doubled Wall Street expectations. Then, two weeks later, the core PPI unexpectedly reaccelerated. The combination of tight labor and sticky prices led to an immediate resetting of interest rate expectations that culminated in a near 1% increase in the 2-Year U.S. Treasury Bond Yield, and the most inverted 2-10 bond yield spread since 1981. As interest rates rose, stocks fell, relinquishing some of the earlier gains.

While the February decline was measured and orderly, a larger and more systemic challenge had begun to emerge. In early March, shares of Silicon Valley Bank sank after the firm sold assets for a loss following a decline in deposits. Two days later, regulators shut down the institution, marking the largest bank failure since the 2008 collapse of Washington Mutual. Signature Bank suffered a similar fate in the following week. Not surprisingly, stocks plunged as inflation fears transitioned to contagion fears, and investors fretted about the composition of banks' deposit bases and the returns from their bond portfolios.

What was unexpected was how quickly the carnage was confined to the regional banks. While the KBW Nasdaq Bank Index plummeted 28.37% in three weeks, mega-cap technology rallied, resuming its safe haven status and providing a ballast for stocks. The combination of emergency liquidity measures from the Federal Reserve, and (modestly) declining central bank lending to the banking sector also helped to calm the shock and enabled a more constructive outlook. As a result, the frantic three months concluded with a bullish tenor…at least for the time being.

At this point, the obvious question for investors is how will the banking crisis affect interest rate policy and the financial markets? But there is a lot to unpack and the issues are complicated and interrelated.

Although premature, we believe the most likely outcome is that the Federal Reserve will signal a pause in its tightening campaign – possibly after one more rate hike – for two reasons. First, while the banking challenges are not entirely policy driven, it is clear that the massive increase in interest rates has amplified the normal competition for deposits. Second, because it is likely that banks slow their loan growth in response to the risk of outflows, the more cautious financial system can accelerate policy authorities' efforts to reduce the velocity of money. As such, the adage that the Fed raises rates "until something breaks" seems apropos.

What is even less certain is how a pause under strain would be interpreted by investors. Although the shift would mark an important step towards more stable equity markets, we do not expect the Fed to move away from its higher-for-longer messaging. This probably blunts some of the impact of the change in the economy in the near-term. High interest rates also means that valuation will remain an important part of the return equation. Looking ahead, we believe that our conservative, probability-focused growth process will help us to continue to weather the uncertainty while we strive to capitalize on attractive valuations to position for better days ahead.

Sources: *FactSet, GICS Sector Classification, Institute for Supply Management Report on Business, U.S. Bureau of Labor Statistics*

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The 2 Year Treasury Rate is the yield received for investing in a U.S. government issued treasury security that has a maturity of 2 years.

Indices are provided for comparative purposes only. Broad-based securities indices are unmanaged and are not subject to fees and expenses typically associated with managed accounts or investment funds. An investor cannot invest directly in an index. This is an actively managed strategy that does not invest in all of the securities of an index, and will have some associated concentration risk. Comparisons have limitations because indices may have volatility, investment and other characteristics that may differ from an investment account strategy to which it is compared. Indices are unmanaged, include the reinvestment of dividends, and do not reflect transaction costs, management, or other fees. See the following for a description of each index used in this material.

The S&P 500 is widely regarded as the best single gauge of U.S. large cap equities. The index includes 500 leading companies spanning all sectors of the U.S. stock market. It covers approximately 80% of the U.S. equity market capitalization and over 50% of the global equity market.

The Russell 2000® Index measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000 Index is a subset of the Russell 3000® Index representing approximately 7% of the total market capitalization of that index, as of the most recent reconstitution. It includes approximately 2,000 of the smallest securities based on a combination of their market cap and current index membership. The Russell 2000 is constructed to provide a comprehensive and unbiased small-cap barometer and is completely reconstituted annually to ensure larger stocks do not distort the performance and characteristics of the true small cap opportunity set.

The Nasdaq Composite Index is the market capitalization-weighted index of over 2,500 common equities listed on the Nasdaq stock exchange. The types of securities in the index include American depositary receipts, common stocks, real estate investment trusts (REITs) and tracking stocks, as well as limited partnership interests. The index includes all Nasdaq-listed stocks that are not derivatives, preferred shares, funds, exchange-traded funds (ETFs) or debenture securities.

The Dow Jones Industrial Average (DJIA), is a stock market index that tracks 30 large, publicly-owned blue-chip companies trading on the New York Stock Exchange and Nasdaq.

The ISM Manufacturing Index is a composite index that gives equal weighting to new orders, production, employment, supplier deliveries, and inventories. Each factor is seasonally adjusted.

The Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services. Indexes are available for the U.S. and various geographic area. Average price data for select utility, automotive fuel, and food items are also available.

The Producer Price Index (PPI) program measures the average change over time in the selling prices received by domestic producers for their output. The prices included in the PPI are from the first commercial transaction for many products and some services.

The KBW Nasdaq Bank Index is designed to track the performance of a selection of leading banks and thrifts that are publicly traded in the U.S. The Index includes stocks representing large U.S. national money centers, regional banks and thrift institutions.

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Index Definition Sources: *Standard & Poor's, FTSE Russell, Nasdaq, Investopedia, U.S. Bureau of Labor Statistics*