Schroeder | Capital Management, LLC
Global Investment

Investment Review and Outlook – Spring 2023

The U.S. Economy – Growth is Slowing:

On April 27th, the Commerce Department reported economic growth struggled in the first quarter of 2023. Gross Domestic Product (GDP) rose at a weaker-than-expected 1.1% compared with 2.6% and 3.2% advances the previous two quarters. Inventory investment declined sharply along with contractions in equipment spending, residential investment and manufacturing. The latter has declined for five straight months, while residential has contracted for eight consecutive quarters.

Meanwhile consumer spending, 70% of GDP, accelerated 3.7% from the fourth quarter's 1.0%, led by an increase in durable goods spending, significantly aided by a large advance in motor vehicle sales. Consumer services outlays rose 2.3% led by health care spending.

The impact that higher borrowing costs are having on the U.S. economy is a concern in the months to come. The Federal Reserve's restrictive monetary policy and rapid rate increases could result in additional stress within the financial system, possibly extend to Corporate America and the consumer sector. Noteworthy is that consumer credit card balances have risen to record levels and 6 of the 7 largest monthly increases in revolving credit in the past 50 years have occurred during the last year. This could weigh on economic growth in the coming months if consumers pull back.

The good news for the Fed is that inflation is slowing. In March the Consumer Price Index (CPI) rose 5.0% on a 12-month basis, a full percentage point below February. Meanwhile, the core CPI, which excludes the volatile food and energy components, was essentially flat at 5.6% over the last 12 months, up only slightly from 5.5% in February.

There were also favorable aspects in the March employment report. In addition to a "Fed friendly" slowdown in the pace of monthly jobs creation, the average hourly wage figure rose just 0.3%, bringing the 12-month rate to 4.2%, the lowest since June 2021. The unemployment rate was little changed at 3.5%. The still-tight job market also suggests that the economy remains relatively healthy.

Corporate Earnings Developments – Mixed Results:

First-quarter 2023 earnings season is in focus and the results have been mixed, as anticipated. Wall Street analysts had expected an earnings decline of 6-7% for Q1 2023 from the previous quarter. With about 50% of the S&P 500 companies reporting, the actual decline was approximately 4%, counter to expectations. However, all signs point to the recent period being the second consecutive quarterly profit decline for the S&P 500 companies. In addition, nearly three-quarters of those reporting results offered a reduced profit outlook over the next few quarters. Materials, healthcare, information technology, and communication services are among the sectors with the largest predicted earnings declines. Overall, analysts are currently estimating a 3-4% drop in earnings for the full year 2023.

Despite the failure of Silicon Valley Bank and Signature Bank, most larger banks reported results that exceeded Wall Street analysts' expectations. As a whole, bank reports did not reveal notable additional stress in the financial system. However, they also warned that banking conditions could deteriorate if a protracted economic slowdown or recession developed.

Wall Street also is paying close attention to corporate profit margins. Many companies have been reducing staff and attempting to protect margins by raising prices, following weakening profit reports at the end of 2022. As inflation impacts operating profits, there is a growing concern that companies will be hard pressed to maintain margins that were bolstered by a series of price increases over the last 12 months. If companies get more pushback from consumers that are already showing signs of spending fatigue, profit margins and year-to-year earnings comparisons would be more difficult.

The U.S. Banking System – The Federal Reserve to the Rescue:

The banking industry has been under intense scrutiny emanating from the failures and closure of the Silicon Valley Bank on March 10, 2023 and then Signature Bank, two days later. In both cases, depositors attempted to withdraw large deposits while the banks had inadequate liquidity.

Silicon Valley Bank, headquartered in Santa Clara, CA and the 16th largest U.S bank, was shut down after its investment portfolio (largely situated in long-term U.S. Treasury securities) suffered significant losses as interest rates increased, creating a liquidity squeeze as its depositors made large withdrawal demands. Management failed to anticipate the effect of locking up depositors' assets in relatively low interest rate securities and had inadequate reserves to meet withdrawals.

The failure of Silicon Valley Bank led to the collapse of Signature Bank in New York, the 29th largest bank in the U.S. Depositors who had large amounts of uninsured deposits panicked after Silicon Valley failed. Signature had significant illiquid assets tied to cryptocurrency.

According to the Federal Deposit Insurance Corporation, the bank collapse was due to “poor management" as officers did not fully understand the risks associated with accepting crypto deposits. Signature Bank embraced the crypto industry just before the failure of FTX in 2022. By late 2022, nearly a quarter of its deposits were from crypto clients. Regulators feared further contagion in the banking sector and closed Signature Bank to avoid further panic.

There is a history of bank failures with more than 550 shut down between 2001 and the start of 2023. However, Silicon Valley Bank and Signature Bank were particularly important due to their size, high tech clientele and venture capital activities. The Silicon Valley Bank was the second-largest bank ever to fail in the U.S., behind Washington Mutual in 2008. Signature Bank was the third-largest bank failure.

In the aftermath of the collapse, federal regulators promised to make all depositors whole, even for those funds that weren’t protected by the Federal Deposit Insurance Corporation (FDIC). The Federal Reserve took steps following the collapse of SVB to improve confidence in the banking system and prevent future banking failures, including a new Bank Term Funding Program introduced on March 12, two days following the closure of Silicon Valley Bank. The program provides one-year loans, backed by U.S Treasuries or other assets, paying full price for the assets even if their market value is lower, to alleviate similar strains on banks and other institutions.

Federal Reserve and Interest Rates – What’s Next?

After putting in place the most restrictive monetary policies in four decades, the Federal Reserve’s policymakers are walking a tightrope in the battle to tame inflation. Despite some progress, inflation remains above the central bank’s 2% target rate, and it is unclear if that goal can be reached without risking a recession or systemic disruptions with additional rate hikes.

Higher interest rates have already led to a liquidity crunch within the banking system and adversely impacted some regional banks while raising concerns about the safety of some customer deposits. This has resulted in the government stepping in to protect some customer deposits in banks other than the now well-known, failed Silicon Valley Bank and the Signature Bank.

The current financial condition of other regional banks and the future health of the overall U.S. banking system, along with current readings of the economy and its outlook over the next several months, will weigh heavily on the Federal Reserve at their meeting next week. Whether interest rates continue to be increased, further constraining the U.S. economy, or if a different path of less restraint is chosen by the central bank is an important decision for the Fed.

Given this high level of uncertainty among bank customers and investors, a paramount concern is the impact that a continuation of the Federal Reserve's action of raising interest rates would have on the overall economy and how deep the current business slowdown might be. How the Federal Reserve plans to manage monetary policy in the near-term to avoid a hard landing recession later this year is the primary focus of Wall Street at the moment.

Investment Strategy – Market Volatility and Staying Defensive:

The recent gyrations of securities markets within both stock and fixed income market sectors that resulted from the regional bank news has caused additional concern on Wall Street. Elevated interest rates, persistent inflation and how future Federal Reserve action might further nudge the slowing economy into a recession had previously been the main focus. All of these factors have now conspired in creating a challenging investment backdrop for both stocks and fixed income securities markets.

As a result, we have redoubled our effort to continuously maintain a very sharp focus on the financial health and prospects of the individual securities within our client portfolio universe. Regarding new additions to our portfolios, those companies that have a track record of producing steady earnings and cash flows, especially during difficult economic times, while maintaining and increasing dividends, are especially favored.

During the current period of rising interest rates, companies that have below average debt levels are attractive investment choices. Their advantage, especially now, is that they are able to lessen the burden of refinancing maturing debt obligations at the higher current interest rates. Consumer staples, telecom and pharmaceutical companies fit in this category and have been included in client portfolios.

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