April 2023

Dear Clients and Friends,

The economy is growing and keeps adding jobs, unemployment is low and inflation is coming down, so all good, right? From where we stand, we are not so sure. It would be easy to take the S&P500's 7% first quarter gain as the all-clear sign. However, after getting walloped last year, a bounce was fairly in character. Challenges for stocks almost certainly lie ahead.

First, investors now see CDs yielding 5% and treasuries paying around 4% versus the S&P500 yielding a paltry 1.6% and savings accounts a mere 0.37% (national average rate). In the past several years the argument for stocks was easy because of TINA ("there is no alternative"). This is most definitely not the case now and billions of dollars are flowing into treasuries and money market funds on a daily basis. Inflation is still high and if indeed the economy is going into a recession, stocks look expensive and anything yielding over 4% looks very attractive.

All eyes were on the Fed… until they weren't!

Investors have been fixated on the Federal Reserve's interest rate policy moves ever since the Fed embarked on their tightening regime of raising rates to rein in inflation. Frequently pundits would make snarky comments to the effect of: "they're going to break something!" when speaking of the rapid escalation of interest rates the Fed has undertaken. Well, that time finally arrived in March when the US experienced its second largest bank failure of modern times. The Federal Deposit Insurance Corp (FDIC) was forced to take over both Silicon Valley Bank and Signature Bank (NY). These failures were largely due to these banks unexpectedly having to recognize losses on significant reserve holdings tied up in 10yr US treasury bonds. These bonds were purchased when interest rates were very low. The subsequent sharp interest rate hike by the Fed has put the value of these bonds well under water. When depositors learned of these losses, an old-fashioned bank run ensued accelerated by the new-tech ability to move money at the tap of a key on your phone.

Regional Banks in Trouble

The loss of value of these types of bond holdings, though far worse at Silicon Valley Bank, is an industry-wide problem and just one of the challenges banks currently face. Possibly more troublesome, regional banks hold and originate the lion's share of commercial real estate mortgages. Defaults are rising in this area while commercial property values are falling, the result of a wave of remote workers not returning to the office and our increasingly online approach to every activity. While the FDIC has taken the position that they will step in to guarantee deposits, this will not prevent the pain these institutions are going to face. Dozens of banks could close or be acquired by larger competitors within the next few years, if the losses occur en masse.

Commercial Real Estate

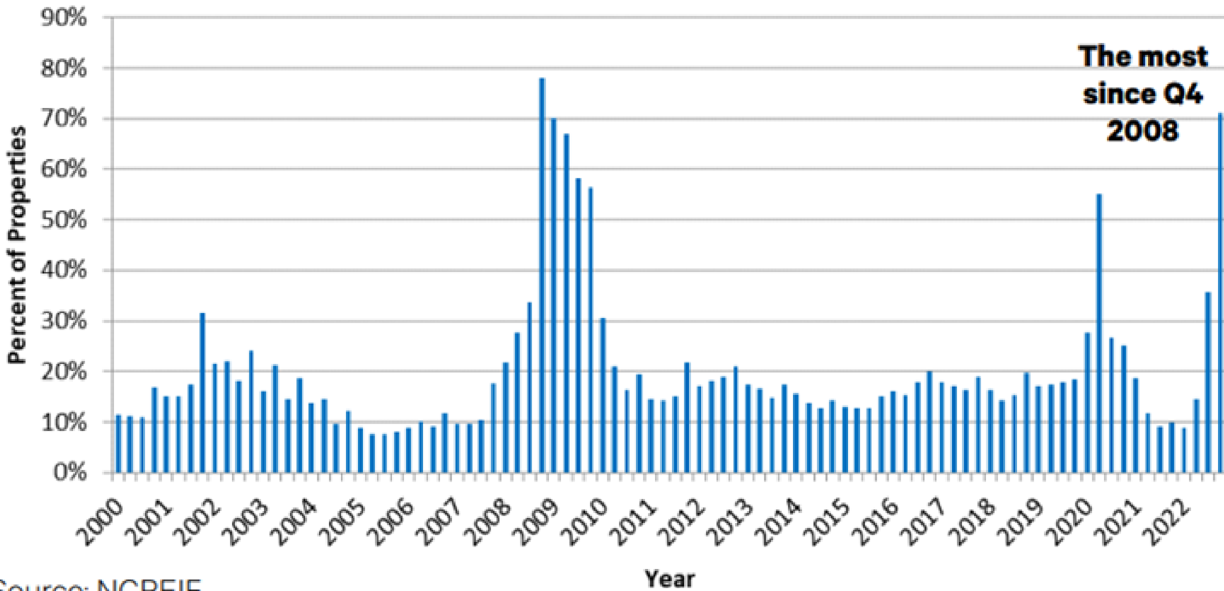
Defining the problems in commercial real estate: office vacancy rates are shooting up while property owners are being forced to refinance maturing commercial mortgages at the highest interest rates in 15 years.

Per Morgan Stanley:

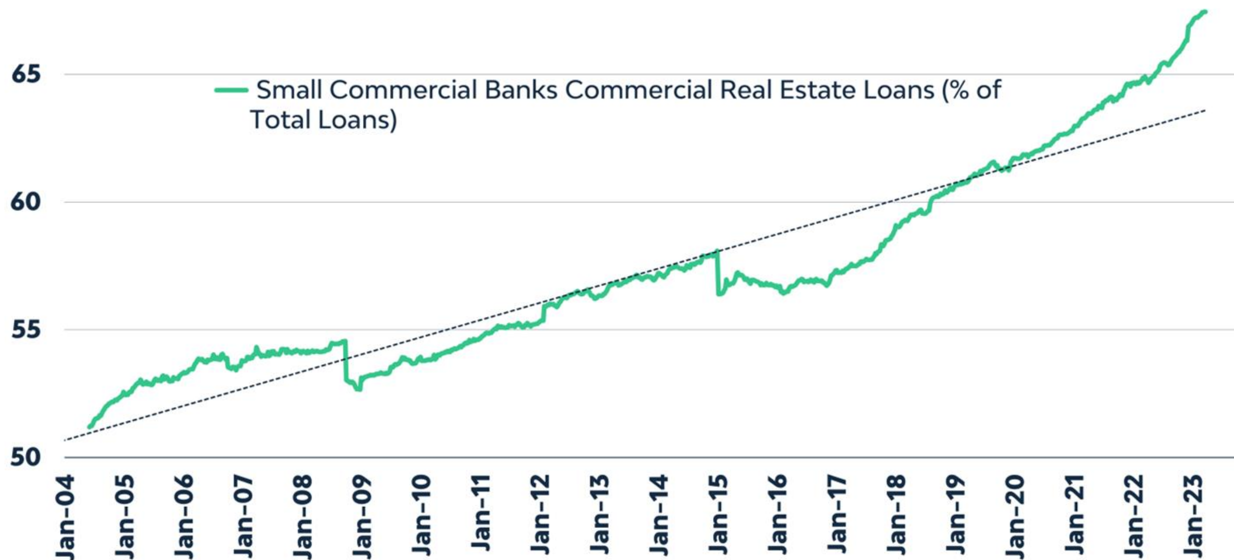
> "More than 50% of the $2.9 trillion in commercial mortgages will need to be renegotiated in the next 24 months when new lending rates are likely to be up by 350 to 450 basis points"

The challenge is not only the higher rates, but the fact that a significant portion of commercial office space is vacant – nearly 1/5th of all units (see following graph). To make matters worse, regional banks are the current lenders for about 70% of the commercial mortgage market, lenders who are in the process of tightening their lending standards. The refinancing of these commercial mortgages will be far more expensive at best, and perhaps unobtainable at worst as banks become more cautious in their lending.

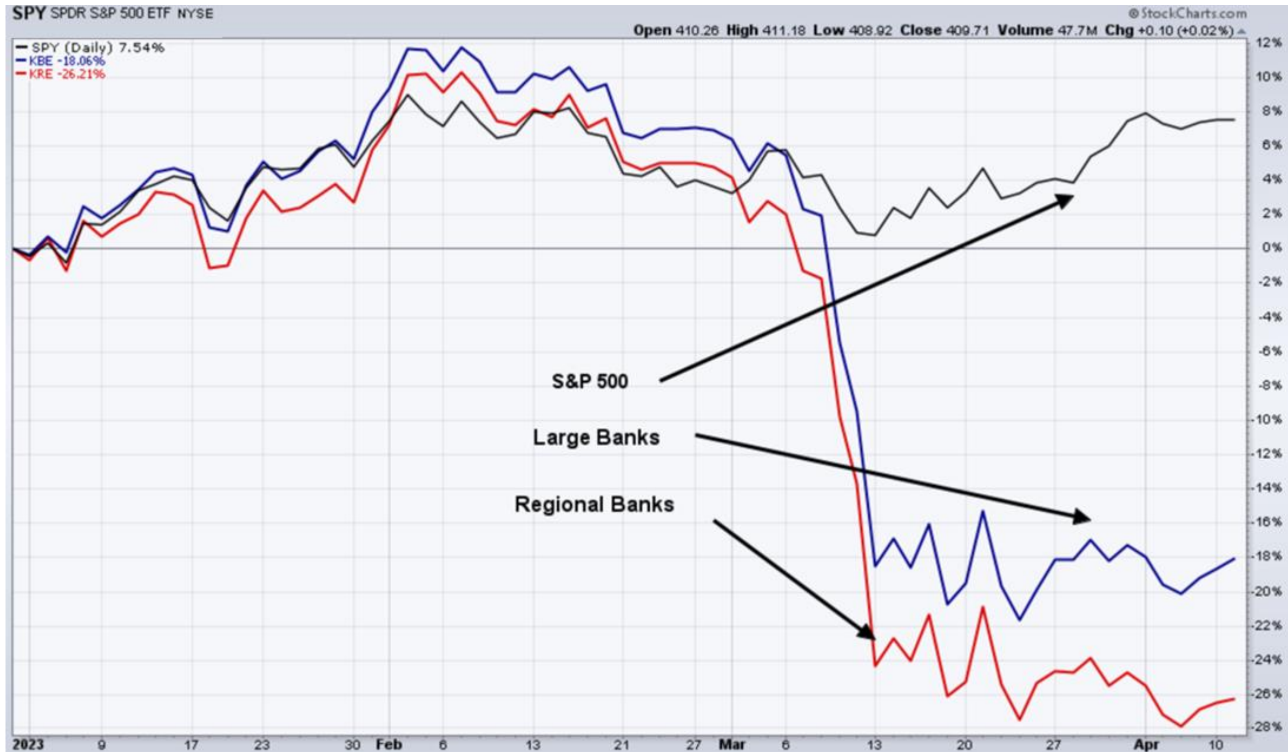
Finally, commercial property values are currently being written down at a pace not seen since the Great Financial Crisis of 2008-2009 (see below).



Distress on this scale, Morgan Stanley says, will hurt landlords and the bankers who lend to them, trickling down to business communities, private capital funders, and owners of underlying securities. The tech and consumer discretionary sectors also won't be immune.



The pain is readily apparent when looking at the stock prices of regional banks which were down over 25% in 1Q23 while shares of larger banks fell 18% over the same period. As Morgan Stanley points out, it seems highly unlikely that this pain in the commercial real estate and banking sectors will not infect the rest of the market.



Recession Watch

At this point there are so many indicators flashing recession. Here are just a few of the indicators currently flashing warnings:

- declining Institute of Supply Management's Purchasing Managers Index (March 2023 was the lowest reading since May 2020)
- a 16% year-over-year decline in earnings per share for global companies for 1Q23
- a massively inverted treasury yield curve for 3mo/10yr and 2yr/10yr durations
- falling global residential and commercial real estate values
- tightening credit and declines in bank lending
- collapsing demand for temporary workers (the precursor to layoffs of full-time workers)

Any one of these on their own could be dismissed as an artifact of the most massive global stimulus program of the post-WWII era. But the likelihood that all these indicators and others are giving us a false signal is very low. Few market watchers now believe a recession will be avoided.

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Corporate Earnings

The question now is to what extent banks will suffer further troubles, and how deep a recession will be. Corporate earnings are already in recessionary mode overall with estimates accelerating to the downside.

S&P 500 EPS growth expectations

Date	1Q23E EPS Growth	2Q23E EPS Growth	3Q23E EPS Growth	4Q23E EPS Growth
10/1/2022	2.50%	0.61%	-	-
11/1/2022	-1.31%	-2.26%	-	-
12/1/2022	-4.80%	-5.44%	2.21%	-
1/1/2023	-6.29%	-6.71%	0.70%	-
2/1/2023	-7.37%	-7.63%	-0.36%	6.20%
3/1/2023	-9.23%	-9.09%	-1.27%	2.80%
4/1/2023	-9.58%	-8.89%	-0.76%	2.99%
4/10/2023	**-110.12%**	**-9.08%**	**-1.06%**	**2.65%**

Source: The Earnings Scout

The first half of 2023 is already expected to be weak. The risk to stocks, then, is that outlooks for the second half are overly optimistic. Bearish investors are pointing to further banking sector woes as a catalyst for a deeper recession. The question will be, as always, how much has been priced in? Recall that the NASDAQ 100 already lost 32% last year. While the Fed may not be cutting interest rates yet, everyone agrees that the end of rate hikes is nearly upon us. Earnings conference calls and the tone of executives' prognostications for the rest of the year are likely to guide where stocks go from here.

The sharp volatility of the first quarter has been very challenging for investors. The good news is that bonds have rebounded somewhat from their terrible 2022 performance. Stocks have been all over the place, depending on which sector you look at, with strength among the market's largest stocks offsetting widespread weakness elsewhere. There is tremendous uncertainty ahead and we continue to believe strongly that a nimble strategy is the key to avoiding upcoming potholes.

To future profits,

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