Broad Market Stabilization Amidst Banking Tremors

1. Q1 2023 Recap

As we turn the page on a tumultuous 2022, the first quarter of 2023 has provided a welcome respite, with stability returning to the broader investment landscape. It has been particularly heartening to see that many of the investments that struggled last year have rebounded and become this year's best performers.

Three key factors have contributed to this stabilization:

1. The reopening of the **Chinese economy** after stringent lockdowns, signaling a departure from the zero-Covid policy.
2. The growing belief that the **Federal Reserve** is nearing the end of its inflation-fighting monetary tightening policy, with market experts largely predicting only one or two additional 0.25% increases in the Fed Funds target rates.
3. **Technical factors** such as short covering and portfolio repositioning by institutional investors.

While the quarter has brought renewed optimism, it has not been without its share of challenges. The unexpected collapse of two major regional banks in the US and the second-largest bank in Switzerland have sent ripples of fear throughout the financial world, reminiscent of the 2008 crisis. Thankfully, regulatory authorities' swift actions have helped prevent further panic and contagion.

Whether these measures have been effective remains to be seen, but it's worth noting that the banking crisis has led to a disinflationary shock, providing the Fed with a welcome opportunity to pause and reassess its approach.

2. Inflation and Recession

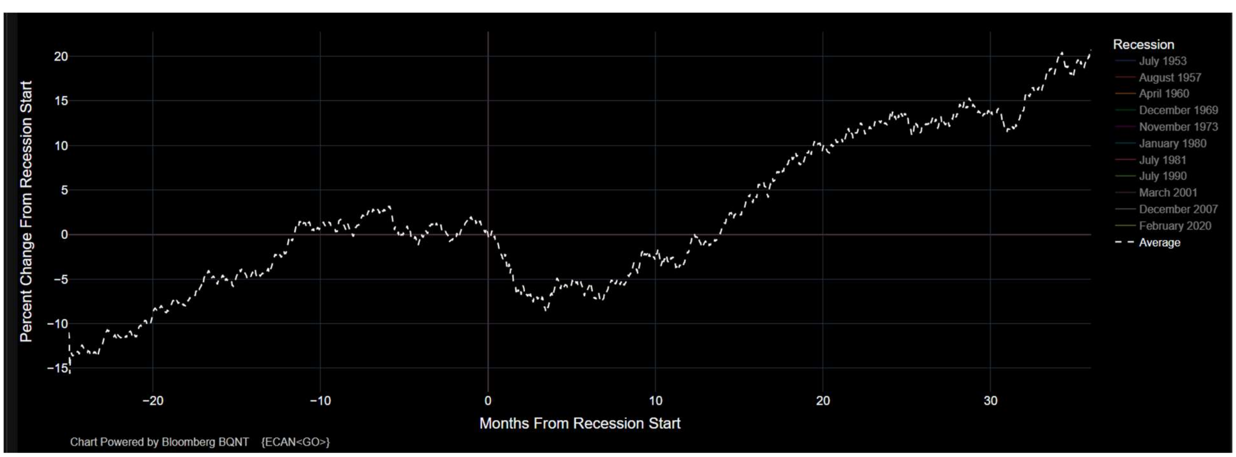
Although inflationary pressures are easing, dark clouds in the form of an impending recession loom overhead. To put it plainly, all indicators that have historically predicted recessions are now flashing red.

The **inversion of the yield curve**, considered by many – including some Federal Reserve's economists – to be a reliable harbinger of economic contraction, is currently at levels seldom seen in the past four decades.

A composite index of ten **US leading economic indicators** also suggests that a recession may be imminent. While some contend that certain sectors, such as manufacturing, are already experiencing a downturn, others, like services, continue to thrive.

It is important to remember that recessions, while painful, are an inevitable part of an evolving economy. They exact a toll on society, but they also come to an end. Financial markets, ever forward-looking, have a history of declining sharply before a recession, stabilizing, and then recovering rapidly during a recession (please see Graph 1).

Graph 1 – S&P500 Index Performance vs S&P500 Index Level at Start of a Recession (since WWII)
The S&P500 Index has dropped sharply on average before a recession, moved sideways in conjunction with a recession, and recovered sharply few months into a recession (data from 1945 to 2022).



Source: Bloomberg Professional Services

3.0 Silicon Valley Bank and Banking Crisis

On March 10, 2023, a dramatic event unfolded in the financial world that bears further examination. **Silicon Valley Bank (SVB)**, which caters to some of the world's most prominent start-ups and venture capital funds, suddenly failed. As it turns out, SVB had made some critical mistakes: they were heavily reliant on their investment portfolio, which was negatively affected by higher interest rates, and they had a very concentrated base of very large depositors. By the following day, panic had spread like wildfire. Signature Bank, a reputable, highly profitable, and investment-grade rated bank in New York, saw 20% of its $88 billion deposits vanish within hours and was subsequently seized by the FDIC.

Bank runs have long been a feature of financial history, with roots dating back to 1825 when nearly 60 banks failed in England. Such events typically share one or more common factors: excessive risk-taking, economic shocks, poor supervision, and contagion.

What sets the banking crisis of March 2023 apart, however, is the unprecedented speed at which the contagion occurred. Our hyper-connected world, where money can be transferred at the click of a button, enables panic to spread rapidly, sometimes based merely on rumors.

Fortunately, authorities acted quickly and decisively to halt the contagion. They guaranteed all deposits of the two failed institutions well beyond the $250,000 FDIC deposit insurance per account. They even hinted that deposits above $250,000 at other institutions would be made whole in case of a bank failure.

Of particular note, the Federal Reserve established a new lending facility, the Bank Term Funding Program (BTFP), offering nearly unlimited amounts of funds for banks to access at favorable terms should they face liquidity issues due to deposit outflows.

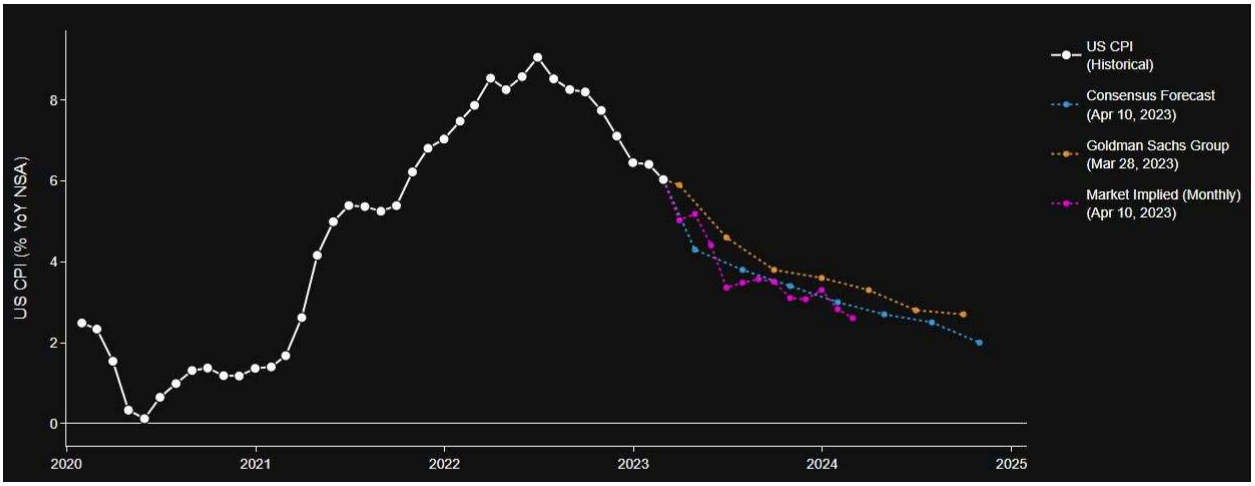
As of now, the coordinated actions of the US Treasury, FDIC, and Federal Reserve have successfully quelled the panic. In the days immediately following the SVB collapse, deposits flowed out of smaller regional banks into larger banks and money market funds, but the situation soon stabilized. Weekly data from the Federal Reserve, the Federal Home Loan Bank, and others confirm that the deposit bleeding and liquidity issues for banks have subsided.

Unfortunately, the damage has been done, and a credit crunch is likely on the horizon. US regional banks form the country's backbone of commercial real estate and small business lending. As uncertainty looms and balance sheets shrink, banks will likely lend less and enforce tighter standards, negatively impacting economic activity.

On a more positive note, the banking crisis will likely help **moderate inflation**, reducing the need for the Federal Reserve to raise rates to control prices. In a recent report Goldman Sachs equates the impact of the two US bank failures to a **0.5%** increase in the **Fed Funds Target Rate**.

Graph 2 – US CPI year-over-year Change: Historical and Projected.

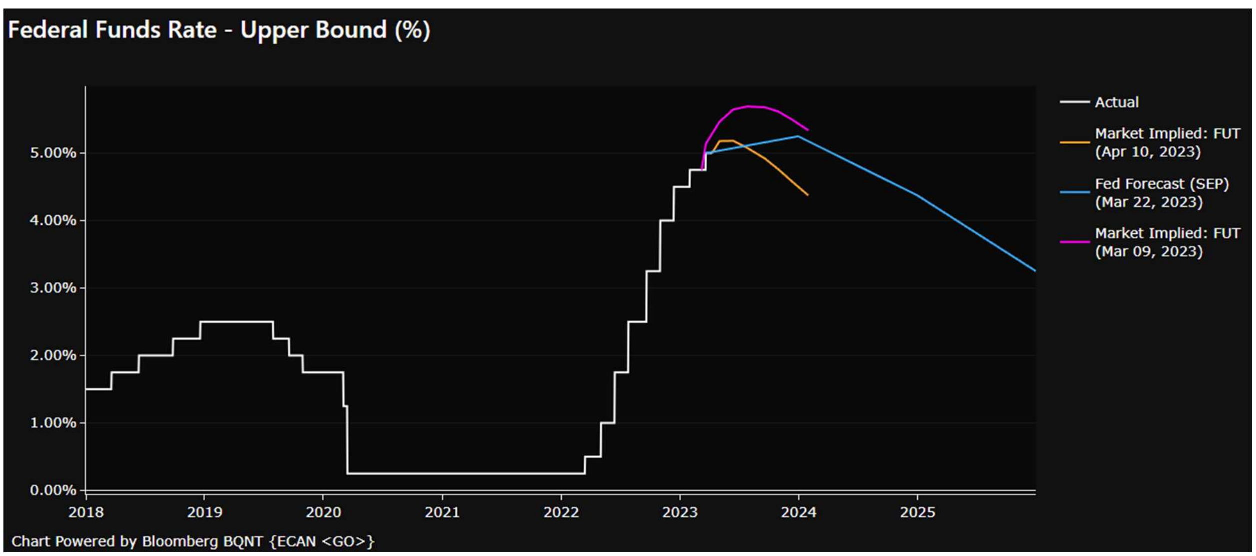
Inflation, as measured by the CPI year-over-year change, peaked in mid 2022 close to 9%. Since then, it has dropped to around 5%. Different forecasters and market-based implied rates of inflation, project the metric to fall into the 2% and 4% range before the end of 2023.



Source: Bloomberg Professional Services

Graph 3 – Fed Funds Target Rates: Historical and Projected.

The Federal Reserve has been hiking Fed Funds Target Rates at a very dramatic pace. The members of the Federal Open Market Committee ("Fed Forecast" in the graph) are projecting some more modest increases in 2023, a pause until the end of the year and then rate cuts in 2024. Market expectations (implied in the prices of Fed Funds future contracts) seem to contradict the central bank's projections. Especially after the bank failures in March 2023, markets are now pricing imminent interest rate cuts.



Source: Bloomberg Professional Services

3.1 Banking Crisis: Additional Risk Management Measures

In light of the recent unfortunate events in the regional banking sector, we have taken measures to update our review and monitoring policies for our current and future positions in the financial sector. Our goals are to remain vigilant and mitigate potential risks associated with our investments.

We have classified banks into three categories based on their total assets: under $100 billion, between $100 billion and $250 billion, and above $250 billion. These categories correspond to varying levels of regulatory supervision and risk. Additionally, we have begun tracking specific metrics, when disclosed, to assess the quality of banks' assets and the percentage of loans that are FDIC insured. This information will help us better evaluate the financial health and stability of the institutions we invest in.

To monitor the liquidity in the banking sector, we have developed an internal dashboard that tracks deposits' aggregate inflows and outflows. This data provides valuable insights into the dynamics of the banking sector and enables us to identify potential red flags before they escalate into a crisis.

While it is impossible to predict a bank run, we are confident that these new monitoring tools will help us minimize the risk of being caught up in the next one. Our commitment remains steadfast: to protect and grow your investments by continuously refining our approach in response to evolving market conditions.

4. Investment Opportunities and Challenges

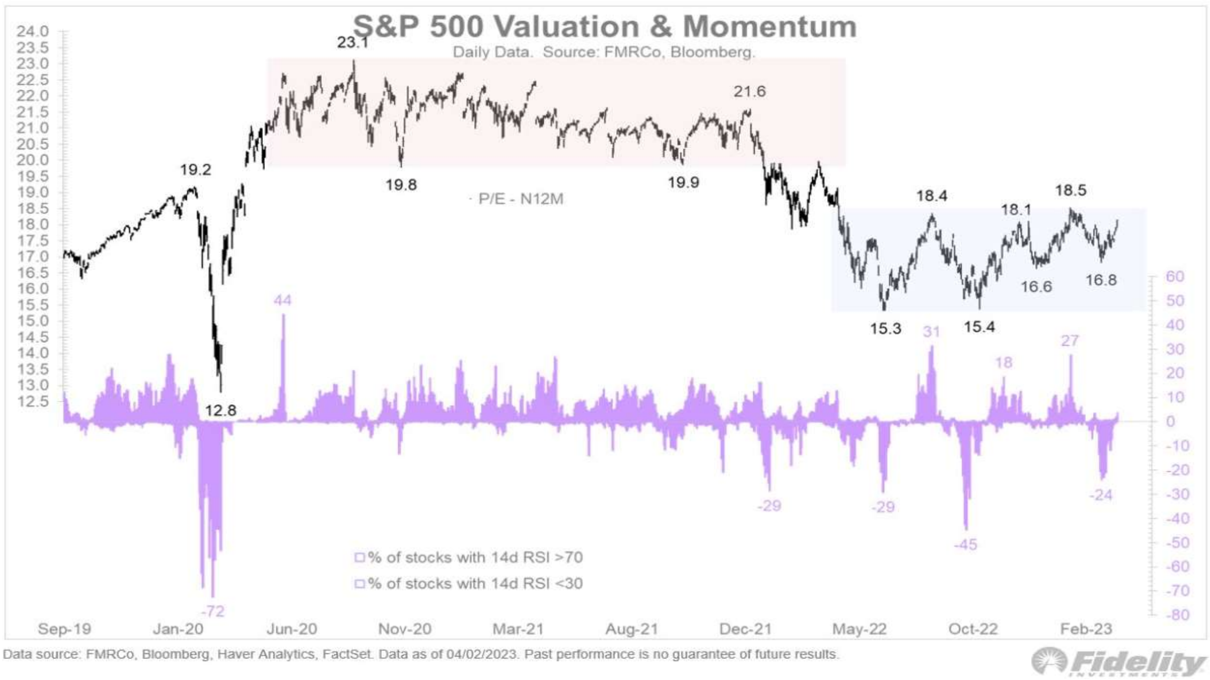
Equity markets have experienced some stabilization in Q1-2023 following a turbulent 2022, and volatility has subsided. The areas and sectors of the market that struggled the most in 2022, such as technology, consumer discretionary, and long-dated bonds, have emerged as the best performers in 2023. Conversely, the top-performing sectors of 2022, like energy, have not fared as well this year.

These market dynamics are likely a result of shifting expectations surrounding monetary policy. While 2022 was characterized by inflation and sharply higher interest rates in the US (beneficial for the US dollar but detrimental to long-duration assets and growth stocks), 2023 is centered around the end of monetary tightening and the possibility of a recession. Many large investors became overly pessimistic about certain assets in 2022 and were compelled to re-enter the market hastily due to rising prices.

As the Federal Reserve nears the end of its aggressive rate hike cycle, the impact on the economy remains to be seen. Our view is that US equity markets in general will likely remain in a trading range (see graph below), with a modest upside bias due to favorable seasonality effects and depressed sentiment, generally a contrarian indicator.

Graph – S&P500 Index forward Price-to-Earnings ratio (P/E) and Momentum indicators

Since the October 12, 2022, market low, the S&P500 Index has been trading between a 15.3x and a 18.5x forward P/E without clear momentum (represented in the lower part of the graph by the net percentage of S&P500 companies trading at a price above their 70 Relative Strength Index (RSI) minus the ones trading below 30.)

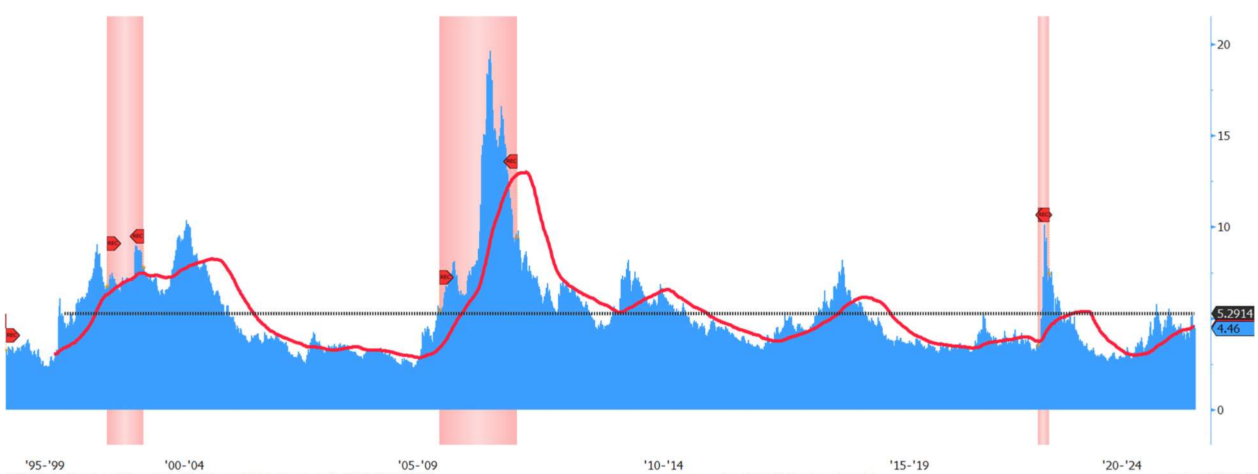


Source: Fidelity Investments

In contrast, credit markets (high-yield bonds) have remained relatively stable and have not sufficiently reflected the potential economic deterioration. Unlike stocks, credit spreads and corporate defaults tend to worsen alongside a recession, rather than prior to one.

Graph 5 – Bloomberg High Yield Bonds Index Option Adjusted Spread (OAS)

Credit spreads (OAS), represented by the blue mountain chart, tend to widen during recessions (pink shaded areas). Currently, at 4.46% they are both below historical average (black dotted line) and inconsistent with other macro indicators.



Source: Bloomberg Professional Services

Our preference lies with **US Treasuries and high-quality investment-grade debt** over high-yield debt. This holds true for investment-grade versus non-investment grade preferred shares as well.

We maintain a **neutral stance with a positive bias towards equities**. Our investment philosophy does not confine us to the growth or value paradigm or a specific capitalization. Instead, we favor high-quality companies with reasonable valuations. Generally, these are companies with high returns on equity (ROE) or returns on invested capital (ROIC), sustainable competitive advantages, honest and competent management, recurring cash flows, products and services that are either necessary or in high demand, and robust balance sheets.

Furthermore, we are drawn to companies that align with one or more of the following long-term secular investment themes:

- **Digital economy enablers,**
- **Gen Y and Z consumers,**
- **US structural housing shortage,**
- **Decarbonization and electrification of the economy,**
- **Aging population,**
- **Regionalization and re-onshoring.**

In these times of uncertainty, we focus on identifying high-quality, resilient companies that will deliver long-term value to our investors.

5. Conclusions

Markets are stabilizing as we approach the end of the monetary tightening cycle, but we must remain vigilant as new challenges emerge. A modest recession may be on the horizon, underscoring the importance of maintaining a well-diversified and balanced investment approach.

Diversification across various asset categories, including those often viewed less favorably, such as high-quality fixed income, is essential to weather the uncertain economic landscape. By spreading our investments across various assets, we can reduce overall portfolio risk and better position ourselves to navigate markets' gyrations.

A long-term plan is also crucial for investment success. While short-term fluctuations can create anxiety, remaining focused on the long-term allows us to make more informed decisions based on market fundamentals and the intrinsic value of the investments. This approach helps to minimize the impact of market noise and keeps us on track to achieve your financial objectives.

Finally, a deep focus on the underlying investments' quality is paramount. By carefully selecting high-quality companies with strong balance sheets, competent management, and sustainable competitive advantages, we can build a more resilient portfolio better equipped to withstand economic challenges.

In conclusion, a well-diversified portfolio, a long-term investment plan, and a strong emphasis on investment quality will be critical factors in determining investor success as we navigate the upcoming challenges.

On a different note, we are excited to share that we partnered up with an independent cybersecurity company specializing in solutions and training for wealthy individuals and families. We think that personal cybersecurity risk management is (and will increasingly be more) a very important part of your overall risk management. Please do not hesitate to get in touch with us to learn more.

As usual we remain at your disposal for any question.

Sincerely,

Livian & Co. team