LaFleur & Godfrey
PRIVATE WEALTH MANAGEMENT

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Is an Economic Soft Landing in Jeopardy?

Economic Perspective:

The economic narrative has shifted quite dramatically in recent weeks. Coming into the year, our investment team had a more positive view than the Fed - and even many Wall Street economists. We had forecast strong, yet moderating, job growth. Inflation was 'rolling over'. Corporate profits were okay. Q1 GDP growth estimates were even over 3%! Then came the second largest bank collapse in U.S. history on March 10th. With the failure of Silicon Valley Bank (SVB), ripples spread throughout small, medium-sized and regional bank land as to who could be next? An estimated $500 billion of savings deposits fled smaller banks to the welcoming arms of too-big-to-fail, larger banks such as JP Morgan, Bank of America, etc. Many investors wondered: Is this another Global Financial Crisis (GFC) like we experienced in 2007/08? Our answer is *absolutely not*!

Yes, this time is different. Here's why! The main reason is because of the regulatory changes that were instituted as a result of the GFC. While many investors primarily focus on the Federal Reserve's interest rate policy, an often-overlooked responsibility of the Fed is its annual bank stress tests. Last year, and every year since 2011, 34 systemically important large banks were 'stress tested' under severely adverse economic scenarios. More specifically, under the 2022 stress test, the Fed evaluated each of the banks' capital positions for: 1.) an unemployment rate rise to 10%, 2.) a 40% decline in commercial real estate prices, 3.) a widening of corporate bond spreads, 4.) a collapse in asset prices, 5.) increased market volatility, 6.) a global market shock that stresses trading positions, and 7.) counterparty default risk. In essence, they tested the U.S. banking system for economic and financial Armageddon! The results, without getting into the nitty-gritty details (which are posted on www.federalreserve.gov), show a banking system with excess capital, below-average leverage and able to absorb large shocks. Quite the opposite when compared to the 2007/08 timeframe where banks were undercapitalized and overleveraged.

This is not to say that other banks won't fail. After all, over 550 banks in the U.S. have failed over the last 20 years. In fact, when looking at recent IMF data, the United States has over 4000 banks today. One could argue that we have too many banks! The next three highest banking countries are Russia (350 banks), the United Kingdom (300 banks) and Germany (about 250 banks). As savings deposits move from small / mid-sized / regional banks to the Top 25 (greater than $100 billion in assets), there will be ripples and even some unintended consequences. The most obvious is less access to credit for consumers, farmers and small / mid-sized businesses. After all, according to Northern Trust, over 90% of farm loans come from small / community banks & 65-70% of commercial real estate and construction loans from banks outside the Top 25. This, along with increased regulation, could slow our economy in the coming months and quarters. The Fed recently lowered its economic growth forecast for both 2023 and 2024 to 0.4% and 1.2%, respectively. The lagged effect of last year's interest rate hikes, along with this new bank 'shock', has us more cautious with our economic forecast over the near term.

Market Perspective:

Some of the financial market impacts due to the SVB collapse have been profound. Specifically, the volatility in the bond market has been unprecedented. The two-year U.S. Treasury note declined from a high near 5.10% to recent lows near 3.50% - in just a matter of weeks! Government bonds benefitted from their safe haven status and attracted significant flows from uninsured deposits at local banks. Bond yield volatility also reflects rapidly changing expectations for fed fund futures- which now predict another 25-basis point rate hike at the next Fed meeting followed by three 25 basis point *rate cuts* in 2023/24. Boy, how things have changed in just a matter of weeks!!

An anticipated slowing economy (without a sustained recession), a Fed on 'pause' and disinflation throughout the second half of the year can all be viewed as 'market friendly' data points. At the present time, 2023 earnings estimates for the S&P 500 Index are slightly above 2022 reported earnings. While a slowdown in our economy would negatively impact top-line sales, we believe a decline in operating costs could mitigate and help offset the impact. As a result, the investment committee expects corporate profit margins to stabilize and even increase as the year progresses. In fact, according to FactSet, the earnings estimate for 2024 is much higher and quite bullish. While 2023 earnings could finish the year in the low $220s, current 2024 earnings estimates predict low double-digit profit growth! We believe an earnings recovery would be very well received by market participants. It could also lead to significant cash on the sidelines being put back into the stock market. The consumer savings rate has been on an upward trend now for several months & money market fund assets recently topped $5.1 *trillion* dollars! Needless to say, that is a lot of 'dry powder' on the sidelines.

Looking Ahead:

The contrarian in us believes that recent bank issues could actually help Fed Chair Jay Powell in his efforts to bring down inflation. There has been much talk about stickiness in several categories of inflation. Specifically with respect to services inflation and wage inflation. We believe the net result of all this economic disruption could be a better balanced economy and jobs market. This is likely to push inflationary pressures lower than the market currently predicts. We know that economic slowdowns are not without pain. Therefore, we are taking more of a balanced, barbell approach to the structure of our equity portfolios. We have an appropriate blend of cyclicals (think technology, energy and industrials names) and defensives (think consumer staples and healthcare names) to weather almost any economic storm. The investment committee believes this is prudent given all the uncertainty.

Thankfully, investors are now well compensated to allocate a portion of their investment portfolios to cash and/or bonds. Money market funds and U.S Treasury bills currently pay interest above 4%. Whereas, high-quality corporate bonds, municipal bonds (on a tax-equivalent basis) and even floating rate notes can provide additional income on top of that. We oftentimes structure our fixed income portfolios similarly to our equity portfolios with a barbell approach. This combines the safety and liquidity of U.S. Treasuries on the short-end with high-quality credits / additional income over the intermediate-term / long-end. From a historical perspective, a fixed income allocation in client portfolios has provided a nice buffer and decreased portfolio volatility over time.

In the long run, we believe a normalization of higher interest rates isn't all bad & our clients can benefit from these market dislocations. With that said, we realize we have weathered well above-average volatility over the short run. History says these periods are typically followed by lower volatilty periods. Time will tell. However, you can be sure that the investment team is committed to helping you reach your individual goals. We are here to help. Patience is likely to be rewarded.

This document contains forward-looking statements, predictions, and forecasts ("forward-looking statements") concerning our beliefs and opinions in respect of the future. Forward-looking statements necessarily involve risks and uncertainties, and undue reliance should not be placed on them. There can be no assurance that forward-looking statements will prove to be accurate, and actual results and future events could differ materially from those anticipated in such statements.