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Economic and Market Outlook

March 31, 2023

Financial Crisis?

*Debt is not a problem until it is a problem,
then it is the only problem.*

-Anonymous

Section I. Introduction

While we don't know who originally uttered our quote, it was echoed many times by our founders, Tom Clutinger and Ed Williams. The Financial System, and more specifically The Banking System, is built on trust. People deposit their money in a bank and then the bank uses that money to make loans. Analysis of the quality of collateral or creditworthiness of those that take out loans along with the risk management performed by the bank will determine whether that trust is broken. Let's examine the current situation to determine if widespread concern is warranted.

Section II. Banks and the Banking System

Bank crises have been around as long as banks have been in existence. The classic Christmas movie, *It's a Wonderful Life*, portrays an easy way to understand the concept. Banks, in their simplest form, take in deposits and then make loans with that money. The bank earns the difference between the interest it pays depositors and the rate charged on loan, less any losses if borrowers don't repay the loan. Like the Bailey Brothers Building and Loan, all banks don't have the cash available to repay depositors if a large number want to make withdrawals simultaneously, also known as a run on the bank. Even otherwise solvent banks can be destroyed by a crisis of confidence. For this

reason, the government created various programs, including capital requirements and FDIC insurance, to bolster confidence in the banking system.

The epic collapse of Silicon Valley Bank (SVB) sent shockwaves through the financial markets and eroded confidence in other banks. While stocks generally have suffered, bank stocks have been particularly hard hit, with the KBW Bank index down almost 22% year-to-date.

Another impact of the banking crisis has been the plunge in government bond yields. The flight-to-safety response has sent Treasury yields rapidly lower from recent highs, especially for short maturities. As the price of bonds are bid up, the yield of those bonds drop.

Bank regulators and investors use Common Equity Tier 1 (CET1) to measure the amount of bank capital available to absorb losses. The higher the CET1, the better. In addition to making loans, banks invest the depositors' cash in securities in two buckets; available-for-sale (AFS) and hold-to-maturity (HTM). These buckets are essential because AFS securities are shown at market value, but HTM is accounted for at amortized cost. This distinction is crucial because the 10-year Treasury yield had risen from 0.5% in August 2020 to 4.1% in March 2023, leaving most bank HTM bond portfolios with significant unrealized losses not reflected in the bank financial statements.

When the Silicon Valley Bank's data is adjusted for the losses in its HTM portfolio, it only had a sliver of its capital left, which still doesn't account for possible losses from its loan portfolio. Unlike Silicon Valley Bank, the average large regional banks and Global Systemically Important Banks (G-SIBs) have a robust capital cushion, even after accounting for securities' losses. The primary U.S. G-SIBs are JP Morgan (JPM), Bank of America (BAC), Citigroup (C), Goldman Sachs (GS), Wells Fargo (WFC), Bank of New York Mellon (BK), and Morgan Stanley (MS), which are subjected to additional regulatory scrutiny and higher capital requirements.

Following the collapse of Silicon Valley Bank, the Federal Reserve announced a new facility to help banks meet withdrawal requests from depositors and restore confidence. The Bank Term Funding Program (BTFP) allows banks to borrow up to the face value of any government bonds held in the bank's portfolio at a very reasonable rate.

Another challenge for Silicon Valley Bank was the inordinate size of its securities portfolios relative to deposits. In its effort to earn more from its deposits, Silicon Valley Bank made large investments in longer maturing Treasuries, exposing their portfolio to

interest rate risk. This divergence from typical regional banks is vital in the current environment because rising yields led to massive losses in its bond portfolios.

It is also important to note that only 3% of Silicon Valley Bank's deposits qualified for FDIC insurance. According to Goldman Sachs, Silicon Valley Bank's average account size was \$1,251,000 versus \$177,000 at the average regional bank. The sizeable average account size is important because once those large accounts become fearful they have a strong incentive to flee since most of their account value could be lost in a bank failure if it is above the FDIC limit. In a significant change from the Bailey Brothers days, depositors no longer need to line up outside the bank to move their money. It only takes a few clicks on a phone or a computer to add to the pressure of a bank run.

Despite the current crisis, the U.S. banking system sits at a multi-decade high capital level. While rising yields and fluctuations in the economy have exposed the weaknesses of some banks, the banking sector does not look to be at a high risk of systemic failure or collapse.

On March 22nd, the Federal Reserve (Fed) met and raised interest rates again to combat inflation. The difference is that in the wake of the crisis of confidence in the banking system, the Fed only increased short-term interest rates for 25 basis points (0.25%) rather than the not-insignificant odds of a 50 basis point hike before the Silicon Valley Bank debacle. The one-year forward Fed funds futures rate now reflects expected rate cuts beginning this summer and the increased odds of a recession in the wake of the pressure on the financial system.

In conclusion, the banking system will not likely make the U.S. devolve from Bedford Falls to Pottersville. Unlike the Global Financial Crisis, the current banking challenge looks like one of liquidity for most banks rather than an issue of solvency. This likely eventual happy ending does not mean there won't continue to be particular pressure on some of the banks perceived to be weaker by the markets. Investors would be wise to know what they own when investing in the financial sector. In addition, any continuing turmoil within the banking system will weigh on the overall market and the economic outlook, as well as lending.

Section III. Inflation

The readings for inflation continue to moderate. Currently the Consumer Price Index (CPI) is 6.0% on an annual basis, and core CPI, which excludes food and energy, is at 5.5%. Both readings are for February 2023. The CPI reading has leveled off and the core rate actually peaked a few months back at 6.4%. This is still well above the

Federal Reserve's 2% target. The problem with all these measures of inflation is that they are backward looking or lagging indicators. The recent efforts by the Federal Reserve to reduce inflation by raising the Fed Funds Rate by 4.75% will continue to have a delayed effect on the economy.

The year over year inflation numbers also do not show the recent slowdown in inflation. Chart #1 is the raw data for CPI. In reality, the CPI has only risen 1.53% from June to February. That translates to a 2.29% annualized rate. Remember that inflation is not about lower prices, but about stable prices. This stability should start to appear in the annual rate in about 3 months. It appears that the Fed's aggressive approach is already having some effect. The normal lag for the effect of rate hikes is 12 to 24 months. Our first hike was last March.

Housing contributes roughly one third to various inflation measures and tends to be one of the greatest lagging indicators, partly because of the method of calculation. Because of rising mortgage rates the housing market may be coming to a screeching halt. With a 30 year mortgage rate rising from 3% last March to over 6.5% today, the value of residential property is already cracking, partly because the average monthly mortgage payment on a new mortgage has jumped about \$600. Chart #2 represents the Case-Shiller Home Price Index. It shows that while the growth rate of home value is still positive, the rate of growth has dropped about 70% to 5.76% over the last year through December. A report from Redfin for February (Chart #3) shows a similar trend in rents, rising just 1.7% year over year.

Chart #4 is the personal savings rate for the U.S. After averaging about 7% from 2000 to 2019, it peaked in April 2020 at 33.7%, right after the beginning of the Covid-19 lockdowns. The reading for March 2023 is down to 4.7%, which is up from our last report, indicating consumers have started to prepare for a possible recession. This should mean reduced demand causing inflation to ease.

Commodities were big contributors to inflation, but that has changed. The CRB Index, which measures a basket of commodities, peaked last June at 351.25 (Chart #5). The current reading is 282.68, which is a decline of 19.52%.

Wages continue to rise in an effort to lure people back into the workforce, as well as adjustments for increases in the minimum wage. These wage increases will not roll back and it is unsure how much further they will need to rise, but wage increases still trail inflation so it is not the problem that many believe. Wages tend to increase in order to keep up with inflation, as opposed to causing inflation.

Section IV. The Federal Reserve and Interest Rates

Because of inflation, the financial media and the Fed have become more focused on interest rates. We have been spoiled by ultra-low rates during the pandemic.

The Federal Reserve has continued with their new monetary policy. Federal Reserve Chairman Jerome Powell raised the Fed Funds rate by 0.25% at their last meeting. This might be a sign that the Federal Reserve is finally starting to moderate their rate increases and not be so far behind the curve. They also have continued to let \$95 billion in bonds roll off the Fed balance sheet each month. Both actions have tightened money supply which once again means lessening consumer demand. This is reflected by the fact that growth in M2 money for February supply is now -1.85% (Chart #6). On the other hand, the recent measures to insure liquidity are adding to the balance sheet, but these actions should prove to be temporary.

One problem we have with the Fed's current path is the pace at which they have been raising rates. It takes time for interest rate hikes to have their full effect on the economy and inflation. The economy does not turn on a dime. The rapid pace and size of the rate increases have partly contributed to the gap on some bank balance sheets.

Rates in most European 10-year bonds are pulling back along with the U.S., because of the flight to safety caused by banking concerns. The U.S. 10-year bond still remains more attractive to international investors for its yield and credit rating. The U.K. 10-year yields 3.28%, German 10-year yields 2.14%, France 10-year yields 2.66%, Italian 10-year yields 4.00% and Swiss 10-year yields 1.15%. These compare to our 3.37% 10-year yield.

Section V. The Recession Model

As we have discussed in past reports, earnings and the economy are the true long term influences on the stock market. Recessions, or fear of recessions, are the major reason we experience corrections of more than 10%. Corrections of less than 10% are just part of normal volatility and can happen multiple times each year.

The official arbiter of recessions in the U.S. is the National Bureau of Economic Research (NBER). They determine when our economy enters and exits recessions. The problem is that usually by the time they declare the official start date of the recession the economy is probably coming out or already done with that recession, in other words no predictive value.

At Clutinger, Williams & Verhoye we have developed what we view as a recession indicator which tracks 5 data sets on a monthly basis. If 3 of the 5 indicators are negative and the S&P 500 is below its 40 week moving average, it is a very strong indication that a recession is near or may already be underway.

Indicator number one compares the current monthly unemployment rate to its 12 month moving average. As of November, the unemployment rate was 3.6% and the 12 month moving average was 3.58%. By being above the moving average this indicator has turned negative.

Indicator number two is represented in Chart #7. This represents the year over year percentage change of Advance Real Retail and Food Service Sales. This is one method to measure the strength of the consumer. Currently the reading is -0.56% for March, so this indicator is barely negative. Any reading above 0 is positive. The reading is also normalizing which should relieve some inflation pressure and it also reflects less money in consumer's pockets.

Indicator number three is represented in Chart #8. This shows the year over year change in Industrial Production. This indicator is also slightly negative. It currently sits at -0.25% for March 2023. Higher production leads to greater supply.

For indicator number four (Chart #9), we look at Total Nonfarm Payrolls divided by the Civilian Labor Force Level on a year over year percentage change basis. This indicator stands at 1.40%. A zero reading represents neutral therefore this indicator is still positive.

Indicator number five (Chart #10) represents the Average Weekly Hours of Production and Nonsupervisory Employees-Manufacturing on a year over year percentage basis. Currently the reading is -1.93%, so this indicator is negative and reflects how supply chain issues have caused a slight slowdown in the economy in the last few months along with the fear of recession.

Currently four of the five indicators are negative but the S&P 500 Index is 0.77% above its 40-week moving average. With the S&P 500 above its forty week moving average this model is no longer giving its first recession warning sign. We will be closely monitoring these indicators in the coming months.

The above indicators are only updated on a monthly basis. To offset this situation we also track two other indicators. They are both indicators that are updated more frequently (on a weekly or daily basis) and we consider them as early recession

indicators. Both are somewhat volatile so we track three month moving averages. These two indicators are separate and independent of the first five and either one can indicate the possibility of recession on its own.

The first one is the Aruoba-Diebold-Scotti Business Conditions Index which is updated on a daily basis and published by the Philadelphia Federal Reserve. The 91 day moving average is at -0.14 currently. The divining line for entering and exiting recessions is -0.8.

The second indicator for recessions is the Chicago Fed Business Activity Index. It is reported weekly and the divining line for entering recessions is -0.7. The three month moving average slightly weakened and sits at -0.13.

In summary, the two “early warning signs” are not predicting recession at this time, but have weakened somewhat in the last three months.

Section VI. Market Psychology

For decades we have measured market psychology using price and volume data in the short and long term from the Dow Jones Industrial Average as well as a 17 week moving average of advancing and declining stocks on the New York Stock Exchange.

Currently 7 of 12 of our price/volume indicators are positive, which is an improvement from our last report. This is reflective of the sideways market after the recent correction in the 20% range. The S&P remains in a trading range from 3800 to 4200.

Our advance/decline line has been positive for the last few weeks and sits at 50.4%, once again reflective of the recent sideways movement. Our model that measures the first and second derivative on price and volume has recently given us a buy signal. We have developed this model to recognize patterns and spot buy and sell signals from reviewing years of historical data.

The S&P was up during the Santa Claus rally, the first five days of the year and the month of January. Since 1950, that trifecta occurred 31 times and the following full year return was nearly 18% with a 90% win ratio. An even rarer occurrence is to get the trifecta after a negative year like 2022. That happened 9 times since 1950 with an average return of 27% and a 100% win ratio.

Another study looked at broad market returns since 1926 (Chart #11). It examined returns after 10%, 20% and 30% corrections in the market. Since we just experienced roughly a 20% correction the middle bar graph is most relevant. It shows an average return after one year of 22.2% and a five year cumulative return of 71.8%.

Section VII. The Economy

Indexes that measure manufacturing data have weakened. The Philly Fed Manufacturing Index was -23.2 in March of 2023. The Empire State Manufacturing Index fell to -24.6. The national ISM manufacturing index fell to 47.7% in February and the ISM services index is at 55.1% (above 50 is considered growth, above 55 is considered exceptional growth). All these readings reflect that the Fed can have an effect on business and manufacturing but very little effect on the service economy. It also shows that we may already be in a recession.

Multiple Wall Street and Federal Reserve predictions for GDP have been lowered because of the banking situation and inflation for 2023. In fact many are calling for a negative GDP number. But GDPNow currently estimates GDP at 3.2% annualized for the first quarter. These economic indicators paint a bit of an opaque picture moving forward and are part of the indication to us that the market could be bottoming.

Section VIII. Conclusion

The concern for the possibility of a banking crisis can only be healed with time. We feel this situation will not develop into a major problem. We also believe the Fed is almost done raising rates and inflation will continue to ease. It would appear that we may see blue skies ahead after a couple more minor storms.

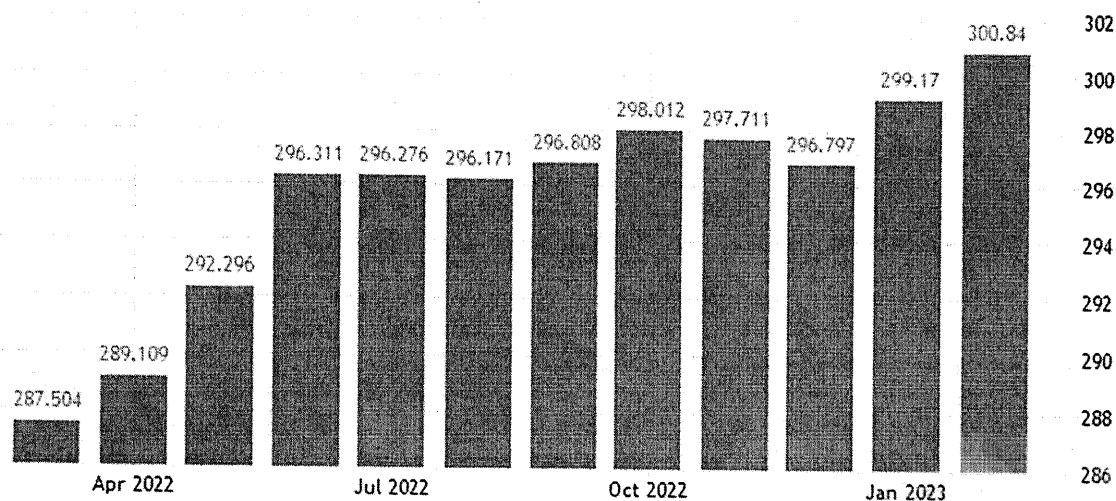
We have grown cautiously optimistic on the markets and feel they are now close to a bottom, with the S&P currently staying in a trading range this year. Even if we are incorrect in the short term, purchases in the near future should prove very profitable in the years ahead based on the cyclical nature of the economy and the stock market.

Have a wonderful spring!

Scott B. Williams, CFA, CFP
Kent Stone

United States Consumer Price Index (CPI)

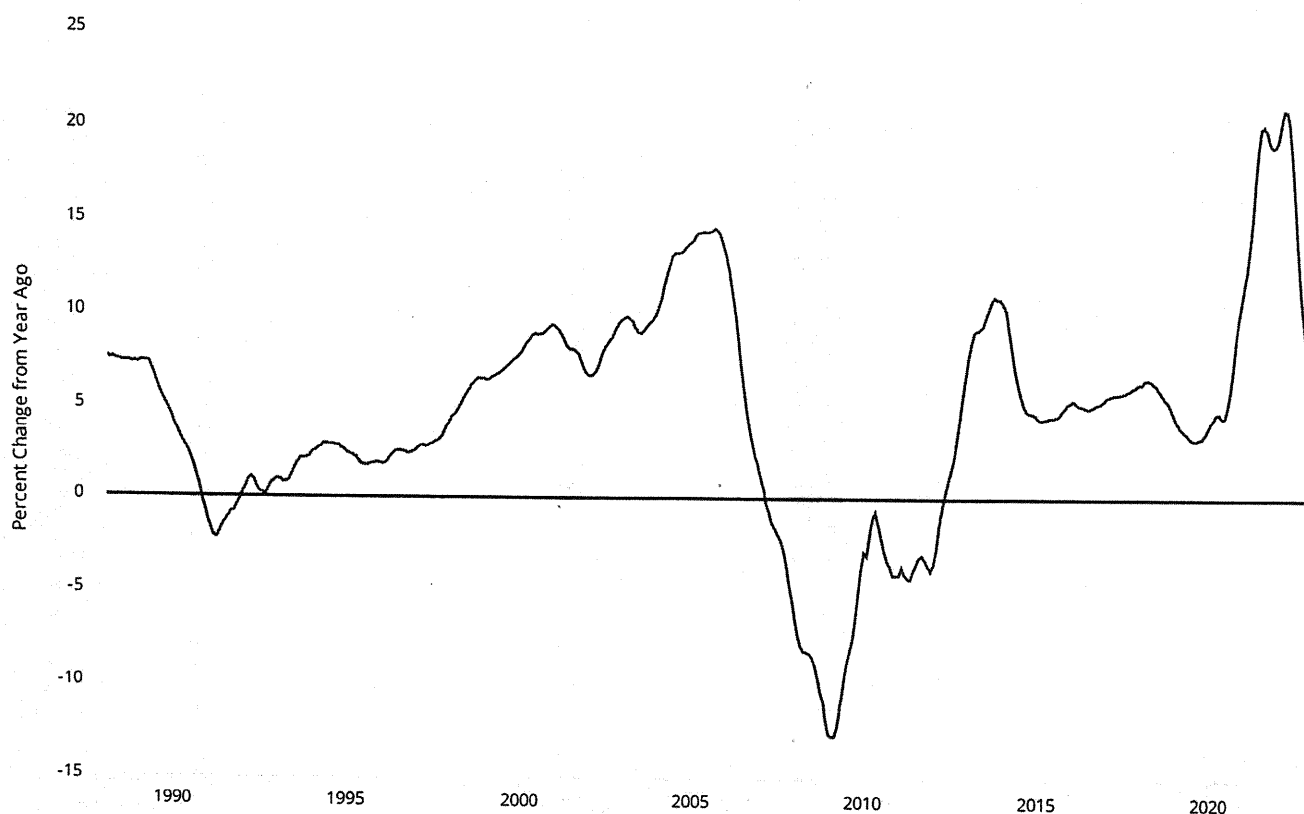
The consumer price index in the United States rose by 6.0 percent year-on-year to 300.84 points in February 2023, broadly in line with market consensus of 300.86 points. The annual inflation rate slowed for an eighth consecutive month, suggesting inflationary pressure in the world's largest economic cooled following the US Federal Reserve's tightening campaign over the past year. source: U.S. Bureau of Labor Statistics



TRADINGECONOMICS.COM | U.S. BUREAU OF LABOR STATISTICS

Chart 2

FRED — S&P/Case-Shiller U.S. National Home Price Index



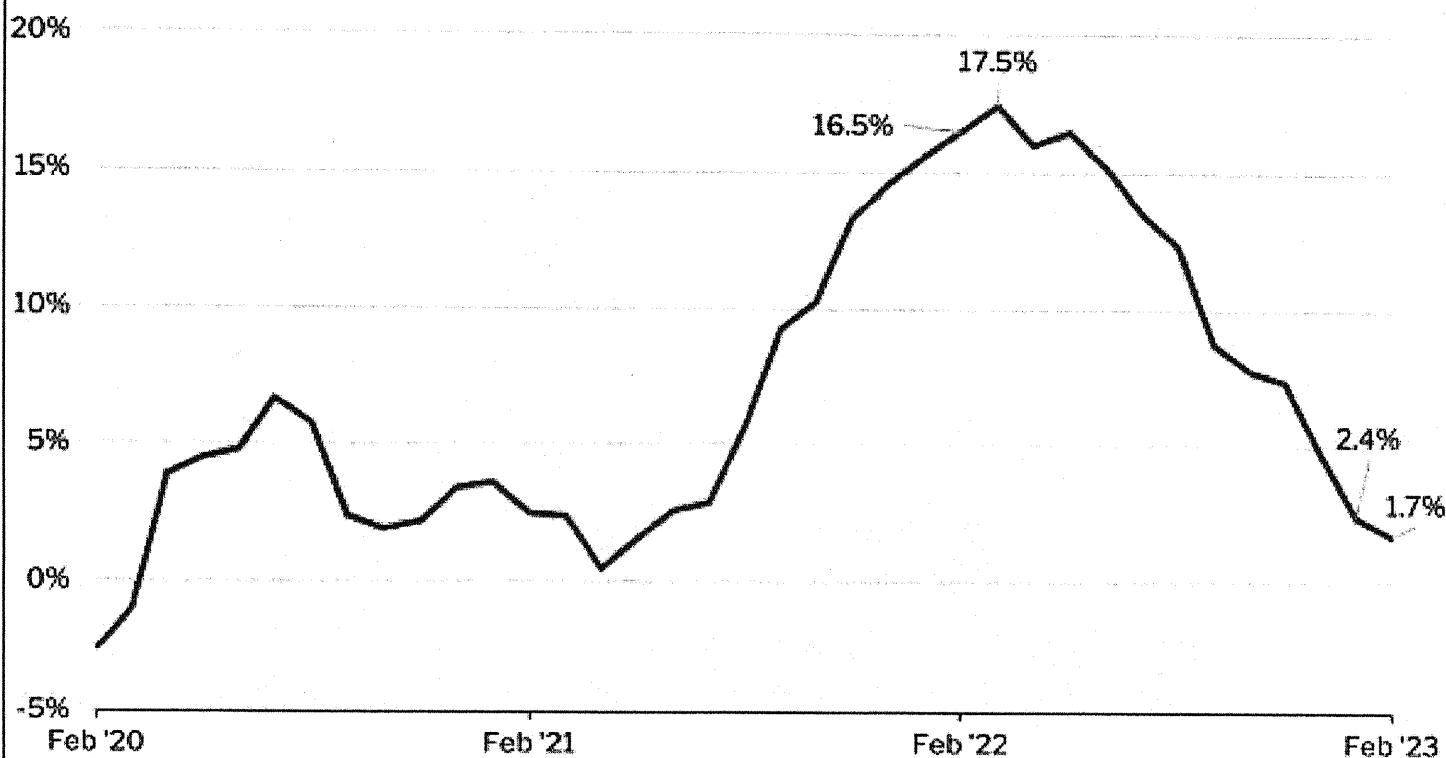
Source: S&P Dow Jones Indices LLC

fred.stlouisfed.org

Rent Growth Continued to Slow in February

Year-over-year change in median U.S. asking rent

Chart 3

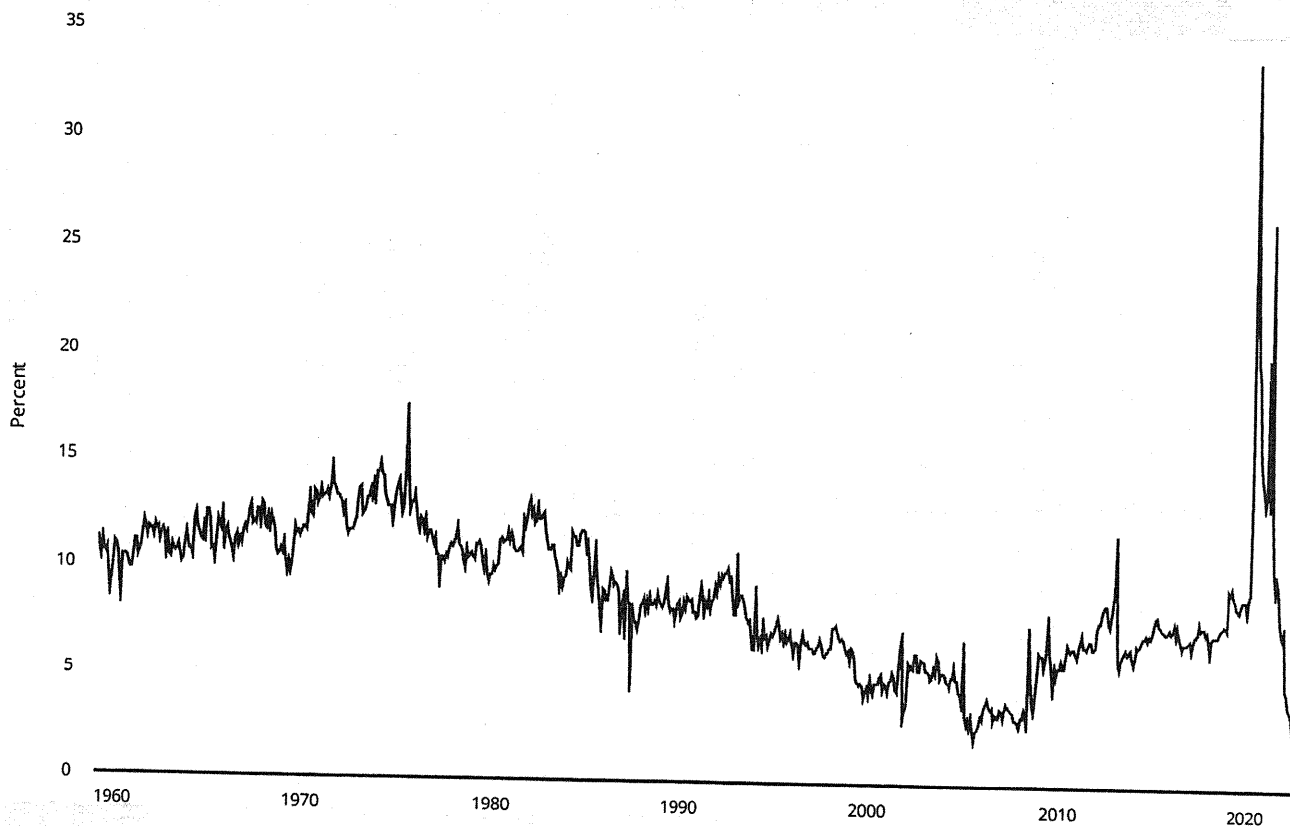


Source: Redfin analysis of asking rents

REDFIN

FRED — Personal Saving Rate

Chart 4



Source: U.S. Bureau of Economic Analysis

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CRB Index



Chart 5

CRB Index (Index Points) 282.68 -0.92 (-0.32%)

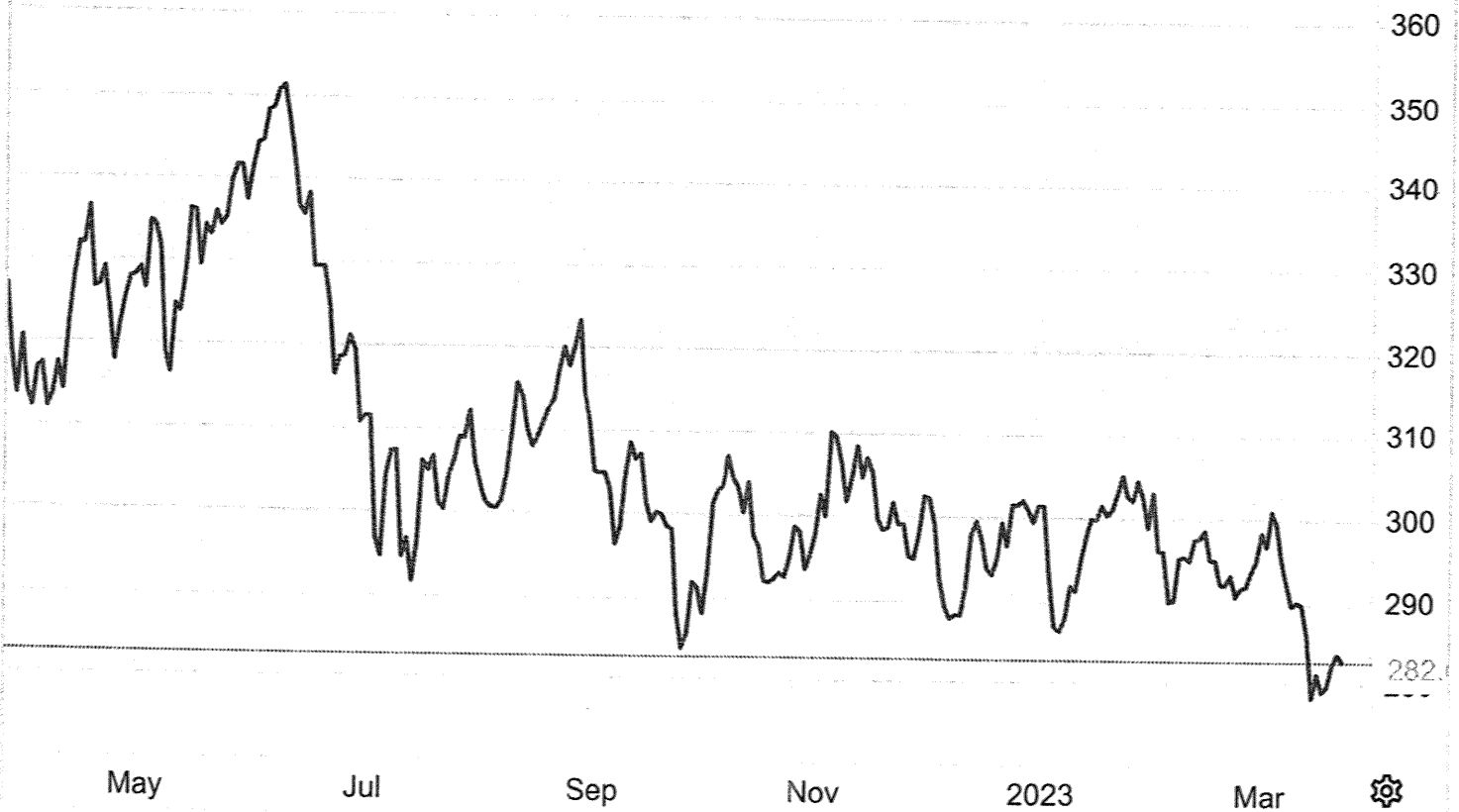


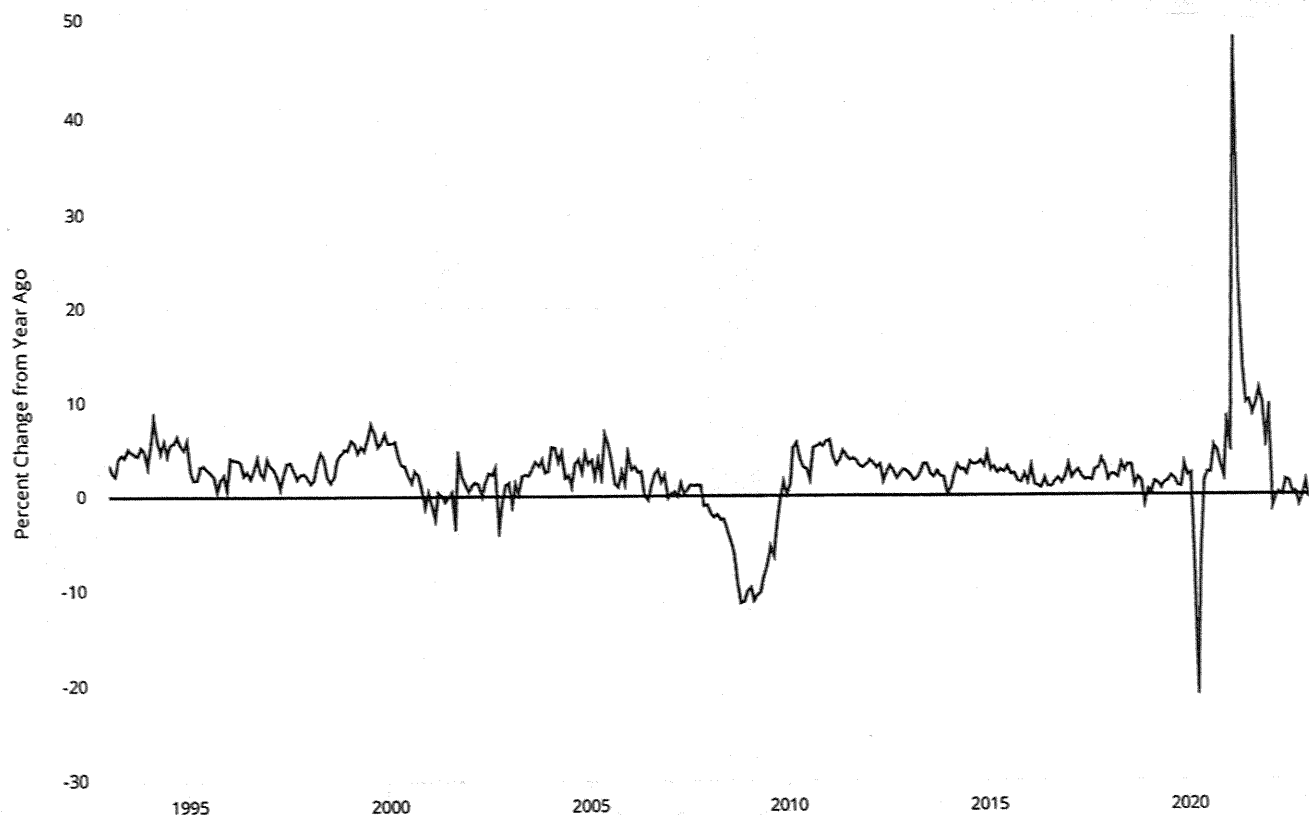
Chart 6

FRED — M2



Source: Board of Governors of the Federal Reserve System (US)

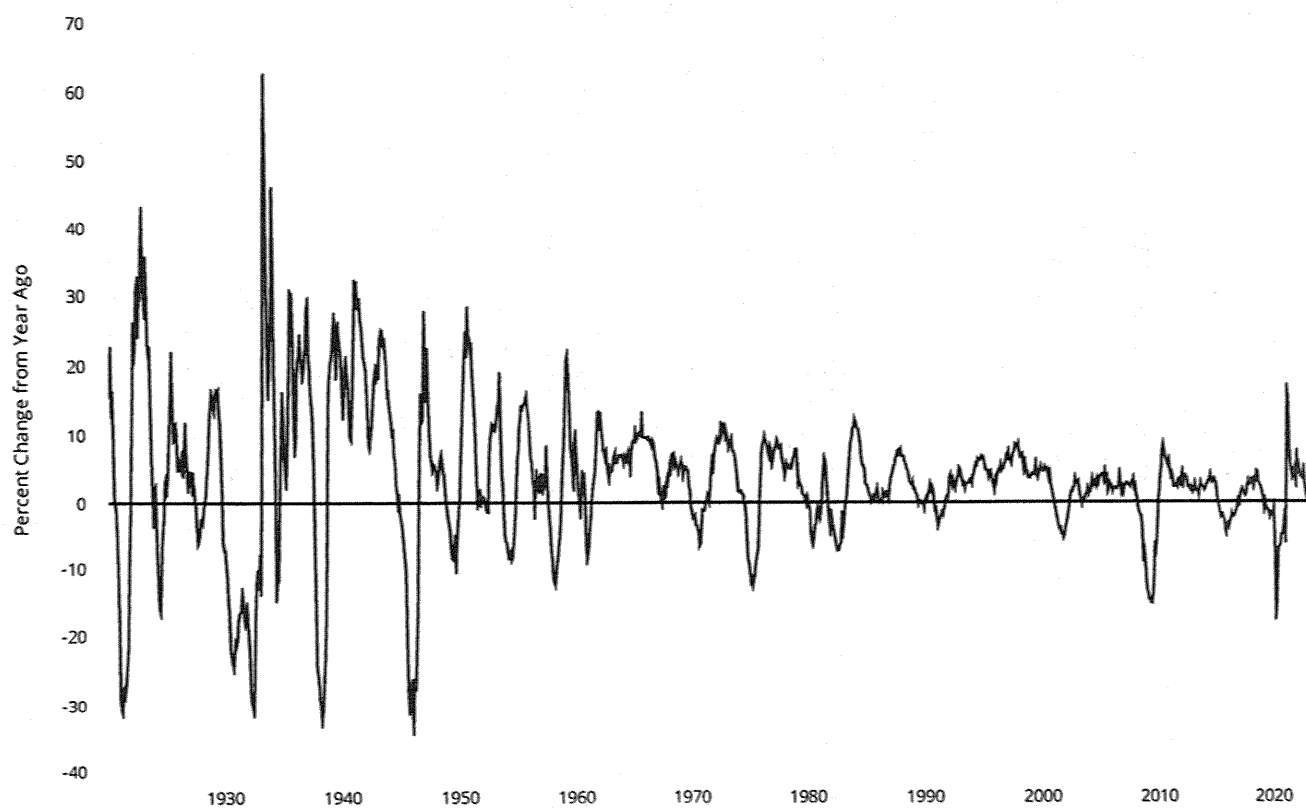
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Source: Federal Reserve Bank of St. Louis

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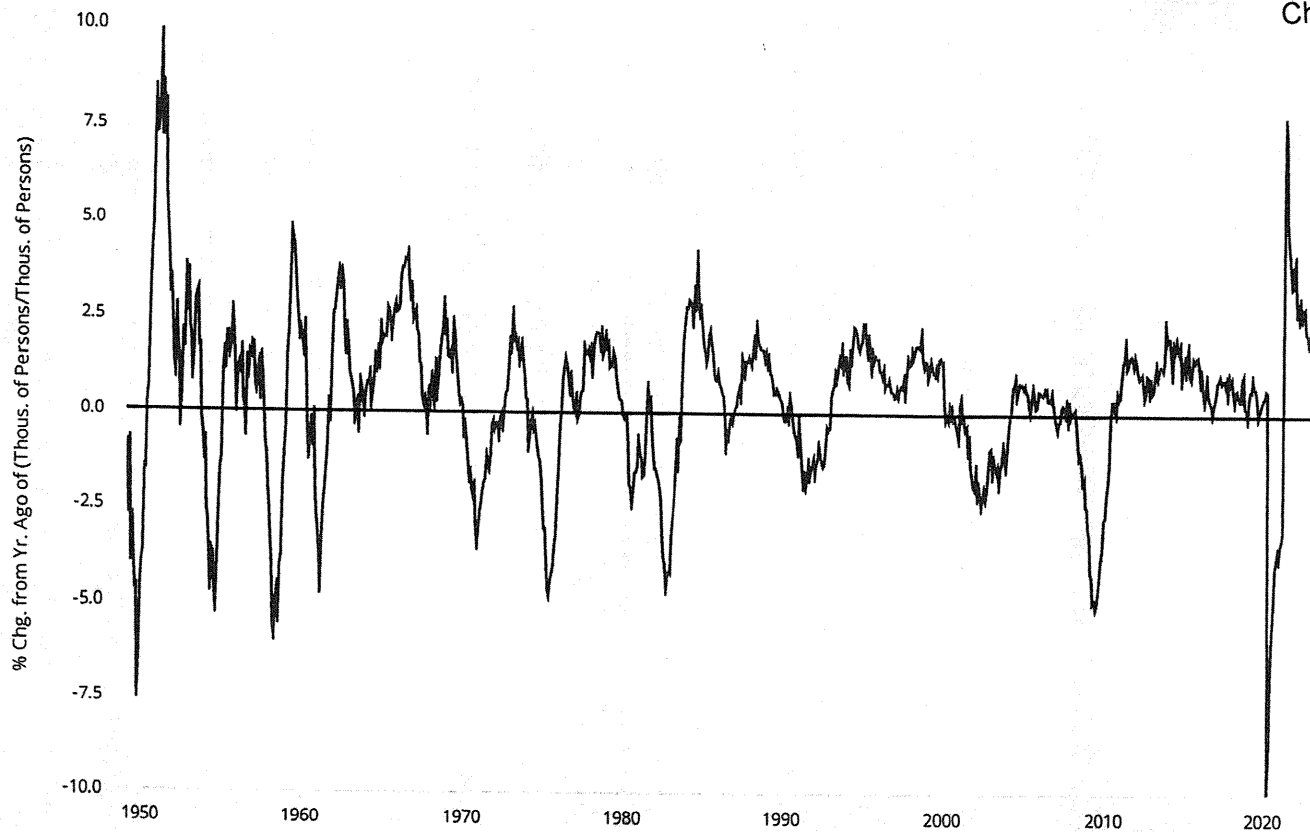
Chart 8



Source: Board of Governors of the Federal Reserve System (US)

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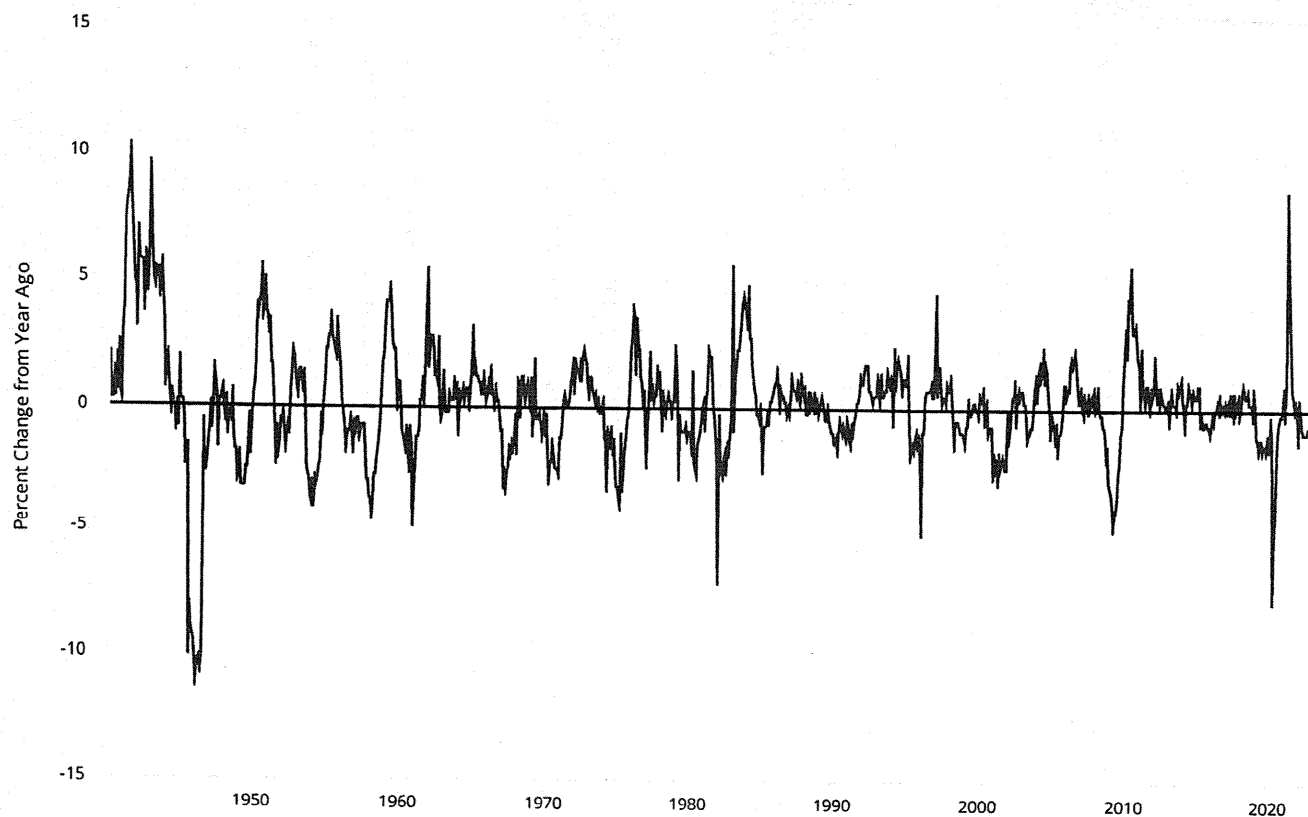
Chart 9



Source: U.S. Bureau of Labor Statistics

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Chart 10



Source: U.S. Bureau of Labor Statistics

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Fama/French Total US Market Research Index Returns, July 1926-December 2021

