Perspectives On Regional Banking Turmoil

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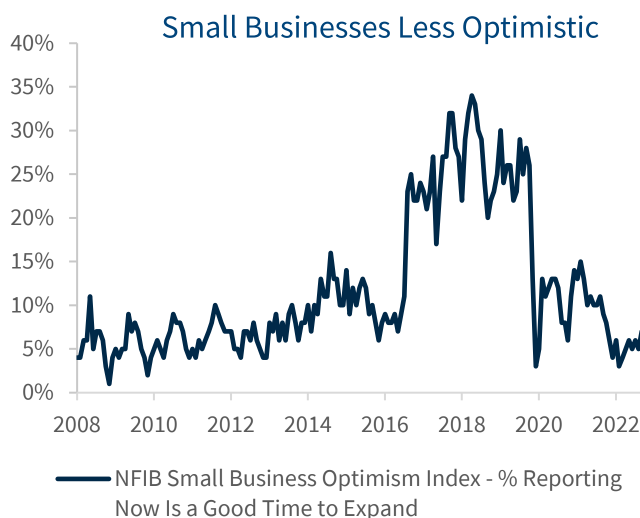
Larry Adam, CFA, CIMA®, CFP®, Chief Investment Officer

In our previous two *Thoughts on the Market* (March 13 and March 20), we pledged to keep investors updated on the events surrounding the unfolding banking sector turmoil. Over the past two weeks, the regional banking turmoil has reemerged as First Republic Bank failed and was ultimately sold to JP Morgan, shares of other smaller regional banks like PacWest and Western Alliance fell demonstrably, and the merger between TD Bank and First Horizon was surprisingly scuttled. While the S&P 500 has been largely flat over this time period, the KBW Regional Banking Index has plummeted, and is now down 61% year-to-date and sits at a three-year low. Volatility in the regional banking sector is likely to continue into the near future. While headlines of bank failures are unsettling for investors, this *Thoughts on the Market* is designed to put the recent bout of headlines and volatility in the banking sector into perspective and provide our views on what it means for the economy and asset classes.

Economy—Not On The Edge Quite Yet

A healthy banking system is important to the growth of the economy, and, fortunately, the recent turmoil has not yet reached a level that would cause us to significantly change our economic forecasts. Tighter lending standards by the Federal Reserve (Fed) were expected to cool the economy and take the edge off inflationary pressures—which it has. But the recent turmoil in regional banks, caused primarily by poor strategy and risk management, will likely have a bigger impact on business lending than on the consumer.

- **Impact On Lending |** As a result of the Fed tightening cycle—ten consecutive meetings of increasing the Fed funds rate—and rising borrowing costs from credit cards to auto loans, lending standards had already been tightening leading into this recent banking turmoil. In fact, at the end of the first quarter, it was noted that a net 45% of banks had reported tightening lending standards, up from -15% (suggesting easing lending standards) just one year ago. Next Monday (May 8), updated figures from the Fed's Senior Loan Officer Survey for 1Q will be released and likely show the trend of further tightening in lending standards. In particular, small/medium sized banks have likely tightened their lending standards which in turn will weigh on both small business borrowing and investment going forward.
- **Small Businesses Hit |** Relative to larger businesses, small businesses rely heavily on regional and smaller banks rather than larger banks (>$250 bn in assets) for financing. As a result, the regional banking turmoil will disproportionally hamper smaller businesses. It is not surprising that the net respondents in the NFIB Small Business Optimism Index reported easier availability of loans declined to the lowest level (-9%) since 2012 and only 2% saw now as a good time to expand, the lowest level since the Great Financial Crisis. As small businesses make up ~48% of total employment and generate ~44% of total economic activity, a slowdown in small businesses will be a headwind for economic growth going forward.



Source: FactSet, as of 5/4/2023.

- **The Consumer Remains in the Driver's Seat |** While tightening lending standards and a potential slowdown in small business activity potentially pose headwinds for economic growth going forward, we do not want to overestimate its impact. Why? Because consumer spending makes up ~70% of GDP and is generally the main driver of the trajectory of the economy. Until a significant slowdown in the labor market occurs, which has not yet occurred (evidenced by the US economy adding 253k jobs in April), healthy consumer spending will likely buoy any weakness in business investment. Highlighting the strength of the consumer, this week's April motor vehicle sales rose to the highest level since May 2021.

Fixed Income—Downward Pressure On Yields

The ongoing tremors in the banking sector have led to sharp swings in Treasury yields, with the 2-year Treasury moving more than 20 basis points (bps) in a day, mostly to the downside, on nine separate occasions over the last 60 days. Moves of this magnitude are exceptionally rare. The last time the market was so volatile was in the 1980s.

Market turmoil, whatever shape it takes, has always been met with a policy response. And while the Fed and regulators have stepped in to shore up confidence and provide liquidity to banks during this recent turmoil, the markets remain concerned there may be more shoes to drop. With uncertainty increasing, there is a disconnect between the market's view and Fed rhetoric regarding the future path of interest rates

The Bond Market's View | The bond market is looking ahead, expecting credit conditions to tighten further and for the economy to react to the lagged effects of the recent substantial tightening. As a result, the market is anticipating interest rate cuts, perhaps as early as July and nearly 200 bps of easing by June 2024. This has led to sharp declines in yields across the curve, with the 2-year Treasury down over 130 bps to 3.75% and the 10-year Treasury lower by nearly 65 bps to 3.34% since the banking turmoil began.

The Fed's View | During past periods of turmoil, the Fed has been quick to the rescue, cutting rates preemptively to mitigate the downward pressure on growth. However, with the current economic backdrop of still elevated inflation, the Fed does not have that luxury today. While Chairman Powell reiterated the Fed will remain data-dependent and "are prepared to do more," our view is that interest rates will be on hold the remainder of the year and that it would take a significant deterioration in economic conditions to see aggressive interest rate cuts. Powell also suggested that "conditions in [the banking] sector have broadly improved since early March, and the US banking system is sound and resilient" and that "the case of avoiding a recession is in my view more likely than that of having a recession." The Fed appears more optimistic about the banking sector and the economy.

Limited To No DC Stimulus | With the debt ceiling negotiations coming to a head, and House Republicans eyeing spending cuts in the upcoming budget, the scope for fiscal stimulus in the next downturn will be severely constrained. With limited fiscal and monetary policy stimulus in the offing, future economic growth will be challenged. This is what the bond market is reacting to, which explains the large gap between market expectations (e.g., the sharp decline in yields) and the Fed's rhetoric.

This tug-of-war between the markets and the Fed seems likely to persist. As we expect a mild recession to unfold in the second half of this year, we maintain our call for a 3.0% Treasury yield at year end and an up-in-quality bias, favoring investment grade and municipals over high-yield debt. A challenging economic backdrop and tighter lending standards could lead to a potential increase in lower-quality bond defaults that have not yet been priced into high-yield spreads.

Source: FactSet, as of 5/4/2023.

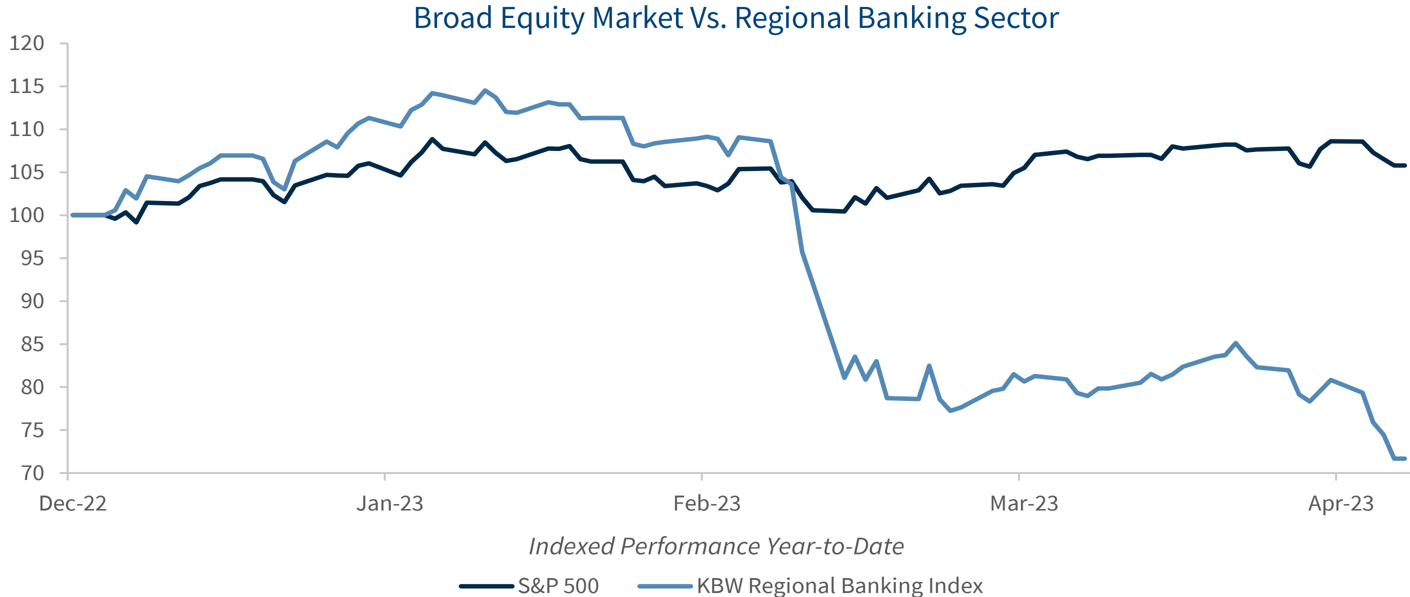
Equities—The Stock Market Is Not The Economy

We have said before that it is important to recognize that the economy and stock market can differ. As a result, while it is important to understand the dynamics driving the economy and financial conditions, it is more important to assess how they specifically impact the stock market. For example:

Influence On The S&P 500 Is Minimal | The banking turmoil has driven a significant number of headlines, but how much does the ongoing turmoil in regional banks impact the stock market? The direct impact of the regional banking turmoil should be minimal on the S&P 500 Index as the regional banking sub-industry is only ~0.30% of the Index as of May 3, 2023. As regional banks have declined in price they've become a smaller portion of the large-cap broad market indices and will contribute little to those returns going forward. Consolidation in the banking sector is now a tailwind for large-cap equity returns as larger banks are much more insulated to the near-term risks these regional banks face.

What Is Bad Could Be Good | The indirect influence on S&P 500 equity returns depends on the impact on GDP growth, earnings growth, inflation, interest rates, and the Fed's response. Our expectation is that the impact to large-cap equities will be neutral to slightly positive. The regional banking turmoil is a larger risk for GDP growth than the risk of a decline of earnings for large-cap companies. If growth were to decline, a potential reactionary Fed pivot (or a pause in its tightening cycle) to help protect the economy will have the secondary impact of supporting slightly higher valuations (particularly for some of the higher-weighting sectors such as Tech, Consumer Discretionary and Communication Services) and increased potential for earnings growth for large and mega-cap companies. The situation remains fluid and data dependent and we will continue to dissect the impact of the economy on earnings.

Market Cap Positioning | Regional banks are a much larger weight (~7.50%) of the Russell 2000 Index and should continue to be a major source of volatility and a direct drag on earnings growth in small-cap equities. Small caps are currently inexpensive by most metrics, but the increased uncertainty makes those valuations more justifiable in the near term. Any acquisitions in the small-cap regional banking sub-industry are likely to be under favorable terms for a large-cap acquirer. This development provides another reason to favor large-cap equities over small-cap equities.



Source: FactSet, as of 5/4/2023. (Index = 100)

Bottom Line

We do not have a crystal ball as to how long the regional banking turmoil will last, and the volatility and headlines from it will likely continue to be uncomfortable. However, as we outlined above, while there will be modest economic spillover effects, the woes of the banking sector will likely remain contained within the regional banking space. As a result, we do not believe that this turmoil will push the US into a severe recession (we expect a mild recession beginning in the third quarter of 2023 as a result of a weakening labor market) and reiterate our 4,400 year-end target for the S&P 500.

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INTERNATIONAL INVESTING | International investing involves additional risks such as currency fluctuations, differing financial accounting standards, and possible political and economic instability. These risks are greater in emerging markets.

OIL | Investing in oil involves special risks, including the potential adverse effects of state and federal regulation and may not be suitable for all investors.

The Consumer Price Index (CPI) | is a measure of inflation compiled by the US bureau of Labor Studies.

Personal Consumption Expenditure Price Index | The PCE is a measure of the prices that people living in the United States, or those buying on their behalf, pay for goods and services.

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FIXED INCOME DEFINITION
AGGREGATE BOND | Bloomberg US Agg Bond Total Return Index: The index is a measure of the investment grade, fixed-rate, taxable bond market of roughly 6,000 SEC-registered securities with intermediate maturities averaging approximately 10 years. The index includes bonds from the Treasury, Government-Related, Corporate, MBS, ABS, and CMBS sectors.

HIGH YIELD | Bloomberg US Corporate High Yield Total Return Index: The index measures the USD-denominated, high yield, fixed-rate 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.

S&P 500 | The S&P Total Return Index: The index is widely regarded as the best single gauge of large-cap U.S. equities. There is over USD 7.8 trillion benchmarked to the index, with index assets comprising approximately USD 2.2 trillion of this total. The index includes 500 leading companies and captures approximately 80% coverage of available market capitalization.

KBW REGIONAL BANKING INDEX | The KBW Regional Banking Index is a benchmark stock index for the regional banking sector representing small to medium U.S. national regional banks.

RUSSELL 2000 INDEX | The Russell 2000 Index is a small-cap U.S. stock market index that makes up the smallest 2,000 stocks in the Russell 3000 Index.

NFIB SMALL BUSINESS OPTIMISIM INDEX | A composite of ten seasonally adjusted components, providing an indication of the health of small businesses in the US.

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Source: FactSet, as of 5/4/2023

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