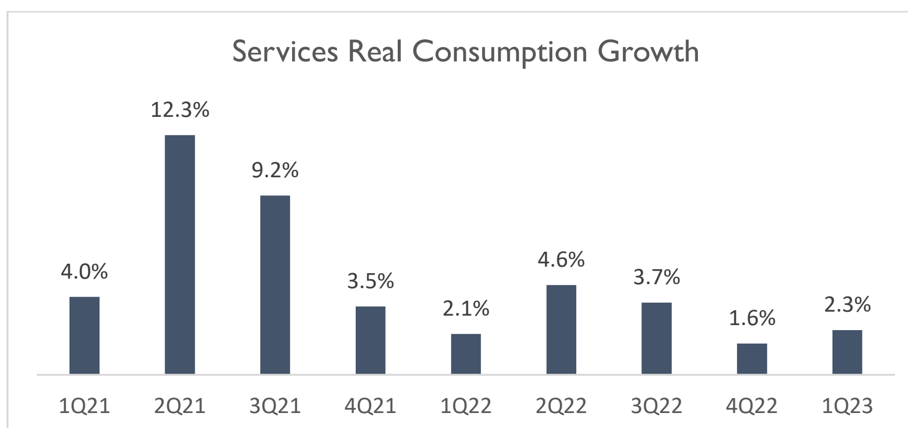
Monthly Market Review & Outlook
5/12/2023

It's So Hard to Be Patient

On our last Monthly Strategy webinar, we acknowledged investor frustration as the markets muddle through this awkward part of the economic cycle. With the S&P 500 Index still 14% off its peak and the Nasdaq Composite 23% below its all-time high, investors are ready for the next cycle to begin. And yet it has not. The most forecasted recession of all time has stubbornly failed to arrive even after extraordinary inflation and surging interest rates. Meanwhile the equity markets have rebounded this year thanks to six large technology stocks, which further blurs reality. With all these moving pieces it is easy for investors to become anxious. Recall our mantra for the year is to "Be Patient". As economic clouds build, we have taken steps to protect portfolios while cautiously taking certain calculated risks. (Replay link: Monthly Strategy Update - It's so Hard to "Be Patient" - YouTube)

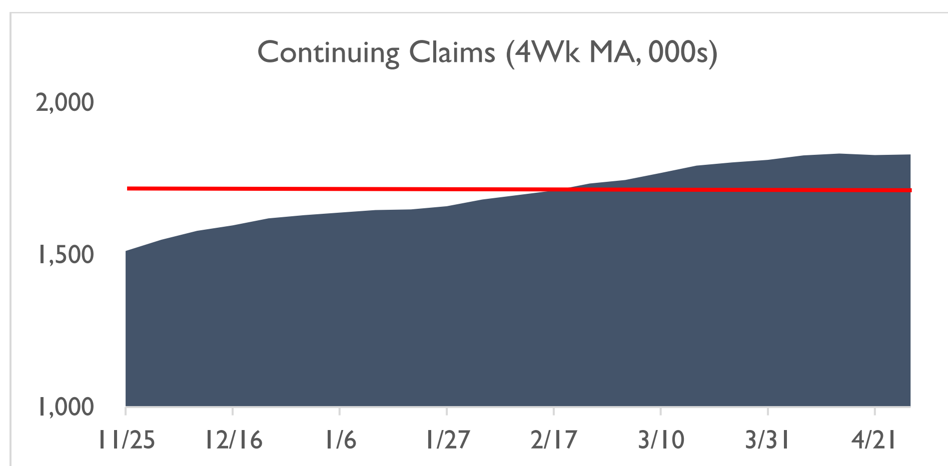
For over a year, we have offered an alternative view on the economy – one based on tangible evidence that various industries have experienced a rolling set of recessions. Housing, consumer goods, technology, energy, and now financial services have experienced economic headwinds driven by a confluence of lower demand, high inflation, and higher interest rates. The remaining holdout is the Services sector, which accounts for approximately 78% of the economy and includes such sub-sectors as restaurants, travel, entertainment, healthcare, and business services[1]. While there is some weakness in specific Services, much of the economy is still growing at a decent clip.



Source: U.S. Census Bureau

[1] The World Bank national accounts data, 2021.

As the graph above shows, the Services part of the economy continues to grow albeit not as fast as the stimulus-induced 2021. Nevertheless, Services have broadly exhibited solid growth despite the substantial headwinds noted above. Supporting this growth has been a one of the strongest labor markets in the history of this country with an unemployment rate of 3.4% and a participation rate nearing 2019 record levels[2] that has enabled consumer spending to remain at historic highs[3]. Therefore, close monitoring of the labor market is required to determine the fate of Services. One metric we favor is a four-week moving average of weekly continuing insured unemployment claims which measures how many workers have become unemployed and are collecting benefits while looking for work. While we do not foresee an abrupt increase in continuing claims or unemployment for that matter, claims have steadily crept up from record low levels and are now slightly higher than the average claims during 2019. This data suggests that a Services recession is not on the immediate horizon.



Source: Bureau of Labor Statistics

Three Critical Questions

With the backdrop of a decelerating economy and an equity market that is uncomfortably propelled by just a handful of stocks counterbalanced by declining inflation and the prospect that the Fed is or nearly done hiking interest rates, we are focused on three critical questions.

1. ***Has the Fed raised interest rates to levels that will cause a broader, deeper recession?***

   The short answer is nobody knows but note that the Fed controls the overnight rate and the market controls interest rates further out the curve. For instance, since October the Fed has raised the overnight rate from 3.25% to 5% while the US 5Yr Treasury bond yield has fallen from 4.44% to 3.34%. Why is this important? Because the 5Yr yield is an approximation for the rate for many loans that drive our economy (e.g., auto loans, mortgages, and other products). Nevertheless, those financing rates are appreciably higher than those just 18 months ago. We have witnessed the negative impact this

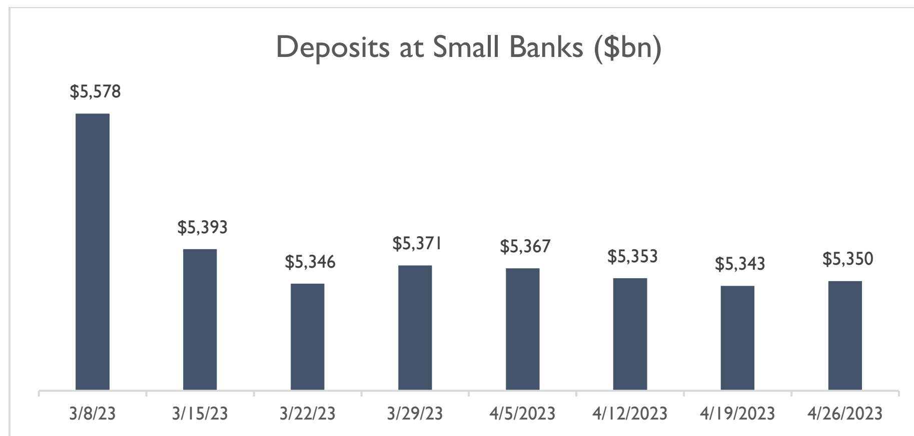
[2] Bureau of Labor Statistics
[3] Bureau of Economic Analysis

increase has had on housing but the extent to which Services will be impacted is unknown at this time.

2. ***Will the banking turmoil tighten lending conditions to a level that impacts economic growth in a material way?***

This concern is warranted but a bit overblown. The theory goes that banks will decrease their lending as deposits leave for higher yielding opportunities in money market funds and will also tighten their lending standards as economic concerns mount.

Deposits leaving banks to seek higher yields elsewhere occurs every interest rate tightening cycle. This is so well known that industry participants refer to the rate of these periods of exodus as "deposit beta". Deposits are critical in providing the funding (i.e., cash) necessary for Small banks to make loans. Hence, high deposit outflows can disrupt a bank's ability to lend. But as shown below, according to Federal Reserve's H.8 report, Small bank deposits have found a new equilibrium after the big outflow post Silicon Valley and Signature Banks' demise during the week ended 3/15/23[4]. This stability is a function of banks increasing the interest rate they are willing to pay for deposits, which does not bode well for their net interest margins but does minimize concerns about their ability to lend.



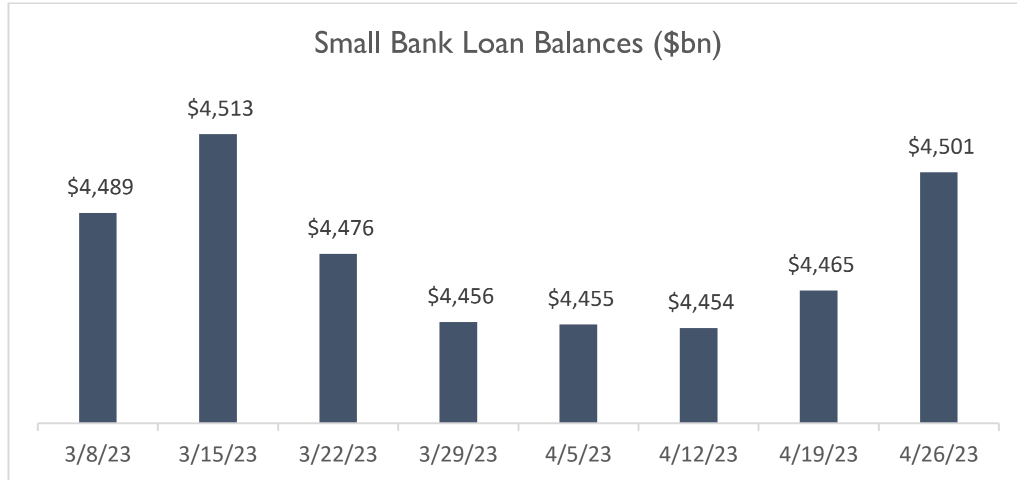
Source: Federal Reserve H.8

The Federal Reserve recently released its Fed Loan Officer Survey[5], which assesses bank lending activity. The survey results showed that indeed banks are slightly tightening their lending standards. The most acute tightening is not surprisingly in commercial real estate where the prospect of high vacancies in office buildings could lead to increased defaults, but this is a small percentage of most banks' loan portfolios. More interesting is the survey showed a significant decline in loan demand last quarter. Commercial & Industrial borrowers declined ~25 percentage points in Q1 versus Q4 last year. Commercial Real Estate loan demand shrunk to its lowest level since 1995. Consumer loans were less negative but still reflected a decline from the prior quarter. There could be several drivers of lower demand for loans with pricing leading the way but, importantly, supply of loans is not the issue.

[4] Federal Reserve, "Assets and Liabilities of Commercial Banks in the United States – H.8," May 5, 2023.

[5] Federal Reserve, "April 2023 Senior Loan Office Opinion Survey on Bank Lending Practices".

The combination of the state of deposit outflows and tighter lending standards are important data to watch. Small banks are much more likely to reduce lending should that time come as they do not have access to as many funding sources as Large banks and do not have the same level of business diversification. However, as shown below, recent Federal Reserve data suggests that Small bank loan balances have also stabilized and may even be growing. This could change but for now the data suggests that Small banks continue to be operating normally.



Source: Federal Reserve H.8 report

3. ***Will the Federal Government's debt limit be "peacefully" resolved?***

We believe the debt limit will be increased but we expect the process to be highly political replete with a full measure of grandstanding and hyperbole on both sides of the aisle. But Democrats and Republicans will eventually – at the last minute – reach a compromise deal out of necessity. The governing constraint is that any debt limit bill will require sixty votes in the Senate. From what we understand about this process, staffers have been trying to find a zone of agreement. The last rumor we have heard is that the debt limit bill will include $300-500 billion of spending cuts.

A favorable outcome relies on the belief that the Federal Government cannot default on its debts. There is even a Constitutional Amendment (#14) to that effect. Putting aside the extraordinary market volatility a default would create, under no circumstances given constant budget deficits and legislated spending still in the pipeline can the country afford any interference accessing the debt markets.

While we expect a solution and no "capital D" default, given how vast the distance is between the House Republican proposal and the White House's demand for a clean debt limit increase we expect higher market volatility until a resolution is achieved. Treasury Secretary Janet Yellen has indicated that the government runs out of money on June 1st, which means there is little time left to reach a deal. The next two weeks could be bumpy.

Market Outlook

We have discussed at length previously that the S&P 500's current forward price-earnings ratio (>18x) is elevated relative to its historical trading range and that the forward earnings estimates have only slightly declined thereby presenting additional downward risk. However, we have also noted that much of this dynamic is driven by just six large technology stocks. In fact, we are finding more stocks offering exceptional value. Considering the potential volatility that could emerge during the debt limit negotiations, we continue to prefer a conservative stance for now. That positioning feels appropriate as we can capture attractive yields on our fixed income positions while we patiently wait.

Conclusion

To conclude, it is important to reiterate our theme for 2023: "Be Patient". We know that is difficult, particularly when investors are anxious to grow their portfolios but that is the environment we are in. From a positive perspective, we are finding attractive opportunities in specific stocks that translates into a growing list of names that we will deploy when the environment starts rewarding risk-taking. And we may not be far from that day. Getting past the debt limit is the next big catalyst after which we expect market sentiment to improve.

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Definitions

The **S&P 500 Index** consists of 500 stocks chosen for market size, liquidity, and industry group representation. It is a market-value weighted index (stock price times number of shares outstanding), with each stock's weight in the Index proportionate to its market value.

The **Nasdaq Composite Index** is a market cap-weighted index, representing the value of all stocks listed on the Nasdaq Stock Market. The composition of the Nasdaq Composite is a mix of long-established companies that have been on the exchange since inception, to IPO newcomers, companies that grew from OTC exchanges or switched from other exchanges.

The **Dow Jones Industrial Average** is a price-weighted average of 30 blue-chip stocks that are generally the leaders in their industry. It has been a widely followed indicator of the stock market since October 1, 1928.

U.S. Treasury securities are guaranteed as to the timely payment of principal and interest if held to maturity. Investment options are neither issued nor guaranteed by the U.S. government.

The **Bloomberg Aggregate Bond Index** represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities.

The **Bloomberg U.S. Investment Grade Corporate Bond Index** covers U.S. dollar denominated, investment-grade, fixed ratee or step up, taxable securities sold by industrial, utility and financial issuers. It includes publicly issued U.S. corporate and foreign debentures and secured notes that meet specified maturity, liquidity and quality requirements. Securities included in the index must have at lease 1 year until final maturity and be rated investment-grade (Baa3/BBB-/BBB+) or better using the middle rating of Moody's, S&P, and Fitch.

The **Bloomberg US High Yield Index** covers the USD-denominated, non-investment grade, fixed-rate, taxable corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below. A small number of unrated bonds are included in the index. The index excludes emerging markets debt.

The **Bloomberg Commodity Index** is comprised of futures contracts and is designed to be a highly liquid and diversified benchmark for commodities as an asset class.

The **Bloomberg U.S. Mortgage-Backed Securities Index** tracks fixed-rate agency mortgage-backed pass-through securities guaranteed by Ginnie Mae, Fannie Mae and Freddie Mac.