MARKET LETTER

A QUARTERLY PUBLICATION *of* FERGUSON WELLMAN, OCTAVIA GROUP *and* WEST BEARING

MARKET LETTER
SECOND QUARTER 2023

IN THIS PUBLICATION

Founded in 1975, Ferguson Wellman is a privately owned registered investment adviser, established in the Pacific Northwest. As of January 1, 2023, the firm manages $7.1 billion for 943 clients that include individuals and families; Taft-Hartley and corporate retirement plans; and foundations and endowments with portfolios of $4 million or more.

West Bearing Investments, a division of Ferguson Wellman, serves clients with assets starting at $1 million.

Octavia Group provides fee-based personal financial services exclusively for Ferguson Wellman and West Bearing clients with a minimum of $5 million managed by our firm.

INVESTMENT EXCELLENCE
LIFELONG RELATIONSHIPS

STALEMATE

GEORGE HOSFIELD, CFA
Director
Chief Investment Officer

A MANIFESTATION OF interest rate risk and deposit flight amid the Fed's ongoing battle to tame inflation precipitated the nation's first significant bank failure since the global financial crisis (GFC). Despite concerns about U.S. banking, blue-chip equity indices finished the first quarter in the black, led by mega-cap technology stocks.

While dramatically higher interest rates over the past year create the potential for adverse banking outcomes, poor management of its balance sheet is what ultimately doomed Silicon Valley Bank. In an industry as large as U.S. banking, exceptions like this exist, but should not be viewed as a harbinger of systemic risk. In contrast to the profligate mortgage lending that metastasized in the U.S. financial system in the GFC, banks today employ more prudent loan underwriting and have notably stronger balance sheets amid heightened regulatory oversight.

Meanwhile, the Federal Reserve is steadfast in its quest to slay the dragon of inflation, which has been slower to retreat of late. Recognizing that historically it takes at least a year to feel the full economic impact of a rate hike, the economy has now only absorbed the weight of the first quarter-point hike that was initiated in March of 2022. Recognizing there is more economic slowing in the pipeline, with the Federal Funds rate now exceeding the yield on the two-year U.S. Treasury, the bond market is signaling to the Federal Reserve that they have done enough … to which we agree.

As the chart depicts, the nature of inflation has changed from the more volatile components of energy and goods, to services such as rent. Service price moderation is dependent on slack in the labor market, and therefore tends to be slower to retreat. A silver lining to bank clouds lingering is that in their quest for additional balance sheet liquidity, banks are likely to make fewer loans, and this headwind to economic activity should help end the stalemate of slower inflation reduction.

Amid generationally low unemployment and an ongoing surfeit of job demand, we observe a U.S. consumer who is gainfully employed with the ability to spend. Given that consumption is over 70% of economic activity, we believe that if a recession occurs, it should be short and shallow.

The Changing Complexion of Inflation

Source: U.S. Bureau of Labor Statistics

As we predicted in our *2023 Outlook*, bonds are proving to be more defensive this year, having delivered both income and diversification benefits. While equities could experience continuing volatility into mid-year as earnings estimates are right-sized for inflation-linked margin pressures and a slowing economy, we remain overweight large-cap U.S. equities, recognizing that they already discount two-thirds of a typical bear market drawdown and tend to rally quickly when sentiment turns.

Our Ferguson Wellman logo is based on a bronze coin of Marcus Aurelius Antoninus, emporer of Rome from A.D. 161 to 180. According to historian Edward Gibbon, he was the only person in history in which, "the happiness of a great people was the sole object of government." Marcus Aurelius was the author of a series of personal writings and meditations that revealed a mind of great humanity, natural humility and wisdom.

BANK STRESS 2023 ≠ GFC 2008

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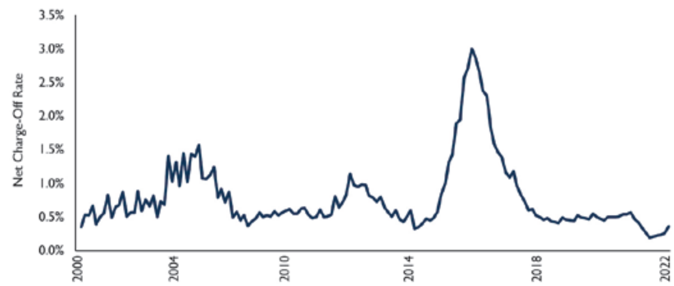
THE WAVE OF ROLLING CRISES THE world experienced 15 years ago amidst what would come to be known as the global financial crisis (GFC) stands in marked contrast to that being experienced today in U.S. banking. We reflect on the shotgun weddings of JP Morgan and Bear Stearns in March of 2008 and Bank of America and Merrill Lynch that September, the same month Lehman Brothers was left at the altar to fail and the U.S. government nationalized the housing finance giants Fannie Mae and Freddie Mac. In a month that will be remembered as one of the darkest in U.S. economic history, Washington Mutual succumbed to a bank run in what to this day stands as the largest ever U.S. bank failure. Stocks plummeted as our U.S. banking system teetered on the verge of collapse, staggered by a loss of confidence spawned by bad mortgages made and securitized here, but which metastasized globally. A total of 165 banks would eventually fail as the U.S. economy endured its most protracted economic downturn since the Great Depression. Thanks to unprecedented actions instituted by the U.S. government and Federal Reserve, asset purchase plans and liquidity programs helped cleanse the financial system of bad assets while providing banks the emergency funding they needed.

LESSONS LEARNED

An enduring legacy of the GFC is bank reform legislation that mandated stronger industry oversight by the Federal Reserve and ended the practice of bank-proprietary trading (the Volcker Rule). As importantly, banks that survived the near-death experience of those harrowing times became more responsible lenders. Sub-prime mortgages became less common as banks eschewed risk and operated under stricter capital guidelines; infamously opaque collateralized debt obligations (CDO) nearly disappeared as bank balance sheets became more transparent. As the Fed attempted to jump start an economy laid low by the financial crisis, zero-interest-rate policy and quantitative easing failed to stimulate a large jump in lending. Once bitten, twice shy, banks operated more conservatively as they made better loans and rebuilt capital, or shareholders' equity. The chart below evidences how more stringent loan underwriting standards over the past 15 years have contributed to improved loan quality (lower loan loss rates) and profitability, which in turn have promoted sturdier bank balance sheets and higher capital ratios.

Subdued Loan Loss Rates Evidence a Healthier Banking System



Source: Federal Deposit Insurance Corporation

Total loans and leases of all FDIC-insured banks averaged $12.1 trillion in the fourth quarter of 2022, and of these, just one-third of one percent were written off. As the chart shows, net charge-offs as a percent of loans have not only declined significantly since the GFC, but they also compare favorably to the average of historical data since 2000. With loans and leases accounting for over half of industry assets, we find this evidence of improved loan quality reassuring amid recent concerns about the industry's health.

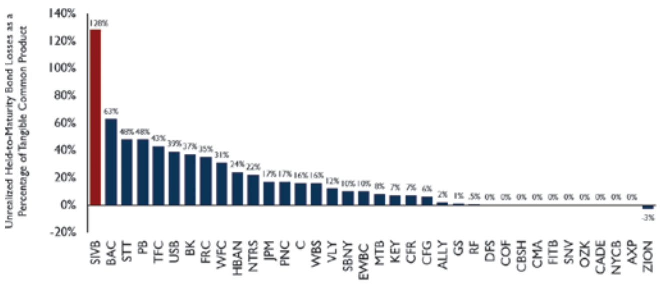
NEW CHALLENGES? YES. SYSTEMIC THREAT? NO.

Responding to generationally-high inflation that has proven to be more enduring than first thought, the Federal Reserve has aggressively raised short-term interest rates over the past year. In related fashion, bond prices fell and fixed income investors endured unusually negative returns, the worst in over 150 years. For most investors, 2022 was a year to nurse their wounds and move on; for Silicon Valley Bank (SVB), its bond losses ultimately proved fatal. On the liability side of its balance sheet, SVB possessed a unique base of depositors — 90% exceeded the FDIC's $250,000 insured deposit limit — concentrated in venture capital and development stage companies that even in the best of times are *users* of cash. This balance sheet peculiarity alone might not have doomed SVB if over half its assets were not invested in longer maturity bonds, the market value of which were materially reduced by the rise in interest rates. SVB's customers got nervous as they realized the bank's capital was impaired, and what ensued was a classic bank run. Pushed into FDIC receivership after failing to raise capital, SVB and its $212 billion mismanaged balance sheet became the nation's second-largest bank failure. As Fed

The laurel is part of our Octavia Group branding. Octavia the Younger was one of the most prominent women in Roman history. She was respected for her nobility and humility. Octavia was hailed as a "marvel of womanhood" and was a political advisor between her brother and husband. She was immune from the "tutela," which placed in her the unique position of managing her own finances.

Chair Jerome Power recently observed, “This was a bank that was an outlier in terms of both its percentage of uninsured deposits and in terms of its holdings of duration risk.” The chart below demonstrates that most banks had nowhere near as much capital exposed to the risk of rising interest rates.

SVB’s Balance Sheet an Outlier



Sources: SNL Financial, Morgan Stanley Research

Following SVB’s demise, Signature Bancorp also went into FDIC receivership. Like SVB, it banked customers with deposits predominately in excess of FDIC deposit limits, but with the added risk factor of having a payments network catering to cryptocurrency customers. To discourage further bank runs, the U.S. government has announced that all SVB and Signature Bank depositors will recover their funds, even those with deposits exceeding the FDIC limit. In the wake of these notable bank failures, the Fed has also reprised its role as lender of last resort, this time by offering banks experiencing deposit volatility a lending facility that allows them to pledge bond collateral at 100% of par. While its recently created Bank Term Funding Program has been lightly tapped so far, the Fed’s traditional discount window has seen a notable uptick in use. We believe that banks with traditional business models — a diversified deposit base used to fund a variety of performing loans and a much smaller proportion of marketable securities —will manage through the current challenges and emerge with adequate levels of capital. With Fed credit facilities available to provide liquidity to the banks as needed, we do not foresee systemic risk to the banking system. However, we do anticipate lower-than-previously-anticipated bank profitability in the wake of recent turbulence.

EARNINGS RISK

Turmoil in the banking industry comes at a time when loan growth had begun to pick up and with net interest margins benefiting from higher interest rates. For this economic cycle to date, most bank balance sheets have been asset sensitive from an earnings perspective; in other words, bank assets were accruing more income from rising rates than the additional interest expense on the liabilities used to fund them. Now, banks are having to pay higher rates on CDs and passbook savings to retain deposits more prone to flight amid higher interest rate alternatives for depositors’ cash. As well, banks’ cost of capital is increasing because loans now comprise a higher percentage of their low-cost deposits, leaving banks to finance a growing percentage of new loans with higher cost borrowings from other banks or the bond market. Higher interest expense is also likely to pressure earnings in an environment of heightened caution, one in which bank loan officer surveys indicate they are less willing to make higher yielding loans and more likely to hold incremental assets in cash and short-term securities.

Another risk that we are less concerned about is that regional banks may encounter credit issues given their greater exposure to commercial real estate loans. While banks smaller than the top 25 largest by assets account for two-thirds of all real estate lending, only 15% of such loans are to office building borrowers struggling with low occupancy rates. Other real estate verticals like healthcare, multi-family and industrial remain fundamentally healthy. We believe office building loan exposures are well known, and while they do not pose systemic risk, they could negatively impact bank earnings if borrowers default.

Finally, additional fees and regulation are possible. The FDIC could increase the levy it imposes on bank deposits to replenish its fund depleted by recent bank failures. As well, regulators might impose new balance sheet constraints to limit mismatches in asset-liability duration.

From a wider perspective, we have messaged our belief that profit projections for the broader market remain too high for 2023. As a top-three contributor to the earnings growth investors expect the S&P 500 to deliver this year, financials may disappoint given the banks’ meaningful representation within the sector. Even more importantly, banking is the lifeblood of the economy. If lenders retrench to the extent that a credit crunch ensues, this will precipitate slower economic growth and heighten the risk of recession. Acknowledging these headwinds, we have become more defensive in our equity sector allocation in client accounts, underweighting the financials sector and we have reduced our regional bank exposure.

RED LIGHT, GREEN LIGHT

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MARCH OF 2023 MARKED THE one-year anniversary of the Federal Reserve's first interest rate increase from the near-zero levels of the pandemic. Additional rate increases over the following eight meetings, including last month, lifted the Fed Funds rate to nearly 5%, as of this writing. Directionally, and at first, it was an easy call to lift rates to combat inflation. While it certainly led to a painful repricing of both stocks and bonds in 2022, financial markets absorbed the outlook with forward guidance offered by Fed Chair Jerome Powell, and for most of the past 12 months, offered a 'green light' for higher interest rates. As in prior economic cycles, the challenge for central bankers comes at the end of the tightening cycle. The Fed's unenviable track record of something 'breaking' due to higher rates was confirmed once again this past month with the failure of Silicon Valley Bank. Turmoil in the banking sector coincided with an explicit change of opinion in the bond market as the prior 'green light' flipped to 'red.'

Market is Signaling to the Fed it is Done

Bank Concerns Have Shifted Expectations

Source: Bloomberg

Just like stock prices, bond yields can convey a lot of information. In particular, the yield on the 2-year U.S. Treasury note has proven to be a good proxy for market expectations for Federal interest rate policy. As you can see in the chart, the upward move in 2-year yields tracked the upward movement of the Federal Funds rate for most of last year. A dip in the 2-year yield to below that of the overnight Fed Funds rate, like we saw at the end of the first quarter of 2023, is a clear sign the market is expecting a change in the economic trajectory

Fed Rate Change Hikes in Recent History

			Performance Between LastHike and First Cut	
Last Rate Hike	First Rate Cut	Time Between Last Hike and First Cut	Stocks[1]	Bonds[2]
3/22/23 (?)	?	-	-	-
12/19/2018	7/13/2019	7 months	+21.6%	+6.0%
6/29/2006	9/18/2007	15 months	+22.1%	+9.6%
5/16/2000	1/3/2001	8 months	-7.4%	+11.0%
2/1/1995	7/6/1995	5 months	+19.2%	+10.5%
2/24/1989	6/5/1989	3 months	+13.3%	+6.9%

1. S&P 500, 2. Bloomberg Aggregate Bond Index

Source: Bloomberg

and a pivot to possible interest rate cuts. This expectation is frequently at odds with official Fed guidance since they don't forecast future recessions, or even policy mistakes from keeping rates too high for too long.

At the recent late-March Fed meeting, Chair Powell suggested rate hikes may be done. Given the heightened concerns in the banking sector, credit conditions undeniably tightened in March. It is very likely that these knock-on effects in private lending markets will serve as a substitute for additional Fed tightening, meaning we may have already seen the last rate hike of this cycle. Looking back over prior periods after a hiking cycle concludes, we make two observations. First, we note the time between the last hike and the first cut tend to be brief, with only one instance lasting over a year. Second as can be seen in the table below, these periods of peak Fed Funds have tended to deliver positive performance across both stocks and bonds.

Managing the end of any monetary tightening cycle relies more on the art than science of central banking. The well-known yet still unpredictable lagged effects from higher rates require a deft touch at the wheel of the economy. Just like driving on the road, running the bond market's equivalent of a red light may have consequences.