Review & Outlook

First Quarter 2023

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Review and In Focus

The first four weeks of 2023 started out strong for the markets. There was a general view that inflation was likely to recede, and that the Fed would be able to throttle back raising interest rates. There was an increasing view that inflation could be tamed without driving the economy into a recession, the successful "soft landing" scenario. At the beginning of February, the broad market measured by the CRSP Index was up over 10%; and the S&P Tech sector was up about 15%, as was S&P small cap (measured by the Vanguard small-cap ETF – Ticker: VB).

Index Performance Data
Total Return as of 3/31/2023

Indices[1]	Q1 2023	Trailing 12 Months
CRSP U.S. Total Stock Market Index	7.15%	-8.77%
iShares MSCI Global ex-U.S. Total Stock Market Index	7.31%	-12.00%
Bloomberg Barclays U.S. Aggregate Bond Index	2.96%	-4.78%

By the middle of February, new data was showing that inflation was not coming down as quickly as many had hoped, while the economy continued to roll along with positive GDP growth, low unemployment numbers, a rising labor force participation rate, and increasing wages. All of this translated to a view that the Fed would have to continue raising rates above 5%, with speculation that another 0.5% hike might be necessary. The Fed backed this sentiment with supporting public statements. By the beginning of March, most sectors were well off early month highs, and overall, down for the month.

In early March, Silicon Valley Bank (SVB) collapsed after large holdings of long-term bonds, much of it secure such as treasury bonds, created massive realized losses when depositors withdrew their money. The uncertainty flowing from that collapse negatively affected most sectors, particularly the financial sector.

With the SVC collapse, the Fed rate raise of 0.5% was viewed as less likely, with some calling for no raise or even a rate reduction. In the end, the Fed raised rates 0.25%, as they believed that not raising rates would send a signal that bank liquidity issues were far greater than publicly known.

Looking forward, the consensus is that the S&P 500 Index continues to be overvalued relative to historical valuations in economic downturns, and that we are facing a recession in the latter part of 2023, possibly continuing into early 2024. Currently, the general view is that a recession would be mild, with a return to growth in the middle or latter part of 2024. Regardless, if valuation multiples contract, stock prices are likely to drop. In particular, there is concern that corporate earnings are going to be challenging in the coming quarters, and analysts have not yet incorporated this into forward earnings estimates.

So, there are two worries here in the traditional price to earnings ratio: (a) price relative to earnings is historically high and may move lower; and (b) earnings may disappoint going forward. Both put pressure on the expectations of future stock prices.

We like to keep watch for other advance indicators that support or contradict our current market view. For example, the price of oil may be telling of future global economic growth, and is worth keeping an eye on. In recent months, the view of broad declining global economic growth has outweighed the positive oil demand from China exiting its zero-COVID policy. Oil, measured by the West Texas Intermediate (WTI) price, was $67 a barrel in March; it has not been this low since November 2021. The $67 price also reflects a nine-month downtrend since oil prices were at $120 a barrel in June 2022, coinciding with peak inflation concerns. Oil has moved up significantly in the past few weeks and is now above $80, but is still well off the June 2022 highs. The OPEC+ countries just announced that they are cutting back oil production with a target price forecast of $95. If oil prices stop their short term rise and revert to the downward trend seen since June 2022, it may be a strong signal that there could be a recession coming sooner rather than later.

You may have heard about banks failing at the beginning of March, Silicon Valley Bank in particular. SVB had deposit size grow dramatically over the past several years. Tens of billions of dollars were deposited by many small venture capital and start-up firms. SVB was offering relatively high interest rates for cash deposits, and managing this by investing deposited funds in long term, high grade, fixed income. According to a regulatory filing, over 85% of deposits were uninsured because they exceeded the FDIC insured deposit limit of $250,000.[2]

Over the past year, the market value of the long-dated bonds, even US Treasury bonds, dropped significantly as interest rates increased. This resulted in very large unrealized losses for SVB. However, this was hidden from the income statement because the bonds were recorded as “held to maturity,” which is allowable under GAAP accounting. If you hold the Treasury bonds to maturity, you would not record a loss, so this accounting exception can make sense. However, if for some reason the banks have to sell the bonds, they are forced into recording a realized loss, and this affects the bank’s balance sheet.

You may have heard about some stress in the tech sector over the past year, and this has certainly been observable in tech stock prices. At SVB, this was manifesting in net withdrawals over recent quarters. In order to cover the withdrawals, SVB was forced to sell bonds and actually record those losses. At which point a lot of people, including highly networked SVB depositors, noticed there was a problem and proceeded to move all their uninsured money elsewhere. The speed and magnitude of withdrawals smashed historical records; the negative feedback loop of a classic bank run in full force. $42 billion was withdrawn in one day. The Federal Reserve had no choice but to shore things up over a weekend, which is exactly what happened.

While the Fed seems to have navigated the SVB failure, and SVB appears to be relatively unique for a number of reasons, it put fully on the radar the issue of holding large unrealized losses in bond portfolios. The stock price of all banks were significantly lower, but many smaller and regional banks were especially hard hit with stock price declines.

While the SVB failure was one of the largest in American banking history, it is viewed as somewhat isolated. The largest banks actually benefitted somewhat, as billions of dollar deposits were moved from SVB. Broadly, banks, especially the largest banks, are far better capitalized than they were in 2008.

The practical effect going forward is expected tightening in the credit market, making it more expensive for companies to borrow. This should have a downward effect on the economy, like the Fed raising interest rates. Hence the view that the Fed may back off raising as aggressively, even if inflation above the target two percent is persisting.

Interestingly, the one sector that has weathered this very well is mega-cap tech like Apple and Alphabet. This might be revealing that these companies are viewed as the best port in a storm, even if still at fairly lofty valuations.

We have had some clients ask if we think that Charles Schwab is somehow at risk, since the share price has come down dramatically since March 10th. It is possible that their earnings will be significantly reduced, as many of their clients are moving the cash in their accounts into money market mutual funds. We did exactly that in almost all of our client accounts. The move away from cash will reduce Schwab’s earnings, and likely reduce their liquidity somewhat, but in no way should it affect their solvency. Additionally, everything our clients have custodied at Schwab is required by law to be partitioned from Schwab’s other assets. So, if Schwab somehow were to have a solvency issue, they cannot use our clients’ assets to raise funds. To be clear, we do not see Schwab having any problems managing through this current banking dilemma.

1. Index performance data provided by ICE Data Services, and calculated by Black Diamond, an SS&C Advent company.
2. Chow, A. R. (2023, March 10). Most of Silicon Valley Bank's deposits were uninsured. Time. Retrieved March 12, 2023, from https://time.com/6262009/silicon-valley-bank-deposit-insurance/

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