ALTMAN
INVESTMENT MANAGEMENT

BRIEF INSIGHTS

March 15, 2023

IN BRIEF:

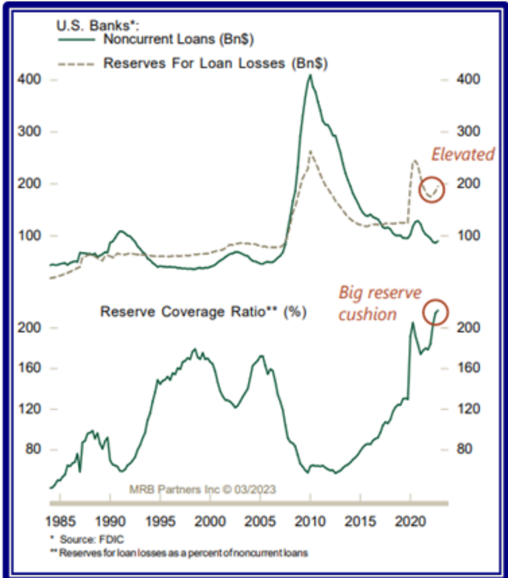
In response to the failures of Silicon Valley Bank and Signature Bank last week, President Biden tried to instill confidence in the U.S. banking system, assuring depositors that their money will be available when needed without a burden on taxpayers. He went on to call for a full account of what led the failure of these banks to prevent a similar incident from happening again in the future. His call for increased regulation in conjunction with the Fed announcement of a new emergency lending program are working together to shore up sentiment. The latest rout in banking with Credit Suisse this morning, while unsettling, does not change our economic and stock market outlook for now. It certainly adds a good deal of near-term uncertainty in markets and - until resolved in a way that minimizes systemic shocks - will place a cloud over markets.

Last week, in Fed Chairman Powell's testimony, the ground work was laid for rates to head higher than originally forecast - building up expectations for a 50-basis point increase in rates at the next meeting. However, last week's events surrounding the banking failures created enough concern to open the door for a Fed pivot. Now, some economists are pricing in only a 25 bps rise in rates at the next meeting. In addition, yesterday's inflation report of a 6% rise in year-over-year prices, although still higher than the Fed's target rate of 2%, marks the lowest inflation rate in over a year. As inflation slows, it could add to considerations giving the Fed pause in its hawkish strategy, even if rates remain higher for longer.

More specifically to the banking sector fallout, the ~10% drop in the sector since March 8th, appears to be on over-reaction to isolated incidents, rather than a systematic problem that would lead to a widespread liquidity crunch. According to MRB Partners, most banks have enough liquidity on their balance sheets to eliminate the need to sell holdings to meet funding demands.

Improving Relative Earnings Should Support Bank Outperformance

Banks Are Well-Prepared for an Increase in Non-Performing Loans



Source: MRB Partners and FDIC

Forward multiples offer attractive re-rating potential in a higher for longer interest rate environment over the long haul. Tailwinds for net interest margins are in place and credit quality trends could deteriorate from here, but delinquency rates remain relatively low at this point in the economic cycle. Concerns over the health of the commercial real-estate market should have less impact on larger cap banks with lower exposure. Banks overall should benefit from improving efficiency ratios and the competition for bank deposits might be overstated considering low loan-to-deposit ratios. Loan growth should moderate as economic growth slows, exacerbated by higher lending standards given the current events that surfaced in the banking sector. But if we are correct in our call for a soft landing, it is unlikely that a rise in credit losses against elevated reserves and coverage ratios would lead to a lending crisis.

A Closer Look at Style Rotation in the Equity Markets:

Given our Value style orientation, which currently has a strong representation in the Financial sector, this is a good time to consider the trends. As the outlook for economic expansion falters, Growth overtakes Value in the shorter term. The S&P 500's Growth index has outperformed its Value counterpart, after underperforming from November 30th, 2021 to January 3rd, 2023. During that period, Growth stocks on average declined 29.3% but Value dropped just 0.5%. Since January 3rd when Growth's price relative to Value bottomed at a two-year low, Growth has outperformed up +8.12%, while Value is down -1.91%.

From a valuation perspective, Growth's forward P/E appears to be on the road to recovery. It had fallen from a peak of 37.3 in January 2021 to 18.9 on January 5th this year. Growth's forward P/E relative to Value bottomed on January 4th at a generational 14-year low of 1.12, when the forward P/E ratios of Growth and Value were 18.3 and 16.4 respectively. The relative P/E is now back up to 1.20 as of Tuesday of this week, with Growth's forward P/Es rising to 19 and Value is falling to 16 accordingly.

In Conclusion:

The Fed has taken the position aimed at stabilizing the banking system, which should also stabilize the financial markets. The meltdown in regional bank stocks following SVB's failure and the rapid decline in Treasury bond yields suggest that investors believe the Fed rate-hike cycle is close to ending. The regional banks could be facing the same regulation that the larger, major banks were forced into following the Great Financial Crisis. Rest assured there will be renewed calls for increased regulation on regional banking which could lead to dividend cuts and tighter capital requirements, underscoring potential earnings and valuation risk that regional banks face in the future. The Fed may pass on a rate hike at the FOMC meeting next week. Or if it goes with a 25bps rate hike to 4.75%-5.00%, it might use the SVB debacle as evidence that the federal funds rate would be restrictive enough to hold off raising rates higher for a while.

We remain in the soft-landing camp, versus the hard-landing scenario, with the odds of the latter less than a 30% probability. We are now more convinced that the 10-year Treasury yield peaked at 4.25% last October 24th for now and that the S&P 500 bottomed on October 12th.

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