HoyleCohen Briefing — March 31, 2023

<u>A hiccup in the fractional reserve banking system</u>
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The Fed finally broke something, and as a result their dual mandate just got a lot more complicated. In the wake of the two bank failures, the market was 50/50 on the outcome of the Fed's March meeting results, vacillating between a pause and a .25% increase in the Fed Funds rate. The Fed can't give up the inflation fight, but the ripple effects from a banking crisis can douse future economic activity just as effectively as more rate hikes. While the upcoming economic data reports will not yet reflect the post bank crisis economic landscape, a number of economists have reduced growth expectations for the balance of the year as a result of the changed landscape.

That said, the Government response to the bank run at Silicon Valley Bank was spot on, as it addressed the cause. Allowing this tier of banks to use face value rather than market value of bonds held as collateral to access funds, then addressing the flash drop in confidence by making ALL depositors whole regardless of size was like a giant dose of Pepto Bismol, calming the markets and reducing the odds of a longer lasting ulcer. Once again, the banking industry is in the crosshairs, and rightfully so, as the banking system is the plumbing of the economy, and as such needs to be reliable and healthy. As regulators, depositors, and investors review the landscape in the aftermath, changes will likely occur. The events of March are water over the dam, and confidence, while improved since mid-March, remains damaged.

Reports from various sources show that bank deposits and bank borrowing from the Fed have stabilized from prior weeks, but the 3-alarm fire with respect to deposit safety resulted in money flowing into large banks, out of smaller banks, with significant amounts of money being directed to money market funds. Considering how bank lending is distributed in the US, this is not so good for smaller businesses. Banks with less than $10 billion in deposits cater to about 40% of small business lending (SBL), the top 13 largest banks handle less than 23% of SBL, with the balance of SBL served by mid-tier banks or non-bank lenders. If we believe the deposit flow to larger institutions is coming from both small and mid-sized banks, those that cater most to smaller businesses have less money to lend. If additional regulations are introduced to "protect" the banking industry, those regulations have a cost that will be borne by the banks and passed on to depositors and/or borrowers. Often, the cost per institution may be similar but the percentage of the cost relative to gross income can differ widely, which favors larger banks, so who pays what will be a debate. For small banks, the combination of less deposits and potentially more costly regulations simply cannot lead to greater lending, the math just doesn't support it.

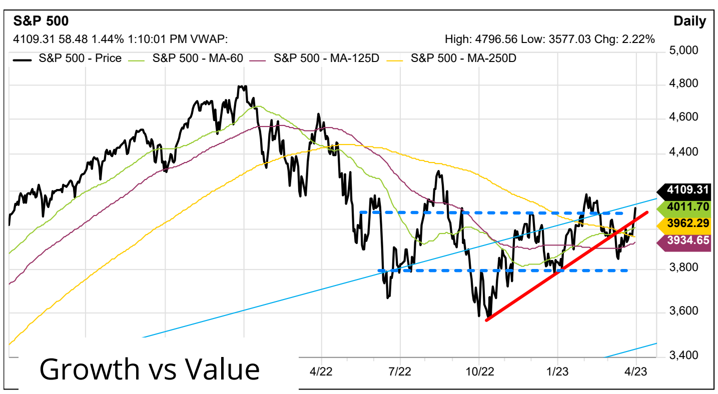
In a confidence crunch the flight to safety, and/or safer growth should ultimately benefit larger banks and well capitalized firms, hurting smaller, less well capitalized firms, with spillover effects to other industries serving smaller, credit needy businesses as well. How profitable the banking activities of a bank will be in the future is an obvious question for the balance of the year.

Despite the March Madness in the banking industry, investors seemed to view the repairs made to address the damage positively with the S&P 500 recovering from its mid-February to mid-March drop to stage a nice rally into the end of the month. We have noted previously that expectations for lackluster company profits in 2023 may already be baked in the cake. Earnings expectations for 2023 and 2024 are still being lowered, but not in a meaningful way over the last 3 months. Looking forward, earnings are expected to increase a little more than 12% from 2023 to 2024, and at some point that data comes into play with respect to market valuations.

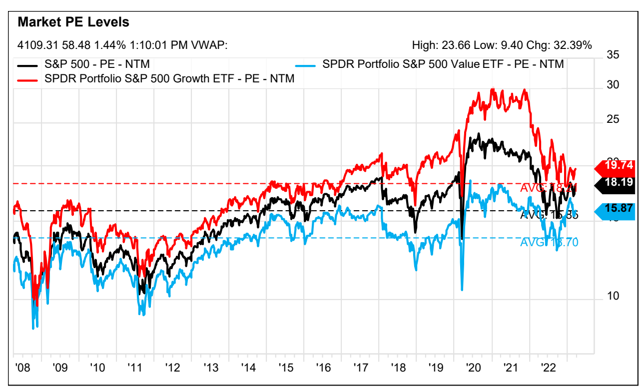
Still a second half story, but it would be nice to catch a break on the news flow....

Stocks:

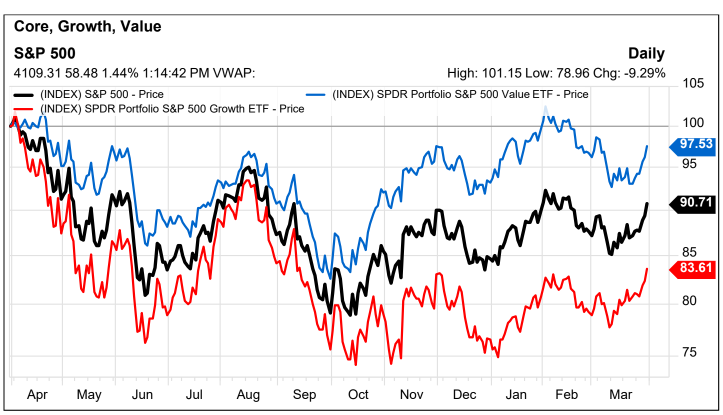
S&P 500 - Price



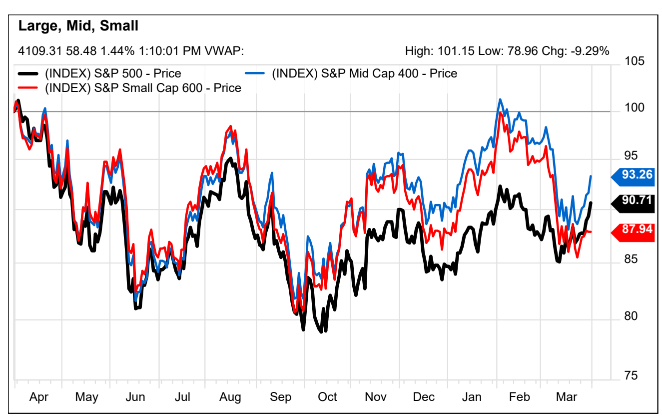
S&P 500 – PE Ratios



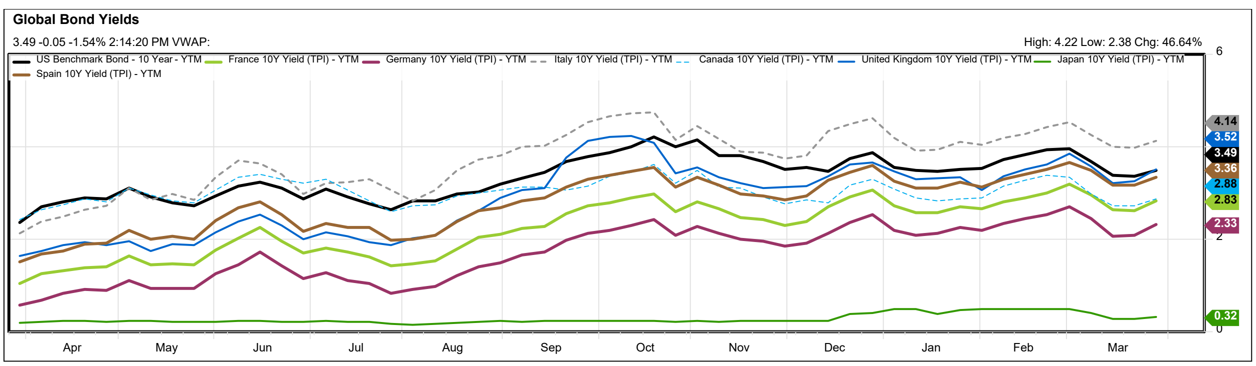
Growth vs Value



Capitalization Compare



Bonds:



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