

Economic Overview

The consequences of persistent interest rate increases are beginning to be felt across all segments of the economy. A full year into the tightening cycle, the Federal Reserve has rapidly increased the federal funds rate by 4.75%. Peak Fed Funds rate is likely to occur this year and corporate earnings are expected to contract. Fed tightening due to sticky inflation, in combination with banking stresses, is creating headwinds for growth. The collapse of Silicon Valley Bank and Signature Bank dampened an otherwise strong start to the first quarter. The Fed, the U.S. Treasury, and the FDIC stepped in with emergency measures to ameliorate funding concerns among smaller banks and stem contagion effects across the industry. Although big banks are well capitalized, smaller institutions are facing the possibility of liquidity crunches due to the combination of deposit flight from low-yielding deposit account to higher yielding money market funds and balance sheet stress from 2022 bond market losses. Worries continue to linger over how extensive the damage may be among smaller regional banks. Additionally, the Swiss bank regulators forced merger of UBS and Credit Suisse stoked investors' fears of financial sector malaise during the quarter. There is also growing unease around banks' exposure to commercial real estate (CRE). An estimated \$2.5 trillion of \$4.5 trillion in total outstanding CRE debt is coming due over the next five years, most of which was financed at significantly lower interest rates than those prevailing currently. Many office landlords, particularly in major city centers, have been struggling since the Covid pandemic kicked off a trend of remote work and led many companies to trim office space to accommodate fewer in-person employees.

Despite the Fed's persistent hawkishness, inflation is cooling at a quicker pace than it did during both the 1974-1975 and 1980-1981 bouts of inflation. Peak inflation during the current cycle occurred in June of 2022 at 9.1%. Year-over-year comparisons will become more favorable (lower YoY inflation) making justification of increasingly higher rates more challenging for the Fed as the economy and inflation cool and tighter bank lending dampen economic

activity. The broadest measures of economic activity for both manufacturing and services, the ISM data, are both showing slowing trends. The Manufacturing index is below 50, indicating a shrinking manufacturing sector. The Services index has been choppy but remains above 50 currently as consumers return to restaurants and travel more routinely.

Constructive Observations

- Easing inflation trends should lead to a less restrictive Federal Reserve.
- Consumer spending remains resilient, buoying GDP.
- Job and wage growth trends remain robust.
- China's economic recovery should be supportive of global markets.
- Protections implemented via Dodd-Frank post-GFC have proven effective amid recent banking stress.

Cautious Observations

- Global economic expansion is mature: risks are elevated and opportunities are limited.
- Banks are likely to tighten credit standards, leading to weaker growth.
- Consensus earnings estimates are likely too optimistic for coming quarters.
- Commercial real estate may be the "next shoe to drop" forcing debt-holders to take significant losses.

Macro Overview

The Atlanta Fed currently projects first quarter GDP to rise 2.2%, following a 2.6% rise in the fourth quarter of 2022. Economic growth remains resilient, and the economy is in decent shape based on continued jobs growth and increasing consumer spending, driven primarily by savings accumulated during Covid. The Fed is likely to hold interest rates higher for longer with the logical outcome being an eventual uptick in unemployment and an increased

likelihood of recession. The stress experienced by regional banks recently will likely lead to higher costs of capital, tightening lending standards, and a decline in overall credit availability.

The forward outlooks provided by corporate management during the forthcoming Q1 earnings cycle are likely to garner more attention than the actual earnings results, themselves. The cumulative impacts of quantitative tightening and higher interest rates are likely to impact corporate earnings as signs of economic weakness begin to materialize.

The housing market has improved since last quarter due to lower interest rates. Existing home sales rose 14% from its January trough. Housing starts rose 9.8% month-on-month in February, coming in more than 10% above the consensus forecast. Sales of new single-family houses increased 1.1% month-over-month to a seasonally adjusted annualized rate of 640k, the highest level since August last year but below forecasts of 650k. Median home prices were down 2.6% from November and down 12.3% from last June's peak. As a result of lower rates and lower prices, the Housing Affordability Index rose to 104.9 in January from 91.3 at the October low.

U.S. payrolls rose by 236,000 jobs in March, driven by gains in leisure and hospitality. For the quarter, payrolls increased by a monthly average of 345,000 jobs, an acceleration from the 247,000 monthly average last quarter. Total nonfarm employment is now up 2% from its pre-pandemic level in February 2020. The unemployment rate remains at 3.5% with the participation rate up slightly from 62.3% in December to 62.6% currently. Average hourly earnings rose 0.3% in March and 4.2% year-over-year, down from 4.5% in December and closer to the Fed's 3.0%-3.5% target.

The University of Michigan Consumer Sentiment Index climbed to 62.0 in March from 59.7 in September but dropped below its 67.0 peak in February as Silicon Valley Bank headlines emerged in March. The Conference Board Consumer

Confidence Index increased slightly in March to 104.2, up from 103.4 in February. The Present Situation Index, which measures consumers' views of current business and labor market conditions, decreased from 153.0 to 151.1. The threat of inflation, higher interest rates, and higher unemployment from a slowing economy pose a meaningful risk to confidence.

Markets Overview

Equities

The S&P 500 Index had a strong start in 2023, increasing 8.9% through early February. Investor confidence was rising in anticipation of an end to Fed interest rate hikes, hopes for an economic "soft landing", China's rapid reopening, and an improved outlook for Europe. Stocks gave up a lot of ground in February as U.S. job growth and inflation measures exceeded expectations; resulting in expectations of a higher peak fed funds rate.

Amid the confusion of March's banking malaise, investors bid up the information technology sector's version of safe haven assets: Apple and Microsoft stock. The S&P 500 has returned to a top-heavy condition: 90% of this year's gains are attributable to just ten technology-centric stocks. The NASDAQ Composite returned 6.8% in March and 17.0% for the quarter. The S&P 500 returned 3.7% in March and 7.5% for the quarter. The Russell 2000, with its heavy exposure to regional bank stocks, declined -4.8% in March and finished the quarter up 2.7%. Growth stocks meaningfully outperformed value stocks for the quarter. The Russell 1000 Growth index returned 14.4% whereas its Value counterpart returned 1.0%. Among small-caps, the Russell 2000 Growth index increased 6.1% for the quarter vs. -0.7% for the Russell 2000 Value index (18% exposure to bank stocks). Sector dispersion was dramatic this quarter with Financials (-5.6%) the clear loser among S&P 500 sectors and Info. Tech. the winner (+21.8%). In addition to Financials, Energy, Health Care and Utilities stocks all lagged this quarter, across the market-cap spectrum.

Fourth quarter 2022 corporate earnings came in better than expected, with 68% of S&P 500 constituents beating consensus forecasts. Although earnings fell -3.5% year-over-year as profit margins declined, top-line nominal sales grew 7.0%. First quarter 2023 earnings results will be closely scrutinized as many companies have issued below-consensus forward guidance.

Returns in international markets varied considerably and many deviated widely from the U.S. markets. The MSCI EAFE index returned 8.6% this quarter, outperforming the S&P 500. European stocks were strong this quarter (+10.7%) despite the ongoing fundamental issues imposed by the Ukraine war. Both French and German stock markets increased almost

15% in the first quarter. The Asia Pacific region performed in line with the U.S. markets, particularly those with more direct exposure to technology. Korean stocks increased almost 10% this quarter and Taiwanese stocks rose almost 15%. China's stock market rose 4.7% as the government assured stimulus programs would be enacted to overcome the effects of the Covid-induced slowdown that was exacerbated by that country's lockdown regimen.

Fixed Income

The headline CPI inflation rate slowed for a ninth consecutive month to 5% in March, according to BLS data released in early April. Despite the slowing trend, inflation remains much higher than the Fed's 2% target. Bond market volatility has been elevated as market participants continuously recalibrate expectations of two parameters: 1.) the ultimate federal funds terminal rate and 2.) the speed by which said terminal rate will fall once it is achieved. The Fed delivered two 25 basis point rate hikes this quarter, one in February and another in March. The most recent increase represents the ninth hike since March 2022, taking the federal funds rate to a range of 4.75% - 5.0%. In early March, after a strong labor market report, the market expected a terminal fed funds rate of 5.5% - 5.75% (higher than the Fed's own projections) and the possibility of as many as three rate hikes this year. By the end of the quarter, amid the banking sector chaos, the market had slashed rate expectations to a terminal rate of 4.75% - 5.0% and no further hikes in 2023, with the possibility of as many as four rate cuts by January 2024. The Fed's policy tools generally function with a "long and variable lag", implying that the ramifications of recent (and/or future) rate hikes, have yet to fully impact the overall economy. Higher interest rates for longer appears to be the current mantra of the Fed, which will likely result in demand destruction, lower corporate earnings, and the possibility of an economic "hard-landing" / recession. Fed Chair Jerome Powell has emphasized that the fight to bring inflation down to the targeted 2% level is not over, and despite markets' expectations to the contrary, "rate cuts are not in our base case" for the rest of 2023. The speed with which interest rates have risen during the current rate hiking cycle is the fastest to occur since 1980.

The Fed's most recent projections for rates, inflation, unemployment, and GDP suggest a high degree of uncertainty remains for the path of policy decisions going forward. The Fed slightly raised their inflation

expectations to 3.3% for 2023 (compared with a 3.1% forecast in December). Unemployment is estimated at 4.5% this year, while GDP is forecast to be 0.4% (down from December's 0.5% estimate).

Similar to the U.S. Fed, the ECB and BOE continued hiking interest rates to curtail inflationary pressures. The ECB has increased its policy rate to 3.5% from 0% since July 2022 and could possibly raise rates another 50 basis points before pausing, although recent improvements in inflation data, especially for countries subject to the most volatility due to energy prices, cast doubt on how much additional tightening may occur.

The recent decline in longer dated interest rates caused bond prices to rise higher this quarter. As investors feared a hawkish Fed and banking stress would push the economy into recession, a significant flight to safety into Treasuries and cash occurred. The 10-year U.S. Treasury yield fell to 3.49% at the end of March down from a year-to-date peak of 4.08% on March 2nd and last October's peak of 4.25%.

The Bloomberg Barclays Aggregate Bond index rose 3% this quarter, with most of that (2.5%) occurring in March. All U.S. Treasury maturities increased in value this quarter with the returns increasing with longer maturities. 1-3 Year maturities rose 1.6%, 3-5 year maturities increased 2.3%, 5-7 year maturities were up 3.0%, 7-10 year maturities returned 3.5% and long-dated (20+ years) U.S. Treasuries appreciated 6.6% this quarter. High yield bonds rose 3.6% in the first quarter and leveraged loans returned 3.2%.

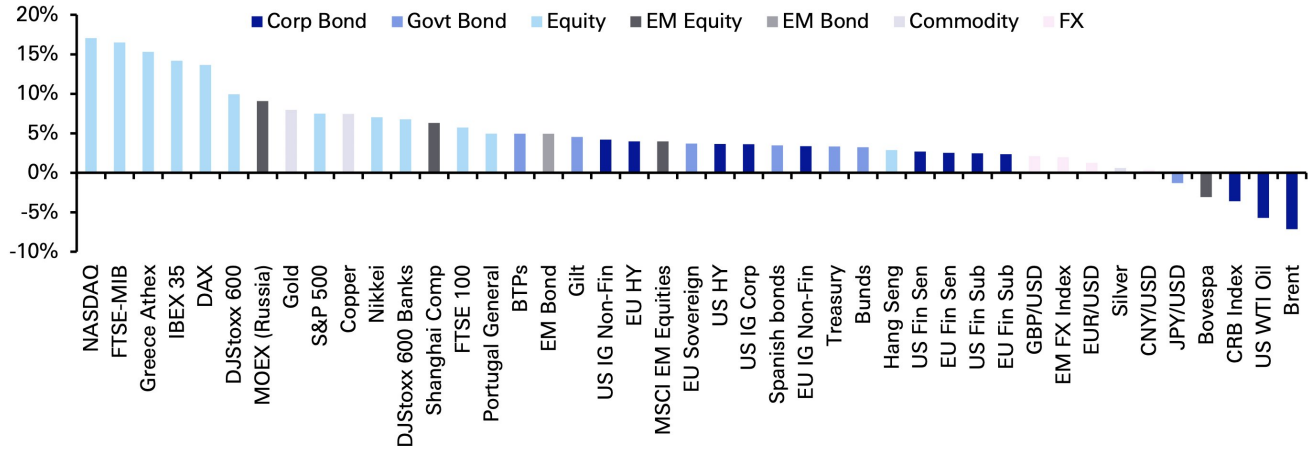
Real Assets

The U.S. dollar is typically a significant factor for commodity prices, as it has an inverse relationship with raw material prices. The dollar fell 1.05% in the first quarter, after increasing 8% in 2022. Despite the move lower in the dollar, most commodities declined in the quarter. Crude oil fell 5% in the first quarter, but natural gas was substantially lower, to the tune of 50%, due to a warmer than expected winter. Agricultural commodities, as a group, were flat with the standouts being sugar (+20%) and lean hogs (-20%). Nickel fell 20% this quarter, whereas copper gained a little over 8%. Gold rose 8% year-to-date and silver ticked up a modest 0.8%.

Charts of the Quarter

Dramatic Dispersion Among Asset Classes in Q1

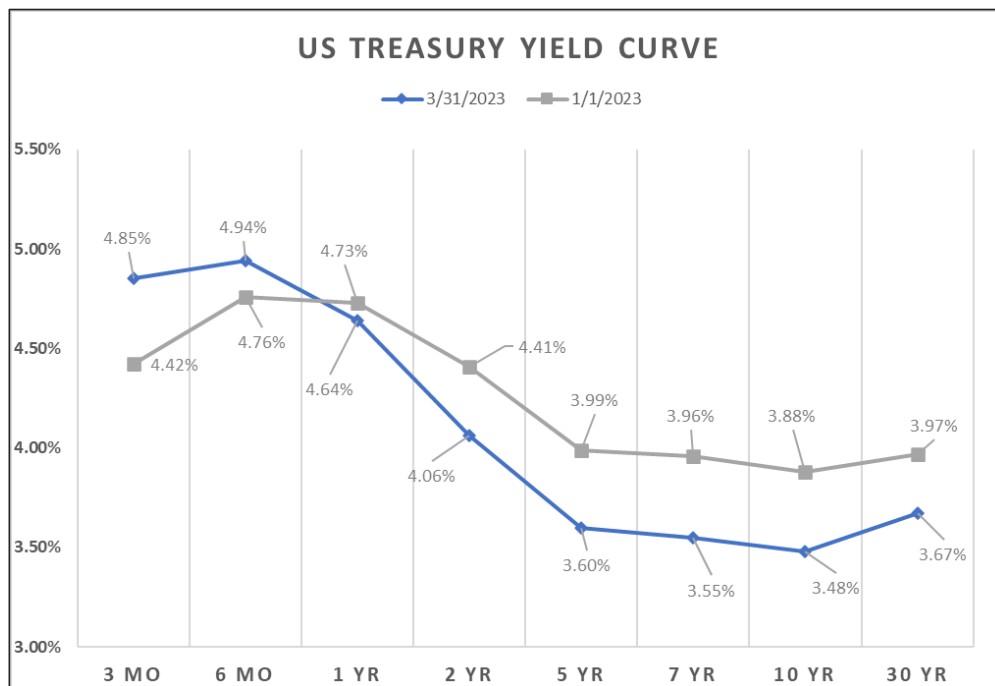
Figure 4: Total Return Performance of Major Global Financial Assets in Q1 (in USD)



Source : Deutsche Bank, Bloomberg Finance LP

Sources: Deutsche Bank, Bloomberg.

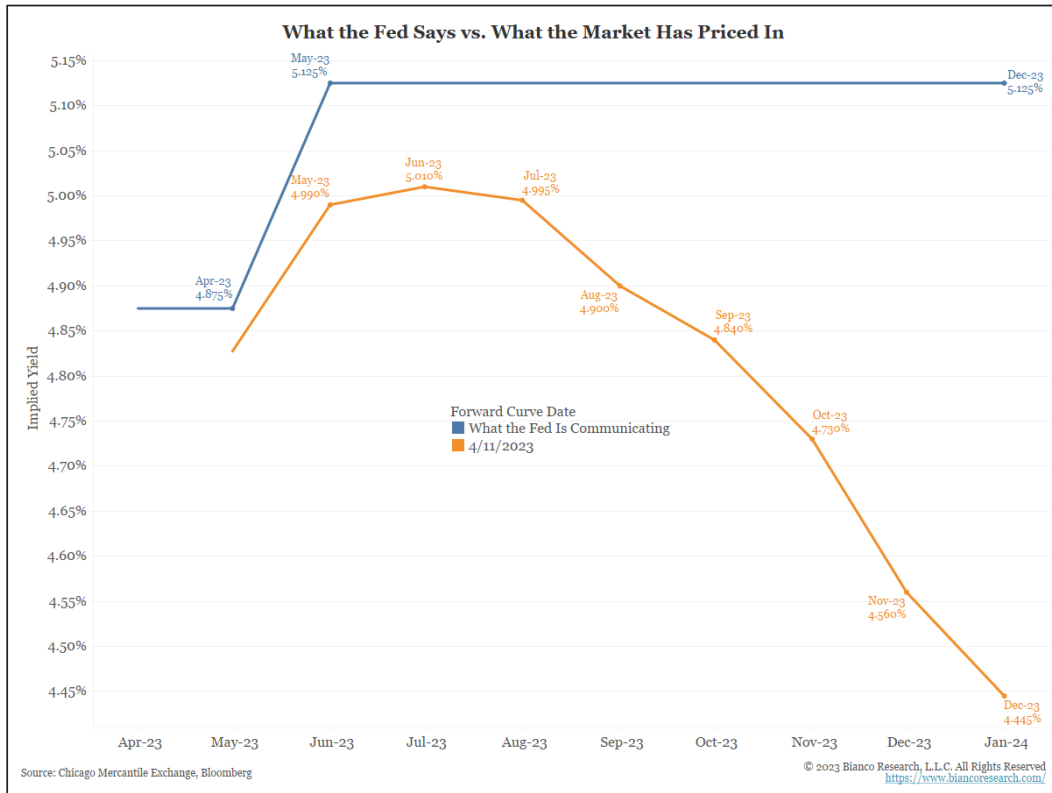
Long-Term Interest Rates Fell Dramatically in Q1



Source: TKA.

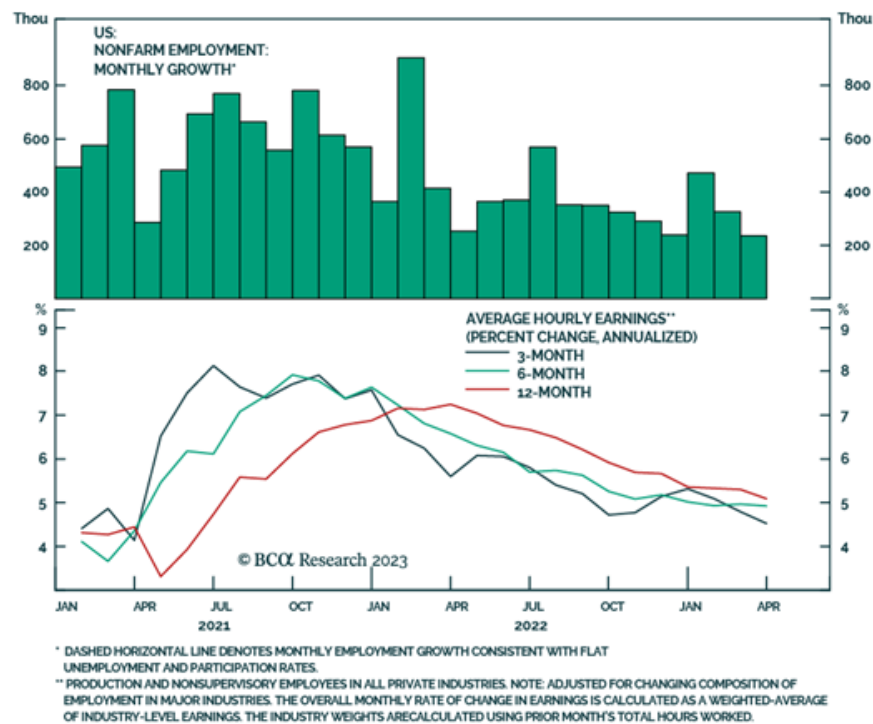
Charts of the Quarter

Disconnect Between Markets Expectations and Fed Messaging



Source: Bianco Research.

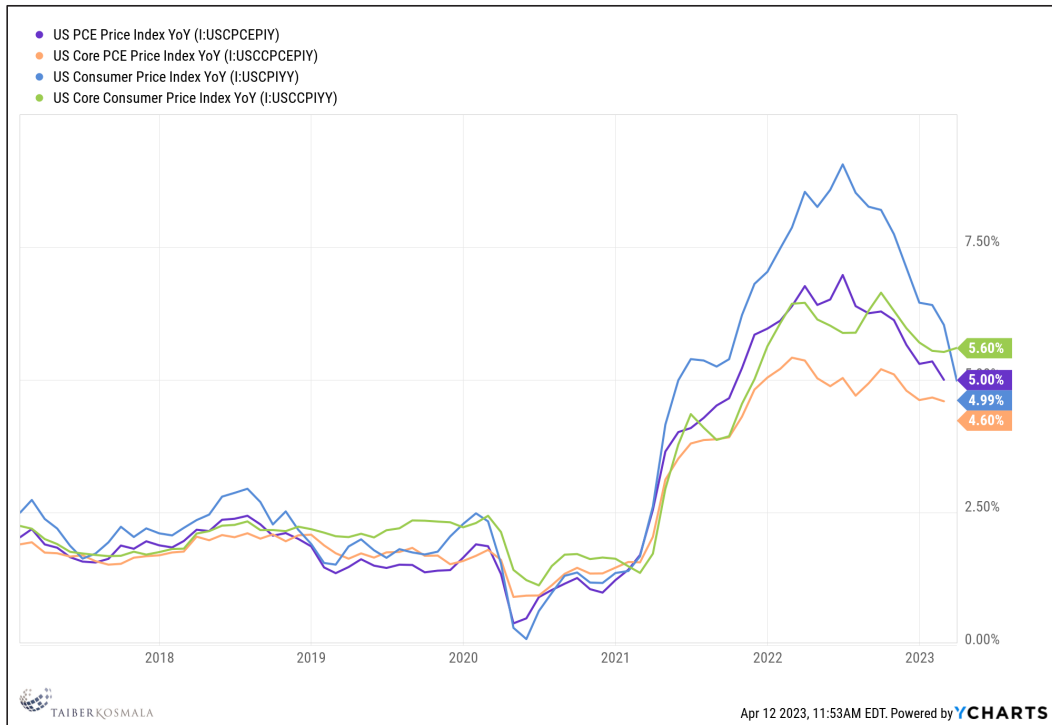
Fed Remains Hawkish into a Slowing Economy



Source: BCO.

Charts of the Quarter

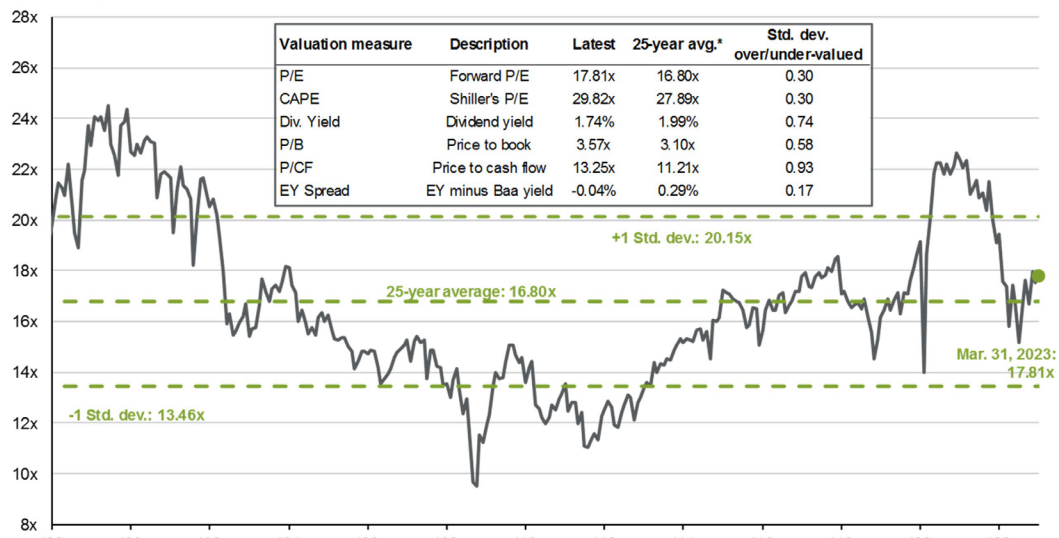
Inflation Peaked Last June; Are Additional Interest Rate Hikes a Mistake?



Source: TKA.

Equity Multiples Appear Lofty if the Economy Is Headed for a Slowdown

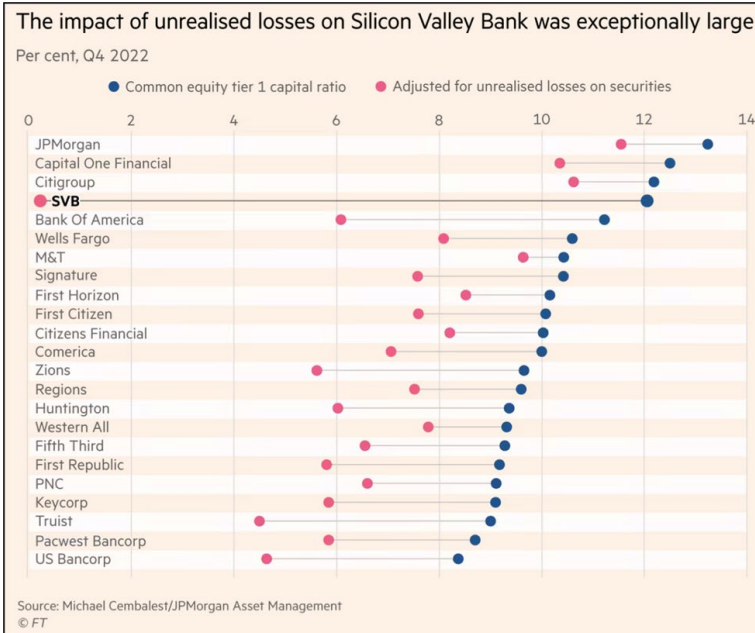
S&P 500 Index: Forward P/E ratio



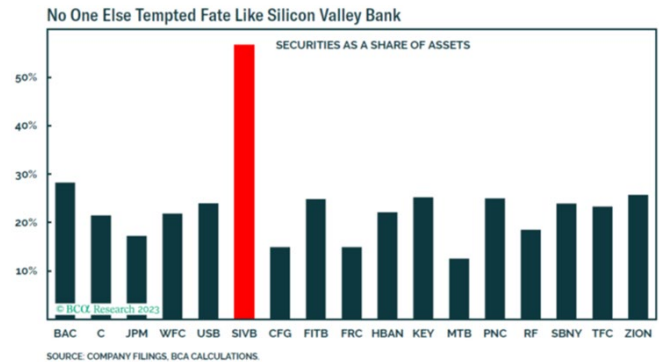
Source: J.P. Morgan.

Charts of the Quarter

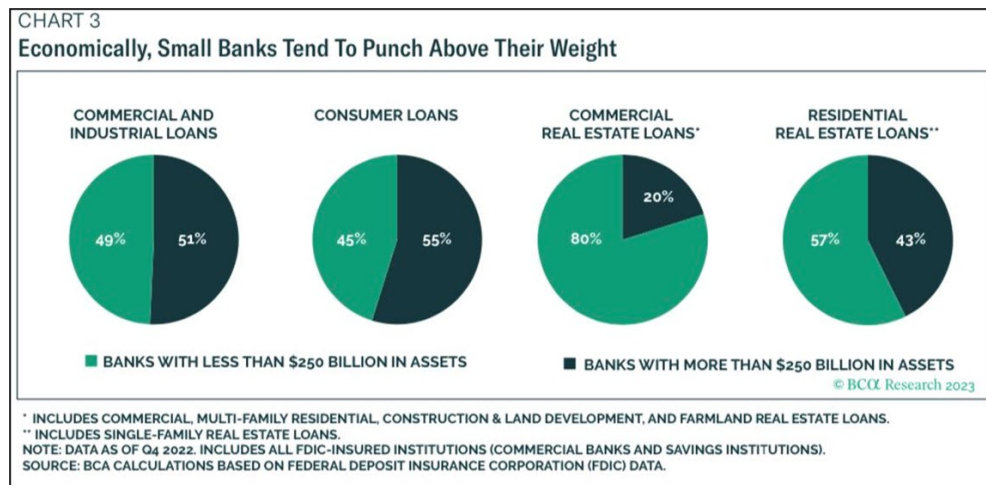
Silicon Valley Bank's Situation Was Unique



Sources: Financial Times, BCA.



Regional Bank Stress Could Have Knock-On Effects in CRE & Residential Loan Markets

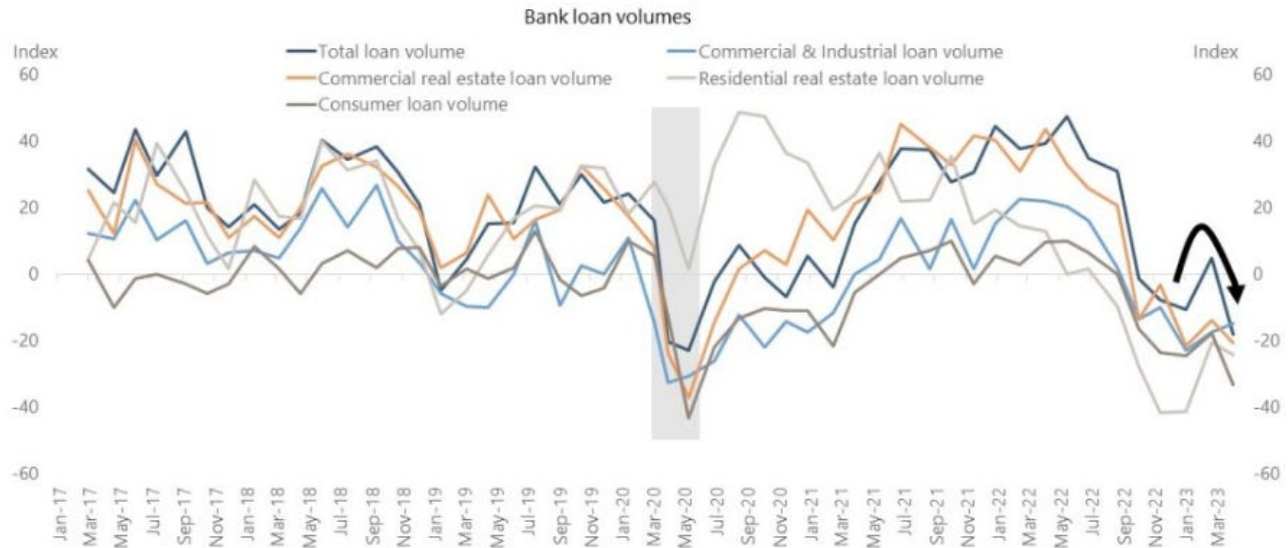


Source: BCA.

Charts of the Quarter

Bank Lending Likely to Slow, Increasing Recession Risk

Bank lending has rolled over after SVB



Source: Apollo Global Management.



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