JAG CAPITAL MANAGEMENT LLC

# Quarterly Comments

## Markets Show Resilience to Start 2023

### Market Overview

The S&P 500 kicked off 2023 with a first quarter total return of 7.5%. Bonds also delivered mostly positive returns last quarter, as interest rates declined, and credit spreads remained relatively tight. It appears investors are expressing optimism that moderating inflation, combined with "better than feared" corporate earnings results, will allow the Fed to pause further rate hikes. These tailwinds were enough to offset a flurry of unpleasant headlines, including the March 10th failure of Silicon Valley Bank, at the time the 16th largest bank in the United States. The collapse of Signature Bank of New York came just days later, and a teetering Credit Suisse was forced into the arms of UBS the very next weekend. These developments, combined with alarming outflows of deposits in many US regional banks, bred concerns about the potential emergence of a broader banking crisis.

In response, the Federal Reserve and the Treasury Department created new lending programs aimed at shoring up regional banks and preventing bank runs. The actions thus far have been effective at calming investors and depositors' fears, but at the time of this writing, there are still several larger regional banks showing signs of distress. While much of the immediate danger seems to have receded, we expect capital markets will be more focused on bank regulations, concentrations, and exposures in the coming months.

However, the banking industry still faces some longer-term challenges, due in large part to the yawning gap between the relatively low rates of interest banks pay on checking and savings accounts and the much higher yields available in money-market funds and short-term Treasurys. This creates a Catch-22 for banks: either they pay much higher rates on their depositors' cash, or their depositors could withdraw some or most of their cash from the banks to pursue higher-yielding, minimal risk alternatives. The former outcome would make banks materially less profitable, which could depress shareholder value. The latter could hurt their ability to make loans, weaken their balance sheets, or even threaten their existence. This dynamic is likely to persist until and unless the Federal Reserve Open Market Committee (FOMC) lowers interest rates, which would narrow this "yield gap." In its March 2023 meeting, it did the opposite by raising the Fed Funds target rate by 0.25%, to a range of 4.75% to 5.0%. Committee members have implied that they may be nearing the end of the current rate hike cycle, but they have simultaneously signaled that they do not foresee rate decreases in the intermediate-term future.


Source: Cartoonbank.com Ivan Ehlers

### Firm Highlights

**Farewell and Welcome**

This past quarter, we said farewell to our colleague **Connie Makarewicz**, who retired after almost 16 years as an operations professional with JAG. We wish Connie all the best in her well-earned retirement and extend our heartfelt gratitude for her dedicated service to JAG and our valued clients.

At the same time, we are pleased to welcome **Eric Bruce** to the JAG team as our new Operations Assistant. Eric comes to us with experience, having previously worked as a financial services representative for Charles Schwab. In his new role, Eric will be supporting our fixed income trading desk as well as onboarding and maintaining accounts.

Eric graduated from Truman State University with a double major in Business Administration: Finance and Management.

Please join us in welcoming Eric to the JAG team!

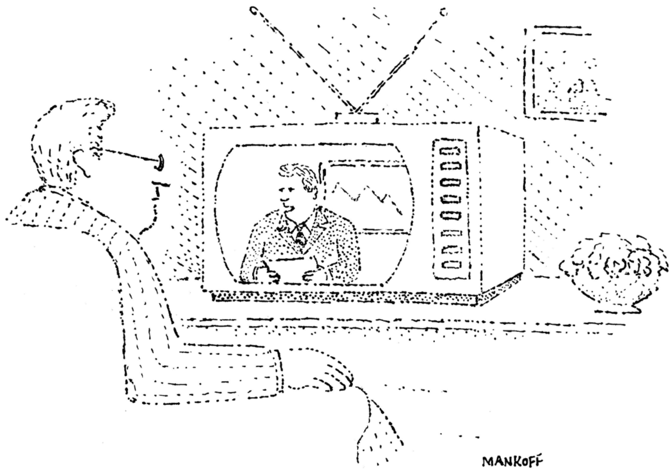
Over the past several quarters, JAG has maintained a cautious view of bank industry securities in our managed equity and fixed-income strategies. Neither our firm nor our clients were exposed to any of the banks that failed in recent months, and we continue to tread cautiously.

Seven of 11 S&P 500 sectors finished the first quarter with positive returns. Index and sector performance thus far in 2023 has represented a sharp reversal of the patterns that prevailed for much of 2022. Technology, Communication Services, and Consumer Discretionary growth stocks generally outperformed the broader market in the first quarter. Some of this may have been driven by lower bond yields, which many investors believe act as a tailwind to shares of faster-growing companies. Given the deep declines many growth stocks experienced in 2022, part of this most-recent sharp rally could simply indicate that these stocks became too oversold late last year and were primed for a bounce. Abrupt reversals in market leadership tend to occur at major inflection points. Historic examples include important stock market bottoms in late 2002, early 2009, and late 2018. Whatever the reasons, the first quarter of 2023 was a much-welcomed respite for investors.

It is important to note that the market is a discounting mechanism. As such, it continuously attempts to incorporate news headlines, fundamental developments, corporate earnings expectations, and economic data into current prices. Most of us agree there has been no shortage of bad news over the past six months, but nonetheless the S&P 500 gained approximately 15% between last September and the end of March. This reminds us once again of the old Wall Street adage, "Stocks climb a wall of worry." The idea behind this phrase is that as stocks continue to rise despite worries, investors who were initially hesitant to invest become increasingly convinced that the market is more stable and may decide to jump in, which can fuel further gains.

This sort of evolution along the emotional spectrum was captured well by the late Sir John Templeton's observation, "Bull markets are born on pessimism, grow on skepticism, mature on optimism, and die on euphoria." Although we generally agree with him, Sir John did not leave us with a precise way to predict changes in investor attitudes. However, the fact that capital markets have been rising for more than six months, despite a noticeable deterioration in economic data, slowing but still-high inflation, and a tightening financial condition may suggest an important facet.

We do not perceive signs of euphoria in our client base or the general investing public. To the contrary, many investor sentiment surveys we monitor tilt more towards skepticism or even pessimism. Many of the more prominent investment strategists we read have neutral or even bearish market forecasts. Also, in our experience, the tendency for financial media to emphasize risks and challenges for investors has tended to be amplified during periods of market volatility. The future is always uncertain, and we agree with those who believe that recession risks have increased. The key is to what extent these concerns are being reflected in current asset prices. After the worst bear market in stocks since 2008, and arguably the worst-ever year for bond investors, it is worth considering that risk assets may have already experienced their peak pessimism.




*"On Wall Street today, news of lower interest rates sent the stock market up, but then the expectation that these rates would be inflationary sent the market down, until the realization that lower rates might stimulate the sluggish economy pushed the market up, before it ultimately went down on fears that an overheated economy would lead to a reimposition of higher interest rates."*

CartoonStock.com

As we described in a recently published **JAG Insights piece**, Artificial Intelligence (AI) has leaped from the realm of science fiction right before our eyes in recent months. We believe the rise of AI is a seminal event for business, investors, and global society. JAG invests in several companies that should be direct beneficiaries of the AI evolution. Our team is actively evaluating both the investment opportunities and risks that may emerge in the intermediate-to-long term future. Ultimately, we believe that the integration of AI tools and processes may become table-stakes for many companies operating in almost every industry and sector of the economy. Our research team will continue to monitor the progress of AI, and we plan to report our thoughts in additional Insight pieces to come.

## Market Outlook

Investors continue to grapple with multiple areas of concern, including the path of inflation, economic growth, Fed interest rate policy, political wrangling over the looming US debt ceiling, ongoing banking crisis, and the now 14-month long war in Ukraine. While these are all significant issues, they are all well-known and very well-covered in the media.

Over the next several months, the debt ceiling debate seems likely to remain in focus. Given the hyper-polarized nature of the partisan blocs in Congress, we expect that the rhetoric from both sides will continue until the politicians are forced to compromise at nearly the last minute. As the account from which the Treasury sends payments continues to dwindle, warnings from the Treasury Department are likely to escalate. Ultimately, we firmly expect a bipartisan agreement to defer or raise the debt ceiling in time to avert any sort of default on the obligations of the United States.

There is also the continued global de-dollarization, recently accelerating among commodity trading country pairs like Russia/China. US dollar dominance, a historical feature, has diminished during the past several decades and is likely to diminish more over time. Superficially, this reduces the demand for US dollars, although we note that the vast majority of global debt is still denominated in US dollars. This may place greater emphasis on monetary policy to maintain the stability of the US dollar, (in other words, a more active Fed), and introduce more volatility in US dollar/foreign currency values, which could increase the cost and reduce the efficiency of global trade. This may also increase the need for more financial contracts and alternatives to global payments, outside of the US-dominated SWIFT system. These changes are likely to create some profound investment opportunities during the next years/decades.

The health of the banking industry also seems likely to remain a topic of collective conversation. One focal point in recent weeks has been the credit quality of real-estate loans held on bank balance sheets. Smaller and regional banks have been more aggressive than the largest banks in funding real estate projects since the end of the 2007-2009 financial crisis. Some of this is due to greater origination of loans (which are then sold off to government agencies like Fannie or Freddie) and some of these loans are held on bank balance sheets. Each has its own opportunity and risks. The value of loans held on bank balance sheets, just like publicly traded bonds, can fluctuate with interest rates. Moreover, real estate related loans are not immune from credit risk. Some banks are simply better than others at underwriting the viability of commercial and residential real estate projects. The value of collateral backing real estate loans can fluctuate for a variety of reasons, including lower than expected lease rates or higher than expected office vacancies. The details matter in terms of specific loans in specific geographies and specific credit profiles. This collection of factors may make for a bumpy ride for investors in certain segments of the financial sector, hence our continued caution.

That said, we see important distinctions between the current challenges faced by the banks versus what occurred during the Great Financial Crisis (GFC) in 2007-2009. Banks are much better capitalized and less-levered today than they were 15 years ago. Regulators and government officials have indicated they are ready to use current tools (or create new ones) to ring-fence troubled banks from the rest of the financial system. Importantly, in contrast to what occurred during the GFC, policymakers are committed to avoid bailing out shareholders, bondholders, or management teams of failed institutions. To the extent that they are engaging in "bailouts," they have focused narrowly on protecting depositors.

We think this is a more sensible approach, with better long-term outcomes for our free market economy. However, the total size of the problem is anything but small. In contrast to the GFC, one of the key issues today is the embedded interest rate risk of high-quality assets like US Treasurys. The problems experienced by financial institutions back in 2008 were less about interest rate risk and more about low-quality "toxic" debt instruments tied to pools of home mortgages. Thus policymakers and regulators appear more interested in addressing bank problems on a case-by-case basis, rather than resorting to the blunt instruments of rate cuts or Quantitative Easing (QE) they applied during the GFC.

Inflation continues to moderate at an uneven pace. We expect this trend of disinflation to continue, although we think the Fed's inflation target of 2% might be difficult to reach by the end of the year. We may be on a higher inflation plateau for the next decade, although this is not altogether worrisome; the capital markets can and will adjust. All in all, we suspect that one of the most intense interest rate hike campaigns in Fed history is nearing its conclusion. This does not necessarily mean that the Fed will lower the Fed Funds rate anytime soon; it may simply hold at the current or at slightly higher levels for months or quarters. Whether or not the economy can avoid slipping into recession is another matter. The probability of a so-called "soft landing" has diminished over the past several weeks. Bank lending standards are tightening, which typically slows economic growth, and corporate layoff announcements are growing.

Our investment process does not rely on predicting the path of the economy, which is impossible to do with any accuracy. Our experience informs us that financial markets do not move in concert with the economy. In the United States, the National Bureau of Economic Research (NBER) serves as the official "scorekeeper" of recessions. The NBER analyzes a variety of economic data, and then retrospectively declares when the economy entered and exited a recession. Using history as a guide, even if the NBER officially declares such a recession this year or in 2024, much of its impact on markets will already be in the past. We saw this most recently in the brief but sharp COVID-19 recession of 2020, but also in the economic contractions of 2008-2009 and 2001-2002.

The type of investments that we focus on have held up relatively well within the current climate, as investors have become more interested in high-quality companies with sensible balance sheets, growing end markets, and strong pricing power. We continue to focus on this evolving cohort of companies and structure our managed equity and fixed-income investment strategies with the same time-tested processes that we have employed in past periods of economic and market turbulence.

Thank you for your ongoing confidence and trust in JAG.

Warm Regards and Happy Spring,

**Norm Conley**
CEO, Chief Investment Officer &
Portfolio Manager

**Mike Kimbarovsky**
Managing Director &
Portfolio Manager

## Disclosures

These comments were prepared by the staff of JAG Capital Management, LLC, an SEC-registered investment adviser. The information herein was obtained from various sources including but not limited to FactSet, Bloomberg, Reuters, Standard & Poor's, ChatGPT, and the United States Bureau of Labor Statistics, and believed to be reliable; however, we do not guarantee its accuracy or completeness. The information in this report, including our opinions in the Market Outlook segment, are given as of the date indicated. We assume no obligation to update this information, or to advise on further developments relating to markets, trends, or securities discussed in this report. Opinions expressed are those of the adviser listed above as of the date of this report and are subject to change without notice. Opinions of individual representatives may not be those of the Firm. Additional information is available upon request.

The information contained in this document is prepared and circulated for general information only. It does not address specific investment objectives, or the financial situation and the particular needs of any recipient. Investors should not attempt to make investment decisions solely based on the information contained in this communication as it does not offer enough information to make such decisions and may not be suitable for your personal financial circumstances. You should consult with your financial professional prior to making such decisions. For institutional investors: JAG Capital Management, LLC, has a reasonable basis to believe that you are capable of evaluating investment risks independently, both in general and with regard to particular transactions or strategies. For institutions who disagree with this statement, please contact us immediately.

**Past performance should not be considered indicative of future performance. Any investment contains risk including the risk of total loss.**

This document does not constitute an offer, or an invitation to make an offer, to buy or sell any securities discussed herein. J.A. Glynn & Co., JAG Capital Management, LLC, and its affiliates, directors, officers, employees, employee benefit programs and discretionary client accounts may have a position in any securities listed herein.
Please let us know if your financial situation or investment objectives have changed, or whether you prefer to place any reasonable restrictions on the management of your account(s) or modify any existing restrictions.

A Veteran Owned Business (VOB) is a business owned, (51% ownership or greater) by a Veteran who has met the definition of a veteran. The following represents the criteria that the National Veteran Business Development Council (NVBDC) uses in determining ownership:

**Ownership:** Fifty-one percent ownership by a Veteran or Veterans. The applicant must share in all risk and profits commensurate with their ownership interest.

**Control and Management:** Proof of active management of the business. Veteran must possess the power to direct or cause to direct the management and policies of the business.

**Contribution of Expertise and Capital:** Contribution of capital and/or expertise by Veteran owner(s) to acquire their ownership interest shall be real and substantial and be in proportion of the interest acquired.

**Independence:** The Veteran owner(s) shall have the ability to perform in their area of specialty/ expertise without substantial reliance on non-Veteran-owned businesses.

# About JAG

JAG Capital Management (JAG) actively invests for institutions and individuals in highly selective, customizable, and nimble equity and fixed income strategies. JAG is a boutique, independent, employee-owned investment management firm with offices in St. Louis and Chicago.

**View Our JAG Video**

JAG CAPITAL MANAGEMENT LLC

9841 Clayton Rd
St. Louis, MO 63124

The Wrigley Building
400 North Michigan Avenue
Suite 1680
Chicago, IL 60611