2023 SPRING INVESTMENT OUTLOOK

Winter seems to be coming in the financial markets and economy despite seasonally passing to spring in the northern hemisphere. The impact of the sharpest tightening of monetary policy in more than 40 years is finally beginning to broaden across the economy beyond the most interest-sensitive sectors such as housing or the supposed one-off UK pension crisis of last fall related to poor hedging in the face of rising rates. The banking industry, which had already been tightening lending standards over the past year to levels historically consistent with recessions, is now experiencing volatility in non-insured deposits (amounts greater than the $250k FDIC limit) as the failure of prominent institutions such as Silicon Valley Bank (SVB) shed light on some poorly-run bank investment portfolios and available liquidity to meet withdrawals.

SVB specialized in providing banking services to start-ups and venture-funded enterprises with little revenue and high levels of cash burn. Such businesses were flush with cash during 2020-21 when interest rates were at 0% as speculative investors funded growth, seeking out-sized returns during this easy money era, and these start-ups deposited the funding into SVB bank accounts. Early in the pandemic and prior to inflation becoming a major policy problem, many investors and economists expected interest rates to remain near historical low ranges for a long time, which prompted banks like SVB to buy long-dated government securities of 10+ years with the deluge of deposits it acquired early in the cycle—essentially a $100 billion one-way bet on interest rates staying very low for a long time.

As renown investor Seth Klarman opined on many occasions over the past decade of easy money, "The idea of persistently low rates has wormed its way into everything… and such policies have persuaded investors that risk has gone into hibernation or simply vanished." Unfortunately, inflation reared its ugly head and the central bank was forced to raise interest rates over the past year at the sharpest pace in more than 40 years. In the case of SVB, start-up and venture funding dried up, most of its clients began drawing on the cash in bank accounts to fund operations, while the bank saw the value of its securities portfolio dramatically decline. As withdrawals accelerated during the first quarter, the bank had a major liquidity and capital issue on its hands as losses piled up from sales of bonds to meet withdrawals, leading to a panic by depositors and the second largest bank failure in the history of the U.S. on March 10th.

Since then, the crisis has spread to other parts of the banking sector such as Credit Suisse (the poorest-run global bank over the past decade-plus), which has seen clients and counterparties flee, forcing the Swiss government to accommodate an acquisition by UBS at a mere $3 billion valuation. Confidence in the small-to-medium size U.S. regional banking system is also being questioned as many account holders are moving deposits to the larger too-big-to-fail institutions in order to get account balances under the $250k FDIC limit at many of the smaller banks, even ones that make very good loans or are not bad players in the system. While the government has guaranteed the uninsured deposits of the banks it has closed over the past several weeks, there is not a blanket guarantee for all bank deposits, according to comments made by Treasury Secretary Yellen on March 16th. The FDIC insurance limit remains in place for now and any future bank failure would need to pose systemic risks similar to those seen at SVB and Signature for uninsured deposits to be protected. Investors will be keenly watching the flow of deposits across the small-to-medium banks over the coming weeks, which comprise approximately one-third of assets in the banking sector. A coalition of smaller banks is already asking the FDIC to extend insurance to all deposits for the next two years to avert a wider run that is almost exclusively due to deposit flight at the current moment and not credit issues (although those are likely to be seen later in the cycle).

Inflation accelerated throughout the first quarter with core CPI rising at a 5.2% annualized rate over the past three months on a sequential basis, reversing some of the disinflation that was seen during the fourth quarter of last year. This complicates the Federal Reserve's job as it now must balance its inflation-fighting credentials with financial stability concerns given the banking issues. Two weeks ago it was almost certain that the Fed would raise rates another 50 bps at its March 22nd meeting along with several further increases thereafter given the recent elevated inflation readings as well as the strong employment trends exhibited in the government's labor models. However, expectations for further rates hikes have been reined-in considerably following the failure of SVB with the terminal interest rate now expected to be 5% per the fed funds futures market. This implies one additional 25 bp hike this week and then a pause.

The S&P 500 is up modestly to start the year but not without volatility. The recent banking news has been taken in-stride by stocks for now but that is most likely due to the recent sharp decline in Treasury yields since the regional banking crisis unfolded. Stock prices are actually down 6.3% since early February on expectations of tighter financial conditions that will be necessary to dampen stubbornly high inflation.

Broad Treasuries have rallied nearly 3% since March 2nd. Two-year yields, a proxy for where Fed policy will be in a year, have declined 109 bps since the March 8th peak of 5.07% to a current 3.98% and the incredible 61 bps decline in yield on Monday, March 13th as the regional banking crisis unfolded is the sharpest one-day plunge since 1982. The yield curve (10-2 spread), while still inverted by -39 bps, has steepened dramatically in less than two weeks from the -107 bps cycle low. Historically, an inverted yield curve is a leading indicator of a recession (with considerable variability in terms of timing) but the steepening that eventually occurs thereafter when shorter maturity yields plunge usually coincides with the beginning of a significant slowdown.

Similarly, commodity indices remain in a downtrend, indicative of slowing growth expectations. Crude oil prices have fallen into the mid-$60s from the low-$90s level that prevailed early in the fourth quarter and banks like Goldman Sachs are no longer calling for $100+ crude oil prices as the "no-landing/soft-landing" economic thesis fades away.

2023 YTD Total Returns

	3/20/23	% Change
Dow 30 Industrials	32,245	-2.2%
S&P 500	3,952	+3.3%
NASDAQ Composite	11,676	+11.8%
MSCI ACWI ex-USA	285	+1.9%

Outlook

The balance of risks seems to be shifting for monetary policy as the lagged impact of higher interest rates and withdrawal of liquidity over the past year finally begin to bite across the broader economy to a greater degree than before. The sudden appearance of the regional banking crisis over the past two weeks has the potential to dramatically tighten credit in the near term for both households and small businesses as banks manage deposit volatility, liquidity, and shrinking balance sheets. Regional banks comprise nearly 33% of bank assets and roughly 40% of all lending. Credit is the mother's milk of economic activity, thus the degree to which lending standards tighten even further and impact credit availability could have knock-on effects to fundamental growth over the coming months. Even larger companies could see credit slow—note that not a single investment grade company in the corporate bond market sold bonds during the week of March 13th. The slowdown that was already underway per many leading indicators could now come faster.

The current regional banking crisis results from a concentration in uninsured deposits, declines in the values of bank securities portfolios, and poor liquidity management. The credit losses on bank books that typically occur in a recession when some loans go sour are yet to come in the forthcoming downturn and could be broad-based including real estate. The crisis will eventually put a magnifying glass on the loan book of many regional banks, especially those that hold commercial real estate mortgages. According to JPMorgan, the smaller banks account for 70% of total commercial real estate loans outstanding. Several high-profile properties have already fallen into default in the first quarter in places like San Francisco, Los Angeles, New York, and Boston as investors balk at higher interest rates when refinancings come due. The most widely followed gauge of commercial real estate prices declined 3.5% in the fourth quarter of 2022, the sharpest quarterly drop since 2009.

While core consumer prices have accelerated as mentioned earlier, core upstream producer prices have shown signs of softening, growing at just a 1.9% annualized rate the past three months and the slowest since mid-2020. Supply chains are normalizing and companies are rationalizing inventories, which should eventually lead to more favorable consumer price inflation. However, the labor market remains tight per analysis of government data and the resultant higher wages have maintained a high level of inflation within the service economy. Payrolls are a coincident economic indicator meaning relevant shifts occur concurrently with general economic changes. Thus, any weakness in the labor market over the spring months would be a warning signal that a significant slowdown is underway. Additionally, analysis of cycles going back to 1960 shows the unemployment rate rising 6-10 months on average before any durable stock market trough is seen.

The optimal Federal Reserve policy remains an enigma given the current bank distress alongside persistently high inflation. A Bloomberg economics model indicates that the tightening of financial conditions due to the banking stress, if sustained through June, is equivalent to a 50 bps Fed rate hike; other economists peg the impact at an even greater equivalent. Thus, the tighter credit environment could do some of the Fed's own work in terms of dampening aggregate demand to help rein in prices. Ultimately, slower loan growth could shave anywhere from 0.50%-1.0% off GDP growth over the next year or two, according to estimates from JPMorgan and Goldman Sachs, unless the present turmoil quickly subsides.

Wall Street profit forecasts for 2023 are still portraying expectations of essentially flat growth for the year at $220 per share with the S&P 500 currently trading at 18x this estimate. Such a valuation multiple is a substantial premium relative to history and notably so when interest rates are at more normalized levels as they are today. Furthermore, the Conference Board's Leading Economic Indicators Index continues to fall after peaking last March with the year-over-year declines consistent with every recession since 1970. Hence, current profit forecasts from the Street appear too optimistic and we would expect stock prices to eventually reflect weakening fundamentals.

Investment Conclusion

The rise in interest rates over the past year has enabled this firm to enhance client cash income at above average growth rates. Maturing corporate bonds and some realized equity gains have been rolled into Treasuries at the highest market yields since 2006-07 and excess cash held in quality money market funds now earns above 4%. Such liquid assets alongside a high quality stock portfolio will serve as good protection during periods of volatile downside while providing funds for reinvestment as better buying opportunities in stocks evolve in the months ahead.

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