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By the Way

Monthly commentary from Jack Way

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"new ideas aren't the problem, it's getting rid of the old ones"

Despite lots of negative news in the first quarter, the S&P 500 finished 7% higher than at year end. Investors discounted, or chose to ignore, efforts by the FED to slow the economy, decreases in corporate earnings estimates, and even the second largest bank failure in U.S. history. However, when we take a deeper look inside the numbers the stock market is reverting to the pre-2022 dichotomy where the Index is being driven by a few mega cap tech stocks (the top five make up 23% of the S&P 500). Big-cap tech was up 31% in the first quarter, while the rest of the Index rose only 2%, and the Financial Sector declined 6%. If we were to give each stock in the 500 an equal weighting, the Index actually declined 2.6% since December 31st.

Those of us who espoused the view that the leaders of the last bull market wouldn't be leaders again have been proven totally wrong; at least for one quarter. In addition, every sector that outperformed in 2022 has underperformed so far this year; (real estate is the exception, it lagged in both periods). We have reached the one-year anniversary of the first FED rate increase and the market is down about 10%, which is not the norm historically as stocks usually continue to rise after the initial increase. We have previously mentioned that stocks also keep declining after the first rate cut. Given the first pattern has proven false, I think we should probably ignore the second. Many of these tried and true lessons don't seem to apply anymore. John Maynard Keynes once said that new ideas aren't the problem, it's getting rid of the old ones. We have been in an S&P 500 trading range between 3800 and 4200 for some time now, and a breakout in either direction will likely prove meaningful. This is a good time to evaluate your personal capacity for exposure to risk (it always is of course). To again quote Marty Zweig; "If you can't sleep at night, reduce your positions" and for me 4% - 5% returns in money market funds can be an effective sedative.

The failure of Silicon Valley Bank (SVB) is worth taking time to investigate. Most bank failures have come as a result of weak economies and bad loans. This event was a result of a rapid rise in interest rates. Over the years, I have discovered one concept that seems to routinely confuse people not involved in financial markets is the fact that the increase in the yield of fixed income assets leads to a decrease in the price of those assets. It is however logical that if you are holding a bond that yields 1% and the purchaser expects to earn 5% you will be required to sell at a lower price. In the SVB case, Peter Thiel (a respected venture capitalist) for reasons not entirely clear, advised companies under his guidance to take their deposits out of SVB. In today's social media world, word spread quickly and SVB was forced to sell assets at a loss (as described above) as deposits were withdrawn. These were not bad assets, in large part they were Treasury Bills, the so-called "risk free" asset. However, as someone reminded me, T-bills are free of default risk, but not price risk. One analyst pointed out deposits have long been taken for granted. That is definitely no longer the case as investors are looking under every rock for the next potential SVB. Deposits continue to drain away from particularly the regional and smaller banks and into money market funds that offer higher yields and at least perceived improvement in safety. This is not to suggest the risk that bad loans won't become an issue as the economy weakens, especially in the commercial real estate sector where prices are falling in dramatic fashion.

The question now becomes what will be the length and breadth of the banking crisis and its impact on a economy already under pressure from the tightening policies of the FED. We are seeing more signs that those policies are achieving the Board's desired results, as momentum is finally coming out of what has been a surprisingly robust U.S. economy so far this year. Purchasing Managers Indices, (a favorite leading indicator of ours) have

fallen into contraction territory. Even labour statistics, that have proven until now to be very positive, are showing some cracks with recent reports showing weakness in U.S. job openings and initial jobless claims. Capital spending intentions are also dropping as corporations worry about the slowing economy and a potential credit crunch. The FED surveys senior loan officers on a quarterly basis, and those executives were already becoming more restrictive before the bank issues and fiscal stability questions arose, and are sure to make credit standards and terms even more prohibitive. I'm a big fan of Howard Marks, who has become extremely rich investing in distressed debt. He will have a field day in such an environment.

As usual, all eyes are on the Fed and in particular Chairman Powell, as to any changes in policy brought on by the bank failures and their effect on the economy at large. Certainly, they can't hurt in the fight against inflation and may mean fewer rate increases will be necessary. The FED's favorite measure of inflation, the PCE, was showing signs of decline even before recent events; the core reading in February was 0.3%, below estimates of 0.4% and the January number of 0.5%. Mr. Powell remains, at least for now, committed to further tightening, but that could change as data changes. His job to control inflation is not made any easier by the spending machine that is the U.S. government and its prolific fiscal policies. In addition there is, and will be more, pressure to back off if and when unemployment starts to rise. Senator Elizabeth Warren of Massachusetts accused him of not caring about the American people in his most recent appearance in front of Congress. Probably the greatest concern for the Fed is the "snowball effect", which suggests once inflation and/or the economy gets momentum to the downside it will be very difficult to control. Like many things in life and economics it often takes a long time for something to happen, but then it happens suddenly. Chairman Powell has had many detractors (including myself), but when I read his press conferences he comes off much less dogmatic than he seems in official FED policy releases. He answers questions with statements such as; "it's a highly uncertain estimate", and "we don't know whether that will happen this time". That sounds more like a guy who "gets it".

Finally, I believe we all should spend more time learning about artificial intelligence (AI). It's been around for a long time, but its impact on our lives is growing by leaps and bounds. The effect of much improved productivity is being offset by a potentially large number of job losses. (Some have even suggested that should include the author of this letter.) We must prepare ourselves for big changes, not only in economics but in society at large.

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