Q1 2023, A Tale of Two Markets Q1 2023

In the first quarter, the U.S. stock market had a mixed performance. The S&P 500 Index rose 4.2% due to strong earnings and positive economic data, while the Nasdaq Composite Index gained 7.8%. However, the Dow Jones Industrial Average lagged behind, posting a gain of only 1.9%. Bond markets were also mixed, with yields on 10-year U.S. Treasuries rising slightly to 1.75% at the end of the quarter.[1]

Amazingly, the above paragraph was written by ChatGPT, an artificial intelligence (AI) text generative application introduced to the public late last year. Once the site is accessed, the program takes just a couple of seconds to answer a question. I simply asked it to summarize U.S. markets' first quarter performance. Versions of generative AI can write music, create convincing but entirely fake photos, carry on conversations, take the LSAT, and on and on. Some of this stuff is frivolous, but obvious applications abound, like cheating or writing quarterlies, and it also seems likely that AI will eventually insinuate itself into our lives in important but unpredictable ways, both good and bad. Quoting Bill Gates, "it will change the way people work, learn, travel, get healthcare, and communicate with each other."

Pretty heady stuff. Only one problem: the numbers quoted above from ChatGPT are wrong, or at least they aren't the numbers from the first quarter of 2023. I spent a little time searching, but it wasn't obvious which year ChatGPT was referring to, if any. AI hubris! Frankly, it's a little scary.

So, it seems we still have some time to get our affairs in order before AI rubs us out, but it did influence markets in the first quarter of 2023…the real first quarter of 2023. The S&P 500 rose 7.5%, pulled higher by mega-cap tech and communications names. The average stock in the S&P 500 rose less than half that amount, with small caps gaining just 2.7%. Sector performance was startling with the tech and communications sectors both up approximately 21% and financials down almost 6%. While the mega-cap tech and communications stocks were due for a bounce after last year's spanking, the move in the first quarter was at least partly driven by AI hype.

It's provocative to see tech and finance diverge so dramatically. Critically, if the bond market were the choir, it's humming the financials' tune, not the mega-cap tech melody. 10-year Treasury yields peaked just above 4% in early March but nosedived under 3.5% when the Fed's extreme rate hiking finally broke something important: Silicon Valley Bank (SVB). SVB was an integral cog in the tech incubation ecosystem and found itself running short of cash as the difficult funding markets last year forced start-ups to tap cash reserves and lines of credit. It did have a large portfolio of government bonds to sell, but there were big

[1] Source: https://chat.openai.com/chat "Tell me about" prompt. ChatGPT, 11 April version, OpenAI.

imbedded losses because of the Fed's historic rate hiking (when rates go up, bond values go down) and SVB's failure to hedge the interest rate risk. Word got out that SVB was in trouble, and an epic run on the bank forced its closure three working days later—the second largest bank failure in our history…in three days. The less well-known Signature Bank in New York also failed that same weekend, the third largest bank failure in U.S. history. Rarely do you see the flames before you smell smoke, but panic happens fast these days. Markets wasted no time in their pitiless hunt for the next victim (most banks hold government securities with at least some imbedded losses), and the Feds were forced to guarantee ALL deposits at both banks and authorize an emergency lending vehicle so banks could avoid taking losses on their bond holdings. This eventually quieted things, but the fact remains that money market rates are attractive for the first time in quite a while and are pulling time deposits out of banks. Banking stress will continue; the odds of a recession have risen.

Can tech stocks panic higher while financials panic lower? In the short-term markets are capable of all manner of mischief. The herd was too pessimistic on tech and communications at the end of last year and clearly unprepared for the AI hype that seemingly came out of nowhere. Never mind that IBM's Deep Blue AI beat Garry Kasparov in chess nearly 15 years ago and Watson won Jeopardy 12 years ago. Something's changed now that we can individually interact with it. But what? By the way, chess and Jeopardy appear undiminished. Bank panics are nothing new, but they absolutely put the squeeze on funding and consequently economic growth. To what degree is always the question, but these two important sectors won't go in opposite directions indefinitely. The banks and the bond market are pointing to a recession, as are leading economic indicators, but the consumer and the job market appear healthy, and tech is strutting again. This tale of two markets will likely be resolved before year-end. Our guess is we face a period of low, possibly negative growth, but much of the market already reflects this. Tech's not immune, AI or not. I asked ChatGPT what will happen; thankfully, it admitted it can't predict the future.

P.S. Right before hitting the send button with this note, I asked ChatGPT again to summarize the U.S. markets' first quarter performance. This time it said it didn't have real-time data access and its knowledge is based upon a cutoff date of September of 2021. In two days, it learned a few things. Amazing.

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