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Doll's Deliberations

Special Edition – The Banking Crisis | March 13, 2023

We have seen in past cycles that the Fed tends to tighten until something goes "bump in the night." We have achieved that again this cycle with the Silicon Valley closure. Last week, we witnessed an incredibly fast failure and closure of Silicon Valley Bank.

Fed actions following Silicon Valley failure:

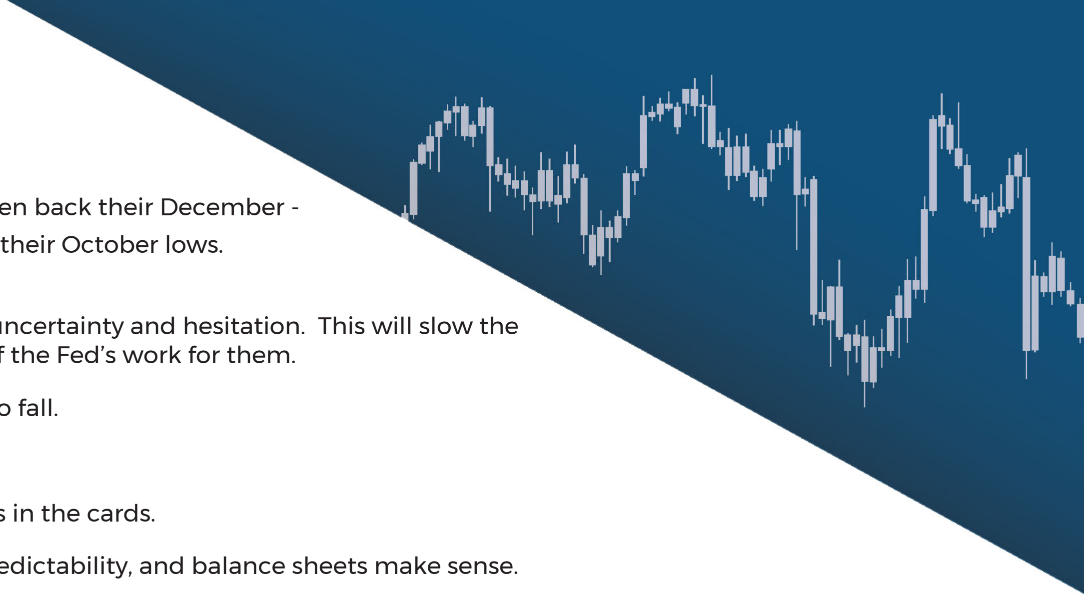
1. Made depositors whole
2. Shut down Signature Bank
3. Created a new liquidity facility enabling banks to access funds at par (not mark to market) to meet liquidity needs.

Observations

1. We have warned often in our weekly commentaries that there are consequences to raising interest rates at the second fastest pace in U.S. history (0% to 4+% in less than 12 months).
2. Every tightening cycle has experienced a credit or liquidity problem ("bump in the night").
   Examples are: Continental Illinois – 1984, LTCM – 1998, Eurozone Crisis – 2012.
3. This event is part of the lagged impact of Fed tightening.
4. There is more we don't know than we do know.
5. The closing of Silicon Valley Bank (16th largest bank in the U.S.) stemmed from a duration mismatch and heavy exposure to tech start-ups. Signature Bank was also closed and was heavily crypto related.
6. Expect tightening bank regulations, tougher supervision, and higher capital requirements.
7. Other banks have duration mismatches and the market will question whether they will be forced to sell. The big rally in bonds (≈ 100bp drop in two-year paper, ≈ 50bp in ten-year paper, and noticeable reduction in further Fed rate increase expectations and the peak Fed funds rate) will help repair duration mismatches.

Current and Likely Impacts

1. A significant decline in most bank and financial stocks.
2. "Higher for longer" is in question and the Fed soon may pause.
3. Peak Fed funds expectations has fallen considerably.
4. Cost of capital for banks has gone up.
5. Slowing of job growth – maybe abrupt.
6. Venture capital and start up world is in disarray.
7. Confidence and visibility toward stabilization is not yet evident.



ECONOMY/STOCKS – Stocks have given back their December - February gains. Banks have taken out their October lows.

1. Credit and liquidity events cause uncertainty and hesitation. This will slow the economy and accomplish some of the Fed’s work for them.
2. Earnings estimates will continue to fall.
3. Recession risk has gone up.
4. Continue to think mild recession is in the cards.
5. Defensive positioning, earnings predictability, and balance sheets make sense.
6. The bear market will eventually end – it likely couldn’t end before a bump in the night occurred. Oversold rallies likely.
7. What do we need to see for a final low?
   - More belief in recession/lowered earnings estimates
   - Probably lower prices

   Remember – stocks have never made their low before a recession started.

The main cyclical issues facing the U.S. economy right now is a too strong labor market and too high inflation. Slowing nominal growth, the lagged impact of all the tightening, and now the certainty of even more restrictive bank lending standards, increasingly make the recession likely. As more stimulus and liquidity bubbles burst, a decline in EPS will likely lead to weaker employment and wages and cooler inflation. If bank failures lead to an economic crisis, P/E ratios will fall further. If the banking shock settles down, markets will rally.

As we have said often, 2022 was a focus on valuation compression; 2023 is a year of focusing on fundamentals and earnings. We continue to expect a test of the October low below S&P 500 3600. Either way, focusing on fundamentals remains a critical factor in security selection. Companies that can maintain profitability and growth will do best in this period.