MACRO & MARKET
PERSPECTIVES

2ND QUARTER 2023
A FIRST LOOK

SPECIAL REPORT:
INFLATION FRUSTRATION

WHY THE SUN MIGHT BE
SETTING ON RAISED RATES

FINDING THE LIGHT
AT THE END OF THE TUNNEL

OAKWORTH
CAPITAL BANK

1Q

ECONOMIC OUTLOOK & OVERVIEW

April 2023

TABLE OF CONTENTS

02
SAFETY & SOUNDNESS

04
LETTER FROM OUR CHIEF ECONOMIST

06
2023 Q1 KEY TAKEAWAYS

08
SPECIAL REPORT

12
ECONOMIC OVERVIEW

19
EQUITIES

24
BONDS

29
ALLOCATION

34
Q2 2023 PREDICTIONS

SAFETY & SOUNDNESS

After the largest capital raise in the state of Alabama, we opened our doors to the public on March 31, 2008. Over the years, we have developed a reputation as one of the safest banks in the United States. In 2016 we expanded our markets in Alabama, adding a South Alabama office in Mobile. In 2022 we expanded to the state of Tennessee, opening a Middle Tennessee office in Brentwood.

Later this year, we intend to open our Central Carolinas office in Charlotte, North Carolina.

Based on our Q4 2022 financial data, we earned BauerFinancial's top rating. BauerFinancial's 5-star rating is a universally recognized, independent affirmation of Oakworth's prioritization of safety and financial soundness, ultimately benefitting our clients, shareholders and communities.

Our core values and overall mission are building blocks for the long-term success of everyone we serve.

BauerFinancial's 5-Star Rating indicates "superior" financial standing, based on profitability, trends, loan delinquencies, reserves, compliance and asset quality.

JOHN NORRIS
Chief Economist

DAVID MCGRATH
Associate Managing Director

A letter from our

CHIEF ECONOMIST

We started the 1st quarter of 2023 still worried about inflation and the Federal Reserve. By the end of it, investors were concerned about the health of the financial system. After all, higher interest rates lead to lower asset prices which reduce bank capital. So, would the Fed kill the economy in order to kill inflation?

The year had started so nicely, too. Stocks rebounded in January after slumping in December. Just about everyone thought the Fed might have only 0.50% worth of rate hikes remaining. It seemed the Fed was finally going to engineer the fabled "soft landing." Then, something happened.

While the inflation data had been better than it was in 2022, Chairman Jerome Powell spooked the markets with his comments after the February 15th Federal Open Market Committee (FOMC) meeting. Investors interpreted them to mean the Fed wasn't done with only 0.50% in rate hikes. Nope. Perhaps it had 1.25% left, possibly 1.50%.

If that wasn't enough, the markets then had to deal with the collapse or near-collapse of several prominent banks. While Silicon Valley Bank might not be a household name in much of the country, it was still a $200+ billion entity. Firms that size simply don't go belly up very often. Overseas, the Swiss authorities arm-twisted UBS to take over the once vaunted Credit Suisse for pennies. Were we on the precipice of another 2008? Fortunately, the answer to that is decidedly no.

The U.S. banking system is in much healthier shape than it was leading up to the most recent financial crisis.

Further, the economic data has been surprisingly resilient after over 4.50% in rate hikes. Finally, the official inflation gauges are poised to fall somewhat sharply during the 2nd quarter. While there are a number of reasons for this, the primary one is how the government calculates it.

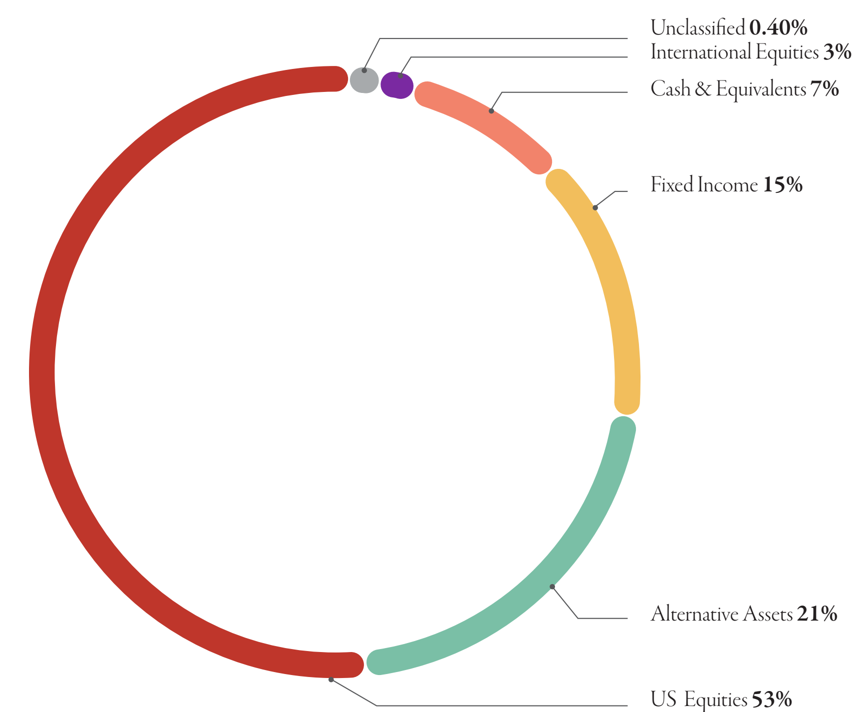
In the end, the 1st quarter was yet another confounding quarter in what has been several years of confounding quarters. However, the good news is the light is at the end of the tunnel, at least as far as the financial markets are concerned. The economy is performing better than it should. Inflation will continue to come down. The banking system is in much healthier shape than the headlines suggest. Finally, the Fed will probably be finished with this tightening cycle by the end of the 2nd quarter.

That should lead to better investment returns in the not-so-distant future.

Thank you for your continued support,

John Norris
Chief Economist

Our Investment Committee distributes information on a regular basis to better inform our clients about pending investment decisions, the current state of the economy, and our forecasts for the economy and financial markets. Oakworth Capital currently advises on approximately $1.8 billion in client assets. The allocation breakdown is in the chart below.



SAM CLEMENT
Portfolio Manager

SAM HARRIS
Portfolio Manager

RYAN BERNAL
Analyst

2023

1ST QUARTER KEY TAKEAWAYS

The first quarter of 2023 was another wild one.
The much-anticipated return to normalcy will just have to wait.

BANKS

By the end of the quarter, investors were worrying about the health of the banking system. After all, higher interest rates mean lower bond prices, and banks own a lot of bonds.

BALANCE SHEETS

There is an old saying in the investment industry: "When the tide goes out, you find out who's been swimming naked." You could argue the 1st quarter brought us a new one: "When interest rates go up, you find out which banks haven't managed their balance sheets correctly."

INTEREST RATES

Everyone knows investors hate uncertainty. They also seem to hate wild swings in interest rates, and who can blame them. It is hard to invest when you can't determine the cost of money in the financial system.

HEADLINES

Some of the headlines in the 1st quarter bordered on the bizarre. While 200-foot Chinese spy balloons and UFOs don't have a direct impact on economic activity and earnings, they can alter investor and consumer confidence.

WAR

During the 1st quarter, the war in Ukraine turned 1 year old. Twelve months on and still no end in sight — to the point that the story largely fell off the front pages.

LABOR MARKETS

The current Fed tightening cycle also turned 1 year old during the quarter. Interestingly, the labor markets remained very strong, which is unusual at this point in the cycle. As long as the economy is creating jobs, the unemployment rate remains below 4% and there are in excess of 10 million job openings, it is hard to imagine the Fed cutting rates aggressively.

OVERNIGHT RATE

The last time the Fed was as aggressive in raising the overnight rate as it was in 2022 was 1980. The University of Georgia won the national championship in football in both years. If you don't like higher borrowing costs, blame the Bulldogs.

COMMODITY PRICES

After spiking in the first half of last year, aggregate commodity prices have steadily come down. This is due to somewhat decreased demand and continued strength in the U.S. dollar. It is hard to fathom runaway inflation when input costs are falling.

MONEY SUPPLY

After falling for the first time in at least 50 years during 2022, the M2 gauge of the U.S. money supply stabilized and flattened out during the 1st quarter. As is the case with falling commodity prices, it is hard to imagine runaway inflation when the money supply isn't growing rapidly.

THE FEDERAL RESERVE

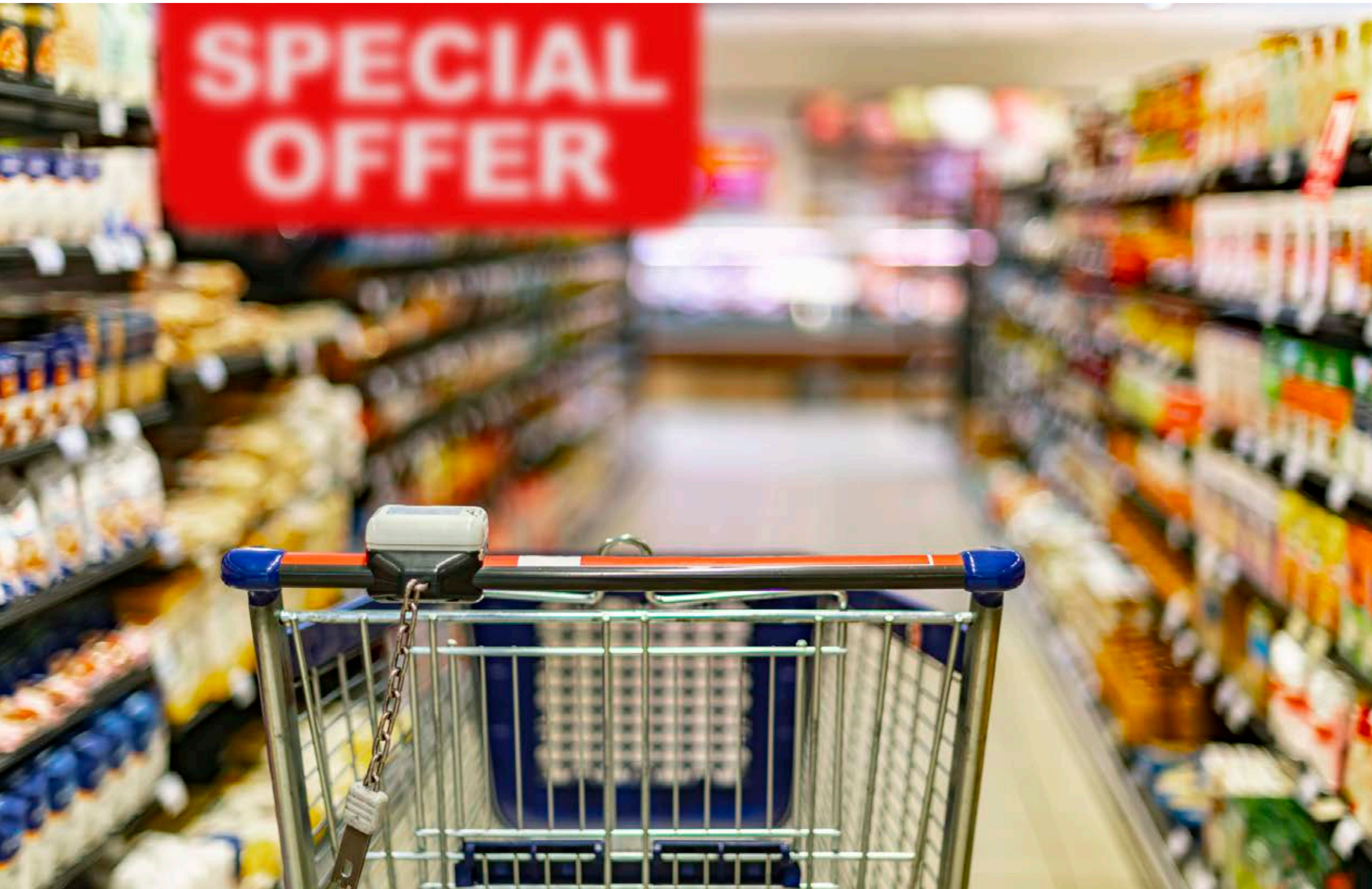
Thanks to the mini-bank crisis during March, the markets dramatically altered their expectations for the Federal Reserve. Prior to Silicon Valley Bank's collapse, investors believed the Fed would keep raising the overnight rate to at least 5.75%. Less than a week later, the expectation had fallen to roughly 5.00%. Obviously, such wild fluctuations in interest rates and expectations make effective asset allocation tricky.

GEOPOLITICAL THREATS

By the end of the quarter, most Americans couldn't ignore the obvious any longer. China is the biggest geopolitical threat to the United States. Russia's quagmire in Ukraine has greatly impacted its global standing in a sharply negative way. The events of the past year have pushed historic frenemies Russia and China even closer together. This alliance between two of the three largest militaries could prove problematic for the United States in maintaining its global hegemony.

SPECIAL REPORT: INFLATION FRUSTRATION

Ryan Bernal



It seems all anyone has wanted to talk about in the last year is inflation. Before this most recent Federal Reserve intervention – prior to 2020 – we lived in a fantasy-like economy set in the midst of a historically long bull market run. The overnight lending rate set by the Federal Reserve hovered around 0% to 0.1%. Money was cheaper to borrow than at almost any point in American history. While it was a good time for many Americans, and business was booming, eventually the bill came due.

Fast forward to today: The last time inflation was as high as it was in 2022, Jimmy Carter was president and the Doobie Brothers released the #1 song "What a Fool Believes." It was 1979. During the period of stagflation in the late 70s and early 80s, the economy had seen modest growth, and inflation had been ticking up for the better part of the decade. This can be traced to a stance of quantitative easing used by the Federal Reserve for the purpose of trying to reach full employment in the early 1970s. This eventually caused a wage-cost price spiral that exacerbated these mounting problems further. Around this same time, the U.S. dollar also lost its gold standard, which means it was a FIAT currency, causing a run on the U.S. dollar.

Turmoil surrounding the economic conditions of the U.S. started to worsen, but politicians were more focused on reelection and pressured the Federal Reserve to drop and keep overnight rates low. In the short term, this boosted the economy by reducing the cost of borrowing money, securing these politicians a little bit longer in office. But in the long term, they only lit the fuse on the time bomb of an ever-growing M2 money supply. Compound these factors with the Oil Crisis of 1979, which almost tripled the cost of a barrel of West Texas Intermediate crude. As a result, inflation hit a peak of 13.54% year-over-year in 1980.

THE DOLLAR: $1 in 1979 has the purchasing power of about $4.38 today.

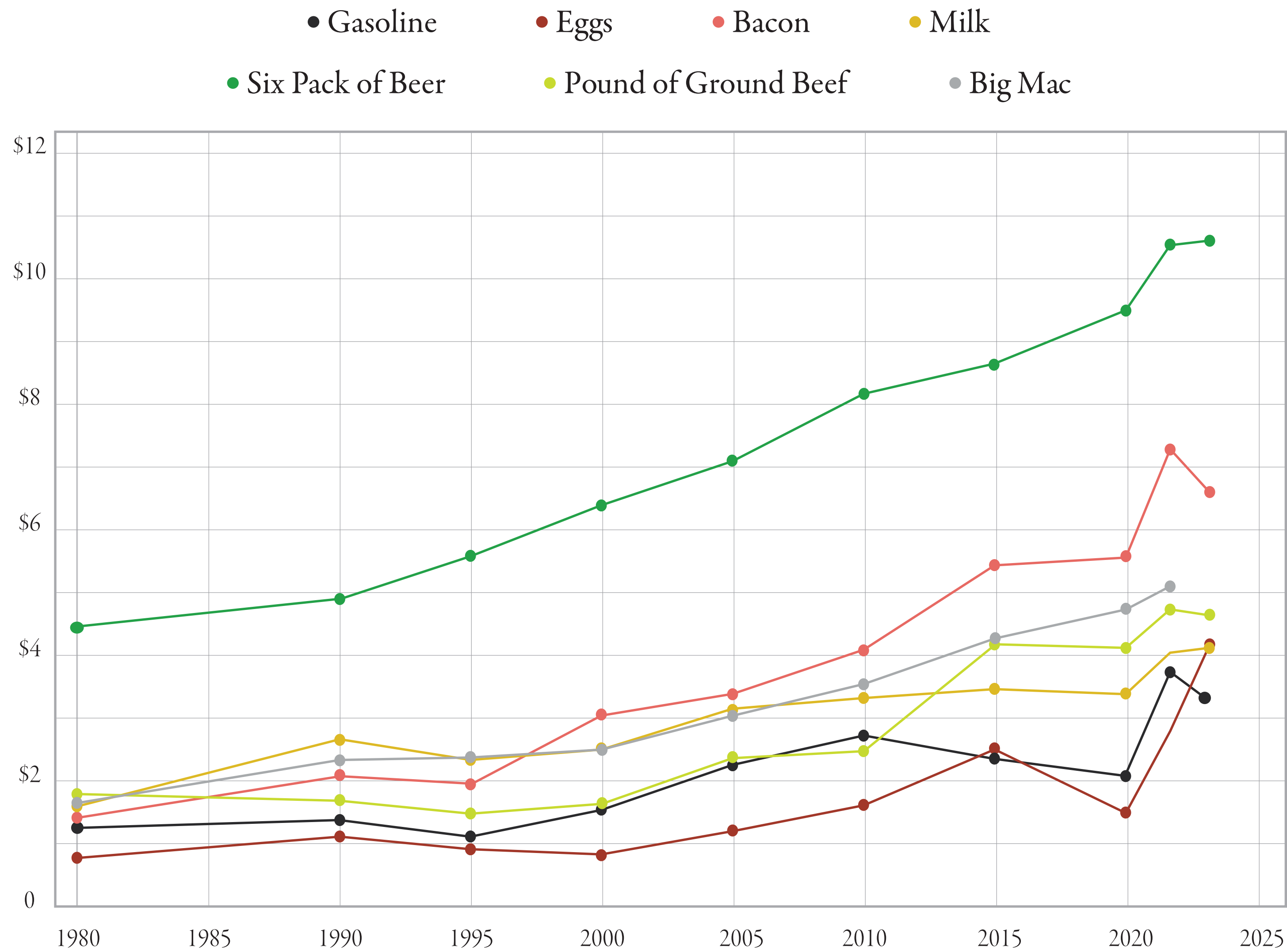
While the inflationary period of the late 1970s and early 1980s has some similarities to our current environment, there are also some stark differences. Past inflation drivers can be traced to easygoing and loose monetary policy, in which low levels of unemployment had been the goal. Similar to today, we saw an unprecedented time during the 2010s, in which rates were kept artificially low to create growth in the economy. Both of these policy stances saw a reduction in unemployment following a recession – the Great Recession in 2008 and the 1974 recession — but later contributed to a red-hot economy in which inflation thrives.

The Oil Crisis of 1979 saw the price of oil nearly triple in a short span, while in late 2021, the war in Ukraine caused the price of oil to nearly double from a price of $65 a barrel to $123 by March 2022. As we all well know, the world was shut down by the 2020 global pandemic, which devastated many parts of the economy. The government intervened by pumping a ton of liquidity into the financial system and deferring debt payments. This new cash injected into the economy helped avoid a long-term recession... but came with the consequences of a sharp spike in M2. This was not the case leading up to 1979. We also saw major supply chain disruptions to the global economy during COVID. Factories abroad that sprung up in the 21st century were effectively shut down overnight, causing major supply and demand imbalances. Additionally, an incredibly strong labor market has prevented the U.S. from experiencing a so-called "hard-landing" associated with recession.

It took a particularly strong-handed Federal Reserve chairman, Paul Volcker, to finally get inflation under control in the late 1970s. Volcker aimed to follow the teaching of monetarist's theories such as those proposed by famous economist Milton Friedman. Rather than target interest rates, Volcker chose to combat the ballooning M2 money supply. To do this, Volcker called a series of special

meetings to raise the Federal Funds rate in correlation with the growth of M2, resulting in an effective Federal Funds rate in early 1981 of 19%. This would put the prime lending rate at around 21.5%. This crushed demand, and eventually led to a recession, but it was exactly what the U.S. economy needed after inflation had been raging for the better part of a decade.

Volcker's strategy was used as a blueprint for economic policy for the next four decades and allowed the United States to evade double-digit inflation through today – though we almost broke that mark in 2022.



Our current Federal Reserve Chairman, Jerome Powell, has increased the Federal Funds Rate at the fastest clip in U.S. history.

Contemporary FOMC members have raised the effective Federal Funds rate by 4.75% in just a year, from a level of 0.08% in February 2022 to 4.83% in March 2023. While commodities prices have fallen dramatically, the prices in services, food and shelter remain stubbornly elevated.

One final sticking point for the current administration is the robust labor market, which has remained at a 50-year low. Now the Fed is looking to reverse the trend of quantitative easing that we saw in the 2010s, with the new narrative of "Higher Rates for Longer." This, they hope, will get inflation more in line with the Fed's 2% goal. Even so, the market is currently pricing in a significant cut in the Fed Funds rate by the end of the year, which directly clashes with this narrative.

	UNEMPLOYMENT	PRIME	FED FUNDS	CPI	10-YEAR YIELD
1980	7.40%	21.0%	18%	12.50%	12.43%
1990	5.6%	10.0%	7.00%	6.10%	8.07%
1995	5.6%	8.50%	5.50%	2.50%	5.57%
2000	4.0%	9.50%	6.50%	3.40%	5.11%
2005	5.1%	7.25%	4.25%	3.40%	4.39%
2010	9.6%	3.25%	0.25%	1.50%	3.30%
2015	5.3%	3.50%	0.50%	0.70%	2.27%
2020	8.1%	3.25%	0.25%	1.40%	0.92%
2022	3.6%	7.50%	4.50%	6.50%	3.88%
2023	3.6%	7.75%	4.75%	6.00%	3.55%

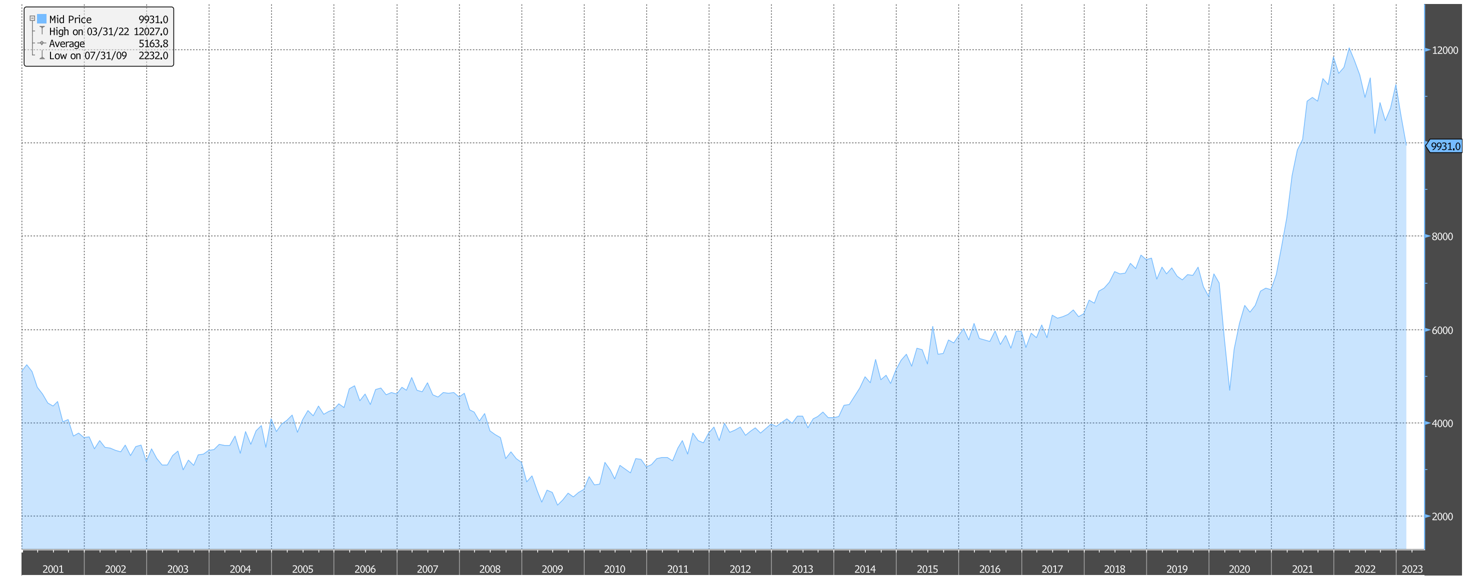
ECONOMIC OVERVIEW

John Norris

After a confusing 2022, everyone hoped things would get back to some sense of normalcy in 2023. Here we are at the end of 1st quarter, and folks are still hoping and waiting. The data continues to paint a somewhat confusing picture. The only thing that seems certain is a worst-case economic scenario doesn't seem likely, at least not now.

The primary reason for this is the continued strength in the labor markets. For all intents and purposes, if you want a job, you can have one. It might not be the job of your dreams, but it will be a paycheck nonetheless. To that end, the Bureau of Labor Statistics (BLS) announced there was an astounding 10.824 million job openings in the U.S. economy during January.

ENORMOUS NUMBER OF JOBS NEEDING WORKERS



Source: Bloomberg Financial

To put this number into perspective, that is slightly more than the entire population of North Carolina. Or, it is equal to the combined populations of Tennessee and Mississippi, or twice the population of Alabama. Take your pick.

Obviously, that is a lot of potential work opportunity for someone, anyone, if they are willing to show up. Trust me, there are a lot of frustrated employers in the country. Further, that level of openings suggest companies are still reasonably confident about their business. Why else would they be looking for workers?

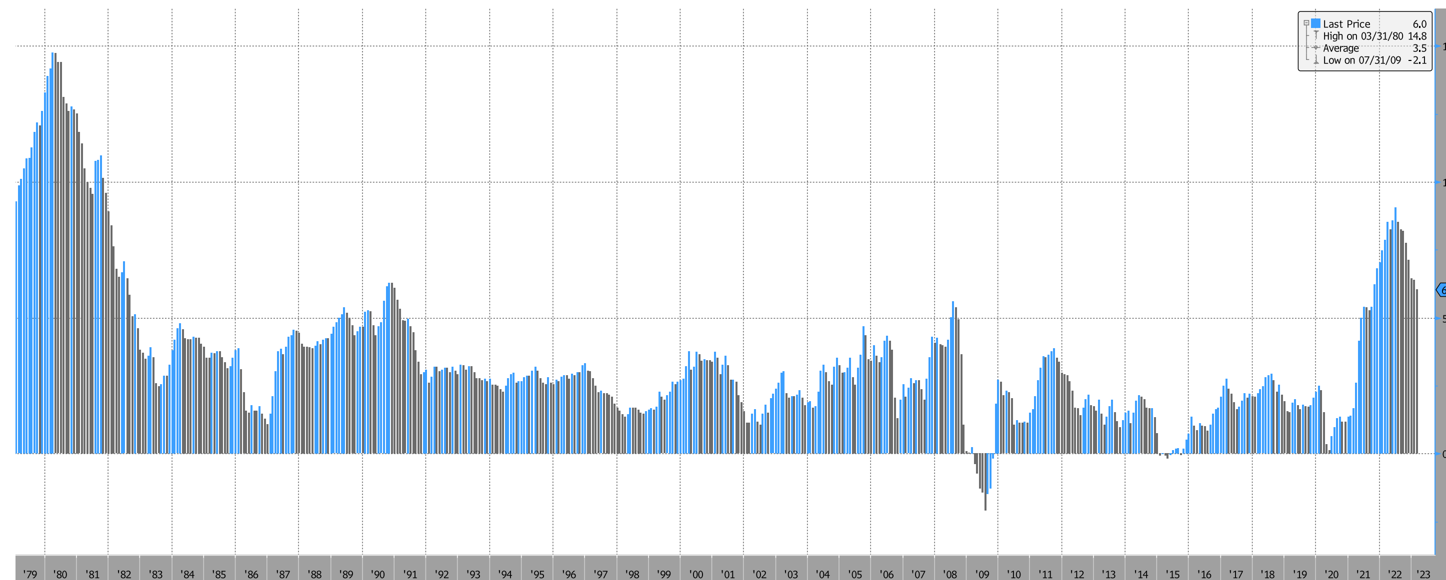
Perhaps even more impressive, especially after the Fed's rate hikes over the past 12 months, the economy added 504K net, new payroll jobs in January and other 311K in February. These would be good numbers during the middle of an economic expansion, let alone in what should be the end of the cycle. Companies should currently be looking to reduce headcount, not add to it, right?

One would think; however, what is the old expression? Never look a gift horse in the mouth?

You see, when the economy is creating jobs, it is creating paychecks. When it creates paychecks, it is creating consumers. This is important, because "personal consumption expenditures" constitute roughly 68% of the Gross Domestic Product (GDP) equation. As such, it is fair to say "how goes the American consumer is how goes the U.S. economy." Taking it one step farther, you could add "how goes the U.S. labor market is how goes the U.S. consumer" to make the statement complete.

Still, if there is something consumers don't like, it is inflation. Unless you haven't been to the store, shopped online, read the news or watched the television over the past five quarters, you know things cost more now than they did. Shoot, at one point in 2022, the trailing 12-month Consumer Price Index (CPI) topped out at 9.1%. That was the highest level since the early 1980s.

IS THE HIGHEST INFLATION IN DECADES COMING DOWN?



Source: Bloomberg Financial

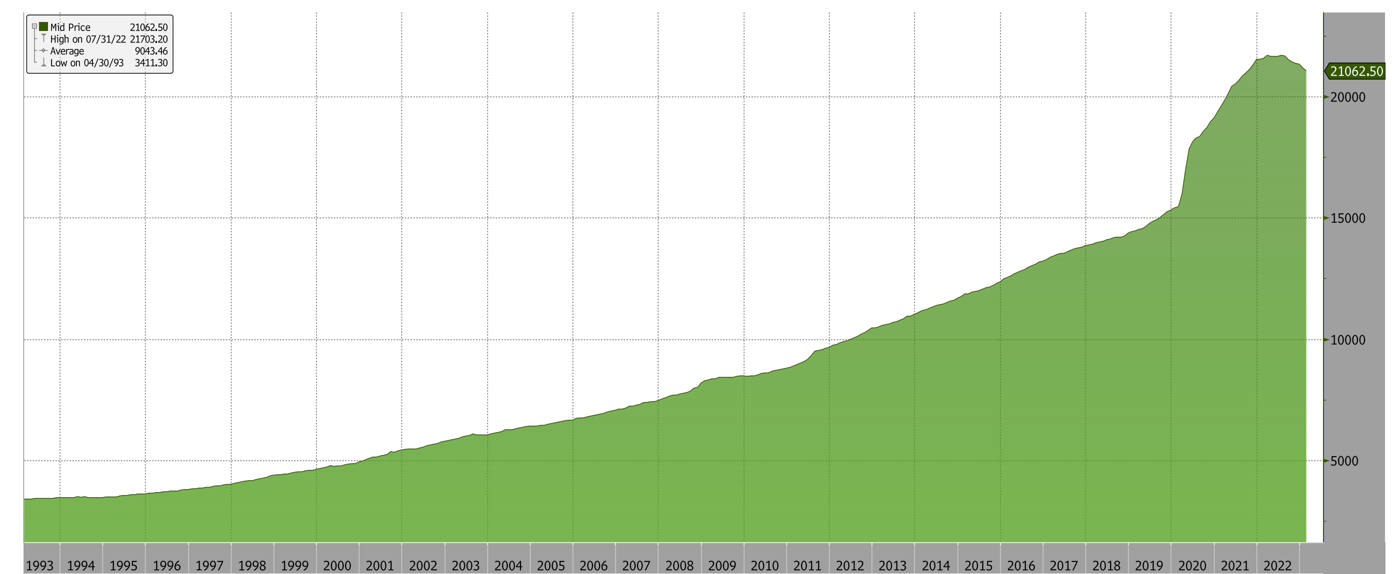
While this calculation had cooled to 6.0% by the end of February 2023, inflation remained too high for anyone's liking during the 1st quarter.

THE QUESTION REMAINS: HOW MUCH LONGER WILL THESE UNCOMFORTABLY HIGH PRICE INCREASES CONTINUE?

Fortunately, the probable scenario is the 12-month CPI will continue to fall during the upcoming quarter. You don't need a crystal ball to make that prediction. All you need to do is scour through some data and understand how the game is played.

- First: the U.S. dollar remains very strong relative to other major trading currencies. Historically, there has been a strong negative correlation between the dollar and inflation. After all, a strong U.S. currency should mean lower import and commodities prices for U.S. consumers and producers.
- Second: businesses are not adding to their inventories at the same pace as they were in 2022. One reason is personal consumption expenditures have stabilized after a torrid pace in 2021 and the first part of last year. Another is that businesses don't want to finance extra inventory at today's higher interest rates.
- Third: the money supply in the U.S. economy, as defined by the M2 index, has actually been falling recently (see chart on next page). To be sure, this isn't an evaporation like it was during the Great Depression. Far from it. However, less money sloshing about the economy, or even stagnant levels, should lead to lower prices. At least they should, as less money is chasing the same level of goods and services.

THE MONEY SUPPLY (M2) DOESN'T FALL VERY OFTEN, DOES IT?



Source: Bloomberg Financial

- Finally, and this is knowing how the game is played, is how the BLS calculates the 12-month CPI. It is nothing more than the product of the previous 12 months. You multiply each month by the next for a year, and voila. It is nothing more than that. So, each month you get to replace an old number with a new number. It really is that simple.

Moving forward, the CPI was 1.0% during March 2022. It was 0.4% during April 2022, 0.9% in May of last year and a whopping 1.2% in June 2022. As such, over the next four months, the U.S. economy will likely replace most, if not all, of those numbers with something lower. Some months might even be substantially lower. As a result, by definition the product of the previous 12 months will fall.

That does NOT mean prices are coming down. At least, not in a meaningful way. However, even a slowing in the rate of price increases should benefit consumer spending.

It also means the Federal Reserve might be able to stop raising the overnight lending target rate and put an end to this tightening cycle. This would be good not only for the consumer and borrowers, but it would also greatly benefit the banking system.

During the 1st quarter, several notable banking institutions essentially collapsed. To the average person, these probably came as something of a surprise. Further, they begged the question, does this signal a return to 2008? Fortunately, the answer to that is probably no.

The underlying causes for the recent hiccup in the banking system are the inflation the powers that be created and their attempts to kill it. As the CPI has climbed, so have interest rates, since they are little more than the cost of money in the economy. Unfortunately, due to their inverse relationship, higher interest rates always lead to lower bond prices. This is important.

Banks own a lot of bonds, many of which they must reflect on their balance sheet at a true market price. Therefore,

lower bond prices have led to a compression in overall bank assets. Obviously, this is a problem since the accounting is: bank assets = bank liabilities + bank equity. So, if the asset side of a bank's balance sheet falls due to higher interest rates but liabilities stay the same, equity decreases. When this happens, banks slow, or stop, lending money.

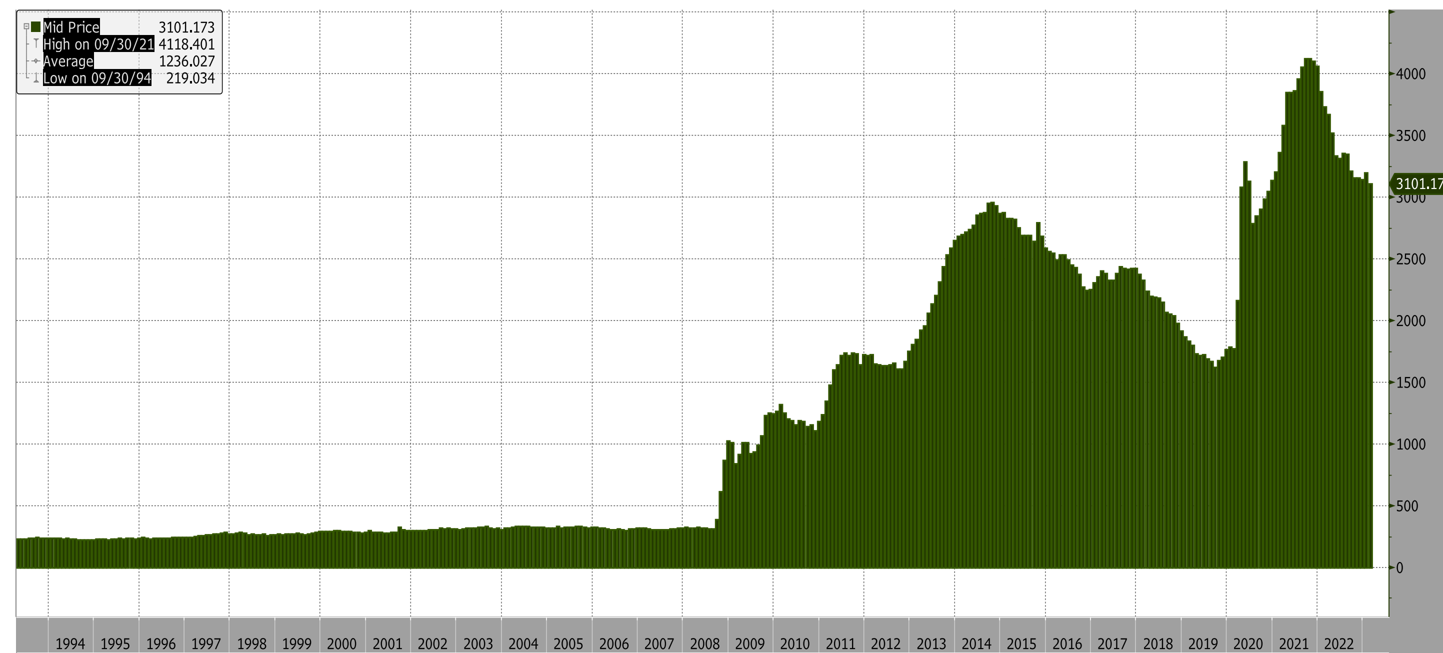
Therefore, intuitively, inflation and the higher interest rates associated with it have had a negative impact on bank equity. It wouldn't take much more than a proverbial "run on the banking system" to cause major headaches. Banks would have to sell securities at a loss to cover outflows, which would lead to the permanent erosion of capital, and things would unravel.

Fortunately, this probably won't happen.

The primary reason is the banking system, as a whole, is still flush with cash.

Consider the following. The Federal Reserve's weekly H.8 report showed the combined banking system at a whopping $3.4 trillion in "cash assets." It had another $593 billion in other forms of short-term liquidity, excluding Treasury Bills. As a result, the system as a whole has essentially $4 trillion in cash with which to meet withdrawals. Frankly, I can't imagine an economic scenario other than complete ruin where there would be that sort of run on the system.

BANK CASH DOWN A LITTLE, BUT STILL EXTREMELY HIGH



Source: Bloomberg Financial

That isn't to say we won't see any more domestic bank failures; we likely will since interest rates will remain higher than they were prior to 2022. However, these will be smaller firms that aren't what the Fed would describe as Systemically Important Financial Institutions. If not failures, I strongly suspect we will see an enormous amount of consolidation among small banks.

According to bankingstrategist.com, there were 2,954 banking institutions in the United States with under $500 million in assets during the 4th quarter of 2022. It is almost impossible to imagine higher interest rates won't make a huge dent in this number. After all, it is entirely plausible the erosion in many of these firms' bond portfolios has decimated what little capital they had. As a result, they have little to no money to lend, and that is what banks are supposed to do.

All of this leads to the following observation about the U.S. economy in the 1st quarter of 2023: It wasn't as pretty as we would like, but we lived through it.

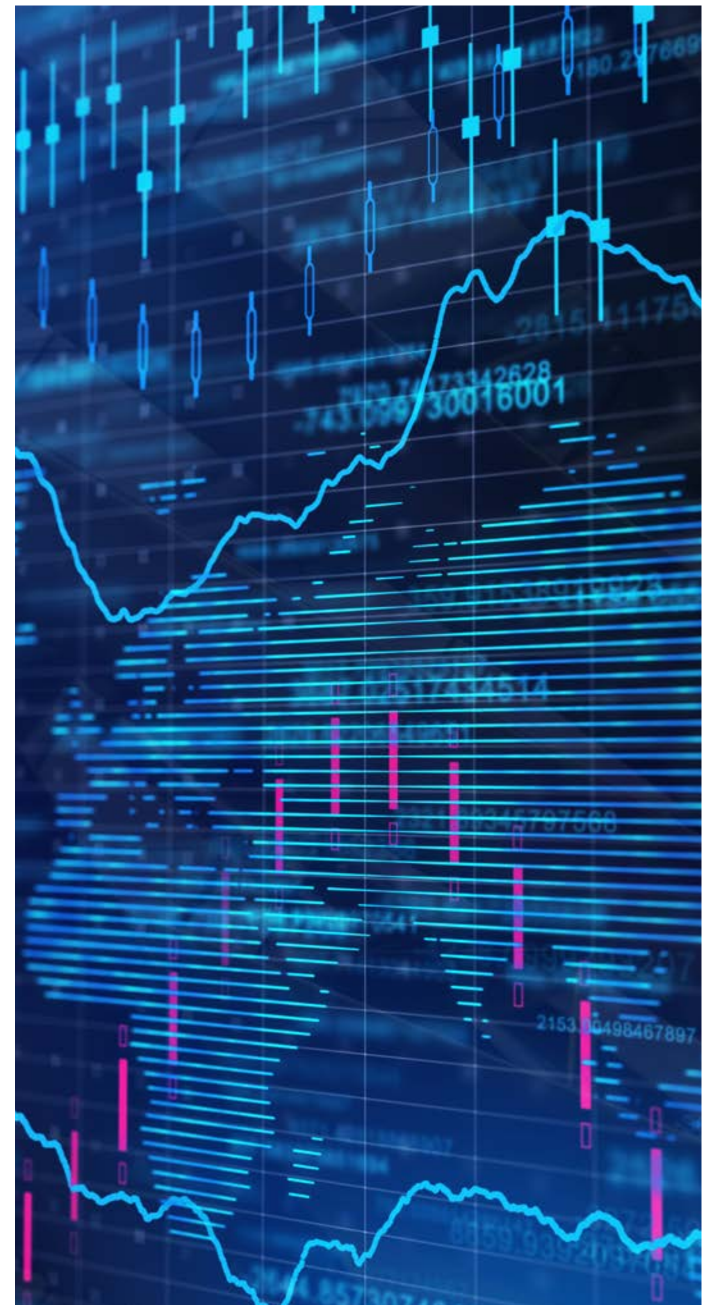
- The U.S. consumer, while slightly weaker due to higher prices, remains pretty resilient in aggregate.
- Inflation should be coming down for a variety of reasons over the next several months. If nothing else, the math will work in our favor.
- Finally, the banking system, in aggregate, remains very liquid even as some banks struggle through the remainder of the year.

Combined, it is difficult to imagine the Fed continuing to be as aggressive as it has been over the past five quarters. Frankly, it is impossible for me. That does NOT mean it will start cutting rates over the next quarter or two, and I suspect it won't. However, simply sitting on the proverbial sidelines for the time being would be a very prudent course of action. It would give smaller, weaker banks a respite from the attack on their balance sheets. It would also give the economy the ability to better plan for the future.

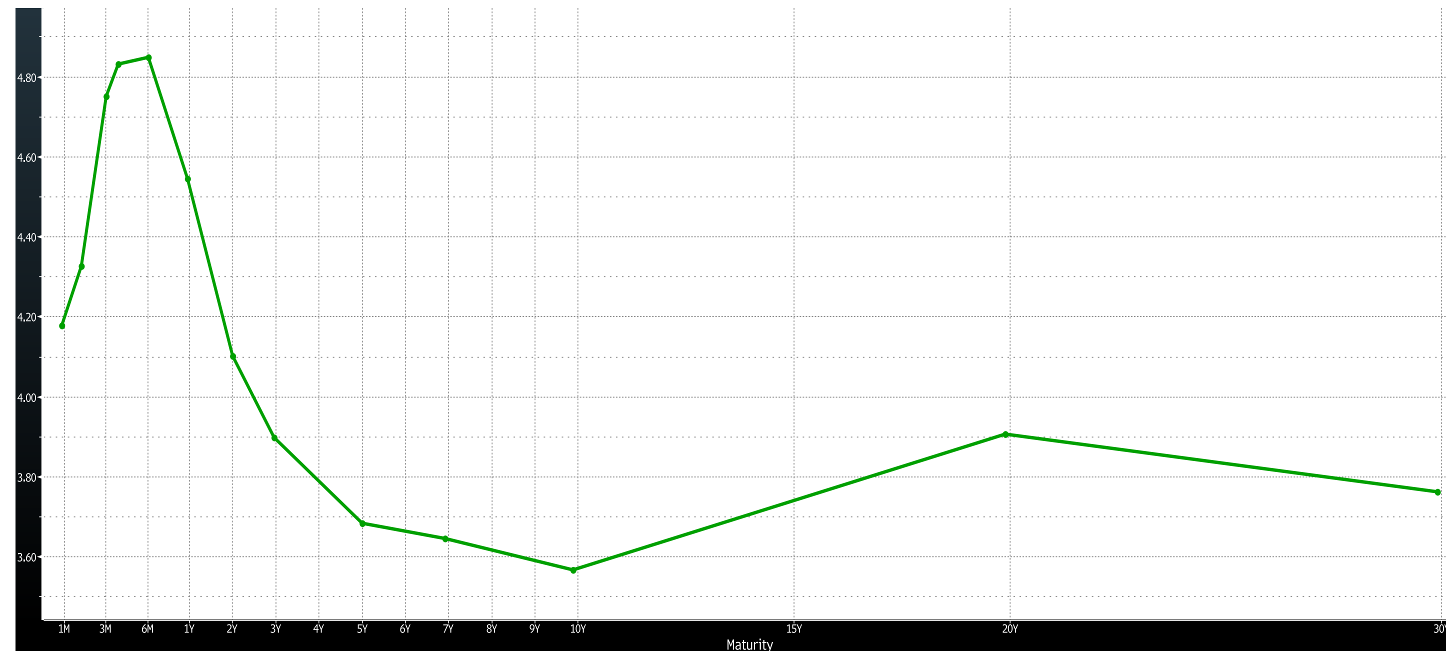
Essentially, the future strength of the U.S. economy in 2023 is almost completely in the Fed's hands. It can continue to be aggressive in crushing inflation numbers, which are coming down anyhow, and flatten the economy. That, or it can slow its roll and attempt to manufacture the nearly mythical "soft landing."

Unfortunately, even that might be a neat trick, given the length of time the yield curve has been inverted. This is when short-term borrowing costs are higher than long-term lending prices. Historically, lending slows and economic activity slows when this happens. However, this does NOT mean these things come to a complete halt. They don't and they won't.

There is an old expression: "Prices go up in the elevator and come down using the stairs." There is no reason to think this time is any different.



THE INVERTED US TREASURY YIELD CURVE, MARCH 30,2023



Source: Bloomberg Financial

AGAIN, THE BANKING SYSTEM REMAINS VERY LIQUID. INFLATION IS COMING DOWN. THE LABOR MARKET IS SURPRISINGLY ROBUST. WE HOPE THE FED WILL BE DONE RAISING RATES. ALL OF IT.

In closing, a best-case scenario of robust economic activity from this point through the remainder of the year is highly unlikely. After all, people are more worried about a recession than they are excited about an expansion. Conversely, a sharp recession, a return to 2008 if you will, is almost equally unlikely due to the reasons I have already given. As such, the probable scenario is another confusing quarter of mixed economic data in the 2nd quarter of 2023.

After waiting as long as we have for normalcy, what's another quarter?

EQUITIES

WHEN GOOD NEWS IS BAD NEWS AND BAD NEWS IS GOOD NEWS

David McGrath

Since the start of 2022, the bulk of any discussion around equity markets has begun with economic releases, and the Federal Reserve's response to those releases. The main question on the line? When will the Fed stop raising interest rates.

WHEN THE EQUITY MARKETS ARE FOCUSED ON THE FEDERAL RESERVE BEFORE ANYTHING ELSE, INCLUDING CORPORATE EARNINGS, BAD ECONOMIC NEWS IS GOOD NEWS FOR THE STOCK MARKET.

That's right, good news is bad news and bad news is good news.

Fewer people getting hired and wages not going up is not great news for the consumer but is does mean inflation should start to recede and the Fed can stop raising interest rates. Last year the Fed signaled that it will do whatever it takes to bring inflation back down to its target of 2% inflation. An economic recession just may be a side effect of those efforts.

As we rolled into 2023, equity investors were rooting for a slowing economy. Each of the three months that made up the first quarter of 2023 had a very different feel for how this was going to play out.

January

All economic releases in January continued with the trend we saw during the last few months of 2022, with all signs pointing to a slowing (but not a crashing) economy. Job growth was slowing, wages were not going up quite as fast and most importantly, inflation was falling. Bad news is good news! It was everything the stock market was looking for! And earning season was in line with expectations. It wasn't great, but it wasn't nearly as bad as feared.

January was optimistic, producing returns that matched that optimism. This peaked with the Federal Reserve meeting on February 1. They raised interest rates by 0.25%, and Jerome Powell's press conference gave some hints that the Fed's hiking cycle may be coming to an end. Equity markets continued to rally, and the narrative of a soft landing, with inflation falling in line without being accompanied by a severe recession, was a possibility.

February

That optimism did not last very long. The morning of Friday, February 3, provided investors with the January jobs report from the Bureau of Labor and Statistics. Economists had expected a gain of 187,000 jobs and that the unemployment rate would tick up from 3.5% to 3.6%. Instead, the report showed a gain of 517,000 jobs and the unemployment rate falling to 3.4%. That was the lowest unemployment rate since May 1969!

Was this report just an outlier, our did the slowing economy from the 4th quarter of 2022 just pick up in January? As February continued, additional economic releases reinforced the jobs report. Both measures of inflation (CPI and PCE) came in higher than expected, and retail sales were also much hotter than expected. The economy was indeed getting stronger. This was the dreaded "good news" the stock market feared. In this case, more people working (and spending those earnings) means the Fed has to raise interest rates even higher to tame inflation.

All of the optimism that was built in January was starting to evaporate, and the S&P 500 was now only up 3.4% for the year. The Nasdaq saw the 12.9% return trimmed down to a 9.4% return. The Dow Jones Industrial Average was now down 1.5% for the year. Markets feared that the Fed would have to raise interest rates through the 2nd quarter, bringing the Fed Funds rate up to, or even over 6%, from its current level of 4.75%.

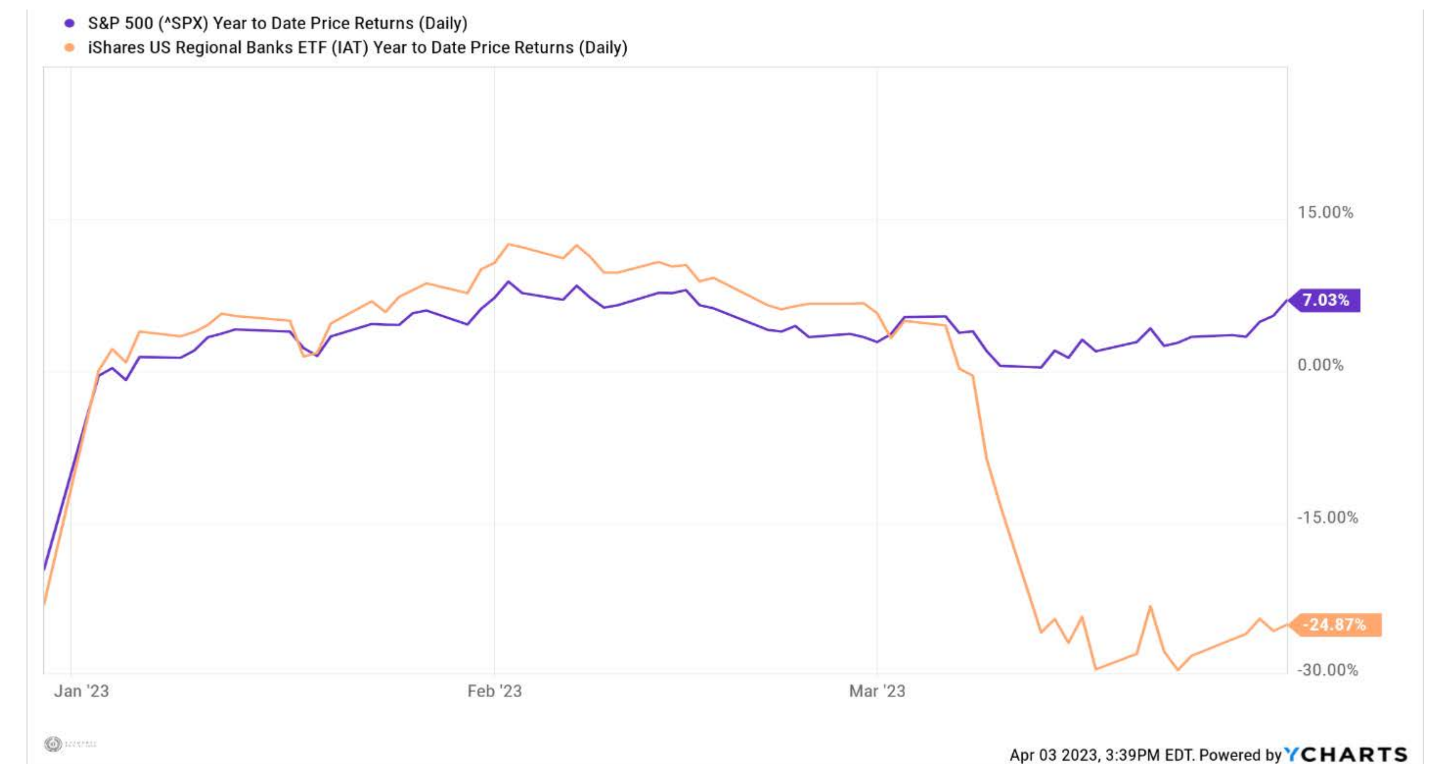
If you thought February was volatile, just wait another week...

March

THERE IS AN OLD SAYING THAT THE FEDERAL RESERVE RAISES INTEREST RATES UNTIL THEY BREAK SOMETHING. A FEW DAYS INTO MARCH, WE STARTED TO SEE A FEW CRACKS.

Silicon Valley Bank closed trading on March 7 at $267.83 per share. In just a few short days, the stock would be essentially worthless. On March 8, the bank announced a plan to raise over $2 billion in capital. Their bond portfolio had significant losses, and the bank needed to recapitalize. The vast majority of Silicon Valley Bank's clients were in the same industry, and word spread quickly that the bank may be in trouble. At the end of the day on March 9, Silicon Valley Bank had more than $42 billion in withdrawals. On March 10, U.S. regulators took control of the bank. Just a few days later, Signature Bank suffered a similar fate. Bank stocks struggled, with regional banks leading the way down. Welcome to the banking crisis of 2023.

THE FALL OF REGIONAL BANKS VS S&P 500



Banks that were not deemed "too big to fail" saw deposits flee to the largest banks. In response, interest rates fell dramatically. The yield on the 1-year Treasury dropped from 5.25% down to 4.28% in just five trading days.

IT IS ALMOST IMPOSSIBLE FOR THE STOCK MARKET TO HAVE ANY STABILITY WHEN THE BOND MARKET IS THIS VOLATILE.

At this point, the entire year-to-date gain for the S&P 500 had disappeared, and stocks were essentially flat for the quarter.

On top of that, equity markets went from expecting a 0.5% increase in the Fed Funds rate to either a 0.25% increase or no change at all. In the end, the Fed did raise interest rates by 0.25% but signaled a pause in rate hikes.

As of March 8, smaller banks that lost deposits did not have the ability to make as many loans, and many of the larger banks wanted to reduce the risk on their own loan portfolios. The net result? Banks were going to slow loan growth. The banks were, in essence, going to help the Fed slow down the economy.

Before the banking crisis, the Fed Funds rate was expected to approach 6%. Now, we may see the Fed pause between 5% and 5.25%. It could be argued that the economy is better off with a "recipe" to bring down inflation that consists of a Fed Funds rate of

around 5% coupled with a more risk-averse banking sector than a Fed Funds around 6% coupled with a banking sector willing, or in some cases eager, to take on more risk.

As we moved past March 14, and the feared contagion of the financial crisis was not materializing, markets began to recover and even ended with a nice rally. Once all the dust settled from a very eventful three months, we ended the quarter with a gain.

INDEX	1Q 2023
S&P 500	7.48%
Dow Jones Industrial Average	0.93%
Nasdaq	17.05%
EAFE International Index	8.65%
S&P Mid Cap 400	3.79%
S&P Sall Cap 600	2.54%

ECONOMIC SECTORS	1Q 2023
Technology	21.82%
Communication Services	20.50%
Consumer Discretionary	16.05%
Materials	4.29%
Industrials	3.47%
Real Estate	1.88%
Consumer Staples	0.83%
Utilities	-3.24%
Healthcare	-4.31%
Energy	-4.71%
Financials	-5.56%

Sector Specifics

Technology, communication services and consumer discretion all showed stellar returns in the first three months of 2023. The other eight sectors added very little to the 7.48% return for the S&P 500. This divergence in returns shows up dramatically with the difference in performance between the Nasdaq and the Dow Jones Industrial Average.

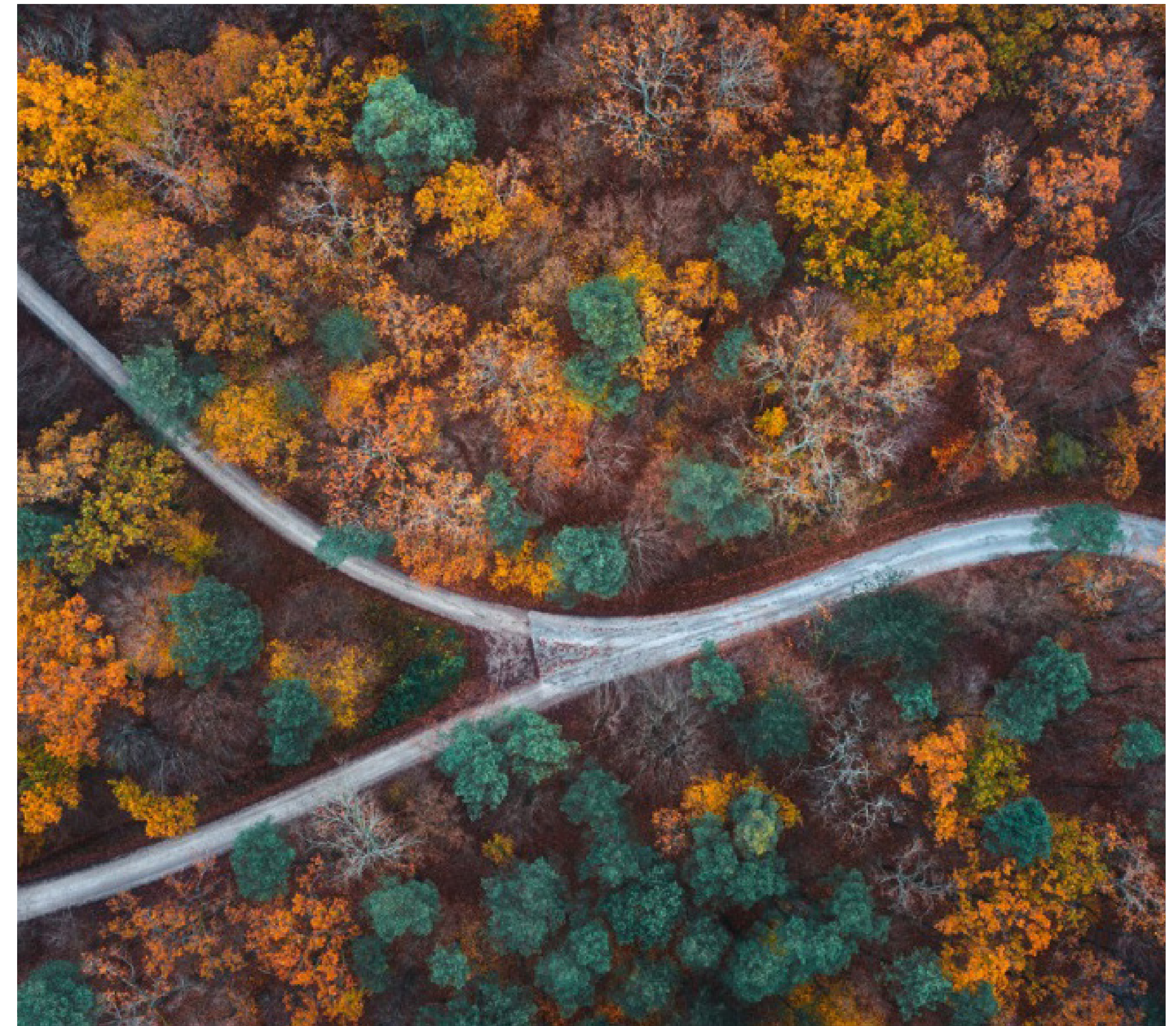
Those three positive sectors were the very same sectors that were punished the most in 2022; showing returns of -28.2%, -39.9% and -37.0%, respectively, for 2022. The realization that the Fed may finally be at the end of raising interest rates provided for a relief rally in the sectors most affected by higher interest rates.

As mentioned, the banking stocks pulled the financial sector down for the quarter. The slower than expected reopening of China from COVID and the rising risk of recession weighed on the price of oil, slowing the impressive rebound in the energy sector. After the 65% return in 2022 for energy stocks, a slight pullback should not be too surprising.

Looking Ahead

The first hurdle will be the continued return to normalcy of the banking sector. Each day and week that goes by with no new news should bring back a greater sense of normalcy. Next, we get a look at 1st quarter earnings. Will the surprise strength in the economy last quarter lead to better-than-expected earnings? Could those stronger earnings cover up the expected earnings shortfall from the financial sector after the banking crisis in March? We should have answers to those two questions by the end of May.

Finally, the most important question that needs to be addressed is the markets' current expectation that the Fed will cut interest rates in the second half of 2023. The two paths that would cause interest rate cuts from the Fed are 1) inflation coming down dramatically in the next several months or 2) the economy falling into a recession and the labor market weakening considerably.



With wages across the economy rising around 4% a year, it is difficult to envision inflation falling all the way to the 2% target. With the strength of the consumer, it is also hard to see a deep recession for the U.S. economy.

If inflation gets stuck around 4%, and the labor market remains strong, there is a good chance we won't see those expected rate cuts from the Fed during the last six months of 2023.

If that is the case, those same three sectors (technology, communication services and consumer discretion) that performed well in 1st quarter may see those early tail winds of 2023 turn in to head winds the second half of the year.

The Oakworth Investment Committee was hopeful that we would find some stability in 2023. If the first three months are any indication, the "fasten seat belt" signs for stock investors may remain on for a little while longer.

BONDS

CHOPPY WATERS ON THE HORIZON

Sam Harris

As Maximus so notably proclaimed in the cult classic flick *Gladiator,* "Are you not entertained? Is this not why you are here?" Between old-fashioned bank runs and poor balance sheet management, bonds have certainly given us a dose of "entertainment" in 2023, receiving much of the limelight in the first quarter. The year 2022 will likely remain forever ingrained in investors' minds, as stock and bond investors alike struggled to find any kind of total return. And 2023, fresh out of the gate, began with quite the bang.

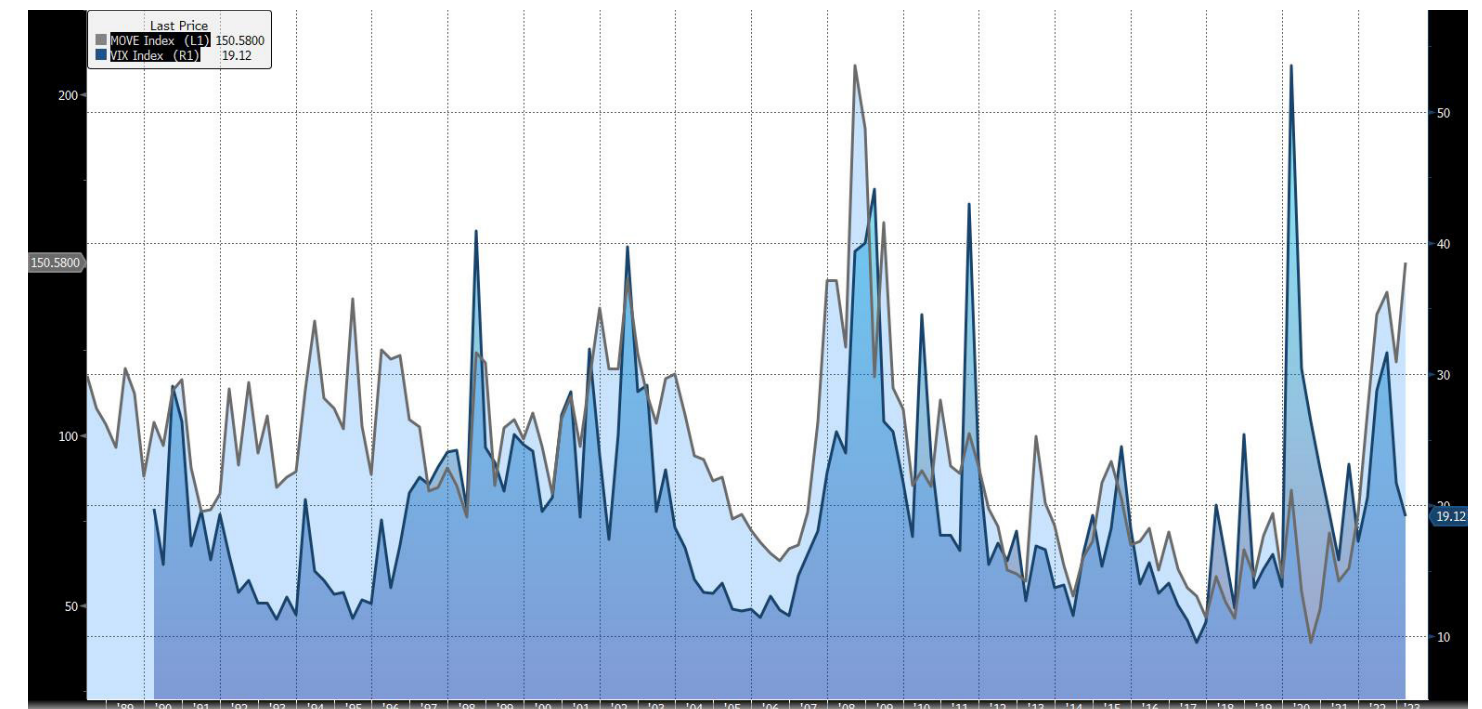
In January alone, the S&P 500 soared over 6.25%; the Nasdaq jumped a whopping 10.72%; and the Dow rose 4.25%. All the while, the Bloomberg Global Aggregate Bond Index rose over 3.25% — a far cry from its -16.25% collapse in 2022.

Despite giving some back in February, the Global Agg still produced a total return of 2.96% at the close of trading on March 31, marking the end of the first quarter.

The bond market during this time saw extreme volatility not equaled since the waning days of the Great Financial Crisis, dating back to December 2009. The benchmark 10-year Treasury note began the quarter yielding 3.79%. The Treasury's yield peaked on March 2 at 4.08% – a near eightfold increase from the 10-year yield's historic low of 0.52% on August 4, 2020 – representing an upward move that typically is not observed under "normal" market and economic conditions. Combine that, the lingering effects of interest rate risk leading to principal investment erosion, with the most aggressive Federal Reserve/Central Bank-tightening cycle since that of Paul Volcker almost three decades ago (and shrinking M2, the overall money supply, by the largest amount since that of the Great Depression), and voila: fissures in overleveraged financial institutions and potential liquidity crunches begin to unfold.

Volatility within the bond market was not lacking in the first quarter, as highlighted earlier by the 10-year Treasury. The BofA (Bank of America) ICE (Intercontinental Exchange) MOVE (Merrill Lynch Option Volatility Estimate) Index measures bond market volatility, similar to that of the VIX Index for the broad stock market. The bond market bucket's sheer size (much larger relative to that of stocks) allows for the index to typically signal what may lie ahead for the equity market.

BOFA ICE MOVE INDEX VS VIX VOLATILITY INDEX

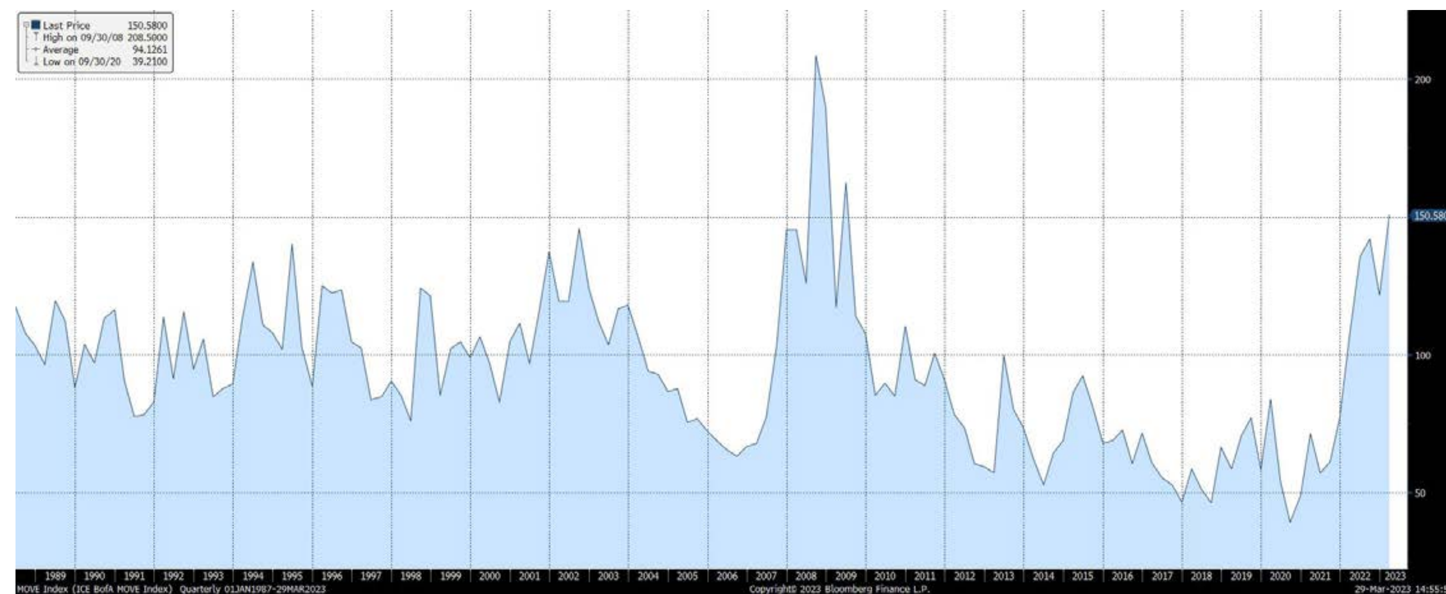


Source: Bloomberg Financial

WHEN THE MOVE INDEX RISES MORE THAN THE VIX INDEX, IT SHOULD SIGNAL TO INVESTORS THERE MAY BE A SERIOUS PROBLEM (OR PERHAPS JUST FEAR) LOOMING IN THE MARKET, BECAUSE BONDS SHOULD NOT MOVE WITH MORE VELOCITY THAN STOCKS.

Looking back to "the COVID year," the MOVE Index briefly hit just under 140 in March 2020, which represented over four standard deviations from its post-2012 average. When the stock (and bond) markets bottomed at the lows of 2022 on October 21, the Index hit 157. On March 15 of this year, at the peak of both rejuvenated financial crisis and monetary policy-mistake concerns, the MOVE Index crossed 200 before closing a bit lower at 198.71. This was the second sharpest rise in the index's history, dating back to its inception year of 1988, with the only higher day on record being September 30, 2008.

BOFA ICE MOVE INDEX SINCE INCEPTION



Source: Bloomberg Financial

Due to the worries and concerns that may lie ahead for investors, the bond market saw rates rise in the first quarter, largely across the curve, with investors opting for money markets, certificates of deposit and general checking accounts. Despite this still, the yield curve itself did not move in tandem. It did not steepen, at least with any meaningful significance, and it remains all bent out of shape. The 10-2 Year Treasury Yield Spread, representing the delta, or difference, between the 10-year Treasury's yield and the 2-year Treasury's yield, began the quarter and year at -0.61%. It bottomed on March 8 at -1.07%, and it peaked less than three weeks later on March 24 at -0.38%.

Obviously, inflation remains elevated in both the marketplace and in the economy.

February's Consumer Price Index, or CPI, came in at a whopping 6.04% year over year, a far cry from the Fed's goal of 2.00%, though inflation has begun to increase at a decreasing rate – which investors have taken as a welcome sign.

Core PCE, the Fed's preferred inflation gauge, came in at 4.60% year-over-year for February, signaling a hotter-than-desired inflationary environment that remains omnipresent. The PCE Price Index for Goods remains trailing that of Services; however, we have seen a tick down in the cost of goods relative to recent months.

So what does this have to do with bonds? Quite a lot, actually.

Higher inflation erodes the purchasing power of future interest and principal payments. As a result, inflation expectations can lead to changes in bond yields, with investors requiring higher yields in order to compensate for the expected erosion of future cash flows, thanks to inflation. Combine that with a period of financial instability or uncertainty, and bonds could perform poorly – and/or experience volatility. As interest rates rise, the expected return for investors on newly issued bonds increases, leading to a general decrease in demand for existing lower yielding bonds. This jump upward in required or expected yield in order to compensate for the higher rate environment can lead to a decrease in the market value of existing bonds, causing bond prices to fall – along with institutions like Silicon Valley Bank.

In addition, financial instability can exacerbate the effects of a rising rate environment on bond prices by increasing the inherent, or perceived, risk of holding bonds, period. Specifically, those with lower credit ratings – whether that may be agency, corporate, or municipal – may be more "at risk." As with anything, when investors are uncertain about the financial stability of the issuer (or the overarching banking system in general) they may very well demand a higher risk premium to compensate for the increased risk. In turn, this can lead to further decrease(s) in demand for the bonds in question, leading to a subsequent decrease in their prices – à la Credit Suisse bonds.

A quick recap from Finance 101 for a moment: Bonds with longer maturities and lower credit ratings tend to be more sensitive to changes in both interest rates and market conditions – longer exposure to "unknowns." Conversely, bonds with shorter maturities and higher credit ratings tend to be less sensitive to rate changes and volatility as their risk profile is lower and are able to provide more stable cash flows.

Looking back on the quarter, however, the different sectors within the broad fixed-income asset class performed quite differently; a welcomed change for bond investors relative to that of 2022, as every sector finished in the black – in both price and total return. See chart below.

TICKER	SECTOR	2023 1Q PRICE RETURN	2023 1Q TOTAL RETURN	2022 TOTAL RETURN
		%	%	%
AGG	Broad U.S. Bond Market Debt	2.73	3.23	(13.03)
SHV	U.S. Short Treasury Debt	0.53	1.13	0.94
LQD	Investment Grade Corporate Debt	3.96	4.65	(17.93)
VTEB	Municipal Debt	2.36	2.83	(8.00)
MBB	Mortgage Debt	2.13	2.67	(11.74)
HYG	High-Yield Debt	2.61	3.73	(10.99)
FLRN	Floating-Rate Debt	0.13	1.04	1.31

Municipal bond holders fared quite well. Despite lagging a few higher-credit sectors, the municipal sector saw a near 2.50% gain for the quarter amid financial uncertainty and slower economic growth (and perhaps even contraction). The municipal bond sector, specifically, carries inherent credit risk – meaning there is risk that the issuer (state and/or local governments) may default on its obligations. The economy, tax revenues and current political environment can all have lasting effects on this. In addition, government(s) prefer to keep social aid programs going, like child welfare and EBT, relative to keeping debt on the books for, say, an annexed subdivision buildout.

Over all, bonds saw a bump up in the first quarter of 2023 – despite the continued "bad" news cycle. That said, based on March volatility and continued sticky inflation, there may be storm clouds on the horizon.

ASSET ALLOCATION

Sam Clement

The first quarter of this year may not be best described as normalcy, but at least it seems to be trending in the right direction — inflation not running near double digits, bonds not performing miserably and the same can largely be said for the stock market. Rates are still rising, and while the impacts of the hiking cycle have yet to fully unfold (outside of some banks), things seem to be settling down. The amount of fear has retreated from its highs coincidentally at the same time markets have recovered from their lows of last quarter.

This must mean we are free and clear of the most talked about recession of all time, right? Actually, no. In fact, the economic data has largely stabilized, if not slightly improved in some areas. So, what does this mean for our asset allocation? The most forecasted recession

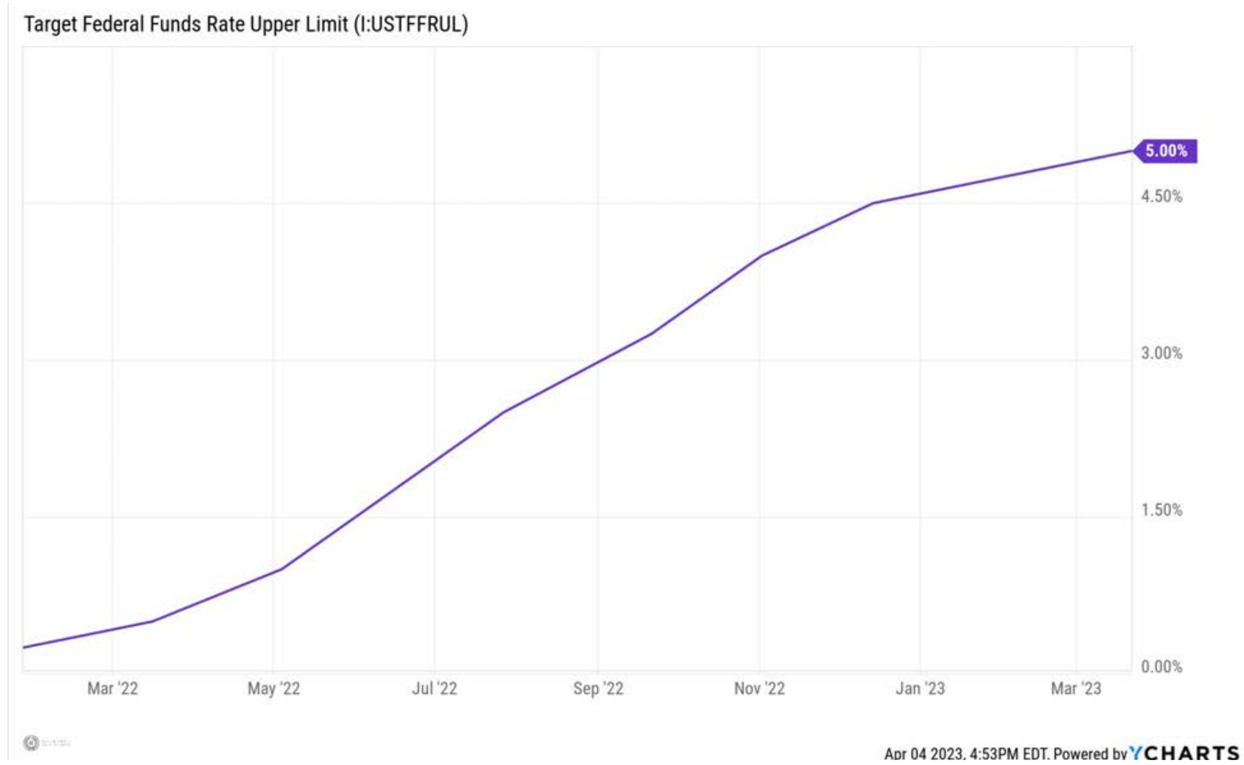
of all time still hasn't happened, and the economic data has not fallen through the floor. It seems Mr. Market hasn't fully nailed down what the future looks like, and for market participants like us, that means opportunity.

As rates rise, cash pays more. As of the end of this quarter, our wealth cash sweep is paying close to 4.5%. As I have often stated, cash is always dry powder, however when you are generating solid returns on it, it's also a legitimate part of an asset allocation.

Cash can be looped into the fixed-income part of an allocation. It's essentially bonds with no duration risk.

As the Federal Reserve moves rates higher and lower, the yield on cash will directly move with it.

TARGET FED FUNDS RATE UPPER LIMIT



Parking extra in high-yielding cash is not the worst option, and our asset allocation has backed that up, with the cash position remaining at some of the highest levels since we opened our doors. The Federal Reserve has openly stated they would like to keep rates elevated for some time and are not going to be cutting rates based on their current projections of economic activity. In layman's terms, unless things get pretty bad, they aren't going to slash rates.

This means that the cash allocation of our portfolio will continue to have an elevated yield and may even continue to tick up.

The market, however, is singing a completely different song. Everyone has heard about the yield curve being inverted, and that's been the case for quite some time now. However, that inversion that is referenced is usually the 2-year Treasury versus the 10-year Treasury. What is also inverted now is the 3-month Treasury versus the 2-year Treasury. Essentially the entire yield curve is flipped upside down. The market is screaming that the Fed Funds rate will need to come down. That begs one question:

Has the Fed done too much because inflation is going to continue to come down on its own, or because there is some economic pain coming that has yet to be felt?

The answer to these types of questions is usually a little bit of both. Inflation is clearly coming down, albeit not at the rate we would all like. Also, even the Federal Reserve has forecasted that to accomplish their goal, a likely consequence is slightly higher unemployment and slightly lower growth.

So, what does this mean for our allocation?

If rates likely come down at some point, it seems to make sense to keep our duration short. Shorter duration is essentially shorter-term bonds - the ones that would be most positively impacted by the Fed lowering rates. It also doesn't hurt that the discombobulated yield curve has those shorter-term bonds paying significantly higher than long-term bonds. In some cases, by over a full percentage point.

After a painful 2022 in fixed income, one of the positives is that higher rates have allowed us to keep a slightly higher allocation toward fixed income as a whole.

Markets desire clarity arguably more than anything. Markets largely can handle rate hikes, sluggish economic data, higher than expected inflation, all that seemingly negative stuff with one caveat: when that stuff is expected. That is largely the biggest issue from 2022 – in which long-term treasuries performed even worse than the equity markets. Everyone was caught off guard by the resiliency of inflation, the fortitude of the Federal Reserve and even the strength of the U.S. economy. Everyone was caught off guard by the resiliency of inflation, the fortitude of the Federal Reserve and even the strength of the U.S. economy. This year, however, markets seem to be a little more sure footed.

Bonds have performed better as the path of inflation and rate hikes seems clearer, and equities have had a significantly better start to this year, largely I would argue, due to those same reasons.

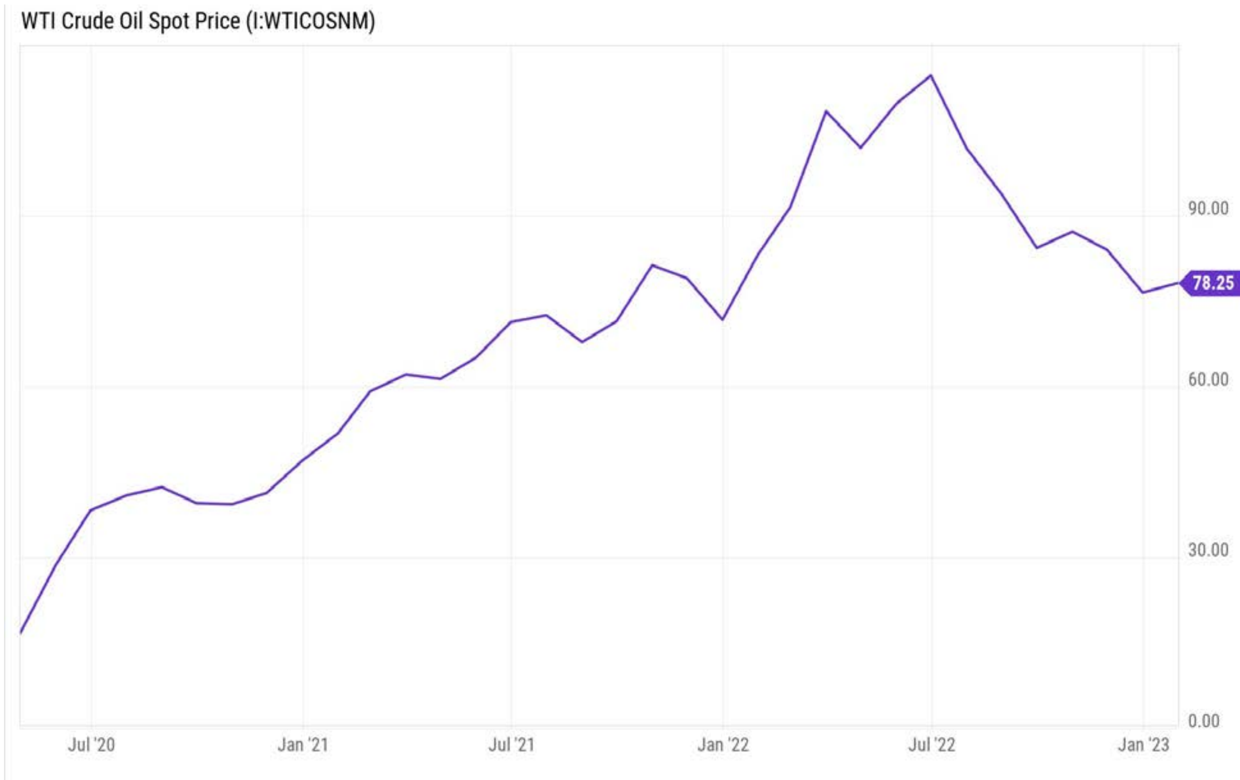
Sure-footed, though, does not mean out of the woods. As stated earlier, the bond market is not giving the all clear, and same for the stock market. What this translates to is a largely neutral equity weighting. Not a big overweight nor underweight to the asset class. What neutral does not mean is sitting on our hands doing nothing. It allows us to maintain the upside when markets perform well, as they largely have so far this year, while also giving us the optionality to increase or decrease our overall equity weightings based on risk tolerance. It is an active choice.

Over the last quarter there have been plenty of opportunities in the equity space. The pullback in the price of crude oil allowed us a good entry point in the exploration and production subsector of the energy market. This has accomplished several goals.

First, we believe that the run up in crude prices over the past year has allowed a sublime transformation of the

balance sheet of these largely mid cap domestic energy companies. Debt has been paid down and the capital allocation is now purely focused on returning capital to shareholders, both through buybacks and dividends. This is music to our ears, and as long as crude remains above $40 a barrel, this plan (and the music) will not stop.

CRUDE OIL SPOT PRICE



Second, the energy sector, as well as mid and small cap companies, is positioned to excel as rates start to fall. Energy is uniquely largely bought and sold in U.S. dollars across the globe, and as rates fall and the dollar subsequently weakens, it takes more dollars to purchase the same barrel. This is constructive to energy prices and affords the ability to return capital to shareholders.

MOVING FROM LARGE CAP TO SMALL AND MID-CAP IS SOMETHING WE HAVE STARTED TO DIP OUR TOES INTO.

It's an increasingly frequent discussion point for our Investment Committee. On top of adding to the E&P space, we also opened up a position in small cap equities by way of pulling from large cap equites. This maintained that neutral equity allocation while positioning ourselves for the future. As the yield curve starts to uninvert, this is likely a position that we will continue to add to.

The best thing that has happened over the past year is the optionality created in the market. This is what any market participant loves to see. The flexibility that is allowed and the creativity available opens up the conversation and the possibilities for us to generate alpha. While we are by no means out of the woods, the first quarter of this year has been significantly better than this time last year, and opportunities continue to present themselves.

HERE TO SERVE YOU

Meet Our Wealth Advisors

Managing both the broad view and the complexities of our clients' wealth management and trust needs is our hallmark. Our holistic approach allows us to manage assets not just for today, but for generations.

Your client advisor works to understand deeply your values and goals, then coordinates an elite, multidisciplinary team of financial experts to preserve your invested dollars, provide a readily accessible stream of liquidity and generate a competitive rate of return – all based upon a statement of investment policy we have defined uniquely for you.

We advise clients on the appropriate asset allocation and execute this strategy through the use of an open-architecture investment platform. We then work closely to achieve their generational financial objectives.

Learn more about our wealth team at:
oakworth.com/our-team/wealth-team

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Investment Management | Wealth Strategies | Fiduciary Services

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RICHARD LITTRELL
Associate Managing Director
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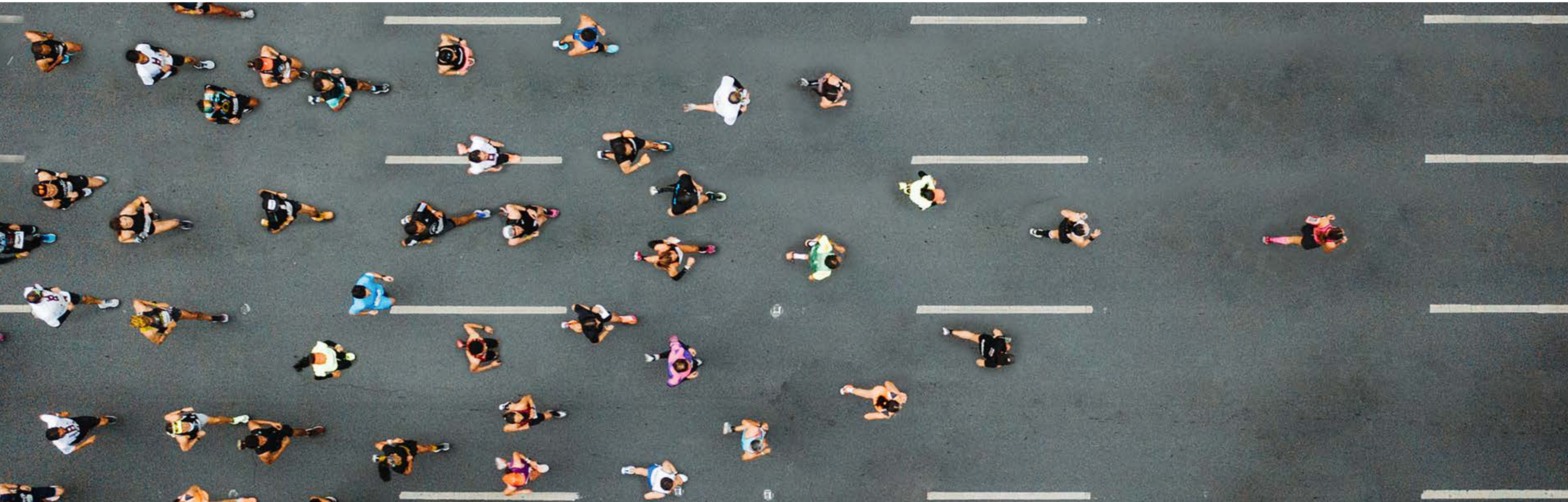
CLIFF NAIL
Client Advisor
Central Alabama

GREER REDDEN
Managing Director
Middle Tennessee

2023

2ND QUARTER PREDICTIONS



- The official **12-month inflation gauges will show marked signs of improvement.** However, this doesn't mean prices are coming down. It means the calculations are replacing much higher monthly numbers from 2022 with lower ones in 2023.

- By the end of the 2nd quarter, the Federal Reserve should have enough cooler inflation data **to pause in raising the overnight lending target.** However, this doesn't mean the Fed will be in a hurry to cut rates.

- The economic data will be confounding. Regional surveys will continue to be less than impressive. Yet the official labor force data will stay surprisingly strong. Simply put, **employers will continue to have a hard time finding capable workers.**

- Despite all of the fears, **the United States will avoid a severe 2008-like recession during this economic cycle.** Why? Despite the wobble in the 1st quarter, the U.S. banking system and the U.S. consumer are stronger in 2023 than in 2007.

- There is an expression in politics: "Never let a good crisis go to waste." Washington takes this to heart and works on **new regulatory frameworks for the banking sector.** This despite the fact almost all bank woes begin with failed monetary and/or fiscal policies.

- **The markets and the economy will continue to bounce around** to no one's great satisfaction until we reach the end of this tightening cycle. Once it is clearly over, some sense of normalcy will return. At least what passes for normalcy in 2023.

- Due to a variety of factors, **crude oil prices will remain higher than people like.** However, a return to last year's peak levels is very unlikely.

- **U.S. public support for supplying Kyiv will start to wane.** Spending untold billions to force a never-ending stalemate in Eastern Europe starts to drain John Q. Public's enthusiasm. He has bills to pay.

- The rift between **the "global north" and the "global south" will continue to widen.** Former developing nations and emerging markets will look toward each other for economic solutions, as opposed to the West. India will take a large, geopolitical role in this regard.

- Russia will reverse-engineer U.S.-donated munitions it captures in its war with Ukraine. While progress will be slow, **the Kremlin will eventually be able to narrow the technology gap** it has with NATO. China and Iran will also likely benefit from this.

- The coronation of Charles III will provide all the pomp and circumstance many love about the British crown. However, due to a persistently sluggish economy, **the average Briton will start to seriously question the concept of monarchy** and the money it takes to support it.

- **Discontent with political elites and the managerial class will continue to simmer,** leading to a growing exodus of people from higher-tax states to lower-tax states. Instead of changing their ways, politicians in the former will double down on policies that alienate much of their population.

- Because of March's banking crisis, **lenders will likely slow the pace of loan growth in the United States.** As a result, the Federal Reserve probably won't have to be as aggressive as originally feared. Interestingly, the system's reactions to problems the Fed helped engineer will ultimately do the Fed's work for it.

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