Quarterly Market Letter

GENTER CAPITAL MANAGEMENT

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Introduction

Most of us have seen the Frank Capra classic *It's a Wonderful Life*. It was one of the early films in the "parallel universe" genre. *It's a Wonderful Life* is the story of a man, George Bailey (played by James Stewart), who lives in the fictional community of Bedford Falls. He is married, with four children, and is a pillar in that community. Over the course of the movie, we learn how, in George Bailey's absence, Bedford Falls would have slipped into a dystopian nightmare.

One of the more stirring sequences in that movie was the run on the bank scene. George pleads with the jittery depositors to see the bigger picture. "The money's not here. Your money is in Joe's house, that's right next to yours, and in the Kennedy house and Mrs. Macklin's house and a hundred others." After some more cajoling, where George literally stands in front of the door and begs his depositors to reconsider, they decide to trust him and withdraw fractions of their savings rather than the full amounts. Later in the film, when a series of accidents and misunderstandings lead to an existential moment for George Bailey, the good people of Bedford Falls ride to his rescue.

There was none of that in the recent banking crisis. The ones riding to the rescue were the federal government and the Federal Reserve. While governmental institutions are more concerned about the real economy than the market, the highly financialized American economy has tightened the nexus between the two. Unfortunately, this sometimes means that the only way to prevent the financial economy from sinking the real economy is through bailouts.

In the crisis of 2008, the Federal Reserve took an enormous amount of flack for bailing out Bear Stearns. Market pundits harrumphed about moral hazard, and to such an extent that when Lehman Brothers started showing signs of extreme distress, and the Fed could not find a buyer at suitable terms, it decided to let Lehman go rather than absorb the costs required to keep Lehman whole. This resulted in the near-death experience of the Great Financial Crash. Since that time, the Fed has not let punditry about "moral hazard" and "market discipline" interfere with its obligation to keep the real economy from imploding. Managing risks from the central bank involves difficult, lesser-of-evils-type choices. Those choices invariably lead to public dissatisfaction and, of course, political opportunism.

Review and Outlook

The specter of recession continues to influence market behavior. 2023 began on a high note, with the "animal spirits" anticipating a short recession resulting in the Federal Reserve changing course and reducing the cost of capital. This positive narrative quickly shifted to worries that labor market readings and inflation prints were not cooling as rapidly as expected. And yet, even with the prospect of higher rates for a longer period, risk appetites were only dampened for a moment.

The wake-up call arrived with the full-fledged banking crisis in early March. The spectacular collapse of Silicon Valley Bank and Signature Bank, combined with the near-death experience of First Republic Bank, shook even the most ardent bulls. Due to their exceptional growth and monied clientele, these banks were market darlings for years. After a harrowing few days, the panic gave way to renewed confidence that the government, including the Fed, would fix things.

We knew that the Federal Reserve's long and aggressive tightening cycle would "break" some things, but it was difficult to know *what* would break, much less *when* it would break. Now that we have seen some breakage, some of the weak links were reasonably predictable: large portions of the cryptocurrency world and profitless business models, particularly for tech companies. Other breaks were harder to predict, like the UK pension crisis. A bank run was not top of mind for many investors, but in retrospect, it was perhaps the inevitable fallout from monetary policy that was too easy for too long, and which incentivized –practically forced, really– investors and financial institutions to take more risk.

With the Fed pushing rates higher, a credit crunch has been felt in capital budgets as well as household consumption. Consumers tend to be the bulwark of the American economy, and there are early warnings of consumption restraint in both the rise in credit card usage and the increase in the savings rate. Another early sign that the consumer is pulling back may be the February Retail Sales report, at a -0.4% month-over-month following an exceptionally strong January number of 3.2%.

As households figure out their spending decisions, the manufacturing sector continues to weaken. The ISM (Institute of Supply Management) index in March decreased to 46.3, the fifth consecutive month below 50, pointing to a further decline in manufacturing output. And the tight labor market, which has undergirded consumer confidence and household spending, may be teetering on the brink. Initial unemployment claims are just beginning to rise from historic lows. The number of job openings has recently fallen to below ten million, a notable decline from a peak of twelve million about a year ago.

The strong employment numbers have confounded the Fed's war on inflation. Models suggest more than two million jobs lost, or an unemployment rate greater than 5%, should be incurred in the fight to contain inflation. But given the difficulty in finding and training qualified employees, we think many employers may try to minimize layoffs. If a recession is coming, it could be a low unemployment recession.

Despite these downside risks, the bank runs and the prospect of a recession, the Fed's progress on the inflation front is slow. While headline CPI has beaten a material retreat to 6% from the recent peak of 9.1% last June, it is still at a high absolute level. Moreover, the decline was powerfully assisted by a sharp decline in energy prices since that June peak. The Fed's preferred measure, PCE Core, at 4.6%, though down from a peak of 5.4% more than a year ago, remains uncomfortably far away from the 2% target.

Yet, whether looking at consumer sentiment or market measures of forward inflation expectations, neither really reflect any sense that long-term expectations for inflation are becoming "unanchored." Part of this is due to the Fed's obvious will to put inflation back into its box. Chair Powell's commentary after the last Fed meeting suggests that, even with the bank runs, the Fed has no intention of taking its eye off the inflation ball. Sagging, and lagging, shelter costs should also help moderate overall inflation. And although wages have increased, they have not kept up with prices, which should provide additional impetus for families to curtail spending.

All this suggests long-term stabilization of prices, but also a narrower window for a soft landing in the short term. Our outlook for the year takes some degree of demand destruction into account. The Fed is using the blunt instrument of rate policy to increase price stability. We expect some sacrifice will be made with an increase in the unemployment rate. Overall, we anticipate the full year will register a very modest increase in GDP, even with a "soft" landing. Inflation should follow in the footsteps of a weaker economy and fall toward the 3% level. Whether the financial markets have correctly priced in these macro trends remains to be seen.

Fixed Income Report

There was an expression in the market: "don't fight the Fed." It no longer seems to hold. When the Fed says it is going to exit 2023 at 5.00-5.25%, and the bond market believes the Fed will exit 2023 at around 4.25%, practically a full percentage point lower, then the market is fighting the Fed.

The standoff helped lead to peculiar market outcomes in the past quarter. For instance, "high risk" and "low risk/safe haven" assets were positively correlated. On one hand, the Two-Year Treasury dropped 130 basis points in yield over eight trading days in March. According to Goldman Sachs, this was an 8-sigma event, the sort of thing which occurs once in a lifetime. It was very much a "risk-off" type of move, yet by the end of the month, "risky" assets like the Nasdaq-100 index were nearly +8% higher.

If the Two-Year is right, then the Fed will be forced to cut rates into a gathering recession. If the Two-Year is wrong, then the Fed is not cutting rates any time soon, which does not necessarily mean that a recession is avoided. In either case, it is difficult to see the rationale for riskier assets. While we understand that many risky assets are "addicted" to a lower rate environment, lower rates mean intensified risks to the downside, and those kinds of risks tend to be disconcerting when they come to fruition. We may be coming to the end of the "bad news is good news" cycle.

The Federal Reserve is the ultimate risk manager in the financial economy. For more than a decade, the risks skewed to the downside, but over the past year, inflation redirected Fed attention to upside risks. With the bank runs amplifying recession risks, the Fed finds itself in a corner, managing into a risk environment with acute threats in both directions. We expect the Fed will try and talk its way out by arguing that the chief threat to the economy remains to the upside, but that it is prepared to backstop the banking system to the hilt. The problem, of course, is that fighting inflation makes the banking system more vulnerable, while backstopping the banking system undermines the fight against inflation.

The Fed has returned to its trusty toolbox to keep banks solvent. A $2 trillion credit facility with favorable lending terms has been crafted to extend to banks over the next year. Additionally, banks are encouraged to use the Discount Window. In recent years, some of the stigma associated with "going to the Window" has been removed. The upshot is that the restrictive policy of quantitative tightening has been slowed, or even reversed. While the Fed continues to retract $95B from its balance sheet every month, Window borrowings, the new credit facility, and bridge loans for failed banks have increased the balance sheet from an $8.4 trillion low to $8.7 trillion now. At its peak, the Fed's balance sheet was just under $9 trillion.

Our base case is that the Fed would prefer to "hold steady" than to "raise then cut". We also think the Fed is monitoring the real economy more than the financial economy, meaning it sees continued strength in the teeth of its restrictive policies, even if market participants are feeling pain. Still, as noted above, the standard is spillover—if the doings in the financial markets threaten the real economy, the Fed will meet the moment, regardless of longer-term monetary consequences.

On the municipal bond front, the market rebounded strongly in the first quarter of 2023. In 2022, municipal bonds suffered historic losses as interest rates rose sharply in the face of persistently high inflation. But the municipal bond market found its footing towards the end of 2022 and carried this forward. AAA benchmark tax-exempt yields fell between 19-35bp's for the quarter.

The higher prices are partly the result of the outflows trend reversing back in November. Retail investors noticed the vastly improved yields and the outflows became inflows. The renewed demand, combined with reduced new issue supply, has provided a tailwind to municipal bond performance. Despite the lower yields, tax-exempt rates still offer considerably more than they did one year ago.

While the credit picture is stable over the short term, and even improving, we also think that—depending upon the severity of any recession—downgrades are more likely to be part of the story next year. In terms of sectors, we remain cautious about hospitals, lifecare, and higher education, which we have been trimming from our portfolios. Despite our view that the rest of 2023 should be generally positive for municipal credit, we expect those sectors to face headwinds.

For taxable bonds, we maintain our cautious outlook towards credit spreads. We prefer to add incremental risk with shorter maturity corporate bonds. Our longer Treasury holdings insulate the portfolio to negative growth outcomes, while our shorter corporate holdings provide attractive yields. The treasury curve is still massively inverted, with 56 basis points between the Two-Year and the Ten-Year at quarter end.

To summarize, the higher yields on the short end provide an opportunity to fatten up on yield while pinning down portfolio duration. At the same time, we are looking for relative value in longer-dated securities to protect our clients in an environment characterized by declining inflation and declining growth. While we are open to the prospect that "escape velocity" from the slow growth, low inflation, low-rate environment of the 2010s has been achieved, in the shorter term, we see obstacles. Again, investments are not only about the "what," but also the "when."

Equity Report

The S&P 500 delivered a solid first quarter, rising 7.03%, narrowly driven by the growth names which crashed last year. This was evidenced by the equal-weight S&P 500 being up a more modest 2.4%. The narrowness of the market move is itself a warning sign as equity investors once again crowded into the same trades and reverted to the same playbook that dominated the "free money" era. The top 25 market-cap weighted names in the S&P were up an average 12.4%. Mega-caps such as NVDA, META and TSLA were up 90%, 76% and 68% respectively in the first quarter. Other mega-caps like APPL, MSFT, GOOG and AMZN were up 27%, 20%, 17% and 23% respectively.

While we are reluctant to be overly critical of investors' "flight to safety" among the largest and "growthiest" equities, it should serve as a reminder to longer-term investors that durable bottoms and new bull markets are historically put in once there is capitulation up and down the market-cap stack. We simply have not seen that, even with the difficult returns last year. In case there was any doubt, the past quarter showed that market inflection points are rarely an easy transition.

The rapidly rising cost of capital has been central to our more conservative thesis around equities and stock selection. Financial capital is the engine of the economy and access to cheap capital has been the lubricant for some time now. The longer the engine operates without that cheap lubricant, the greater the likelihood it will seize up. The short but ferocious move among financials in early March may have been a preview for the broader market, as liquidity slowly exits the system and investors demand higher rates of return for their increasingly scarce capital.

Against this backdrop, Technology and Consumer Discretionary names were the leaders this quarter. Even in those sectors, it was the handful of mega-cap tech stocks that were the standout performers. The still-high levels of liquidity sloshing through the system, combined with the "flight to safety," resulted in the same crowded trades as the past.

The Financial sector was the biggest laggard in the quarter (down almost 6%), but only fell out of bed as the reality of massive deposit flight sunk in. The large unrealized losses in the held-to-maturity segment of bank portfolios created severe near-term liquidity and capital issues for several banks caught "offsides." This created a classic bank run on SIVB, SBNY and FRC, while the rest of the banking system was pulled down as investors waited for the next shoe to drop.

As noted above, the Fed was quick to implement significant liquidity facilities for any other banks that were faced with potential duration mismatches, that is, short-term deposits versus longer-duration books needing to be marked to market to redeem deposits. This seemed to quell the systemic deposit flight which could have spun out of control. Still, the damage has already been done and investors now are assessing how much credit tightening the banks will be forced to implement to ensure that their balance sheets remain unchallenged.

Over the past year, we have been reducing our financial exposures on growing concerns that rapidly rising interest rates were creating stresses in the banking system. We have been significantly underweight Financials for several quarters, selling our last regional bank last year for precisely the reasons which concern investors today. This worked to the benefit of our clients, of course, and some stocks are now attractive. We are seeing opportunities to purchase strong franchises that are being thrown out alongside weaker businesses. As such, we have started to increase our financial holdings, establishing new positions in Capital One and M & T Bank. In our view, these names are selling well below their intrinsic value. We will look for additional opportunities to increase our financials exposure.

The financial crisis in early March reignited fears that a recession would be "deeper and longer," with the market struggling, in our opinion, to make sense of that risk. Energy was the second worst performing sector (after Financials), down 5.3% in the quarter, which makes sense if recession fears are real. But defensive sectors like Healthcare and Utilities were the next worse performing sectors, down 4.7% and 4.0%, respectively, which we find unwarranted if recession risks are indeed rising.

We are maintaining our more conservative view of positioning within the equity market as risk premia are still too low in our view given the higher rate environment and the present economic crosscurrents. We believe that tighter credit conditions are just starting to bite on the consumer side of the economy and expect that, given the recent events in the banking system, commercial credit will be increasingly pinched. We see earnings risk as elevated in the near term and view the prospect for revisions as having more downside than upside risk.

At this juncture, we continue to be buyers of lower PE and higher free-cash-flowing names. We are looking for opportunities to become more pro-cyclical. That will happen when we see stronger signals that the crosscurrents have found some equilibrium, from which we can take the next leg up, and when valuations of individual businesses more fully discount the risks that we still see on the near horizon.

Conclusion

Every decade, it seems, we learn anew that a bug in the free enterprise system is the vulnerability of bankers to large capital flows—and the vulnerability of the rest of us to bankers. Expanding the government backstop to protect large and ultra-large depositors seems like a rigged system, but it is probably a necessary safeguard for the rest of us. Given the leveraged, interlocking nature of the financial system, and the key role it plays in the life of the American economy, it makes more sense to find other ways to balance the scale. We learned with Lehman Brothers that letting large banks die means throwing the baby out with the bathwater.

It's a Wonderful Life was made in 1946. The United States was at an inflection point but, again, inflection points are rarely easy transitions. At the time, Americans were triumphant in the aftermath of the 20th century's greatest crisis. Ten million American men had seen some terrible things, and the other 130 million Americans also suffered greatly, burying their sons, their husbands, their brothers, and their friends. Americans were deeply anxious about another depression, but as they braced for another severe downturn, what they got was inflation. Lots of it. From 1946 to 1948, CPI inflation averaged more than 10% per year. Perhaps the clearest indication of widespread dissatisfaction with the big picture was incumbents being tossed out at the ballot box in November 1946.

And yet, despite the unsettling nature of that moment in time, Capra pointed to the concurrent fact of ordinary human decency and kindness, arguing that it, too, finds its way into the big picture. It is a reassuring theme for our own time as well, mainly because it carries some truth. It may not be a wonderful life, but it is also not so bad. Then, as now, there were frustrations; but then, as now, there were opportunities. In a few short years, the United States would be embarking on its Great Prosperity. While we are not predicting a second Great Prosperity, we do think conditions are in place, as we transition through this inflection point, for a new era of expansion and growth.