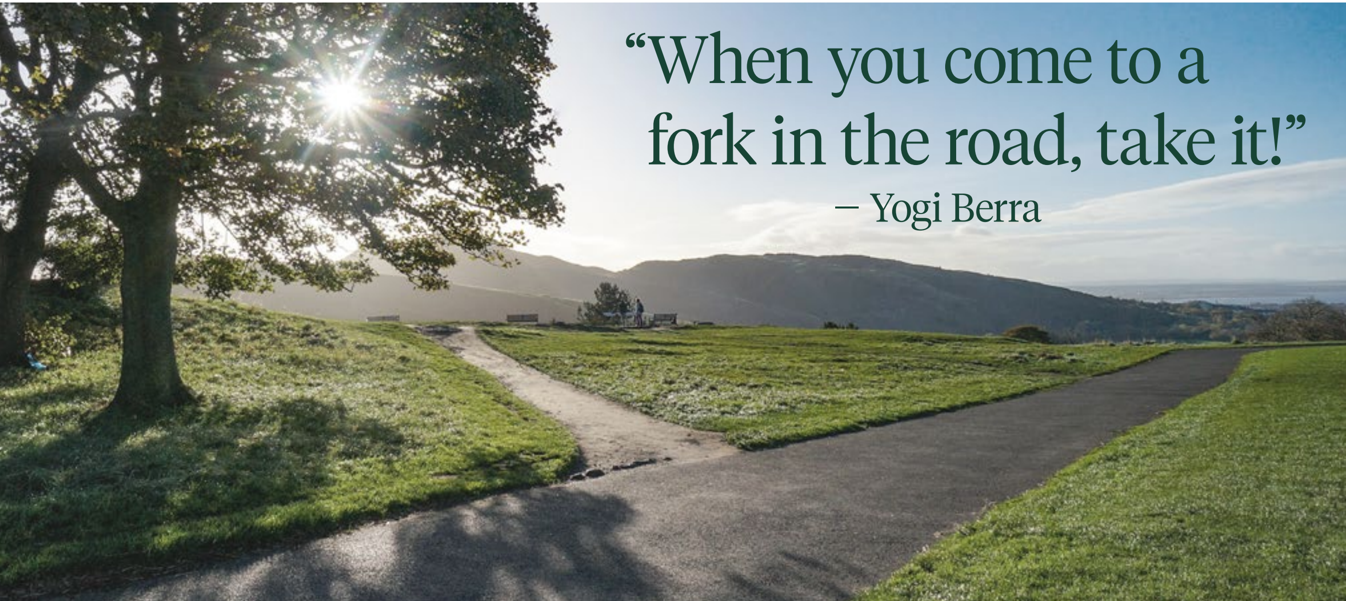
BALENTINE

Quarterly Market & Economic Report

Q1 | 2023



2023 started on an optimistic note, offering a brief respite from the challenges of 2022. By the end of the first week of March, stocks had rallied 12% from the lows of October last year, looking to escape the bear market they had entered last summer. The economy also seemed to be shrugging off concerns about an imminent recession — the GDPNow indicator from the Atlanta Federal Reserve, which proxies the economy's growth rate in real time, was tracking north of 3% for the first quarter.

Last year, markets began transitioning away from an era of low inflation and low interest rates to a world of more expensive and scarcer capital. This prompted the Federal Reserve (the Fed) to raise short-term interest rates from 0% to the precipice of 5% in its quest to subdue inflation, enacting the quickest and most significant monetary tightening we have ever experienced. To reduce too much money chasing too few goods and services, the Fed also began to reduce its balance sheet of bonds to drain excess liquidity from the system.[1]

We've written before that when monetary policy is tightened, something in the financial system always "breaks." Generally, the breaks occur in areas that have been poorly managed and over-leveraged. It is often hard to predict precisely when and where the break will occur beforehand, and in this cycle, the jolt of the 2022 interest rate shock made it particularly difficult to predict. In retrospect, the failure of Silicon Valley Bank (SVB) on March 10th, which sent shockwaves rippling through the banking sector, should not have been a surprising event at all.

What was more startling was the speed with which SVB's failure occurred, highlighting how suddenly sentiment can change and how violently prices can adjust in modern capital markets. By the end of the first quarter, some of the optimism that greeted the year had faded. Long-term interest rates fell considerably, fueling a vicious, counter-trend relief rally in a small number of U.S. Growth stocks and International Developed equities, leaving stock markets up around 5%. In addition, the GDPNow indicator had fallen from over 3% at the beginning of March to expecting only a little over 1% growth for the first three months of the year.

[1]This process has become referred to as "quantitative tightening," the opposite of "quantitative easing."

Increased Chance of a Recession, Starting Sooner?

Given the potential stress SVB exposed, at the end of the quarter, markets began to discount the possibility that the banking system, in general, would be less willing to lend to the economy. Accordingly, the recessionary signals the capital markets have been sending since the summer of last year, when it entered a bear market that it has yet to escape, have been amplified. Today, the yield curve remains sharply inverted, and earnings expectations continue to be revised downwards, as we have been discussing over the last nine months.

Does this tightening of credit excuse the Fed in pausing its monetary tightening campaign, perhaps leading it to cut interest rates before the end of the year to cushion the impact of a slowing economy? Unfortunately, that wishful thinking may not come to pass, given that the Fed is currently in the horns of a trilemma, which we will explain further in a moment. But first, let's put the SVB failure in context.

A Digital Bank Run for the Ages

In its simplest form, banks accept short-term deposits from savers as a source of financing so that they may lend to borrowers over the longer term. When short-term rates are lower than long-term rates, and the yield curve is "positively sloped," banks enjoy a tailwind for profits. Unfortunately, the exact opposite has been the case since the summer of last year, with a significantly "inverted yield curve" creating a substantial headwind for banks' earnings. That headwind set the stage to compound several other factors unique to SVB.

At any given time, a bank holds a small percentage of deposited funds in cash because depositors rarely need their funds simultaneously. This allows banks to invest their excess capital in other "safe" securities, such as Treasury bonds. In the aftermath of the Global Financial Crisis (GFC), regulators increased the amount of capital banks were required to have on hand and regularly stress-tested the value of banks' portfolios to ensure that they had a sufficient cushion to continue to lend. These regulations were strictly imposed for larger banks, deemed systemically "too big to fail," but were eased on regional and smaller banks in 2018. Across the board, these stress tests did not contemplate a scenario of short-term interest rates rising so quickly and significantly.

The fragility of the banking model can quickly be exposed if a large percentage of depositors request their cash simultaneously — referred to as a "bank run." The irony is that the more investors pull their deposits, the more confidence in the bank is undermined, and the more likely it is that they will lose their source of funding, creating a self-fulfilling prophecy.

Three reasons made SVB vulnerable to such a bank run:

1 **A Shrinking Deposit Base.** As a darling of our innovation economy, SVB was beholden to technology companies and startups, which needed their deposits to make ends meet as the economy began to slow last year.

2 **A Sudden Doubt That They Were Adequately Capitalized.** SVB increased its sensitivity to losses from higher interest rates because it increased its investments in longer-term bonds just before the Fed started to increase interest rates in March 2022. This decision was exposed when SVB marked its portfolio to market the day before the bank run started, to the shock of investors,

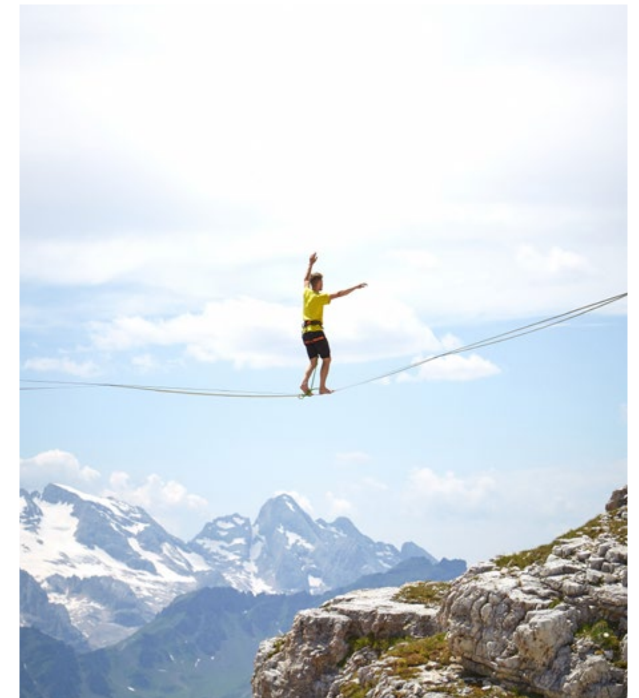
3 **A High Level of Uninsured Deposits.** SVB had a relatively high proportion of its depositors above the Federal Deposit Insurance Corporation's guaranteed limit of $250,000.

With the ability to bank digitally, depositors moved a staggering $42 billion out of the bank on March 9th, requesting a total of $142 billion, over 80% of the bank's total deposit base, through early March 10th, when the FDIC shut it down. Before the days of digital banking, depositors would have had to visit their local branch and request their cash in person – and it would have taken days, not hours, for a bank run to reach its apex!

The speed of this bank run is unmatched in history, and it created ripple effects in the U.S. and around the world. There were bank runs on institutions similar to SVB, including Signature Bank.[2] In addition, people called into question the stability of more lightly-regulated regional and smaller banks, wondering if they would need to raise capital to offset their mark-to-market losses on their portfolios of Treasury bonds as well.

As money leaves the deposit base of the regional banking system into Treasury-backed money market funds and larger banks en masse, it remains unclear what the U.S. Treasury will do to reduce these concerns. By allowing all depositors at SVB to access their funds while letting the bond and equity owners of the bank go bankrupt, it seems that the U.S. Treasury is trying to walk a tightrope of avoiding unpopular bank bailouts while preventing an isolated bank run from turning a liquidity crisis into a solvency crisis.

The turmoil in today's banking system does not compare to the scale and significance of the GFC, which was a solvency crisis. Today there is not an existential crisis about whether the banking system will survive like there was in 2008–2009. However, though SVB's failure was isolated, the cloud of uncertainty will likely lead to regional and smaller banks tightening their standards, reducing their likelihood of lending to the economy. Widening credit spreads are signaling a higher risk of a recession starting sooner this year than markets were expecting before the episode. How things play out from here depends on how the Fed resolves the countervailing forces on future interest rates.



[2] *In addition to the failure of U.S. regional banks, Credit Suisse, a large bank based in Switzerland, which had been performing poorly for several years, was purchased by UBS to avoid failure.*

The Federal Reserve's Trilemma

Congress holds the Fed accountable for simultaneously fulfilling a three-part mandate: low inflation, full employment, and financial stability. To this end, the Fed sets and guides future short-term interest rates and utilizes its balance sheet to buy or sell longer-dated bonds. Today, it is being pulled in different directions.

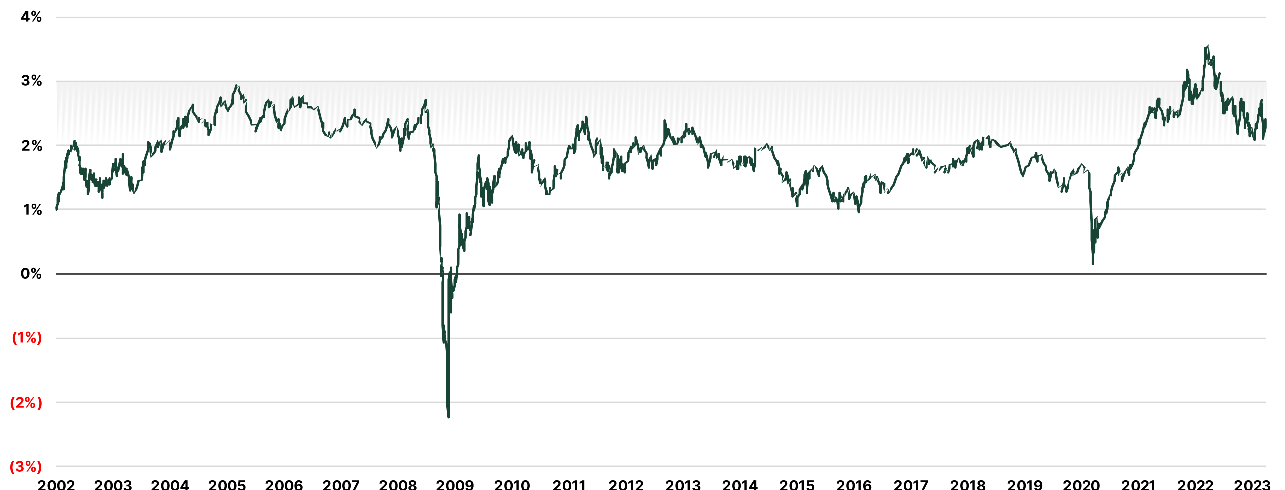
- **Low Inflation:** Though the Fed has raised interest rates to 5%, and headline inflation has cooled from the peaks of last year, core inflation looks to be remaining sticky above 5%, far above the Fed's target of 2%, which indicates that further monetary tightening could be needed to keep inflation expectations in check.

- **Full Employment:** The labor market continues to create jobs, but at a much slower rate in recent weeks, with announcements of layoffs trending up. Will this give the Fed an excuse to announce that it no longer needs to increase interest rates further, as its past tightening is beginning to work by slowing down the economy?

- **Financial Stability:** What can the Fed do to shape the yield curve to become "less inverted," easing pressure on the regional and smaller banking system?

Figure 1, a chart we first discussed in our last quarterly letter, shows that inflation expectations remain well anchored between the 2%–3% zone of comfort over the next five years, as measured by the 5-year forward "breakeven rate" between nominal and inflation-adjusted bonds. This implies that markets remain convinced that inflation will trend back down to this level over the next few years. Unlike the decade of the 1970s, when the economy endured a prolonged period of "stagflation," inflation expectations remain anchored at this time, as markets feel confident that more expensive and less abundant capital will lead to lower prices for goods and services over the medium-term. Will this allow the Fed to soon announce a "pause" on further monetary tightening, given growing evidence of a weaker job market and its priority of financial stability? Will it risk its hard-won inflation-fighting credibility in search of a "soft landing" where the economy avoids a recession? Given the tightening credit conditions resulting from the turmoil in the banking system, it seems unlikely that this trilemma can be resolved without at least a short and mild recession later this year.

Figure 1: The 5-Year Forward Breakeven Rate shows that inflation expectations remain anchored between 2% and 3% over the next five years.



Source: Federal Reserve Bank of St. Louis

Safeguarding Client Assets

As we wrote in March, in times like these, our clients can rest assured that their assets are protected because there are already safeguards in place:

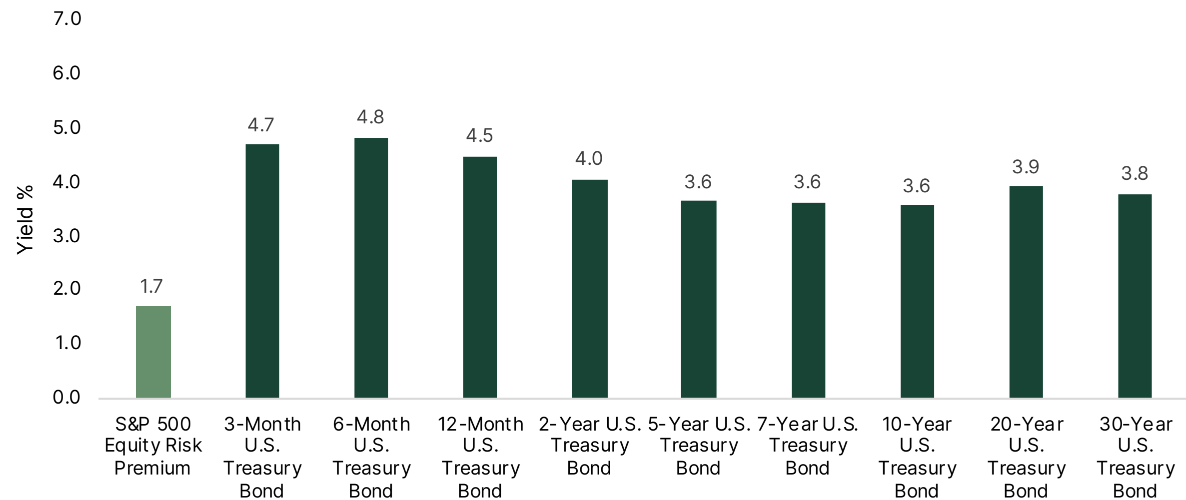
- **Fiduciary Business Model:** We put client needs first, prioritizing risk management, capital preservation, safety, and security.
- **Cash Management Strategy:** We recommend that all clients hold two years of cash in their portfolios net of portfolio yield so that their cash flow needs are taken care of regardless of market conditions. This minimizes the chances of permanently impairing capital by being a forced seller when prices are artificially depressed.
- **Independent Custodian:** We custody assets separately from our advisory business. Our partner, BNY Mellon's Pershing, segregates assets and employs rigorous internal controls, holds itself to a high standard of excellence, and provides investment protection for high-net-worth clients. Read more about the protection offered by working with Pershing here.

Selectivity in Public Markets

After a period of what we believe to be strong performance over several quarters, our strategies lagged their benchmarks during the first quarter of the year. The global stock market index outperformed domestic bond markets, fueled by a narrow, counter-trend rally in U.S. Growth stocks and International Developed equities, two areas our discipline has been calling to de-emphasize for a while. While we made no changes to our stance of being underweight in stocks relative to our longer-term targets, we did make two changes to be more selective within our equity exposure.

Figure 2 highlights how expensive the U.S. stock market has become compared to Treasury bonds across all maturity levels by comparing the equity risk premium[3] for the S&P 500 to the yields to maturity over various time horizons. As it stands right now, as shown in Figure 2, equity investors are being offered only an additional 1.7% to invest in stocks over the current risk-free rates. Owing to this meager premium, the equity markets are relatively expensive compared to if they were offering a more expensive premium. As a result, we are unlikely to increase our stock exposure until either: stocks become less expensive when compared to bonds, based on the equity risk premium and other objective criteria we track, such as the slope of the yield curve, or we confirm that they exhibit the distress that typically accompanies capitulation in sentiment, which typically marks that the bear market is in its ultimate innings.

Figure 2: The U.S. Stock Market has become expensive relative to U.S. Treasury Bonds.



Source: Balentine & Bloomberg

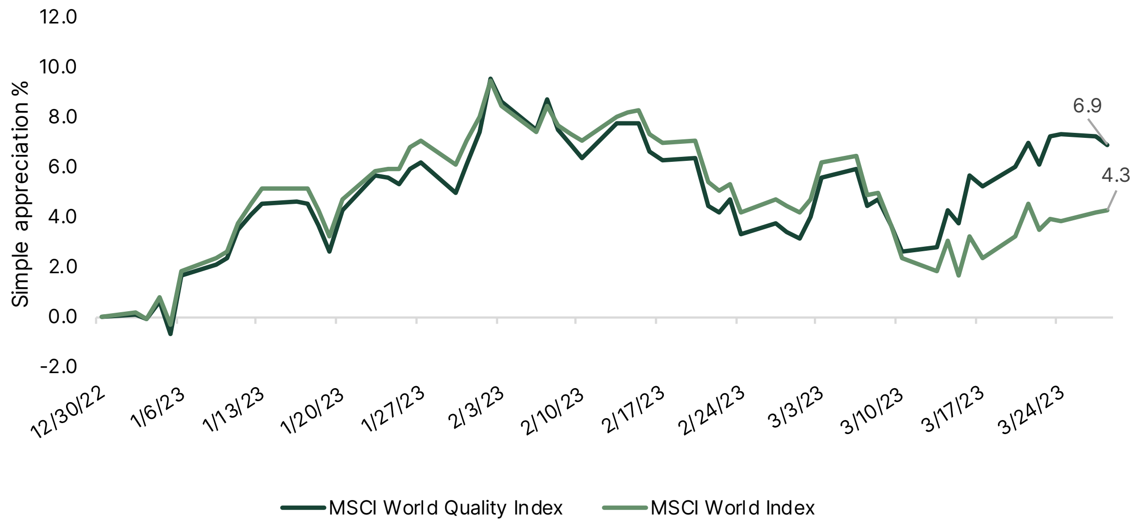
Within our equity and equity-like exposure we refer to as Market Risk, we have become more selective by:

- **Investing in High-Quality Stocks:** Last year, we tilted our long-term equity positions (Strategic Global Allocations within Market Risk) toward high-quality stocks. These stocks have lower levels of leverage on their balance sheets and more stable top and bottom-line earnings than the average stock because they have the underlying pricing power to pass on the effects of high and sticky inflation to protect their margins. They are, therefore, positioned to potentially outperform in an era of more expensive and scarcer capital than the unusual period of cheap and abundant capital from 2009 to 2021. They have started to outperform the broader markets this year, in line with the longer-term trend, as interest rates have risen to more normal historical averages[4] (Figure 3).

[3] *The equity risk premium is a measure of how much stock market investors are being compensated over and above risk-free U.S. Treasury yields to assume equity market risk.*

[4] *Read more about our approach to high-quality investments in this article from our 2023 Capital Markets Forecast.*

Figure 3a: High-quality stocks have outperformed broader markets in 2023.



Source: Balentine & Bloomberg

Figure 3b: High-quality stocks have outperformed broader markets over the long run.

Source: Balentine & Bloomberg

- **Establishing a Position in Gold:** Our models called for us to establish a position in gold as the price of bullion began to break long-standing resistance levels, given the strong momentum it has enjoyed relative to stocks for several months. Weakness in the U.S. dollar has provided a tailwind for gold to outperform, as markets have discounted the possibility that the Fed is closer to the end of its tightening cycle. Gold's defensive properties were also highlighted by its outperformance during the recent banking turmoil, which raised concerns about the stability of the financial system.

- **Buying International Developed Equities:** We neutralized our multi-year underweight of International Developed equites after a sustained period of momentum relative to U.S. stocks. Now, many of the macroeconomic and fundamental conditions that typically accompany outperformance from this area of markets are beginning to confirm that the cycle of underperformance they have been mired in for so long may be coming to an end. Some of these conditions include a declining U.S. dollar, the trend of Value outperforming Growth (overseas stock markets tend to have a concentration of Value sectors than in the US), relatively cheap valuations, and positive earnings revisions.

If our discipline is calling for patience and selectivity in public markets, we are staying committed and starting to play offense in private markets.

Staying Committed and Starting to Play Offense in Private Markets

The collapse of SVB brought the private equity world in general to a screeching halt. Many start-up and early-stage companies had billions of dollars deposited in the bank, and many private capital managers had credit line agreements to help fund operations. We are proud of how our private capital managers have navigated the situation with minimal disruption to their operations so far.

As we have discussed in previous letters, we have long been preparing our private capital programs for an opportunity like the economic slowdown that appears to be ahead, given the tectonic shifts underfoot in capital markets. In fact, our Credit Opportunities 2023 access fund[5] was designed explicitly with the idea that an economic slowdown might lead to general credit distress. This is a vehicle blending several managers, similar to our Decarbonization 2022 access fund, built for the sole purpose of taking advantage of the dislocations that should arise in credit markets. We have approved two managers thus far, the first a distressed debt fund managed by the credit team at the Dell family office. The second is Whitehawk, an asset-based lender out of Los Angeles with a long track record of sourcing and underwriting loans to companies as the lender of last resort. Asset-based lending is a niche market where above-average yields can be achieved with lower risk by allowing asset values to stand in for the credit of the company.

Separate from Credit Opportunities 2023, Monroe, our senior secured lender, is also well positioned to take up where regional banks can't lend to fundamentally sound, growing companies anymore. With lending rates at decade highs, we see an opportunity for lenders in senior positions to be paid well for providing companies with the debt they need to acquire and grow. We are looking to add around our core position in Monroe to take advantage of the opening we see.

In addition to that, we are partnering again with J.F Lehman on its sixth buyout fund focused on the aerospace, defense, maritime, and environmental services industries. The combination of J.F Lehman's history of actively managing through multiple cycles, and the non-cyclical nature of the sectors they invest in, convinces us they are well-positioned to invest in a landscape where more than just financial engineering will be needed to produce attractive returns.

[5]Like our Decarbonization Access Fund, this is a pooled vehicle we have created to facilitate access to this opportunity for our clients. Balentine receives no additional fee for doing so.

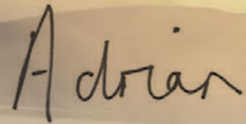
In Closing

It has been a harrowing end to the first quarter of the year. A rally starting late last year and continuing through the beginning of 2023 seemed that it might be signaling the "all clear" for markets, putting concerns over a likely recession to rest. Then Silicon Valley Bank suddenly failed in early March, creating a turning point in the Fed's yearlong quest to quell inflation by making money more expensive and capital more scarce. Now it must resolve a trilemma – low inflation, full employment, and confidence in the banking system – in the face of an increased risk of a recession and the possibility that the recession may start sooner than anticipated.

Hopefully, this has been a useful summary of recent events, and our perspective on how to help protect capital and generate meaningful returns in both public and private markets provides some peace of mind as we strive to position your strategy to meet your goals. Our forward-looking, objective models, which continue to guide our decisions, have a long track record of navigating several market cycles successfully.

Thank you for the trust you place in our team. As always, we welcome any questions you may have at any time.

Sincerely,



Adrian Cronje, Ph.D., CFA®
Chief Executive Officer

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The MSCI ACWI (All Country World Index) Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets. The MSCI ACWI consists of 45 country indices comprising 24 developed and 21 emerging market country indices. The developed market country indices included are: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Israel, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, the United Kingdom and the United States. The emerging market country indices included are: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, and Turkey.

The MSCI World Quality Index is based on MSCI World, its parent index, which includes large and mid cap stocks across 23 Developed Market (DM) countries*. The index aims to capture the performance of quality growth stocks by identifying stocks with high quality scores based on three main fundamental variables: high return on equity (ROE), stable year-over-year earnings growth and low financial leverage. The MSCI Quality Indexes complement existing MSCI Factor Indexes and can provide an effective diversification role in a portfolio of factor strategies.

The S&P 500® Index is the Standard & Poor's Composite Index of 500 stocks and is a widely recognized, unmanaged index of common stock prices.

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