Market Update

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Alex Hart, CFA, CAIA

PATHSTONE

Cutting Through the May Daze

The S&P 500 posted back-to-back gains in March and April, bringing year-to-date returns to nearly 10%. If you had not read the headlines, you'd never have guessed that on May 1 the U.S. would see its third major bank failure in as many months. In the days following, the Federal Funds target Interest rate reached a 16-year high, rumors of further bank failures circulated, and the Department of Labor surprised the market with an unexpectedly robust jobs report.

Beneath the surface of a resilient market and economy, the stresses of rising interest rates continue to reveal risks lurking below. If interest rates stay elevated, we believe regional banks will continue to face significant headwinds caused by the ongoing shift of deposits to larger money center banks and money market funds. In this context, we are reaffirming our guidance to clients to 1) maintain a modest underweight to growth assets and 2) prepare stability assets to deliver the liquidity and diversification necessary to position portfolios for the opportunities to come.

Developments so far this month

- **First Republic Bank fails:** After 40% of First Republic's deposit base left the bank in Q1, California regulators stepped in to facilitate a sale of the bank at month-end. By Monday morning May 1, it was announced that JP Morgan would acquire the bank and protect all deposits with a risk-sharing agreement supported by the Federal Deposit Insurance Corporation (FDIC). This marks the third U.S. bank to fail so far in 2023, following the collapses of Silicon Valley Bank and Signature Bank in early March.

- **Fed hikes 0.25% and signals pause:** On May 3, the Federal Reserve raised the target Federal Funds rate to 5-5.25%, a widely anticipated move. In their statement, the Fed signaled that they would pause further rate hikes and instead carefully monitor the economy and the effects of their policy changes. In the opening comments of his press conference, Fed Chairman Powell sought to reassure investors that the U.S. banking system was "sound and resilient" and that conditions had improved since March.

- **Further bank failures in focus:** Just hours after Chairman Powell's comments, Bloomberg reported that PacWest Bancorp was seeking strategic alternatives, inclusive of a sale of the company, sending the stock down more than 50%. Rumors begin circulating that more banks may be at risk, including Western Alliance Bancorp, putting pressure on stock prices across the industry.

- **Strong jobs numbers:** The headline jobs report released on Friday, May 5, showed a surprisingly strong increase in nonfarm payrolls in April (+253k), pushing the unemployment rate down to 3.4% from 3.5% previously. We did see February and March employment figures revised lower, offsetting some of the positives from this month's report. However, when looking at the strong April jobs numbers combined with preliminary Q1 unit labor costs, which grew by 6.3%, we can understand how the consumer has helped the economy to maintain its footing.

- **Debt Ceiling Debate Heats Up:** President Biden and Speaker of the House Kevin McCarthy meet to discuss the looming debt ceiling following pleas from Treasury Secretary Yellen, who insists that the Treasury's resources could be depleted as early as June 1st.

What does this mean for portfolios?

These developments support our assessment that now is a good time to continue to extend duration in fixed income portfolios. The latest Fed announcement increases our conviction that we are at or near the peak of the rate-hiking cycle, and the failure of First Republic highlights the possibility of further market and economic stress. Under these conditions, we believe high-quality longer-duration fixed income assets will serve as an important diversifier to riskier asset classes. Returns on cash are still attractive but with the potential for further bank stress and the looming debt ceiling deadline, a hands-on approach is required to optimize for a balance between liquidity, safety and return.

On the equity side, regional banks make up a small component of the investable universe, and the strategies we implement carried de-minimis exposure, in our view. Given the risks we have highlighted and our view of valuations, we continue to favor a modest underweight to equity strategies broadly, with a tilt toward high-quality international equities, which provide lower valuations and have performed well against dollar-denominated investments.

What is next?

The question on everyone's minds is whether the failure of First Republic will spark further contagion in the banking sector and beyond. In our assessment, these failures are a function of rapid shifts in depositor base facilitated by attractive yields in money market funds and the ease of money movements in a smartphone generation. Unlike prior crises, credit quality is less of a concern for now, so contagion risk is largely a function of customer sentiment. This is an inherently difficult factor to forecast, but if the Fed continues to maintain or boost its lending rates, we believe it may lead to further economic challenges for banks as well as borrowers.

We are comforted by the fact that in this series of bank crises, 100% of customer deposits were protected and available immediately. However, the ongoing shift of assets from regional banks to larger money center banks and money market funds may have negative derivative impacts on lending practices – and therefore economic growth. In response, we are sourcing and reviewing opportunities in the private credit and real estate markets, where we believe well-resourced and thoughtful private lenders may be able to step in as a source of capital and drive excess returns for investors.

Conclusion

In addition to proactively addressing investment positioning, Pathstone's leadership and operations teams have been hard at work ensuring that the financial institutions we partner with continue to serve you at the highest level. Even as we remain confident in all of our partners, we have carefully reviewed our internal positions and operations to ensure our ability to serve you remains uninterrupted.

As always, we welcome your questions and value your trust. Please do not hesitate to reach out to your advisory team with any needs.

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