First Affirmative
FINANCIAL NETWORK
Invest for a Sustainable Future

Unintended Consequences

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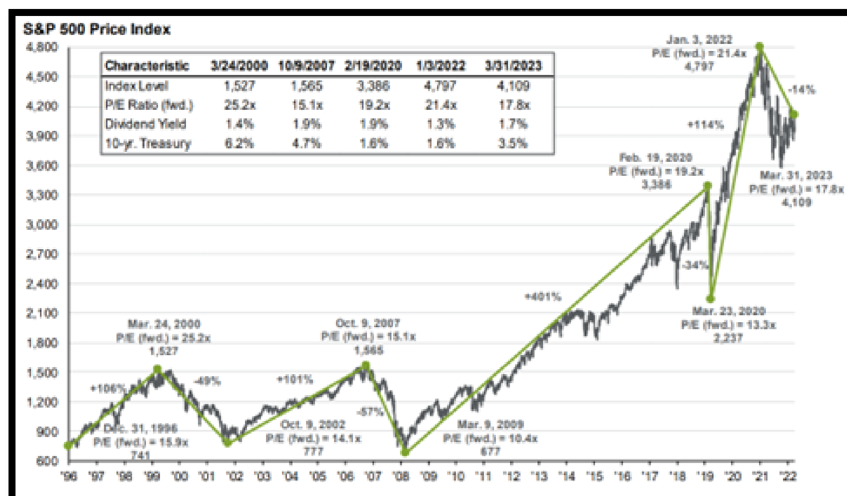
Overview

Negative real interest rates and government bailouts continue to underpin highly volatile markets. Even with the inflation-fighting surge in interest rates over the past 12 months, real interest rates remain more than 200 basis points below nominal rates. This easy money, combined with "whatever it takes" support from Uncle Sam and his European and Asian counterparts continues to support businesses and consumers, provides a cushion against economic volatility, and helps maintain confidence in the markets. So far, the unintended consequences of this recent government and Central Bank largesse includes the near-simultaneous collapse of Silicon Valley Bank and Signature Bank, and "near misses" on a First Republic, a third mis-managed US bank, and Swiss behemoth Credit Suisse.

The market impact of recent financial sector difficulties was short-lived as governments and central banks came to the rescue. As a result, following a 7.6% increase in the fourth quarter of 2022, the S&P 500 advanced 7.5% in the first quarter. Looking ahead, we anticipate bailouts will continue to play a significant role in the market, particularly as central banks look to maintain economic stability in the face of ongoing uncertainty. Of course, we are concerned about the potential long-term implications of these bailouts, particularly their impact on inflation and the broader economy. Although we believe commercial real estate could be "the next shoe to drop" – amid rising vacancy rates and sharply higher financing costs – we do not know when this will happen. In the meantime, global equity markets will continue to "climb a wall of worry" as earnings decline, inflation moderates, and interest rates stabilize.

Figure 1. S&P 500 at Inflection Points – Bull and Bear Markets, 1996 to Date



Characteristic	3/24/2000	10/9/2007	2/19/2020	1/3/2022	3/31/2023
Index Level	1,527	1,565	3,386	4,797	4,109
P/E Ratio (fwd.)	25.2x	15.1x	19.2x	21.4x	17.8x
Dividend Yield	1.4%	1.9%	1.9%	1.3%	1.7%
10-yr. Treasury	6.2%	4.7%	1.6%	1.6%	3.5%

Source: J.P. Morgan Asset Management Guide to the Markets – U.S. Data are as of December 31, 2022

Corporate Profits – The Decline Accelerates

Macro factors – particularly the surges in inflation and interest rates, the war in Ukraine, and China's "Zero COVID" policy -- drove global equity markets lower in 2022. We remain convinced the focus has shifted to corporate profits this year. This has become even more true as valuations have moved into neutral territory

after two consecutive quarterly increases in stock prices (see Figure 2). Returns and valuations by sector are shown in Figure 3.

Figure 2. S&P 500 Valuation Measures, 1997 to Date

Figure 3. Returns and Valuations by Sector

		Energy	Materials	Financials	Industrials	Cons. Disc.	Tech.	Comm. Services*	Real Estate	Health Care	Cons. Staples	Utilities	S&P 500 Index
Weight	S&P weight	4.6%	2.6%	12.9%	8.7%	10.1%	26.1%	8.1%	2.6%	14.2%	7.2%	2.9%	100.0%
	Russell Growth weight	1.4%	1.3%	6.7%	8.2%	14.3%	41.8%	7.1%	1.5%	11.7%	6.0%	0.0%	100.0%
	Russell Value weight	7.9%	4.5%	20.1%	10.9%	5.9%	8.0%	8.6%	4.5%	16.4%	7.6%	5.6%	100.0%
	Russell 2000 weight	6.5%	4.6%	16.0%	17.0%	11.4%	12.4%	2.7%	6.3%	16.0%	3.8%	3.3%	100.0%
Return (%)	QTD	-4.7	4.3	-5.6	3.5	16.1	21.8	20.5	2.1	-4.3	0.8	-3.2	7.5
	YTD	-4.7	4.3	-5.6	3.5	16.1	21.8	20.5	2.1	-4.3	0.8	-3.2	7.5
	Since market peak (February 2020)	77.9	42.7	10.9	27.4	14.0	51.1	2.2	1.2	31.5	28.4	7.0	27.7
	Since market low (March 2020)	303.6	123.3	94.3	118.5	67.0	119.4	43.1	62.4	82.4	69.0	66.2	92.8
β	Beta to S&P 500	1.3	1.1	1.1	1.1	1.2	1.1	1.0*	0.8	0.8	0.6	0.5	1.0
ρ	Correl. to Treas. yields	0.0	-0.5	-0.3	-0.5	-0.6	-0.7	-0.8	-0.6	-0.4	-0.3	-0.4	-0.6
%	Foreign % of sales	38.8	50.8	21.8	32.7	30.8	57.4	40.4	17.0	34.8	43.6	1.8	38.6
EPS	NTM earnings growth	-17.0%	-10.5%	3.6%	11.6%	21.2%	3.4%	14.0%	0.8%	-5.1%	5.4%	6.9%	3.8%
	20-yr avg.	100.6%	15.8%	20.8%	14.0%	16.9%	13.3%	10.2%*	6.8%	8.2%	7.7%	4.3%	11.1%
P/E	Forward P/E ratio	10.1x	16.5x	12.6x	18.4x	24.4x	24.5x	16.1x	17.2x	16.9x	20.1x	17.7x	17.8x
	20-yr avg.	13.7x	14.8x	12.4x	16.3x	19.3x	18.0x	18.7x*	17.0x	15.1x	17.3x	15.8x	15.5x
Bbk	Buyback yield	3.7%	2.5%	2.9%	2.5%	2.2%	2.6%	5.0%	-1.8%	1.9%	1.3%	-0.8%	2.5%
	20-yr avg.	1.6%	0.9%	0.4%	2.2%	2.4%	3.0%	1.6%	-1.3%	2.0%	1.8%	-0.9%	1.8%
Div	Dividend yield	3.3%	2.1%	2.1%	1.9%	1.0%	1.0%	1.0%	3.9%	1.8%	2.7%	3.3%	1.7%
	20-yr avg.	2.8%	2.4%	2.3%	2.2%	1.4%	1.1%	1.2%	3.9%	1.9%	2.8%	3.9%	2.1%

Source: J.P. Morgan Asset Management Guide to the Markets – U.S. Data are as of March 31, 2022

According to FactSet (see Figure 4) the blended earnings decline forecast for the S&P 500 in the first quarter is -6.5%. If -6.5% is the actual decline for the quarter, it will mark the second consecutive quarterly earnings decline (-4.6% in the 4Q) and the largest earnings decline reported by the index since the COVID-stunted second quarter of 2020 (-31.6%).

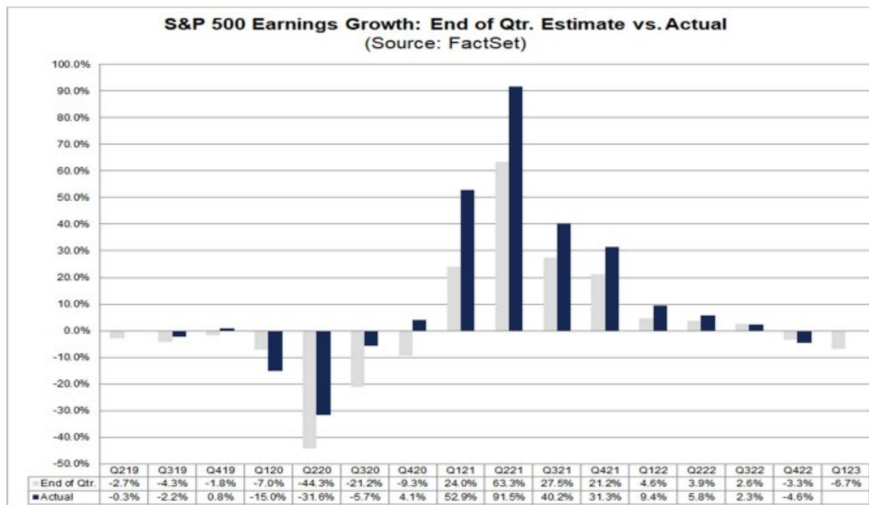
We continue to monitor two factors closely:

- **Earnings estimates.** Analysts are notoriously bad at forecasting earnings declines. Again, looking at Figure 4, the actual fourth-quarter earnings decline exceeded quarter-end estimates, and we believe the same will be true in the current quarter.

- **Profit margins.** As shown in Figure 5, profit margins contracted in the fourth quarter, reflecting rising input costs, including raw materials, labor, and capital. As sales growth

decelerates and turns negative in some sectors, margin contraction will accelerate, and operating profits could fall further. Pricing power should continue to differentiate winners and losers in 2023. Energy companies will continue to benefit from high margins, while businesses that provide essential goods and services should be supported. Elsewhere, rising labor costs, higher interest rates and slowing nominal sales growth should bite into profits. In addition, a much higher dollar poses a headwind for companies with overseas sales and recession concerns could cause management teams to further reel in spending and investment.

Figure 4. S&P 500 Earnings Growth: End of Quarter Estimate vs Actual



	Q219	Q319	Q419	Q120	Q220	Q320	Q420	Q121	Q221	Q321	Q421	Q122	Q222	Q322	Q422	Q123
End of Qtr.	-2.7%	-4.3%	-1.8%	-7.0%	-44.3%	-21.2%	-9.3%	24.0%	63.3%	27.5%	21.2%	4.6%	3.9%	2.6%	-3.3%	-6.7%
Actual	-0.3%	-2.2%	0.8%	-15.0%	-31.6%	-5.7%	4.1%	52.9%	91.5%	40.2%	31.3%	9.4%	5.8%	2.3%	-4.6%	

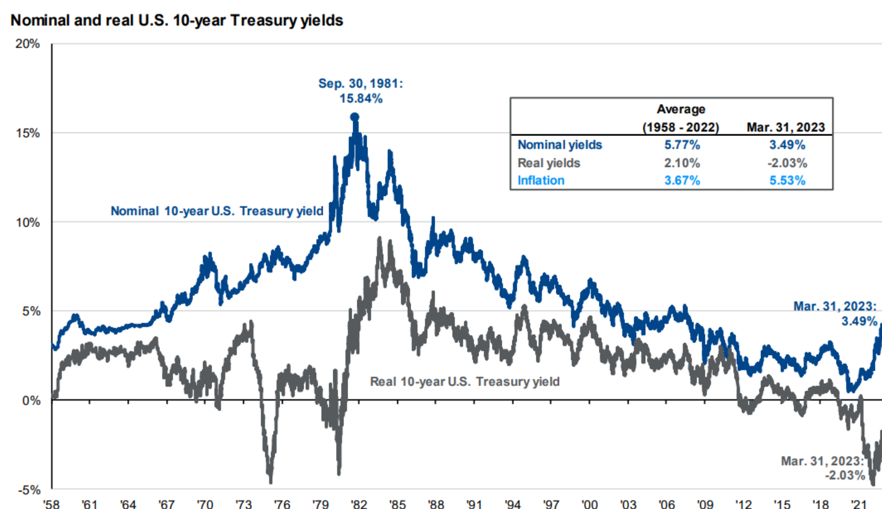
Figure 5. S&P 500 Profit Margins, 1992-2022

Source: J.P. Morgan Asset Management Guide to the Markets – U.S. Data are as of March 31, 2022

On the macro front, we continue to be heartened by the closure of the gap between inflation expectations and reality as evidenced by the recent decline in real interest rates (see Figure 6). As noted in previous Market Commentaries, either nominal rates must rise to reflect the surge in inflation, inflation will retreat, or we will see some combination of the two (as we expect). The narrowing of the gap accelerated in the first quarter as the Fed continued to raise interest rates, market sentiment shifted, and commodity prices retreated ushering in decelerating inflation.

Given the interdependence of global economies and the large non-US components of the earnings of multi-national companies, better inflation news in the US may be tempered as we move through 2023. The rise in the US dollar relative to the euro and Russia's stranglehold on European energy supplies suggest the inflation pain in Europe could exceed that of the US. Also, the ECB is behind the Fed in its response to inflation. Energy price controls, a mild winter, and supply mitigation efforts so far have softened the blow to European consumers and businesses. However, UK inflation remains above 10%, suggesting further pain ahead for both consumers and companies.

Figure 6. Nominal and Real 10-Year Treasury Yields, 1958-December 31, 2022



Fourth Quarter Market Review

Notwithstanding the Credit Suisse debacle, European equity markets were the best performing in the world in the first quarter, advancing 12.2% in USD (see Figure 7). Germany (+14.8%) and France (+14.7%) performed best, followed by Korea (+9.7% in USD). India (-6.3%) and Brazil (-3.1%) were the worst performing markets in the first quarter. Large Cap stocks outperformed Small Cap and Growth outperformed Value, as evidenced by a 14.4% surge in US large growth, compared with a 0.7% decline in small value.

Figure 7. Global Equity Markets, December 31, 2023

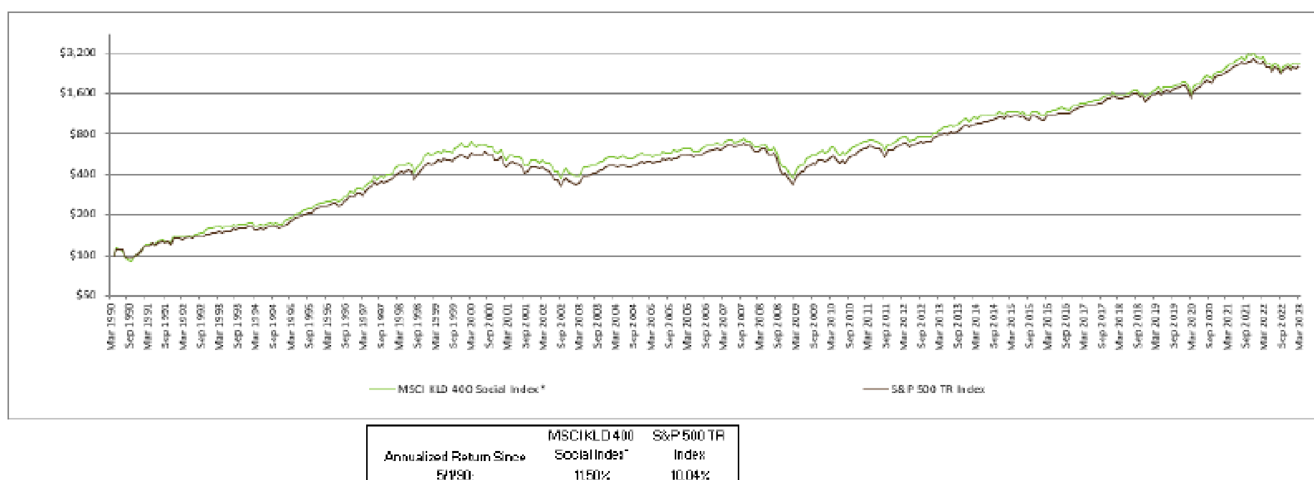
Returns	2023		2022		15-years	
	Local	USD	Local	USD	Ann.	Beta
Regions						
U.S. (S&P 500)	-	7.5	-	-18.1	8.8	0.9
AC World ex-U.S.	6.3	7.0	-9.2	-15.6	2.0	1.0
EAFE	7.7	8.6	-6.5	-14.0	2.3	1.0
Europe ex-UK	10.5	12.2	-12.2	-17.3	2.4	1.2
Emerging markets	3.8	4.0	-15.2	-19.7	1.0	1.1
Selected Countries						
Japan	7.3	6.4	-4.1	-16.3	2.5	0.7
United Kingdom	3.2	6.1	7.2	-4.8	1.4	1.0
France	12.7	14.7	-6.9	-12.7	2.8	1.2
Canada	4.4	4.5	-5.8	-12.2	3.0	0.7
Germany	12.8	14.8	-16.5	-21.6	0.9	1.3
China	5.1	4.7	-20.6	-21.8	0.6	1.0
India	-6.9	-6.3	3.0	-7.5	2.4	1.2
Korea	12.9	9.7	-24.4	-28.9	1.6	1.3
Brazil	-6.9	-3.1	8.6	14.6	-2.1	1.4

Achieving Long-Term Investment and Impact Objectives

The shift into sustainable, responsible, and impact (SRI) investments continues – albeit at a slower pace. Following years of excess performance and a rare period of underperformance in 2022, as shown in Figure 8, the MSCI KLD 400 index resumed its winning ways in the first quarter. The sustained, consistent excess performance of this standard SRI/ESG benchmark over time supports our view that strategies incorporating environmental, social and governance (ESG) factors – with an eye toward making the world a better place – and mainstream financial returns can be achieved simultaneously.

As always, everything we do at First Affirmative is driven by our dedication to enabling advisors to deliver financial results to clients and belief in the power of capital to bring about lasting environmental and social change. Our innovative Values-Aligned Direct Index Solution (VADIS) and Sustainable Managed Mutual Fund and Multi-Manager Investment Solutions are built to enable clients to achieve their financial goals over the long term, along with their individual environmental, social, governance, ethical, and values-based objectives. Each portfolio is carefully constructed to be well diversified across assets, sectors, geographies, securities, and management styles –– and designed to weather periods of uncertainty and volatility.

Figure 8. MSCI KLD 400 vs S&P 500 Indices, March 31, 2023



Annualized Return Since 5/1/90:	MSCI KLD 400 Social Index*	S&P 500 TR Index
	11.50%	10.04%

Source: Morningstar. *Data prior to 9/1/2010 is that of the MSCI KLD 400 Social Index GR, while data since 9/1/2010 is that of the MSCI KLD 400 Social Index NR. Indexes are unmanaged groups of securities. Index performance does not include the impact of cash, fees, or transaction costs. Investors cannot invest directly in indexes but may purchase mutual funds or other investment products designed to track the performance of various indices.

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