MARKETS IN FOCUS

FIRST QUARTER 2023 APRIL 13th, 2023

GEMMER ASSET MANAGEMENT LLC
LOCAL PARTNER GLOBAL INVESTING

Market Benchmarks			
Market Indices	**1st Qtr**	**3-Yr An**	**5-Yr An**
S&P 500 Index	+7.5%	+18.5%	+10.0%
Russell 2000	+2.7%	+17.4%	+4.6%
Global Equities	+7.2%	+15.9%	+6.9%
Int'l Index (EAFE)	+9.0%	+13.3%	+3.5%
Emerging Mkts	+3.6%	+9.3%	-0.2%
Other Indicators	**3/31/23**	**12/31/22**	**12/31/21**
Fed Funds Rate	4.75%-5.0%	4.25%-4.50%	0%-0.25%
2-Year Treasury	4.03%	4.43%	0.73%
10-Year Treasury	3.49%	3.88%	1.51%
S&P 500 P/E Ratio*	17.8	16.7	21.2
Crude Oil	$75.67	$80.35	$75.45
Core Inflation	4.6%	4.7%	4.7%

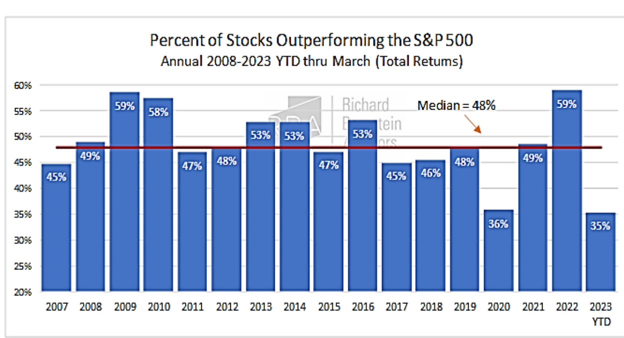
*Forward 12-month operating earnings per S&P

Quarter-In-Review – It's a rite of passage for many in the investment business to write an outlook piece around year-end for the coming year. Of the dozens and dozens we looked at late last year and early this year, not one had 'massive banking failures' on their 2023 bingo card. This is the definition of a surprise, a Black Swan in investing parlance, something out of the blue that no one expects. The failure of Silicon Valley Bank (SVB), Signature Bank, and Credit Suisse, all within days of each other is extraordinary in historical terms, but the market's reaction to the bolt from the blue is also something of a surprise.

It ended up being a solid quarter for stock investors. The S&P 500 gained +7.5% for the three months, with the stocks hit hardest during the bear market of 2022 gaining the most during the quarter. But the rally was narrow. Only a third of all U.S. stocks beat the S&P return in the first quarter, the lowest beat rate in a number of years (chart below). Smaller-cap stocks lagged significantly (+2.7%), as did REIT stocks, up just +1.7% for the quarter. Finally, as you would expect, bank stocks suffered some pain. The broad banking index (SPDR S&P Bank ETF) lost -17.3% during the quarter while (SPDR S&P Regional banking ETF) an index of smaller regional banks lost -24.7%.

One of the consequences of the banking troubles was that interest rates declined, and bond investors recouped some of their losses from last year. The yield on the 10-year Treasury fell to 4% while the yield on 2-year bonds declined 39bps. Consequently, intermediate-term Treasury bonds gained +3.9% for the quarter while short-term bonds edged up +1.1%.

Is Bad News Good News Now? – How do you reconcile bank failures with gains in the stock market? To many, this disconnect epitomizes the markets at their irrational best (or worst, depending on your perspective). But there is a certain logic to this disconnect. It actually isn't unusual for risk assets such as stocks and corporate bonds to rally when the headlines take a turn for the worse. Over the years we've seen numerous instances when a supposedly good employment report or robust retail sales number was greeted with broad based selling because it meant hotter inflation or a more hawkish central bank. Conversely, the opposite can be perceived as good news by the market because it implies less inflation, fewer rate hikes, or a combination of both. This is the situation investors found themselves in last month, but we are getting ahead of ourselves.

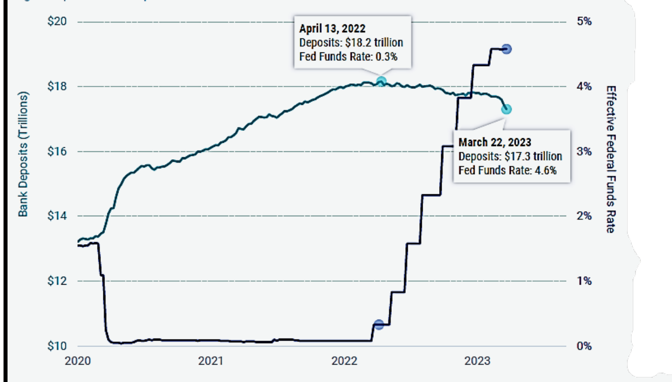


Source Richard Bernstein Advisors LLC, S&P Global, Bloomberg Finance L.P.

Fractional Banking is Inherently Unstable – What is it about banks that puts them at the center of most financial crises? Economic history is, in part, a history of banking blowups. Everything from the crisis of 1907 to the Latin American debt crisis in the 80's to the housing bust last decade, all had banks as the epicenter. So why do we stick with the banking model when it has caused (or at least been adjacent) to so much turmoil? Because most of the time the business of banking plays a useful social function. Banks historically have served as the conduit between savers with short time horizons and borrowers with much longer horizons. Think of a world without banks and you want to raise funds to start a grocery store. You'd have to canvas hundreds and thousands of small savers, none of whom want to tie up their hard-earned cash in a multi-year project of unclear quality. They want to access their money whenever they want to and don't want to see its value fluctuate. Those are two things most business borrowers can't promise. Enter a bank. They take short-term deposits and match them to longer-term borrowers through their due diligence process while at the same time (usually) offering savers full access to their funds 'at par.' Conversely, borrowers don't have to worry about their loans being called away right before a contractor is due payment or employees need to be paid. It's easy to lose sight of just what an important role this is and why banks have been around for so long.

But banks also run on confidence. Kids learn at a young age that the dollar they deposit in a bank doesn't just sit in the vault. It's lent out to a consumer or business, and that loan then becomes a deposit somewhere else. Rinse and repeat. This is the essence of a fractional banking system. Banks create money through the lending and deposit process, but they also run a leveraged business that is susceptible to a bank run if too many kids want their dollars back at the same time.

Figure 1 | U.S. Bank Deposits and the Effective Federal Funds Rate



Data from 1/1/2020 – 3/22/2023. Source: Board of Governors of the Federal Reserve System, Federal Reserve Bank of New York. The Federal Funds Rate is the interest rate at which depository institutions, such as banks and credit unions, lend and borrow funds from each other on an overnight basis to maintain their reserve requirements. References to specific securities are for illustrative purposes only and are not intended as recommendations to purchase or sell securities. As of March 31, none of the funds referenced in this document had exposure to the securities referenced greater than 0.01%.

SVB's deposits were concentrated in a small number of clients' accounts, and those clients talked to each other. When rumors started to circulate about SVB being technically bankrupt if their bond portfolio was marked-to-market, these depositors, many of which had multiple millions of uninsured deposits at risk, all fled at the same time. The outcome was the same as bank runs in the 1930's: insolvency (chart below).

The More Things Change……the more they stay the same. The story behind SVB's failure is as old as banking, but with modern twists just to keep things interesting. Ever since the Great Financial Crisis the Fed has basically kept short-term rates pinned at zero, with a brief exception between 2016 and 2019. Even then there was little difference between keeping your cash in a bank, a money market account, or under the mattress. Yield was in short supply and most of us were pretty indifferent about where we stashed our cash. However, as the Fed started moving rates up in 75bps increments in early 2022, the gap between bank yields and money market yields became too good to turn down, and once the Fed Funds Rate hit about 5%, bank deposits started to bleed (chart above). Nealy $400BN in deposits left U.S. banks over the 4-week period ending March 22nd – the largest 4-week decline since the start of 1973.

Normally this wouldn't be a problem. Banks typically hold lots of liquid securities to cover deposit outflows. However, the increase in interest rates last year meant that many banks were sitting on losses in their bond portfolios. Due to some unique bank accounting requirements, some of these losses didn't have to be reflected on the balance sheet. SVB was at the tip of the spear, so to speak, in terms of both deposit growth and exposure to losses in their bond portfolio. SVB's unique market niche servicing start-ups and venture capital firms meant a huge influx of deposits during COVID. Much of this cash found its way into longer-term government bonds to earn a decent, supposedly risk-free, spread. In late 2022 this seemingly benign relationship turned vicious. Tech companies started to hemorrhage money at the same time SVB's bond portfolio fell in value. And what made SVB special also made it susceptible to an old-school bank run.

More cliff than valley

Silicon Valley Bank, $ per share

Source: Bloomberg *Pre-market trading

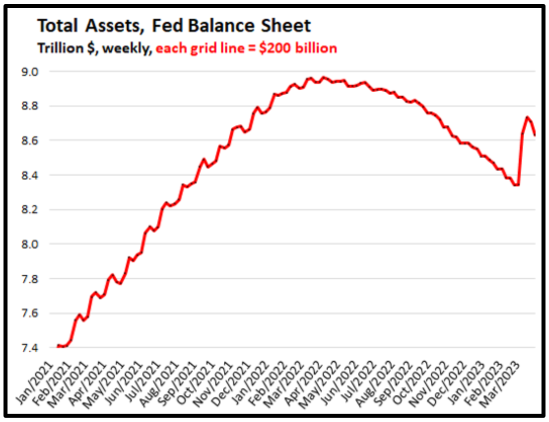
The Economist

Shortly after SVB's demise, Credit Suisse was forced into a shotgun marriage with its long-time rival, UBS. Like SVB, Credit Suisse was experiencing a massive deposit outflow and the Swiss authorities were forced to take action to avoid a much bigger problem. For a couple days in March, it was looking like a string of banking dominos were going to fall, bringing the financial system to its knees.

Dusting Off the Crisis Playbook – In years past the regulatory authorities would have hemmed and hawed for a few weeks as the problems metastasized. They might have let SVB go under thinking it would discipline other firms, only to see fear spread quickly, taking down other organizations. Regulatory disagreements would only be resolved when a really big problem showed up that threatened to tank the entire economy. This is basically a timeline of the crisis response back in 2008 and 2009. Remember the failed TARP vote and the thought that letting Lehman go under would introduce some market discipline into the system?

This time around the Fed took a page out of the COVID response – go big or go home. Just as SVB failed they rolled out a massive lending program for the banking system called the Bank Term Funding Program (BTFP). This allows banks to borrow unlimited amounts at favorable rates, with an interesting twist. Banks can pledge Treasury bonds or mortgage-backed securities as collateral for the loans and receive face value back, not the discounted market value. Yes, this is a big subsidy for the banking system, but so far this program has worked. Deposit flight has continued, especially from the smaller regional banks, but the risk of a systemic crisis has abated.

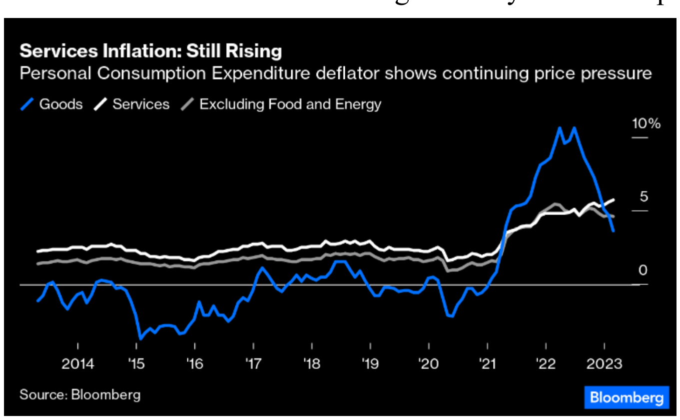
What is Different This Cycle? – No two crisis are the same. The bank failures of 2007 and 2008 were tied to different problems (residential housing) than those in the 1980s (commercial real estate). What's interesting this time around is that there are no real credit issues. No one is questioning the quality of SVB's loan book or First Republic's credit underwriting standards. It's all about what rising interest rates have done to their otherwise high-quality bond portfolios and the huge disconnect between what banks pay on deposits and money market yields. In a sense this crisis is much more like Orange County's bankruptcy back in 1994 when rising interest rates hammered Robert Citron's leveraged bond portfolio.



This has important implications for the broader economy. First, there is every chance that SVB is an isolated case. Few banks in the U.S. have the combination of its unique client base, massive growth, large exposure to longer-term bonds, and a small number of large balance deposits funding those bonds. Secondly, because most bank's loan books are not impaired, the risk of a so-called credit crunch is diminished somewhat. What typically happens during a banking crisis is that banks stop lending to rebuild their balance sheet and deal with problem loans. This leads to a deep recession as credit is very much the lifeblood of the modern economy. The BTFP program should help alleviate this problem, at least to some extent.

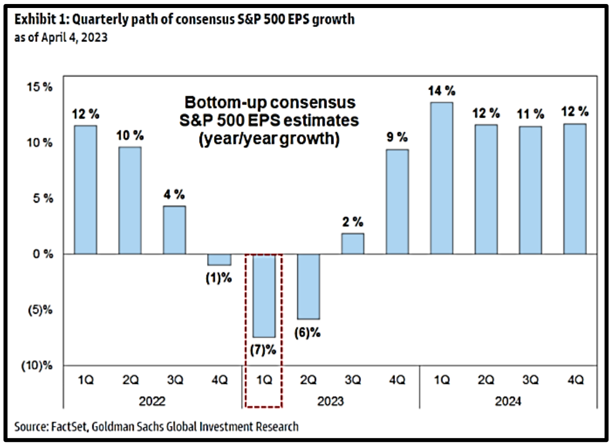
But the BTFP program has introduced a new variable – a massive increase in liquidity sloshing around the system. The chart above shows the Fed's balance sheet, and as you can see, up until recently it had been shrinking (stricter liquidity conditions) as the Fed conducted its Quantitative Tightening program to try to rein in inflation. However, the recent loans to the banking system have reversed a big portion of the QT so far. The direct result of this easing in liquidity conditions is: 1) a pronounced fall in interest rates, 2) a rally in risk assets and 3) a consequent easing in financial conditions. Why did risk assets rally in the first quarter? This chart explains at least part of it – investors love rising liquidity.

<u>Everything Has a Cost</u> – In one respect the fall in rates is welcome. Any bank that was sitting on losses in their bond portfolio late last year is now looking at an improved P&L statement. However, falling rates and easing financial conditions are not helping with the Fed's other big concern before SVB- inflation. Right up until the banking problems broke, the general view was that the Fed was going to need to continue to tighten policy at least through the middle of the year to get inflation on a downward trajectory. As you can see from the chart at the bottom of the page, while inflation in goods has come off the boil, inflation in services remains sticky and core inflation is still well above the Fed's target. The banking problems introduce a number of cross-currents. Clearly the Fed's rate hikes played a key role in SVB's demise. There's an old saying about rate hike cycles that central banks tighten until they break something. Now whether SVB is the shattering sound we usually hear near rate peaks has yet to be seen, but the Fed has to be cautious about moving rates aggressively higher from here. However, the sharp increase in the Fed's balance sheet, fall in interest rates, and easing in financial conditions are all inflationary at the margin.



The other big unknown is what happens with bank lending. We noted earlier that a credit crunch a la 2008 is unlikely, but we can't rule out a tighter credit environment from here on out. This doesn't mean banks cutting off loans altogether, only being more selective. This seems very likely, especially as it relates to commercial real estate. Small and medium sized banks provide upwards of 80% of all commercial real estate loans in the U.S. They are likely to be more discriminating going forward. How the Fed balances all these competing forces is tough to discern. Do they choose financial stability over the inflation fight? Or is inflation credibility more important to them, meaning the Fed Funds rate is on its way to well over 5%? We are not sure, and we'd wager the members of the Fed board aren't sure either. Our best guess is they tighten one more time in early May by a quarter-point then pause, primarily because the economic outlook is growing murky.

<u>Soft Landing or Recession?</u> – The latest batch of economic data all point in the same direction – much slower growth. And this makes sense. It would be historically very unusual not to see growth slow significantly after 500bps in rate hikes combined with a banking system that is getting pickier about how it distributes credit. How worrisome is this trend? We can't be sure, but we don't see a replay of the deep recessions of the past. After all, in 2007/2008 large parts of the banking system were bankrupt and not lending at all. In this cycle, banking liquidity and capitalization is generally good. Also, unemployment remains low and housing values are relatively stable. But even so, higher rates, corporations rolling over maturing debt at less favorable terms, less easy credit for consumers, etc. all should conspire to slow growth materially. And in a way this needs to happen. Inflation isn't moderating on its own, but a quarter or two of flat to slightly negative growth will go a long way towards slowing price increases.



Will this scenario mean a big rise in unemployment? Not necessarily. This gets to the heart of the debate between soft landing and recession. A soft landing would be two-to-three quarters of flat growth without a big increase in joblessness. So far, a big rise in unemployment does not look likely outside some areas in tech, but time will tell. Economists think growth will slow from roughly +1.3% in the first quarter of this year to +0.2% in the second to -0.5% in the third before rebounding. This feels about right, although the slowdown may take longer and the rebound might not happen until 2024.

Market Implications – Let's touch on bonds first. Yields have already come down due to the banking problems, but if the above scenario plays out, we think there is more downside in yields and upside in prices over the next couple quarters. Rates aren't likely going back to 0% because we don't think inflation will stay dormant for long beyond 2024, but that is an issue for another day. Over the short-term we think high quality bonds can generate reasonable returns and act as a portfolio diversifier again.

The outlook for equities is muddied by a few things. Generally, an economic slowdown or recession is bearish for stocks because it means earnings are going to come under pressure. But this is already happening and widely expected. As you can see from the chart above, analysts think earnings will contract by -7% year-over-year in the first quarter and another -6% in the second quarter. This earnings recession is almost certainly priced into markets today. Could we see bigger earnings contractions in an economic recession scenario? Certainly, but a mild recession might only mean third quarter earnings are modestly negative – not the end of the world. The even trickier thing to factor in is what happens with equity multiples if rates fall. Last year stocks were down sharply simply because rates went up and price-to-earnings multiples contracted. If we see lower rates this year, multiples could actually stabilize or expand, largely offsetting any hit from an earnings recession. Furthermore, if we get to a point where it's clear inflation has peaked and the Fed might be on a path towards cutting rates in late 2023 or early 2024, stocks will move quickly to discount this more dovish scenario. This is the 1973/1974 scenario we have talked about in prior letters. Our message isn't so much that stocks will do this or that over the short-term, only that timing the ebbs and flows will be awfully hard. The rally this quarter came out of the blue because 1) the banking problems were unexpected, and this 2) led to a big expansion in liquidity, which 3) drove down interest rates, and 4) enticed investors to pay higher multiples for many stocks. No one could have timed this sequence of events!! If forced to guess, we suspect stocks might have another decline left in them sometime this summer as we start to worry about the growth slowdown/recession (and maybe the debt ceiling). But it won't last long, and will be even harder to time, because inflation will likely moderate quickly. This should take central bank tightening off the table for good this cycle and quite possibly lead to a more profitable period for equity investors going forward.

Final Thoughts – This was a quarter that will go down in history for all the turmoil in the banking sector. Strangely, the fallout from the second largest bank failure in U.S. history may prove to be pretty contained, but we suspect the combination of slower credit growth and the rate hikes to date slow the economy in a meaningful way and cap the short-term inflation risks. The debate between soft landing and deep recession is likely to lead to much volatility, but we think the more constructive scenario is likely to play out over time.

Charles Blankley, CFA
Chief Investment Officer