Capital Markets Commentary and Quarterly Report: 1st Quarter 2023

Capital Markets Highlights

The stock market[1] rallied in Q1 2023, despite the collapse of three U.S. banks in March that shook confidence in the health of the banking system. Those failures might easily have led to a market rout and rattled investors imagining another financial crisis and a deep recession. Instead, the stock market showed great resilience in the face of tremendous uncertainty, with investors concluding that the banking system remains strong, albeit with pockets of vulnerability that can be managed. We think that bodes well for the stock market's prospects and we continue to be upbeat in our stock market outlook for the year, while still expecting continued volatility along the way.

The year started strongly in January, reacting to better news on inflation, but then declined in February, when the inflation news was less good and Federal Reserve Chairman Powell said that the central bank was prepared to raise interest rates higher than previously expected[2].

March was a rollercoaster for the market, rattled by news that the 16th largest bank in the U.S., Silicon Valley Bank, had failed[3] along with two other smaller regional banks. Then, a few weeks later, the centuries-old global bank, Credit Suisse, was forced to merge with its rival UBS, as Swiss authorities were concerned that Credit Suisse would not survive on its own.

There was a palatable fear in March that this could be the beginning of a string of bank failures caused by the forced sale of Treasury securities bought by banks at much lower interest rates (higher prices) if depositors all demanded their money back at the same time.

But after an initial selloff, the market stabilized following assurances from the Fed, Treasury, and the FDIC about the integrity of the banking system and the safety of consumers' deposits beyond the $250,000 Federal Deposit Insurance limit. The market rallied from there and finished higher for the month.

During the quarter, the Federal Reserve raised interest rates twice, by ¼% each, in February and March, to the current 4.75%-5.00% short-term rate. It was the 9th consecutive interest rate increase since the current rate hike cycle began in March 2022.

For some time, there has been a belief that the most rapid increase in the Fed Funds rate since the 1980s was creating a high probability scenario that something would break in the global financial system. But no one knew when or where until the Silicon Valley Bank failure in March. Though fears about financial system contagion have mostly abated, investors understandably remain nervous about further aftershocks. Our thoughts about this and our bank investments are discussed further in a section on financial stability on the 4th page of this letter.

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[1] All references to the stock market are the S&P 500® unless otherwise noted.
[2] NY Times, Fed Chair Opens Door to Faster Rate Moves and a Higher Peak, March 7, 2023.
[3] The second largest bank failure in U.S. history, Barron's, March 31, 2023

In other news, the war in Ukraine entered its second year and the human suffering has been horrific. But the world's economies have adapted and avoided the worst-case scenarios of energy shortages and deep recessions.

Stock market performance in Q1 2023 was led by the Technology and Communications Services sectors[4], last year's worst performers. Financials, Energy, Health Care, and Utilities were all down in the quarter showing mid- to low-single-digit declines. Among styles, Growth significantly outperformed Value[5] and Dividend Strategies. The NASDAQ was up double digits in the quarter versus Value's 1% return and the SPDR S&P Dividend ETF's decline of -1%.

Fixed Income returns were generally positive in the 1st quarter but were also very volatile over the period. For the first two months, yields rose and pushed bond prices down, worsening the large unrealized losses in Treasuries held by banks that contributed to the failure of three banks. Treasuries rallied across the yield curve after the banks failed, driven by a combination of a rush to safe havens, a belief that the Fed would slow their interest rate increases, and an increasing concern that bank failures could be a catalyst for a recession. Intermediate and long-term bonds outperformed shorter-term bonds, recovering some of last year's losses.

Our 2023 Outlook

We began the year optimistic about the stock market's prospects in 2023. Market valuations came down a lot last year, while earnings and dividends for many high-quality companies rose in 2022. Our valuation work showed above-average appreciation potential. One caveat to this upbeat outlook was that we anticipated short-term market swings along the way.

Historically, powerful stock market rebounds have followed significant stock market declines. In early 2023, CNBC noted that since 1945, negative years in the stock market have been followed by gains 81% of the time, with an average increase of 14.2%. Our experience has been that most recoveries occur at a faster pace than generally expected and start when least expected. We do not think a deep recession is likely in 2023. We believe a pause in the Fed's raising rates is likely to happen soon, and that coupled with a mild recession would be well-received by the market, ultimately leading stocks higher.

As a result of the Fed's strong actions and words, reported inflation and inflation expectations data have improved meaningfully since mid-2022, notwithstanding some recent upward blips. Also, manufacturing and distribution logistics issues are easing markedly. Together, these should give the Fed comfort that its inflation-fighting actions are working.

Surprising to many, the employment situation is still quite constructive overall, with low unemployment and an expanding labor market. This data may be confounding the Fed, which vigorously raised interest rates over the last year in an aggressive campaign to cut inflation by slowing the economy and employment.

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[4] This and future references to Sector or Asset class specific returns are from J.P. Morgan Market Insights "*Guide to the Markets®" US 2Q/2023 as of March 31, 2023*

[5] iShares Russell Growth & Value ETFs

We look for slower, modestly positive economic growth for the balance of the year, but in the aftermath of the Silicon Valley Bank failure, believe the chance of a shallow and short-lived recession has increased. The full impact of the rapid rise in interest rates has yet to be felt and businesses and consumers will likely be even more cautious after the recent bank failures. Banks are likely to tighten lending further, as they manage their liquidity more carefully. Recent economic data is already indicating a slowdown in economic activity with the effects of the mini-banking crisis yet to be reflected in the numbers. Manufacturing, retail sales, and housing are all signaling moderating growth. Unemployment is expected to rise as the economy slows but remains at a historically low level, with the last unemployment report for March at 3.5%. Earnings expectations, usually optimistic at the beginning of the year, are subdued.

However, we think the economic picture will look brighter by year-end, and the stock market, as it has done historically, is likely to rise well before the beginnings of accelerating economic expansion become obvious. We remain confident that this will be a good year for stocks, with continued volatility.

With one quarter in the books, so far so good. As mentioned earlier, the stock market showed great resilience in Q1 in the face of much uncertainty. After the strong rebound in Growth stocks in Q1, we expect the market's advance to broaden to more market sectors and expect a slowdown in the melt-up in the mega-cap technology firms.

Financials stand out to us as a sector that is due for a nice bounce as confidence returns to the strong companies in this area. The sector got off to a good start in 2023 but fell out of favor when three badly managed banks failed. The banks where we have investments are all large, well-managed, very profitable, strongly capitalized, and trading at attractive valuations with good dividend yields. In recent weeks, growing concerns about commercial real-estate loans have brought down valuations further for all banks. But most of those loans, 67% [6] are held by small and mid-size banks below the top 25 lenders. Credit quality generally, consumer and commercial, remains very good. Ultimately, we look for significant P/E multiple expansion for larger banks on growing earnings, as forecasts of forward economic conditions improve, and they gain market share. The pullback in interest rates in March is also a positive for the group, reducing the paper losses in their securities holdings and loan portfolios.

Other sectors that look attractive to us are Consumer Discretionary, Industrials, Health Care, Communications Services, and select Technology stocks.

Despite a strong relative 2022, we believe our Health Care stocks have continued upside potential and after a breather in the first quarter, are poised for gains as the year progresses.

Technology and Communications Services were the worst-performing sectors in 2022. Last year's harsh sell-off in these sectors did not differentiate strong, profitable companies from more speculative names. We believe each of our holdings has excellent outlooks for their long-term business performance and remains attractively priced, even after their Q1 rally.

6 WSJ, Smaller Banks' Critical Role in Economy Means Distress Raises Recession Risks, March 19, 2023.

After the worst bond market in 50 years, we are upbeat about short-term bonds for 2023. We believe that high-quality short-term bonds (1–3 year maturities) are attractive, offering good income with small principal risk.

Predicting the Fed's action on interest rate hikes from here is a coin toss but we do not anticipate short-term interest rates will move significantly higher from current levels. We expect the fallout from the recent bank failures will weigh on the Fed's thinking about future rate hikes, making them more cautious about putting additional unnecessary stress on the banking system and the economy. Our best guess is in line with the consensus thinking that the Fed is either already done hiking rates or will stop after possibly one more ¼% hike at the May meeting, as they have previously projected.

The risks to the economy and stock market we see in 2023 remain like those expressed in our year-end letter: the Fed continuing to raise interest rates higher and for longer than necessary to combat inflation that is already trending down and the unpredictable but ever-present geopolitical risks with China and Russia. The political standoff about the debt ceiling will create a lot of noise but will ultimately be resolved.

<u>Thoughts on Financial Stability</u>

In mid-March, after three banks failed and were taken over by the FDIC in one week, we sent an interim note to clients with a summary of what had transpired and our thoughts. Our early take that the Federal Reserve, Treasury, and the FDIC had stepped up in a meaningful way to protect the integrity of the financial system and that contagion or a full-blown financial crisis would be averted seems on the mark.

We agree with Jamie Dimon, the CEO of JP Morgan Chase, who in an April 7th CNN interview stated that the bank crisis is probably nearing its end, even if more unforeseen failures occur.

During this mini-banking panic, we did a deep dive into all of our banks and were very comfortable that all are well-capitalized with strong liquidity and were not seeing any unusual activity in their banking operations. We are confident that our banks will weather the current storm of investor and depositor stress and many, because of their size, strength, and reputations, are likely to gain deposits as bank customers seek out the safest banks.

<u>Large Cap Value Strategy</u>

In the 1st quarter of 2023, Matrix's Large Cap Value Portfolio (LCV) posted a solid mid-high-single digit return, in line with the S&P 500® and nicely ahead of the Russell 1000 ®Value Index. Many of 2022's weakest sectors and stocks rebounded strongly and led the portfolio higher this year.

During the quarter, we started a new position in PNC Financial, swapping out from Truist Financial. Both companies are strong, well-managed regional banks, but in the recent sell-off of regional bank stocks, we believed this was a quality upgrade with similar upside potential.

PNC Financial is the 6th largest bank in the United States by assets. The firm's branch network extends from St. Louis to Pittsburgh and down to Texas and Florida. PNC has a long history of being a "relationship-based" bank with more of its revenues coming from lower-risk clients and lower-risk service fees such as treasury, payments, and asset management. We view PNC positively for its growth potential from national expansion, lower credit risk historically, a disciplined acquisition strategy, valuation discount to historical metrics, and strong technology. The firm pays a safe and healthy dividend yield which should grow nicely due to good earnings growth and a conservative payout ratio.

We also added to the portfolio's position in Amazon, funding that purchase with a partial sale of eBay, and sold Schlumberger when it reached our target sale price.

The largest sector weights in the portfolio on March 31st were Technology, Financials, Health Care, and Communication Services. We believe our investments in these sectors have strong appreciation potential from current levels.

Overall, the portfolio has an average estimated upside potential of more than 44%, above its historic mid-30s average. Its P/E ratio of 14.3 times estimated 2023 earnings is at a 14% discount to the S&P 500's P/E.

Dividend Income Strategy

After a very good relative year in 2022, defending well in the market's sharp decline, and rebounding sharply in the 4th quarter, the Dividend Income strategy took a breather and lagged both the S&P 500® and the Russell 1000 ® Value Indexes with a modest decline in the first quarter of the year.

The stock market's gain in the quarter was driven by low- or no-dividend Technology stocks, an area where our Dividend strategy has limited investible options. The portfolio's return was generally in line with Dividend Income strategies which were modestly lower for the period[7].

In the first quarter of 2023, nine portfolio holdings raised their dividends by an average of 6.1%. On March 31, the portfolio had a 3.12% dividend yield, which compares favorably with the 1.68% yield on the S&P 500®, the 2.36% yield on the Russell 1000 ® Value Index, and is competitive with the 3.47% yield on the 10-year Treasury.

During the quarter we added a new position in Union Pacific Railroad. We also added to positions in Tyson Foods and Home Depot.

Union Pacific (UNP) is the 2nd largest railroad network in the United States just behind Burlington Northern Santa Fe. The firm operates in the Western, Midwestern, and Southern portions of the United States. 90% of UNP sales come from the US and 10% from Mexico. Over the past decade, railroads gained market share from the trucking industry because it costs 10-40% less to ship via rails than trucks. The company has a long history of consistent operating growth and profitability. The shares fell from a high of $278 in May of 2022 after the firm experienced operating challenges due to a slower macro environment and higher expenses.

[7] VMY Equity return was down -1.82% and the SDY Equity return was down -0.53% in Q1 2023.

Below $200 a share, the valuation is attractive at 16.5 times 2023 EPS estimates versus a typical valuation range of 18-19 times earnings. The railroad pays a 2.63% dividend yield and grows its earnings and dividends consistently at 10% + per year.

During the March sell-off in financial stocks, we stress-tested our holdings in that sector for potential vulnerabilities in their financial position with a focus on upgrading the quality of holdings without sacrificing appreciation potential. Following that review, we sold our position in Truist Financial and added to our holdings in Bank of New York Mellon, M&T Bank, PNC Financial, and US Bancorp.

We also filled in positions in American Electric Power and Medtronic on price weakness.

We sold our position in Kimberly-Clark to fund better investment opportunities and our holding in Paramount Global over our concerns about the level of the dividend during a peak spending year for the company as it invests in its streaming business, which is showing strong growth. We believe that Paramount Global will be successful as an independent company or acquired by someone else for its valuable assets and media franchise. We continue to own the stock in our LCV portfolios for its meaningful appreciation potential but concluded that at this time it was not an appropriate holding for our Dividend strategy.

We trimmed our holding in Coca-Cola at a good price to fund other investments and in Air Products and Chemicals when its position became oversized due to price appreciation early in the quarter.

On March 31, the Dividend Income portfolio's largest sector weightings are in Financials, Heath Care, and Technology, all areas where we think there is significant upside potential for our holdings.

As discussed above, Financials came under severe pressure during the quarter, and we believe that the selloff is overdone and will be short-lived. We expect strong rebounds in the high-quality Financials owned in the portfolio.

Health Care defended well in last year's sell-off, and we think the sector will continue to do well as the group provides consistent and growing earnings in an uncertain economic environment.

Technology was one of last year's worst-performing sectors. We believe each of our holdings in this sector has excellent outlooks for their long-term business performance and remain attractively priced, even after their Q1 rally.

On March 31, the MDI portfolio was attractively priced at 14.4x 2023 estimated earnings which is at a nice discount to the S&P 500's 16.6x P/E multiple. Our estimate of the average upside potential for the portfolio at the end of the quarter was 36.9%, well above its historic average of 27.0%.

We believe the portfolio is positioned to show healthy gains when the market rally expands beyond the mega-cap Technology stocks. We also expect the portfolio to defend well during periods of downside volatility, as it has done historically.

Bonds

In Q1 2023, bond returns were generally positive but very volatile over the period. Compared to prices on December 31, 2022, yields for Treasuries dropped across the yield curve. The 2-year Treasury started the year with a yield of 4.43% and yielded 4.03% on March 31, 2023. But along the way, the yield reached 5.07% on March 8. Similarly, the 5-year Treasury started the year with a yield of 4.00%, ended the quarter yielding 3.57%, and had a high yield during the quarter of 4.35%. For the 10-year Treasury, the numbers were 3.88% on December 31, 3.47% on March 31, and a high yield of 4.06% on March 2. The 30-year started the year yielding 3.96% and ended the quarter at 3.65% with a high yield during the quarter of 3.99% on March 2.

The inverted yield curve (higher short rates versus longer-term rates) suggests that investors think that inflation is not a longer-term problem, that the economy is going to slow down, or both.

Matrix's fixed income positioning has been very conservative in recent years, focusing on high-quality corporates, U.S. Treasuries, agencies, and municipals with nearer-term maturities. This served us well in the 2022 bond market sell-off and allows us to get very healthy current income streams with short-term bonds paying the same or more than longer-dated bonds.

During the quarter, we continued to take advantage of the solid yields offered on shorter-term bonds and built our portfolios with a focus on three-month to three-year US Treasuries and Agencies.

Our taxable and municipal bond portfolios were modestly higher for the quarter and their performance was generally in-line with our benchmarks.

Looking ahead, we think there is a good probability that short-term rates have peaked for this rate hiking cycle. The Fed may raise rates another ¼% at their May meeting to show their seriousness about fighting inflation but doing more than that risks further shocks to the banking system and an economy that is showing widespread signs of a slowdown.

Shorter-term bonds are attractive to us, offering good income and minimal principal risk. We continue to be cautious about long-term bonds where we think there is more interest rate risk when the economy reaccelerates, and the yield curve normalizes (higher long-term rates versus short-term rates).

Balanced Accounts

After a difficult year in 2022 for balanced accounts where both stocks and bonds declined, we look for both to return to their more traditional return characteristics with stocks driving long-term growth and bonds providing portfolio stability, income, and modest gains over time.

We continue our overweight to equities believing that stocks are more attractive than bonds for capital appreciation. But after years of being very cautious in our fixed income outlook, we are upbeat about short-term bonds. Their yields are attractive and provide good income with minimal risk of capital loss.

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Thank you for the trust you have placed in us. Please contact us with any questions you have about the information in this commentary or your portfolio.

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All data is through (or as of) 3/31/2023 unless otherwise noted.
For more information about Matrix Asset Advisors, please visit our website at www.MatrixAssetAdvisors.com. Our website includes our firm's Client Relationship Summary document.

Definitions:

S&P500 ® Index *is a broad-based unmanaged index of 500 stocks, which is widely recognized as representative of the equity market in general. You cannot invest directly in an index.*
Russell 1000® Value Index *measures the performance of those Russell 1000® Index companies with lower price-to-book ratios and lower forecasted growth values.*
Fixed Income *types of investment security that pay investors fixed interest or dividend payments until their maturity date.*
Inflation *a sustained increase in the general level of prices for goods and services.*
Central Bank *a national bank that provides financial and banking services for its country's government and commercial banking system, as well as implementing the government's monetary policy and issuing currency.*
Treasury Securities *often simply called Treasuries, are debt obligations issued by the United States Government and secured by the full faith and credit (the power to tax and borrow) of the United States.*
FDIC *The Federal Deposit Insurance Corporation is a United States government corporation supplying deposit insurance to depositors in American commercial banks and savings banks.*
Interest Rate *the amount a lender charges a borrower and is a percentage of the principal—the amount loaned.*
Fed Funds Rate *is the interest rate at which depository institutions lend reserve balances to other depository institutions overnight on an uncollateralized basis. Reserve balances are amounts held at the Federal Reserve to maintain depository institutions' reserve requirements.*
Recession *a significant, widespread, and prolonged downturn in economic activity.*
iShares Growth & Value ETF's *seeks to track the investment results of an index composed of large-capitalization U.S. equities that exhibit growth & value characteristics.*
Credit Quality *a measurement of an individual's or company's creditworthiness, or the ability to repay its debt.*

P/E Multiples *the ratio for valuing a company that measures its current share price relative to its per-share earnings.*
Yield Curve *a curve on a graph in which the yield of fixed-interest securities is plotted against the length of time they have to run to maturity*
Market Valuation *the value of an asset based on the price that would be paid for it if it were sold at a certain time.*
Retail Sales *tracks consumer demand for finished goods by measuring the purchases of durable and non-durable goods over a defined period of time.*
Housing Data *a comprehensive source for historical statistics on households, housing, and housing finance.*
Unemployment *when someone is able to work and wants to work but is unable to find employment. The Bureau of Labor Statistics (BLS) specifically defines unemployed persons as those who don't have a job but are available for work and have looked for work in the past four weeks.*
Asset Management Valuation *the process of determining the fair market or present value of assets, using book values, absolute valuation models like discounted cash flow analysis, option pricing models or comparables.*
Dividend Yield *a financial ratio that tells you the percentage of a company's share price that it pays out in dividends each year.*
Earnings per Share (EPS) *is a company's net profit divided by the number of common shares it has outstanding. EPS indicates how much money a company makes for each share of its stock and is a widely used metric for estimating corporate value.*
Municipal Bond *a bond issued by state or local governments, or entities they create such as authorities and special districts. In the United States, interest income received by holders of municipal bonds is often, but not always, exempt from federal and state income taxation.*
NASDAQ *an online global marketplace for buying and trading securities.*
SPDR S&P Dividend ETF's *designed to measure the performance of the highest dividend yielding S&P Composite 1500® Index constituents that have followed a managed-dividends policy of consistently increasing dividends every year for at least 20 consecutive years.*