MARKET STRATEGY
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Elevated Near-Term Risk as Banking Uncertainty Creates an Overhang

Following last week's unexpected announcement that federal regulators had seized control of California-based SVB Financial (SIVB), the parent company of Silicon Valley Bank, due to an interest rate-driven liquidity crisis as deposit customers requested withdrawals, investors late last week were understandably concerned about the safety and availability of customer funds at other depository institutions. Importantly, the Federal Reserve Bank (Fed), on Sunday (3/12/23), stepped up to provide immediate short-term liquidity to the U.S. banking system, which should help provide financial market stability in the days and weeks ahead. However, we believe that the rapid increase in U.S. interest rates (as the Federal Reserve Bank tightened credit conditions) over the past twelve months was a leading factor in SVB's liquidity crisis, and likely reflects evidence of emerging stress in the U.S. economy. In our view, the potential for a U.S. recession beginning in 2023, which was already an outcome considered by investors, has increased and is likely to create ongoing volatility in U.S. equity markets.

On Sunday afternoon, the U.S. Federal Reserve Bank (Fed) announced the creation of a Bank Term Funding Program (BTFP), which will allow banks to borrow funds that may be needed to satisfy short-term liquidity needs. In a statement issued by the Federal Reserve Board on 3/12/23 in conjunction with the U.S. Treasury and the Federal Deposit Insurance Corporation (FDIC), the Program will help the FDIC protect all Silicon Valley Bank depositors, both insured and uninsured. We expect this action to alleviate immediate stress in the U.S. banking system that could arise if customers withdraw cash deposits at other depository institutions. Banks could still be vulnerable to business instability if they lose depositors, decide to increase interest rates paid on cash deposits, or suffer realized losses in fixed income investment portfolios. While the S&P 500 Financials sector could rally as the BTFP is implemented, we expect increased volatility in the sector.

To combat inflation, the U.S. Federal Reserve Bank (Fed) has increased its overnight bank lending federal funds (fed funds) target interest rate by 450 basis points (bp) since March 2022, the most rapid pace of interest rate hikes since the early 1980s (more than 40 years). As of 3/13/23, the fed funds target range was 4.50% to 4.75%, up from 0% to 0.25% one year ago. Primarily due to strength in the labor market (growth in new jobs) and consumer spending (personal consumption expenditures), as well as elevated consumer inflation (consumer price index, CPI), the Fed has indicated that further increases in the fed funds target range is appropriate. As recently as 3/7/23, Fed Chair Jerome Powell, in his semiannual report to the U.S. Congress, stated that inflation pressures were running higher than previously expected and that the peak level of the fed funds rate target would likely also be higher than previously expected. This places the Fed in a difficult position as it must balance ongoing rate hikes to keep inflation at bay with economic cracks that could be forming from interest rate hikes previously implemented (there is often a significant time lag between rate hikes and the full impact on the economy).

While we expect the Fed to announce yet another interest rate hike at the upcoming Federal Open Market Committee (FOMC) meeting on 3/22/23, the liquidity crisis at SVB and subsequent federal BTFP to protect borrowers could indicate the increase is likely to be 0.25% rather than the 0.50% that some had expected. It is also possible the Fed will pause its hiking path at the March meeting due to the banking crisis and allow the economy to more fully realize the impact of previous hikes put in place over the past several months. While that view goes against what Chair Powell said just one week ago, it is reasonable given the surprise hit to confidence in the banking system. Since 3/8/23, the yield on the U.S. 2-year Treasury bond has dropped to 4.03% (on 3/13/23) from 5.06%, a dramatic decrease in short-term interest rates in just three days. To us, this indicates that bond investors believe that U.S. interest rates have peaked for now and that the Fed is unlikely to pursue a series of rate hikes from current levels. This makes the February consumer inflation data (CPI) scheduled for release on 3/14/23 important in the Fed's policy equation. The FactSet consensus estimate (as of 3/10/23) for February CPI is up 6.0% year-over-year (Y/Y), which compares to a 6.4% Y/Y increase in January, and up 0.4% month-to-month (M/M). Should the data come in below those estimates, the Fed will feel better about pausing rate hikes, while inflation above those estimates will add to the Fed's dilemma.

The widely followed large-company S&P 500 dropped 4.5% last week (the week ended 3/10/23), the largest weekly decline since late September last year. This put the price return (not including dividends) of the index in 2023 through 3/10/23 up just 0.6%, as most of January's 6.2% gain has eroded. We remain cautious on U.S. equity markets, and our S&P 500 fair value estimate is 3,900, basically in line with the 3/10/23 closing price of 3,862. We have expected 2023 S&P 500 earnings estimates to trend lower, and as of 3/10/23, the FactSet consensus earnings estimate reflects year-over-year growth of 2.4% (compared to 2022), while the estimate at the end of December reflected 5% growth. While the federal response and BTFP should help to avoid a run on bank deposits, the negative surprise of a potential banking crisis could weigh on economic activity if consumers, businesses, and/or bank lending divisions begin to operate more conservatively. The S&P 500 remains 9.5% above the 3,577 cycle low set on 10/12/22, and that becomes a key market support level if earnings estimates and economic forecasts erode from current levels.

We believe that equity investors should remain invested in high-quality, market-leading companies, many of which are able to gain share and become stronger during times of economic uncertainty. U.S. equity portfolios should remain broadly diversified across sectors including exposure to defensive sectors such as Consumer Staples, Health Care and Utilities. The Financials sector, and especially the banking industry, is likely to remain under pressure in the short-term. However, the BTFP should provide stability to many bank deposit bases, creating some opportunity in high-quality names for long-term, diversified investors.

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The Federal Reserve Bank's Open Market Committee (FOMC) consists of twelve members--the seven members of the Board of Governors of the Federal Reserve System; the president of the Federal Reserve Bank of New York; and four of the remaining eleven Reserve Bank presidents, who serve one-year terms on a rotating basis. The FOMC holds eight regularly scheduled meetings per year. At these meetings, the Committee reviews economic and financial conditions, determines the appropriate stance of monetary policy, and assesses the risks to its long-run goals of price stability and sustainable economic growth. The federal funds rate is the interest rate at which depository institutions lend balances at the Federal Reserve to other depository institutions overnight.

The National Bureau of Economic Research (NBER) is a private non-profit research organization. The NBER is widely used as an organization that analyzes U.S. economic data and the business cycle and determines the start dates and end dates of economic recessions. The NBER defines recession as "a significant decline in economic activity that is spread across the economy and that lasts more than a few months;" and also looks at the depth, diffusion, and duration of the downturn.

The Treasury yield curve displays the market interest rate across different contract lengths for U.S. Treasury bonds, indicating the relationship between the interest rate and the time ("term") to maturity. The yields of the 2-year and 10-year U.S. Treasury bonds are widely followed barometers of the current U.S. interest rate environment. Treasury bond data used in calculating interest rate spreads is obtained directly from the U.S. Treasury Department, through FactSet.

The forward S&P 500 price-to-earnings ratio (P/E) is a valuation measure, calculated by dividing the price of the S&P 500 index over the weighted average earnings per share (EPS) estimate of each company in the index. Earnings are based on "forward" consensus estimates expected over the next 12 months (NTM), using quarterly analyst estimates as provided by FactSet. Fair value refers to a valuation method based on our view of the intrinsic value of an asset or index, determined by macroeconomic factors and earnings expectations rather than current market prices. This is our view of intrinsic value as of the date of this report.

FactSet is a data aggregation software utilized by D.A. Davidson's Wealth Management Research. The FactSet Consensus refers to the aggregate of all analyst estimates from firms that submit estimates to FactSet for a given financial metric.

U.S. Personal Consumption Expenditures (PCE) is an indicator of the growth in consumer spending and measures the value of goods and services purchased by persons who reside in the U.S. It is reported monthly by the Bureau of Economic Analysis. Retail Sales, reported monthly by the U.S. Census Bureau, reflects a monthly survey of sales by retail and food service firms in the U.S.

The consumer price index (CPI) is a measure of average change over time in the prices paid by urban consumers for a market basket of goods and services. It is reported monthly by the U.S. Bureau of Labor Statistics.

The Bureau of Labor Statistics (BLS) compiles U.S. labor statistics from two monthly surveys. The household survey measures labor force status by demographics; the establishment survey measures nonfarm employment and data by industry. The nonfarm payrolls component of the establishment survey is drawn from private businesses and government entities. The nonfarm payrolls number is among the most widely used data points to assess U.S. employment trends. The unemployment rate is the percentage of the labor force that is jobless and actively willing and available to work.

We define "Defensive Sector" as sectors whose constituents are companies that are generally less exposed to changes in the business cycle, and thus have less volatility in revenue and earnings. Traditionally we view Consumer Staples, Utilities, and Health Care as defensive sectors, although some companies in these sectors are less defensive than others, and some companies in other sectors have defensive qualities.

On 3/12/23, the U.S. Federal Reserve Board created a new bank Term Funding program (BTFP) to provide depository institutions an additional source of liquidity to service deposit requests if needed. More information can be found at https://www.federalreserve.gov/newsevents/pressreleases/monetary20230312a.htm