COMSTOCK®

Paul Comstock Partners ®

Your Partner in Investment Decision Making

1ST QUARTER 2023

Market Commentary

Can't you understand what's happening here? Don't you see what's happening? Potter isn't selling. Potter's buying! And why? Because we're panicking, and he's not. That's why. He's picking up some bargains! – George Bailey, It's a Wonderful Life

Equity markets shrugged off the turmoil in the banking sector, with the S&P 500 returning 4.2% for the month of March and 7.5% for the full quarter. Large technology stocks led the market with the FAANG-dominated NASDAQ 100 Index returning 20.8%. Speculative investments experienced a large bounce from the lows of last year. Bitcoin, while still down approximately 40% since the end of 2021, appreciated over 70% in the first quarter. The ARKK ETF, the poster child of tech stock speculation during the pandemic, rebounded 29% during the first quarter, trimming its loss from December 2021 to -58.2%. Meme stocks GameStop and AMC Theaters also returned over 20%. The main sectors of the Russell 1000 Growth Index – Technology, Communication Services and Consumer Discretionary – posted double-digit first quarter returns. Energy, Financials, Healthcare and Utilities declined, led by the -5.6% return of the S&P 500 Financial sector. Our managers tend to overweight technology and underweight financials, particularly banks, and this contributed to a majority of them outperforming during the quarter. European stocks returned 9.9% for the quarter, outperforming other major regions. Within emerging markets, the rebound of technology stocks contributed to the outperformance of our managers in that region. Bond values recovered, with the 3.0% total return of the Bloomberg US Aggregate Bond Index slightly higher than the approximate income return for the quarter of 1.2%. Intermediate-term municipal bonds delivered similar performance.

Inflation continued to moderate, albeit slowly, with February CPI coming in at an annualized rate of 4.9%. While commodity prices continue to moderate, inflation in the services sector remains elevated in the 4-5% range. This prompted the Federal Reserve to announce a 0.25% rate increase at its March meeting and reiterate its commitment to fighting inflation. Nevertheless, after the failures of Silicon Valley Bank and Signature Bank, the market expects the Fed to begin cutting rates in the second half of the year. At the end of February, the futures market expected Fed Funds to increase to 5.4% during the third quarter of this year. After the events of March, the market now expects a half-point decrease from the current 5.0% Fed Funds rate by the end of September and a full point by the end of the year.

Banking

Headlines about bank failures in the financial press stoked fears lingering from 2008. However, current circumstances bear little resemblance to that period. The FDIC quickly resolved the failures of Silicon Valley Bank and Signature Bank without any loss to depositors. The Federal Reserve simultaneously expanded the liquidity available to banks, allowing them to borrow against the par value of held securities. This resolved immediate concerns about interest-rate driven unrealized losses. Within the banking sector, Silicon Valley and Signature were outliers, with large concentrations of corporate deposits in excess of FDIC insurance limits and large bond holdings.

The banking sector's exposure to commercial real estate (CRE) lending has also been getting some attention in the financial press. Nearly one-third of the $4.5 trillion currently outstanding in CRE mortgages matures over 2023 and 2024. Banks own around 38% of these mortgages and it comprises approximately 20% of their aggregate assets. Additionally, most of the $478 billion in construction loans held by banks will mature over the next few years. Construction loans total less than 4% of total bank assets but comprise larger percentages for a few individual regional banks. Losses from all commercial real estate loans during the 2008 Global Financial Crisis peaked at under 3.5% of outstanding loan balances with similar losses during the S&L crisis of the late 1980s / early 1990s. Total losses for all bank lending activity peaked at 3.0% during 2008-2009. Most banks could withstand this level of loss today. Bank Tier 1 capital ratios currently are more than three percentage points higher than in mid-2000s, before the Global Financial Crisis. This simple comparison does not incorporate the more conservative underwriting standards since 2008, which would reduce loan losses and further mitigate against widespread distress among banks.

The banking reforms after 2008 increased capital ratios and penalized risky lending. As a result, the banking system remains strong, with no risk of a 2008-style systemic collapse. However, the large interest rate increases last year created difficulties. Banks continue to resist increasing the rates paid on deposits, with the average interest-bearing deposit account still paying

under one percent. Banks face the prospect of either losing deposits to higher yielding money market funds or increasing the rates on deposits above what they earn on loans made over the last few years. Low deposit rates drive customers to move their assets to money market funds and/or Treasury Bills. Banks took in $4.7 trillion in new deposits during the pandemic and, since the April 2022 peak, customers withdrew $665 billion. The combination of a shrinking deposit base and the requirement to pay a more competitive rate of interest will impact bank profitability, and more importantly for the broad economy, availability of capital to lend.

Recession

The risk of a pullback in bank lending, which impacts small businesses and consumers, presents a greater risk to the economy than a few isolated bank runs. Recent economic data, much of which predates the banking issues in March, indicates slowing activity in both the manufacturing and services sectors. While employment data remains robust, these metrics tend to fall only after the start of a recession – businesses respond to a slowing economy with layoffs and reduced hiring. Layoffs and a weaker job market then exacerbate the slowdown as consumers pull back on their spending. Credit contraction from the banks will reduce the need for the Federal Reserve to continue hiking rates but increases the risk of recession.

A slowing economy poses risks to corporate earnings. Goldman Sachs recently forecast the worst earnings season this quarter since the initial impact of the COVID pandemic. Consensus analyst estimates now project the S&P 500's 2023 earnings to be around 5% below 2022. While valuations reset last year in response to higher interest rates, stocks now face volatility from earnings expectations.

The NBER, the government agency responsible for declaring recessions, takes on average over nine months to name a recession. Often by the time the NBER declares the recession it has already ended. Official start dates of recessions occur around the peak economic level, so if the current slowdown worsens to the point that the NBER declares a recession, its start date most likely is behind us.

What to do?

While the economy clearly shows signs of slowing, formulating a trading strategy to time equity markets remains too risky. Investors must accurately time both the exit and re-entry for market timing to add value, while incorporating the impact of any capital gain taxes incurred.

Throughout the growth-dominated market of 2020 and 2021 and the bear market in 2022, we focused on rebalancing portfolios around expected cash flow needs. As a result, diversified client portfolios began this year well-positioned for a wide range of outcomes. The challenges of the current environment will also begin to present opportunities. While it is early for many investment strategies, publicly traded apartment REITs declined over 30% from their 2021 peak, reflecting the impact of higher interest rates, whereas private market values are only just starting to correct. These companies feature high quality assets and low levels of debt. For portfolios that have space for this type of investment, we will be introducing several new private funds that will be deploying assets over the next few years.

- Stephen C. Browne, CFA
Chief Investment Officer
Chief Compliance Officer

Upcoming Office Closures

May 29, 2023 In Observance of Memorial Day
July 4, 2023 In Observance of Independence Day

New to Comstock Team

Sonja Borda, CFP®, CDFA®, has joined Comstock as a Senior Wealth Strategist. She comes to the firm with over 20 years of experience in the financial planning industry. She will be serving clients by providing customized wealth strategies, cash flow management, and ongoing monitoring of portfolios to help clients achieve their objectives. Areas of specialized expertise include multi-generation wealth transition planning, and retirement planning.

Renier Selman has joined Comstock as an Operations Associate. With a Bachelor of Science in Finance as well as 9 years in the industry, Renier joins our Operations team and will be serving clients by facilitating cash movements, completing new account paperwork, and trading.

Mark your calendar…

Upcoming Smart Investing Webinars & Luncheon

Tuesday, July 18, 2023 at 11:30 Central

Tuesday October 10, 2023 at 11:30 Central

To view past recorded webinars:
https://paulcomstockpartners.com/resources/smart-investing-webinars/