Convergence Commentary

February 2023 Market Recap

Quick Hits:

- Stocks corrected in February after one of the strongest Januarys on record.
- Interest rates rose throughout the month in response to hotter-than-expected economic data and in anticipation of higher-for-longer interest rates.
- Inflation spiked in January due to continued pressure from shelter prices and a tight labor market but continued its overall downward trajectory.

Market-Moving Highlights

CPI accelerated in January after showing signs of deceleration through the end of 2022. Headline CPI increased 0.5% on a monthly basis, the largest increase since October, and came in at 6.4% over the last 12 months. Meanwhile, Core CPI rose 0.4% in January and sits at 5.6% on an annual basis. The main driver of the reacceleration in inflation was the continued stubbornness of the shelter component of the index, which was up 0.7% in January and accounted for about half of the overall increase in the index. As we have noted several times, the shelter component of CPI uses lagged data, so it will likely take longer to come down than other parts of the index. While it was disappointing to see inflation make a comeback in January, the process of getting prices back to acceptable levels is not a linear journey. There will be times when prices temporarily increase, but the longer-term trend should still continue to drift lower over time. The annual rate continued to move marginally lower from December's annual rate of 6.5%, so the disinflation narrative is still in place, despite the elevated monthly reading. A higher inflation reading likely indicates that it's less likely that the Federal Reserve will halt their interest rate hikes in the near term, and the possibility of rates being cut anytime soon is slim.

The downturn in the markets began after the January jobs report showed businesses added 517,000 jobs in January, coming in far higher than previous estimates that 185,000 jobs would be added. This hot report was widely unexpected and caught the market off guard, with investors focused more on the economy slowing down throughout the start of the year. However, this report signaled to the market that an economic slowdown is further away than

previously anticipated and likely gives the Fed more reason to continue to hike rates and keep them higher for longer. As long as new jobs are being created, the Fed will be able to continue focusing on stable prices over maximum employment.

Earnings season has largely come to an end with about 97% of the S&P 500 releasing reports in February. Overall, earnings declined 4.9%, a slight improvement over the past couple of weeks as more positive reports came out, but the first negative quarter since the third quarter of 2020 (LPL). Some analysts feared earnings would be much worse than they actually were, so their modest decline had largely been digested by the market already. The only sector that saw estimates increase through reporting season was consumer staples, so the disappointing earnings were broad.

Index Performance

Index	1 Month	1 Year	2022	5 Year
S&P 500	(2.28%)	3.69%	(7.69%)	9.82%
Nasdaq Composite	(1.31%)	9.61%	(15.96%)	10.50%
Russell 2000	(0.63%)	7.89%	(6.02%)	6.01%
MSCI ACWI ex US	(4.25%)	4.35%	(6.70%)	2.10%
Bloomberg US Aggregate Bond	(2.50%)	0.41%	(9.72%)	0.53%

Equities consolidated in February after the strong start to the year. Some pullback was to be expected, as the S&P 500 was up almost 10% year to date at its 2023 highs in early February, which would amount to roughly the long run annual average return. The decline was driven by hotter-than-expected economic data which led the market to believe that higher rates are likely here to stay over the intermediate term. International stocks struggled with similar issues, particularly in Europe, where inflation is much worse than it is in the United States. Finally, bond prices fell in response to interest rates rising. The 10 Year Treasury yield went from 3.52% on February 1st to 3.92% at the end of February on the back of an increasing probability of interest rates remaining high over the long term.

S&P 500 Sector Highlights & Commentary

Best-Performing Sectors		Worst-Performing Sectors	
Technology	(0.13%)	Energy	(8.26%)
Industrials	(0.17%)	Utilities	(5.65%)
Consumer Staples	(1.14%)	Real Estate	(5.30%)

All of the S&P 500 sectors were negative in February, with Energy leading the index downward. Energy stocks were met with several headwinds, including revamped concerns about a global growth slowdown, a slower-than-expected reopening of the Chinese economy, and oil supply remaining higher than average in the United States. Utilities and real estate are interest rate-sensitive sectors that declined in response to the sharp rise in rates throughout the month. Technology and industrials held up relatively well due to solid earnings reports from some of the larger weights within each sector. On the year, consumer discretionary, communication services, and technology are the best-performing sectors.

What to Watch in March

Inflation reports released throughout the month will be in focus to determine if the hot inflation from January was an anomaly or if there is a more sustained reversal of the downward trend in prices.

The Federal Reserve meets on March 22nd and will likely increase rates once again. Currently, the market expects another 25 basis point hike, but more hot inflation data could cause the Fed to return to 50 basis point hikes.

Job data for February will be released in early March. Another above-expectation report would have multiple effects. Primarily, strong employment data would indicate a recession is less likely in the short term. It also would increase the likelihood of a 50 basis point hike later in March, as it would strengthen the argument that the tight labor market is increasingly becoming a primary driver of elevated inflation.

Market Wrap

February was a challenging month for the markets, but after the strong January, it was not all that surprising to see some pullback across the board. The reasoning behind the pullback was cause for concern, as economic data painted a mixed picture. On one hand, renewed inflation, strong employment numbers, and a rebound in manufacturing and services data complicates the narrative for the Fed and likely means we will see more interest rate hikes despite hopes in January that the hike in March could be the last one. Continued interest rate hikes increase the probability of the Fed overtightening and causing a recession. On the other hand, stronger-than-expected data shows that the economy is remaining resilient despite early indicators pointing toward an economic slowdown. The mixed data has led some financial pundits to call for a "no landing" scenario. In our view, a "no landing" scenario only means the "soft" or "hard" landing is pushed off further into the future, as the economy will eventually stabilize and return to steady growth with minimal economic damage (a soft landing) or will fall into a moderate recession (a hard landing).

As we mentioned in the last market commentary, the S&P 500 achieved a rare "January Trifecta" that often leads to a strongly positive year to follow, especially following a bad year like 2022. The Trifecta refers to years when all three seasonal indicators (the Santa Claus rally, the First Five Days Early Warning System, and the January Barometer) show gains for the S&P 500. As shown in the chart below, when a January Trifecta happens, February tends to be a month of "payback," where the market gives up some of the strong gains from the prior month (Fundstrat). The median for the month of February is lowest among any month in a year where the January Trifecta occurs. It is also tied for the lowest win ratio, which represents the number of times a positive month has occurred in the past. Moving forward, we expect markets to continue to remain choppy until there is a clearer economic picture and interest rate volatility subsides.

Rule of 1st 5 Days: Feb is payback month

Returns for all years with first 5D >1.4% and neg prior year

Since 1950. N = 7. Average, median, and win ratio excluding 2023

ALL YEARS SINCE 1950 WITH NEG PRIOR YEARS & >1.4% FIRST 5 DAYS

	Monthly Performance											
	Day 5 --> Jan End	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
1958	1.7%	-2.1%	3.1%	3.2%	1.5%	2.6%	4.3%	1.2%	4.8%	2.5%	2.2%	5.2%
1963	2.3%	-2.9%	3.5%	4.9%	1.4%	-2.0%	-0.3%	4.9%	-1.1%	3.2%	-1.1%	2.4%
1967	4.6%	0.2%	3.9%	4.2%	-5.2%	1.8%	4.5%	-1.2%	3.3%	-2.9%	0.1%	2.6%
1975	9.9%	6.0%	2.2%	4.7%	4.4%	4.4%	-6.8%	-2.1%	-3.5%	6.2%	2.5%	-1.2%
2003	-6.0%	-1.7%	0.8%	8.1%	5.1%	1.1%	1.6%	1.8%	-1.2%	5.5%	0.7%	5.1%
2012	2.5%	4.1%	3.1%	-0.7%	-6.3%	4.0%	1.3%	2.0%	2.4%	-2.0%	0.3%	0.7%
2019	5.0%	3.0%	1.8%	3.9%	-6.6%	6.9%	1.3%	-1.8%	1.7%	2.0%	3.4%	2.9%
Average	2.9%	0.9%	2.6%	4.0%	-0.8%	2.7%	0.8%	0.7%	0.9%	2.1%	1.2%	2.5%
Median	2.5%	0.2%	3.1%	4.2%	1.4%	2.6%	1.3%	1.2%	1.7%	2.5%	0.7%	2.6%
Win Ratio	86%	57%	100%	86%	57%	86%	71%	57%	57%	71%	86%	86%
2023	4.7%	-	-	-	-	-	-	-	-	-	-	-

Feb = payback = ouch

Source: Fundstrat, Bloomberg

Sources

Closing the Books on Fourth Quarter Earnings Season | Daily Market Update | March 1, 2023 (eloqua.com)

Feb "payback" giving way to March + April "buy the dip" as we enter best 8 weeks. EPS revisions support OW Tech/FAANG here. Ex-FAANG S&P 500 P/E is 14.8X, hardly demanding - FS Insight

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Jason Buford

Vice President,
Financial Advisor

Dr. John Stansfield, CFA

Director of
Investments

632 E 69th Terrace
Kansas City, MO 64131
816.737.8393
www.convergencefinancial-kc.com

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