Second Quarter 2023 Investment Outlook

You Can Take That To The Bank

"We believe the last few days introduced investors/banks/policymakers to the new risk of deposit runs in the age of social media."

– Bank of America / Merrill Lynch Research

"Data suggests deposit outflows are not accelerating and remain more idiosyncratic than systemic. Financial stability issues have not affected broader consumer sentiment….market attention may shift back to macro data."

– Citigroup Research

"There are only four instances where the ISM manufacturing reading was this low without a recession in the following 12-18 months."

– Jim Reid – Deutsche Bank

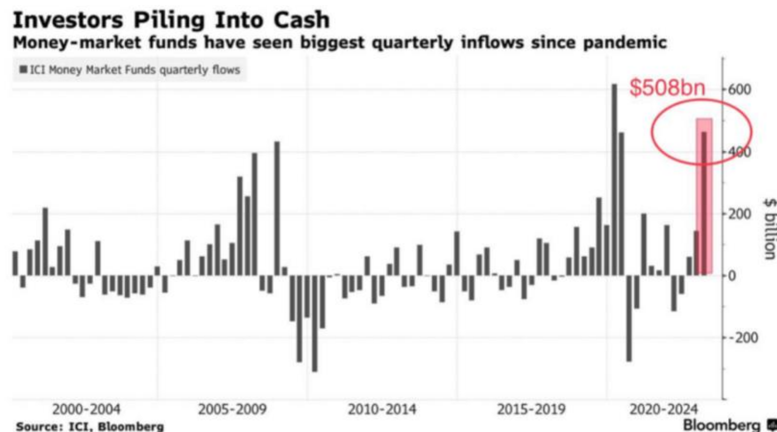
"You can take that to the bank" used to be a popular saying to describe a sure thing or to imply a statement or information had almost 100% certainty of being true. This saying came about when banks were held in high regard. Banks were considered places to deposit your savings or store valuables in a safety deposit box to gain peace of mind. Througout U.S. history, financial crises have occured which temporarily undermined public confidence in banks. The Great Depression was the worst one, when nearly 50% of the banks in America failed. The last major one was the 2008 Global Financial Crisis when 25 banks and several prominent financial services companies failed including AIG, Bear Stearns, and Lehman Brothers. The situation was so dicey that the U.S. Treasury and Federal Reserve had to step in and provide a financial backstop in order to restore public confidence in the financial system. As a result, more heavy handed government regulation came about via the Dodd Frank Act, which forced banks to reduce risk in their investment holdings and hold higher levels of liquid capital to absorb larger potential losses in the future. Annual stress tests were created for SIFIs, or Sytematically Important Financial Institituions, and a SIFI's ability to increase dividends or buyback stock is dictated by the more stringent capital rules established under Dodd Frank. In response to tighter regulations and to pass liquidity stress tests, banks hold more cash, Treasury bonds, and government backed agency mortgage bonds instead of making higher risk loans or investing in higher risk investments in order to earn higher returns on their deposits.

Several weeks ago, two large U.S. banks failed, several others remain under duress, and we now have another crisis of confidence in U.S. banks. The crisis spread to Europe as Credit Suisse was forced into a combination with UBS. Unlike 2008, when financial institutions became insolvent due to low quality investments that plummeted in value, the present day banking crisis is much different. The two banks that failed held very high quality assets, but the immediate and rapid withdrawal of depositor balances forced those banks to sell their high quality assets at a loss, which would have forced them to raise new capital to offset those losses in order to stay in compliance with regulatory capital requirements. In the case of Silicon Valley Bank, it issued a press release about selling securities at a loss and raising capital after the stock market closed on a Wednesday. The next day, its stock price plunged 60% and depositors withdrew $42

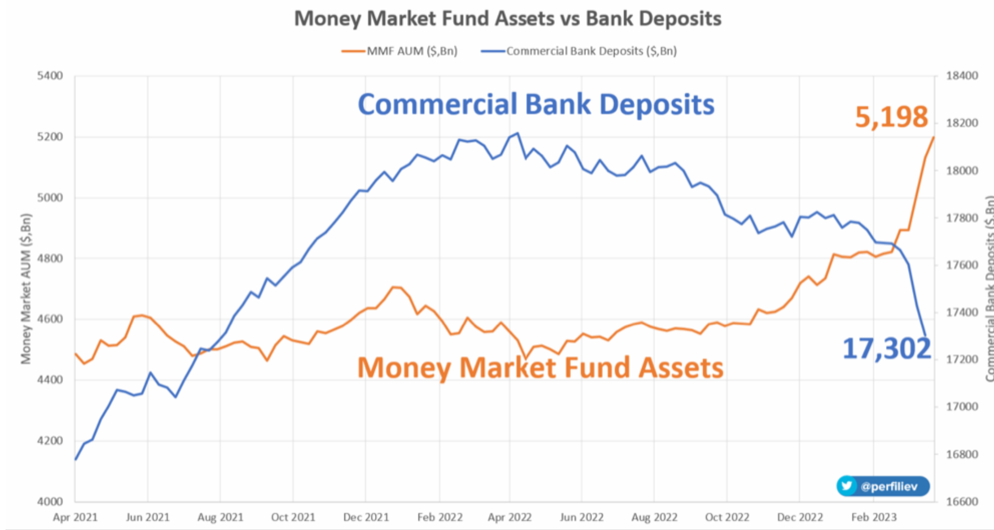
billion, and the bank expected another $100 billion of withdrawals the following day. By comparison, the worst withdrawal rate one bank faced in 2008 was $17 billion in one week. The rapid nature and size of depositor withdrawals forced the FDIC to step in and takeover the bank in less than 48 hours because the bank could not sell its assets or raise new capital fast enough to comply with regulatory capital levels. The situation became an instantaneous liquidity crisis as opposed to a solvency crisis that hit most failed financial institutions back in the 2008 and whose demise took longer to play out.

In 2008, there wasn't broad acess to cellphones and digital banking apps like there is today since the first Iphone was only launched in 2007. In this latest banking crisis, rumors about Silicon Valley Bank spread immediately across social media platforms like Twitter. The immediacy of information that social media offered to the public contributed to the accelerated demise of these banks at a speed never seen before. Mobile banking apps allowed depositors quick access to their accounts to move cash out without physically standing in line at a bank branch. Banking regulations have not been updated to address these technology developments giving depositors the ability to instantly move deposits around. Congress will most likely have to update banking regulations to address some of the issues that occurred during this latest banking crisis. Even so, poor decisions by the management teams of the banks the FDIC took over set them up to fail and banking regulators didn't do their job with thorough oversight either. In addition, the Fed's decision to aggressively raise interest rates over the past year has contributed to the vulnerability of banks. Rapidly rising interest rates has had a material negative impact even on high quality bonds held by many banks. Ironically, these bonds were held by the banks due to more stringent banking regulations established by Congress.

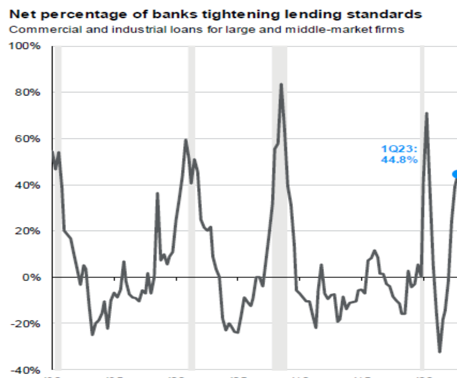
The recent banking crisis accelerated the process but deposit withdrawals from banks started in earnest last Fall once the Fed raised interest rates to a level where money market funds offered more attractive yields than checking/savings accounts. The chart below of quarterly money market fund flows shows that assets transferred into money market funds have surged by over $500 billion this year due to higher yields plus the panic reaction of depositors to transfer cash from bank accounts into money market funds. The recent surge into money market funds is the second largest of the past 23 years. If the Fed pauses on interest rate hikes but keeps interest rates steady for the rest of the year, then investors/savers with cash in money market funds can earn nearly 5% yields with virtually no investment risk. This dyamic is a significant change from one year ago when interest rates were near 0%. The investment return opportunities in both bonds and stocks now have to be more compelling in order to move assets out of money market funds.

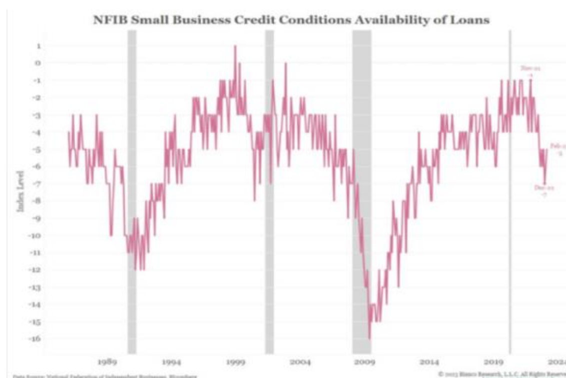


The next chart compares money market fund assets to commercial bank deposits over the past two years. Bank deposits soared in 2021 when the government was handing out free money post the C-19 pandemic but started to decline in the summer of 2022 after the Fed started to aggressively raise interest rates. When the banking crisis hit in mid-March, bank deposit withdrawals accelerated and money market fund assets surged as shown on the far right side of the chart. Only $10 trillion of the $19.2 trillion of deposits at U.S. banks are covered under the FDIC $250,000 insurance coverage. If there is more stress on the banking system in the months ahead, Congress may need to pass a temporary increase in FDIC insurance limits to slow down cash withdrawals.



Banks are the lifeblood of the U.S. economy. According to Barclays Capital, U.S. banks provide 45% of the commercial loans across America and small and medium businesses rely mostly on community/regional banks for credit. When a banking crisis hits, and the risk of depositor withdrawals increases, banks become more conservative and raise their lending standards. The following chart on the left shows the Bank Lending Officer survey since 1990. In times of crisis or as recession risks increase, banks tighten lending standards and reduce loan availability. When the line goes higher it mean more banks are tightening lending standards and making less credit available to both consumers and businesses. The percentage of banks tightening lending standards is now at nearly 45%. During the 2008 Global Financial Crisis, it hit 80%. Over the past year, lending standards have tightened significantly and the events of the past several weeks will likely mean even tighter credit conditions in the months ahead, which will have a negative impact on U.S. economic growth. The chart on the right is the National Federation of Independent Business survey of small businesses and credit availability. It confirms the data on the left chart and shows less credit is being made available to small businesses. The grey area of the chart are recessions and when credit availability shows large declines then a recession typically follows.

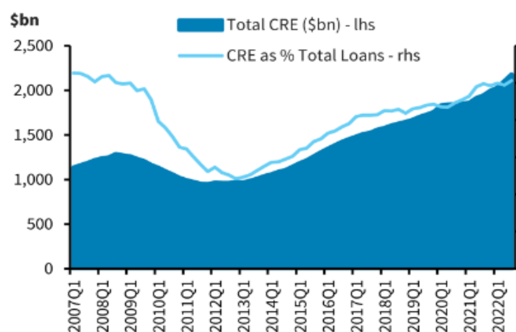


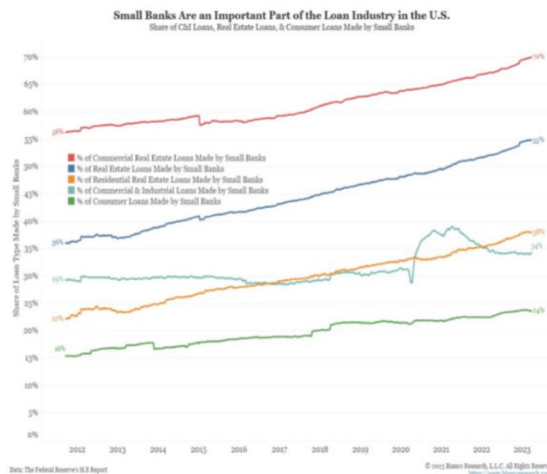


Source: JP Morgan

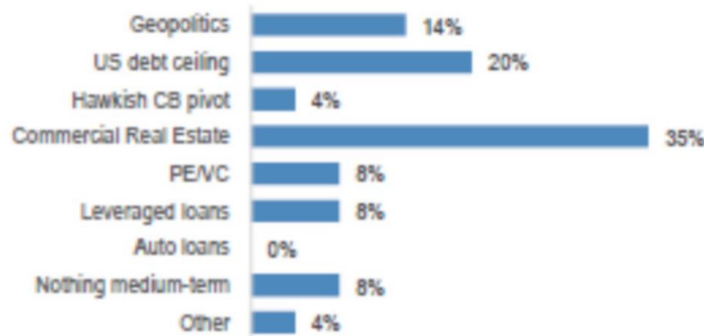
There were some unique circumstances surrounding the two banks that failed in March. 88% of Silicon Valley Bank's deposits were uninsured and the majority were sourced from venture capital funded companies. As credit availability tightened, venture capital funded companies started to draw down their bank deposits at Silicon Valley Bank to fund their operations. 90% of Signature Bank's deposits were uninsured and it had a sizable amount of its deposits associated with crypto currency companies. Neither bank was your run-of-the-mill community/regional bank. Although the Fed's rapid increase in interest rates over the past 12 months has put more funding pressure on banks, this is not a situation like 2008 and contagion should be limited. The majority of community and regional banks are managed conservatively and have capital levels above regulatory minimums.

One area of focus of investors is the commercial real estate exposure of banks with loans to office buildings being the greatest concern. Work-from-home trends starting after Covid-19 has significantly reduced demand for office space and negatively impacted the value of office properties the most. Over the next two years $1.4 trillion of commercial real estate debt comes due. The next chart on the left shows that U.S. banks in aggregate have around 20% of loan books in commercial real estate mortgages. The red (top) line in the chart on the right shows that small banks make 70% of the commercial real estate loans in the U.S. and 55% of all real estate related loans including residential housing. Banks will get more defensive and pull back on making loans if they have to absorb losses on commercial real estate loans.

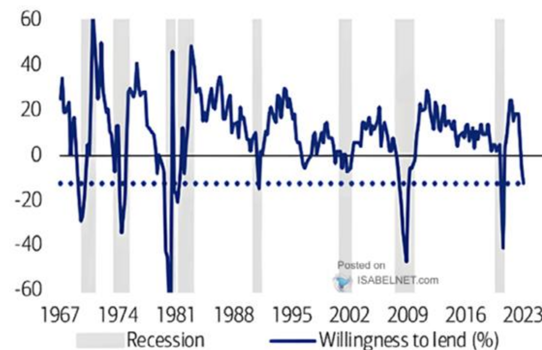




Investors now have the greatest concerns over commercial real estate as shown below in a recent survey of institutional investors. The U.S. debt ceiling is the second greatest concern.



The same tightening credit conditions now impacting companies also applies to consumers. The next chart shows a Senior Loan Officer survey on consumer lending going back to 1967. In this chart, a declining line means banks are less willing to make loans to consumers. The grey sections of the charts are recessions. The historical survey data shows that when banks tighten their lending to consumers it is typically during a recession. The blue dashed line marks the level in the survey when most recessions occurred. While the current survey is not yet below the dashed line, consumer credit availability is tightening and the odds of a recession hitting later this year or in early 2024 are increasing as a result.



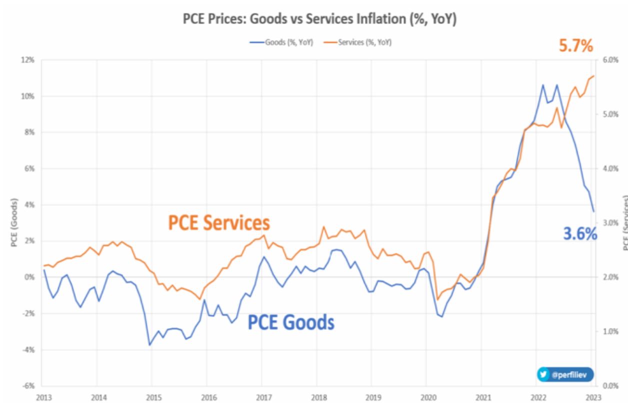
The current banking crisis will only become more problematic if more depositors continue withdraw their cash, which will increase funding pressure on banks. However, in all likelihood, the Federal government is not going to let the situation get to that point and may have to consider raising the FDIC insurance levels temporarily to eliminate the risk of other bank runs. In the case of both Silicon Valley Bank and Signature Bank, the FDIC decided to fully issure all deposits, not just those below $250,000. In addition, in recent testimony before Congress, Treasury Secretary Janet Yellen suggested the Biden Administration would consider similar measures to protect depositors at other banks if it came to that. Although contagion from

the recent banking crisis should be limited, the U.S. economy now faces higher odds of a recession in 2023. Banks were already getting more defensive and pulling back on credit availability and that will increase more now.

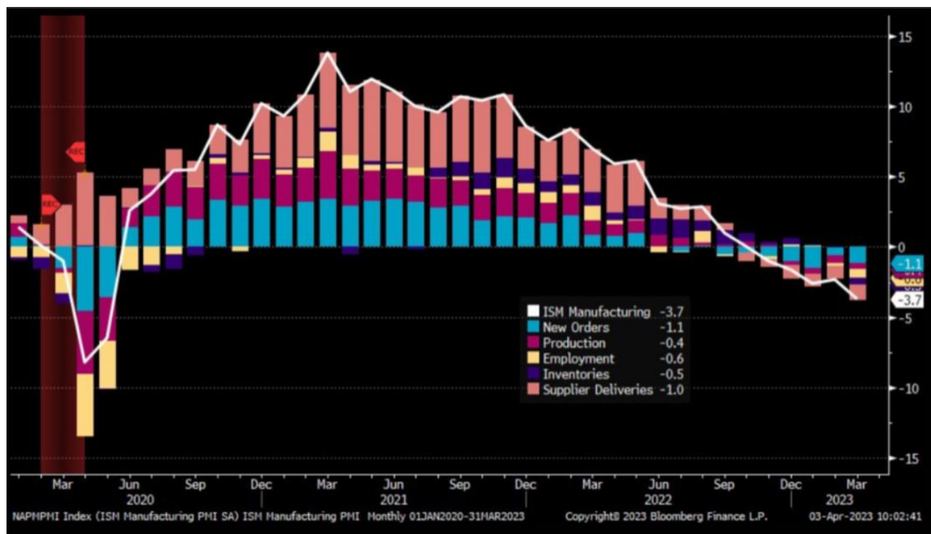
The banking crisis situation may be limited to a few banks with idiosyncratic risk profiles but another major issue looming on the horizon is the U.S. debt ceiling. Because politicians today rarely make tough decisions, Congress has used a band-aid approach to addressing the Federal government debt ceiling over the last several decades. Once again, the Federal government is approaching its borrowing limit and may reach it at some point in June or July. The House is now controlled by Republicans, who want to negotiate budget cuts as part of an agreement to raise the debt ceiling. For now, President Biden won't play ball and is unwilling to consider budget cuts to get a deal. Not raising the Federal debt ceiling would mean a debt default by the U.S. government, something that would be extremely bad for financial markets. All the political players know this and so it is highly likely a deal will be reached. However, any deal that goes down to the wire will add more risk and volatility to financial markets the closer the U.S. gets to a potential default, as was the case during the Obama Administration in 2011, when a deal was struck just two days before a potential default.

While the banking crisis has taken on greater focus the past few weeks, inflation is still an important issue for financial markets and the economy. Over the past several months, headline inflation numbers have been "sticky" or not falling fast enough. Before the banking crisis hit in mid-March, U.S. Federal Reserve Bank Chairman Powell's testimony before Congress implied that a 0.50% interest rate hike was likely at the March meeting because the most recent inflation data remained elevated. Because of the greater risks to the U.S. economy caused by the latest banking crisis, the Fed hiked interest rates 0.25% instead.

The next chart on the left shows the Core Personal Consumption Expenditures (PCE) Index (light blue line), the Fed's preferred inflation gauge. Core PCE has come off of its peak level of 7% in mid-2022 but remains elevated at just under 5% and still significantly above the Fed's 2% target inflation mandate. The chart on the right shows how goods and services inflation have diverged over the past year. Services inflation is the main culprit of "sticky" inflation while goods inflation is decelerating. Services inflation includes airlines, hotels, restaurants, movies, concerts, etc. Anyone that goes out for dinner at a mid-priced restaurant knows you can rarely get away with less than a $40 per person dinner tab. Services businesses were understaffed for a long time and had to raise wages to attract workers. For example, several airlines have recently negotiated contracts with pilot unions that included wage increases of over 30%. Even quick serve restaurants like McDonald's usually must offer above minimum wage for entry level jobs.

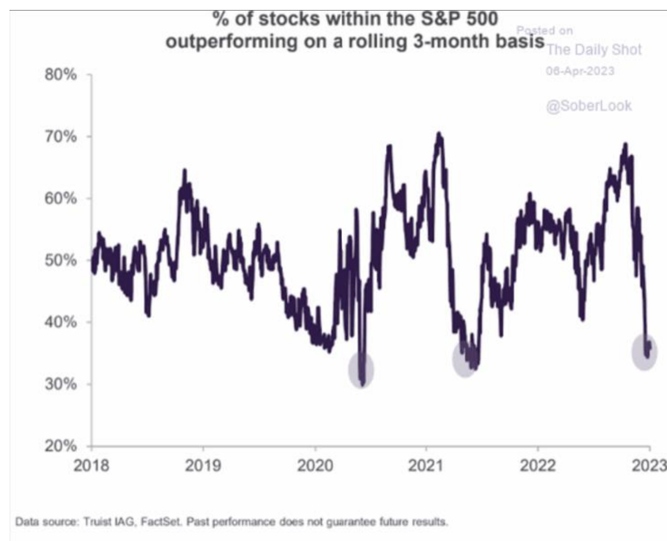


The Fed's rapid increase in interest rates over the past year and higher interest rate environment is starting to have a negative impact on U.S. economic activity. The next chart shows the ISM Manufacturing Index going back to the start of 2020. The 0 level represents a reading of 50 on the ISM index, the demarcation line between manufacturing growth and contraction. The shaded section on the far left is when the C-19 pandemic hit and shows what a large negative impact that event had on the U.S. manufacturing sector. Once C-19 lockdowns ended and monetary and fiscal stimulus flowed, U.S. manufacturing took off like a rocket and the ISM Manufacturing Index peaked near 63 in March 2021. However, the last five monthly ISM Manufacturing readings have been below 50 or in contraction territory with the March 2023 ISM reading of 46.3 the weakest since early 2020.



The recent banking crisis caused major dislocations in the stock market during the first quarter. The financial services sector and banks in particular got hit hard as investors made of flight to safety pivot towards safer investments like Treasury bonds and money markets. One sector that disproportionately benefited from the banking crisis was the technology sector. The first quarter saw a significant return spread with tech stocks massively outperforming as reflected in the Nasdaq Index return of +20.5% compared to the regional banking sector return of -24.7%. According to Citigroup research, just 7 stocks were responsible for 92% of the +7.5% return of the S&P 500 Index during the first quarter. The magnitude of this market dislocation is reflected in the next chart, which shows the price/earnings (PE) multiple of the technology sector versus the S&P 500 Index. As of 3/31/23, the technology sector PE multiple was trading at a 37% premium to the broad market compared to its trailing five year average PE premium of 18% (blue line). This massive rotation into tech stocks also reflects a flight to safety trade, as investors worried about financial stocks and the U.S. economy believe tech stocks will weather a potential recession better. Future return prospects from large cap U.S. stocks and especially index funds are likely to be limited given that the tech sector represents nearly 27% of the S&P 500 Index and the largest tech stocks in the S&P 500 Index are trading at rich valuation levels. Better return opportunities are likely to come from other areas of global stock markets.

Despite a surprisingly strong +7.5% return during the first quarter, under the surface, the broad U.S. stock market is not that healthy. The next chart shows only 35% of stocks are outperforming the S&P 500 Index on a rolling three month basis, indicating fewer stocks are carrying the market higher.



The setup for the Nasdaq Index is similar to the S&P 500 Index as very few stocks contributed to its outsized +20.5% return during the first quarter. The next chart shows the Nasdaq Index in the dark blue line while the red line represents the Nasdaq New Highs Minus New Lows Index. A declining red line means fewer stocks are hitting new highs and more stocks are hitting new lows. Even though the Nasdaq Index rose substantially and had a huge gain during the first quarter, the gain was very concentrated. Eventually this situation will be resolved by either 1) the largest tech stocks stop outperforming while the rest of the stock market catches up or 2) the largest tech stocks will decline and catch down to the rest of the market. It should also be noted that despite the over 20% return during the first quarter, the Nasdaq Index remains well below its all-time high hit in early 2022. Without more stocks participating, the broad U.S. stock market has limited upside ahead because the largest stocks have already significantly outperformed in recent months.

Summary

The latest banking crisis puts another marker in the negative column for the U.S. economy. Banks will tighten lending standards further, making credit less available, which will lead to slower economic growth or possibly a recession. As the economy slows, layoffs will increase, and then the U.S. consumer is likely to become more cautious on spending. Despite the solid first quarter returns for both stocks and bonds, uncertainty levels are increasing and it is prudent to hunker down, stay more defensive, and wait out the storm. Since low risk money market funds are paying nearly 5% annualized yields, investors are getting paid to be patient and wait for a better risk/return setup. Financial markets don't always go up, especially during times of elevated inflation, slowing economic growth, and while the Fed is raising interest rates. Savvy investors know that losing less is a positive outcome during challenging times. It is a valuable investment lesson, one that you can take to the bank, even if you don't want to deposit more cash there.

Mark J. Majka, CFA
Chief Investment Officer

April 10, 2023

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