DayMark
WEALTH PARTNERS

Monthly Market Commentary

Q2 2023

Recap of Q1 2023: Size Mattered

Stocks saw major dispersion in the first quarter of 2023, with the Nasdaq rallying 17.1% for its best quarter since 2020. Meanwhile, Large Value lagged (+1.0%), primarily due to underperformance in Financials, which were down (-5.6%). Small Caps (+2.7%) also lagged, as Financials make up a larger percentage of the Russell 2000 Index versus the S&P 500. Overall, the S&P 500 finished the quarter up 7.5%. As shown below, five of the best seven performing stocks in the S&P 500 were in the Tech sector, while six of the seven worst performing stocks were in the Financial sector.

Historically a strong first quarter bodes well for the remainder of the year. Since 1950, when the S&P 500 gained over 7% in the first quarter, the full year has never been negative.

Source: Bloomberg and Morningstar

Q1 2023: Best Performers in S&P 500	
Nvidia	**90.1%**
Meta	**76.1%**
Tesla	**68.4%**
Warner Bros. Discovery	**59.3%**
Align Technology	**58.4%**
AMD	**51.3%**
Salesforce	**50.7%**

Source: Morningstar & YCharts

Q1 2023: Worst Performers in S&P 500	
First Republic Bank	**-88.3%**
Zions Bancorp	**-38.3%**
Charles Schwab	**-36.8%**
Comerica	**-34.0%**
DISH Network	**-33.6%**
KeyCorp	**-27.0%**
Lincoln National	**-25.4%**

Source: Morningstar & YCharts

Q1 Returns >7% Bode Well for the Remainder of the Year

Year	Q1 Return	Full Year Return
1954	9.7%	52.3%
1956	7.5%	6.5%
1961	12.8%	26,9%
1967	13.2%	23.9%
1971	9.7%	14.2%
1975	22.9%	37.2%
1976	15.0%	23.9%
1979	7.1%	18.6%
1983	10.0%	22.6%
1985	9.2%	31.7%
1986	14.0%	18.7%
1987	21.3%	5.2%
1989	7.1%	31.7%
1991	14.5%	30.5%
1995	9.7%	37.6%
1998	14.0%	28.6%
2012	12.6%	16.0%
2013	10.6%	32.4%
2019	13.7%	31.5%
2023	7.5%	?
Median		**26.9%**
% of the Time Higher		**100%**

The Story of Q1 2023: Banking Crisis

The issues that plagued Silicon Valley Bank (SVB) are a problem throughout the financial industry to varying degrees.

Banks like SVB saw enormous success and surge in deposits in the years leading up to 2022, in part due to an era of zero interest rates and QE. As a result, banks invested this excess cash in Treasuries and other similar securities, but some banks reached for yield and invested in longer duration securities. A sudden pivot by the Fed away from low rates (due to surging inflation) led to large unrealized losses in these securities as yields surged. Banks are normally able to use an accounting method called “Held to Maturity” (HTM) to avoid losses, as long as these bonds are held until maturity. The surge in Treasury yields since 2022 left many bank’s HTM securities massively underwater, and a run on smaller banks forced them to unload their HTM securities at a massive loss. Below provides a brief timeline of the Banking Crisis in March:

March 8th

Silvergate Bank announced that it would wind down operations and liquidate assets. Silvergate specialized in helping institutional investors transfer government issued currency to crypto exchanges. The bank was hit by a wave of redemptions after the collapse of FTX .

March 10th

Silicon Valley Bank (SVB) announced that it entered FDIC receivership, making it the 2nd largest bank failure in US history. SVB was a major lender to Venture & Growth funds and a had a concentrated client base in this area. A run on the Bank forced SVB to liquidate large Treasury & Agency positions at deep losses.

March 12th

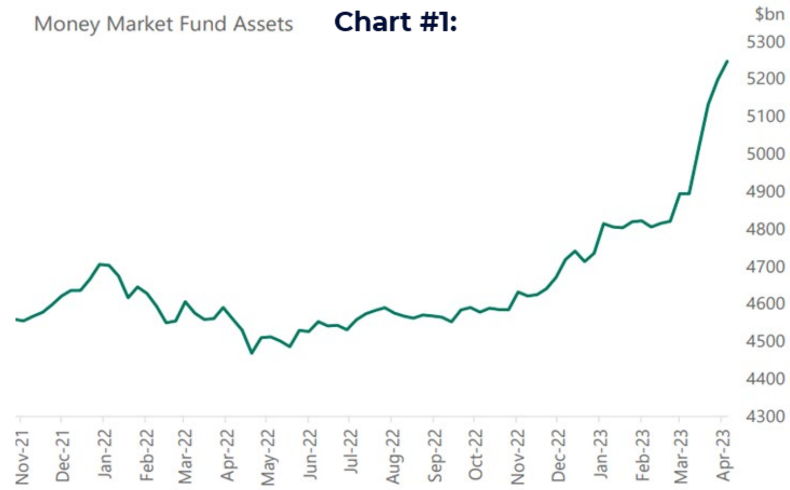
Signature Bank announced that it entered FDIC receivership, making it the 3rd largest bank failure in US history. The collapse of crypto prices in 2022 led to wave of deposit withdrawals at Signature Bank. Concerns around Silvergate and SVB accelerated a bank run.

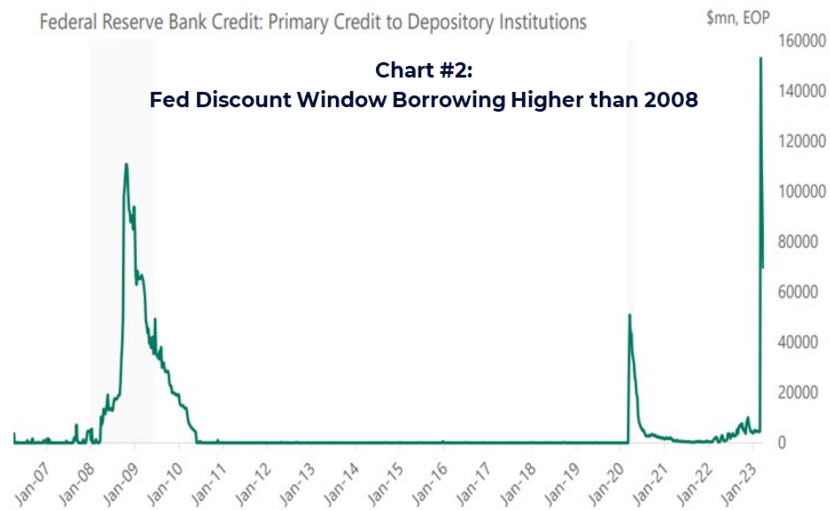
March 19th

Credit Suisse had been plagued by a number of scandals and mismanagement, including exposure to family office Archegos Capital – which cost the bank over $5 Billion. Following negotiations with the Swiss Government, UBS acquired Credit Suisse for over $3 Billion.

Major Takeaways from the Banking Crisis

- Most Banks don't have the level of uninsured deposits as a SVB, or the crypto exposure of a Signature Bank.
- It's important to note the government guaranteed all deposits for SVB and Signature Bank because they were in receivership and deemed a "systematic risk exception."
- Over the past two weeks, Banks have seen their deposits decline by a record $300 Billion. After SVB went under, some deposits that left Small Banks went into Large Banks. Other deposits moved to higher yielding Money Market Funds, with a record $5.2 Trillion in these funds (see Chart #1).
- To improve liquidity and stability, Banks utilized the Fed's Discount Window and the Fed's newly established Bank Term Funding Program (BTFP). Both allow Banks to borrow short-term loans from the Fed by providing collateral (i.e. Government Bonds) at Face Value, regardless of market price. This resulted in the biggest surge in borrowing using the Discount Window since 2008 (see Chart #2).

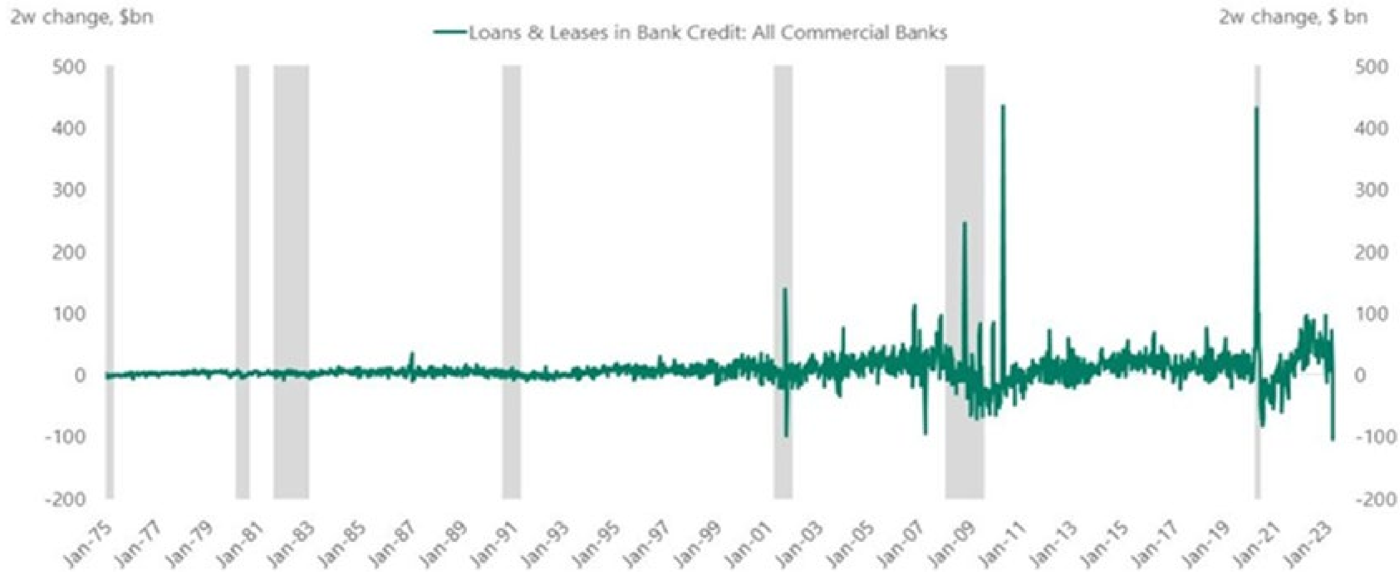




Major Takeaways from the Banking Crisis Cont.

- Usage of the Fed's Facilities resulted in a jump in the Fed's Balance Sheet by $300 Million, despite QT.
- The Dodd-Frank Act tried to reduce concentration among Banks, but we expect further consolidation now.
- According to Apollo, tighter financial conditions and lending standards equates to an additional 150 basis points in the Fed Funds Rate. Already, Bank Lending has plummeted (see Chart #3).

Chart #3:
Largest 2-Week Decline in Bank Lending



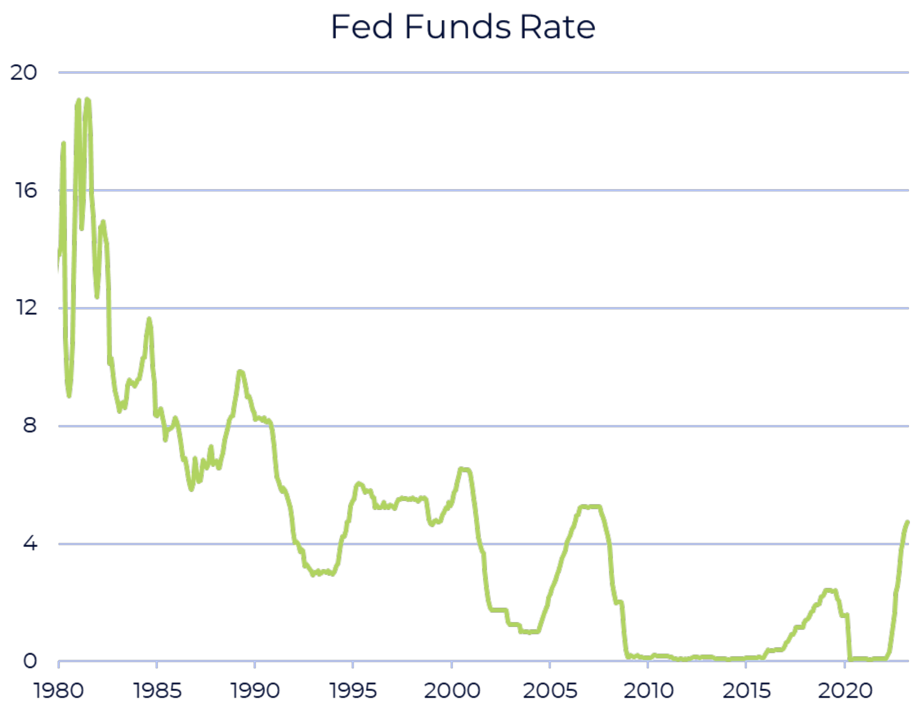
Financial Crises are Part of Tightening Cycles

It's not unusual for a Tightening Cycle to result in a Financial Crisis. In response, the Fed has historically either Eased or Paused. In some instances, a Recession was avoided (i.e. 1984 Failure of Continental Illinois), while other times a Recession quickly followed (i.e. Global Financial Crisis). In the past, a financial shock/crisis has never ended until the Fed paused or cut rates.

The Fed's response to the recent Banking Crisis is highly unusual, as the Fed hiked rates 25 basis points in March and continued Quantitative Tightening. Prior to the Banking Crisis, markets were pricing in a 50 basis point hike, but financial stability took precedence over price stability. The Fed continues to be in a difficult position of trying to battle high inflation while also managing a crisis in the Regional Banking system. We believe the Fed is nearing the end of its tightening cycle, especially with a deep inversion of the yield curve.

Financial Crisis or Shock	Date	Fed Reaction
Bank Failure: Continental Illinois	May 1984	Eased
Black Monday	Oct 1987	Eased
Mexican Peso Crisis	Dec 1994	Eased
Asian Financial Crisis	Jul 1997	Paused
Russian Financial Crisis	Aug 1998	Eased
Tech Bubble	Apr 2000	Eased
Global Financial Crisis	Feb 2007	Eased
European Debt Crisis	Feb 2012	More QE
SVB/Banking Crisis	Mar 2023	Hiked/QT

Source: Bloomberg and The Federal Reserve

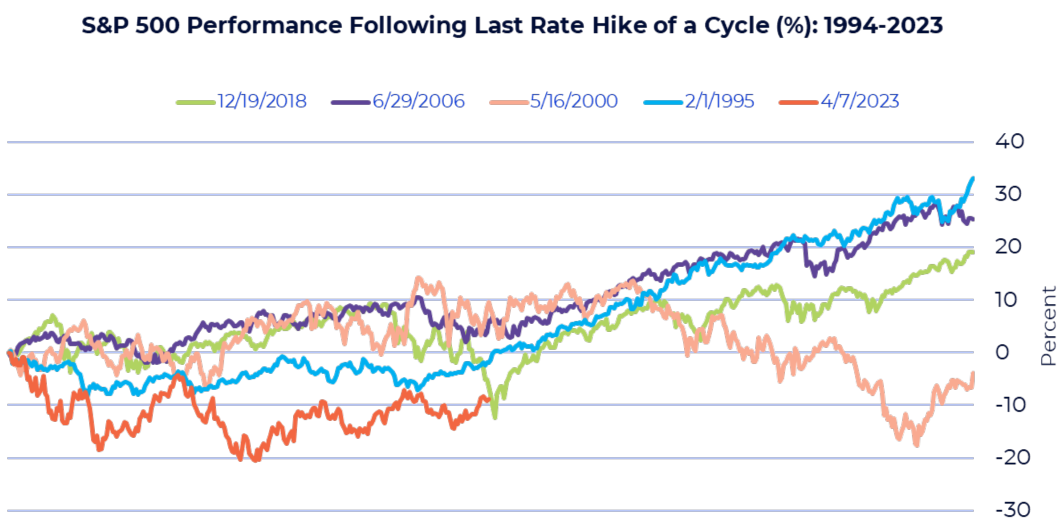


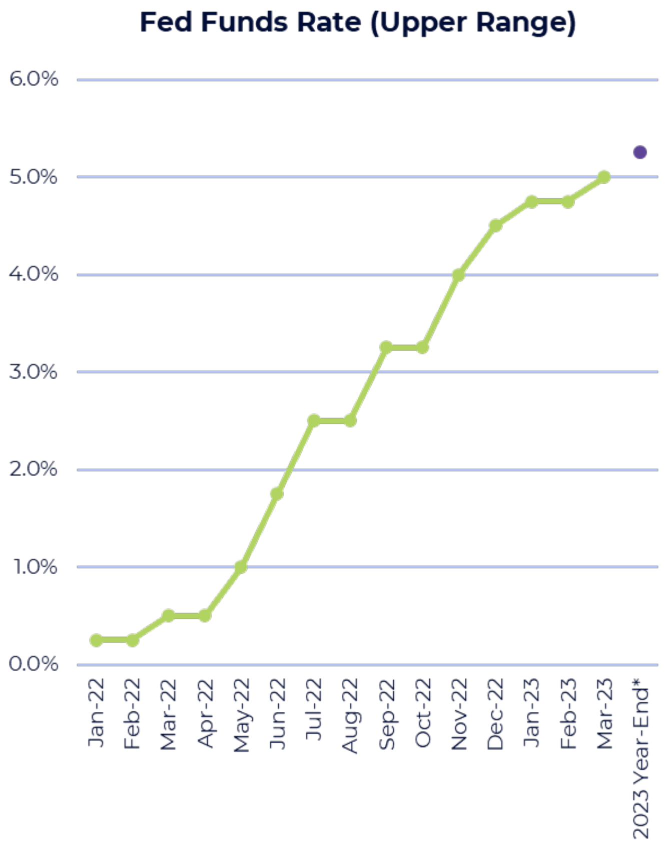
Source: BofA Global Investment Strategy, Bloomberg, The Federal Reserve

Equities Historically Rally After the Last Fed Hike

In March, the Fed raised rates to a range of 4.75-5.00% and released its updated "Dot Plot," which showed a majority of FOMC participants forecasting just one additional rate hike in 2023. The market continues to price in a much different outlook for rates, with expectations of multiple rate cuts in the second half of 2023.

In looking at the past 30 years (going back to 1994), there have been five prior rate hiking cycles – including the current cycle. In the prior four cycles, equities rallied after the last rate hike except in 2000 during the Tech Bubble. The end of the current rate hiking cycle could be bullish for equities.





The Bond Market Continues to Signal Warning Signs

Markets were previously pricing in a peak Fed Funds Rate above 5.50% on March 8th. After the collapse of Silicon Valley Bank, the market quickly shifted to expecting multiple rate cuts. To end the quarter, the market now expects rates to finish 2023 at 4.25%.

Implied Fed Funds Rate After Jan 2024 FOMC Meeting

Short-Term Yields also plunged in response to the Banking Crisis. At one point in mid-March, the 2-year yield sank over 100 basis points in less than two weeks.

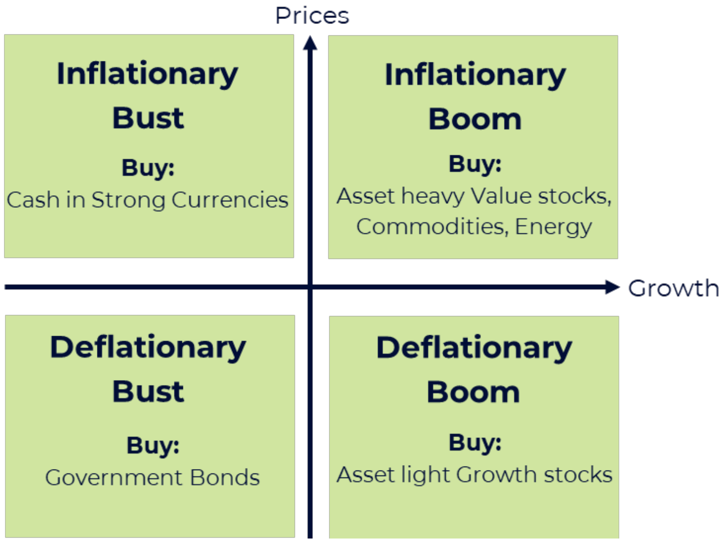
2-Year Treasury Yield (%)

The 10yr-3month curve is at its most inverted level (-160 bps) since the early 1980s. Historically if there is a Recession, it is preceded by the steepening of a yield curve that was deeply inverted.

10 Year Yield Minus 3-Month Yield (%)

Investment Implications

1. **Our original forecast of "higher for longer" rates and higher US 10-yr yields was looking good until the Banking Crisis. This forecast is way tricker now, as the Fed's updated Dot Plot shows one more rate hike in 2023 versus multiple rate cuts for the market.** The Fed's view is consistent with the "Inflationary Boom" scenario outlined in our Q1 Outlook. In this scenario, US Growth continues at a relatively brisk clip, with inflation remaining above the Fed's target into 2024. The market, however, is pricing in a "Disinflationary Bust" scenario that we labeled as possible (but not probable) entering this year.



Source: Bloomberg and Dynasty Financial Partners

How this interest rate dissonance resolves is incredibly important and will have very different implications for the investment environment. One thing is pretty clear, we should expect some steepening of the yield curve from current levels. Since 1934, there have only been two periods where the 10-year to 3-month yield curve was as inverted as now – once in the early 1970s and between 1979 and 1981. Each time, it became quickly less inverted.

We see two possible scenarios playing out:

1) With the Fed Funds target rate at 5% and banks struggling, the implications for the flow of credit to real economy and growth are of obvious concern. The likely result would be a Recession. This is the scenario where the Fed cuts in response to deteriorating economic data (ISM Manufacturing PMI fell to cycle low of 46.3 in March). In this disinflationary bust scenario, the yield curve will disinvert with the short end falling faster than the long end in a classic bull steepening.

2) However, it is also possible that the banking stresses are successfully contained, the US economy avoids a near-term Recession, and the Fed doesn't move aggressively. In this inflationary boom scenario, the US yield curve will still disinvert, with the long end rising faster than the short end as the bond market prices in more growth and inflation: a classic bear steepening.

We still favor scenario 2, but admittedly with less conviction than start of the year. We are hedging equities (balance between growth and value) and adding duration in fixed income.

Investment Implications Cont.

2. **There are powerful price and seasonality trends that cannot be ignored.** The stock market appears to be shaking off scenario 1 of the previous page, as the market has showed gains since the banking crisis started. Other bullish signs are the Zweig Breadth Thrust indicator and strong Q1 returns (>7%) historically leading to strong calendar year returns. The 3rd year of a Presidential cycle has historically produced the strongest equity returns in a four year cycle. The month of April has also seasonally been one of the strongest month for equities over the past 50 years.

3. **Adding duration to US Treasury** exposure as a small hedge for a higher probability of a weaker economy and Recession.

4. **Enhance the overall quality of the portfolio** by focusing on high quality equities (i.e. high free cash flow and low volatility) and reducing lower credit exposure among economy uncertainty.

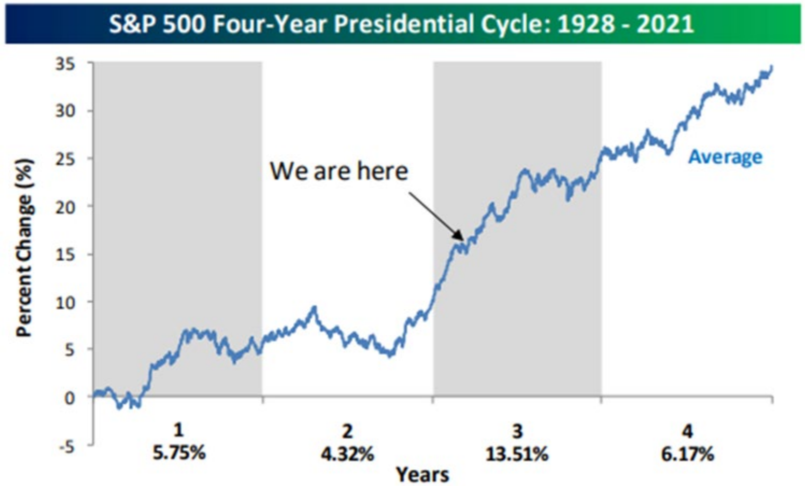
5. **Rotate out of US Small Caps**, which are names with the most embedded active risk due to the Banking Crisis

6. **Tactical Tilt into Growth,** as these names continue to be a flight to safety for investors during the Banking Crisis. However, longer-term we believe there will be a Regime Change away from Big Tech.

7. **Expect the US Dollar to continue to decline**, especially with the Fed nearing the end of its rate hiking cycle

8. **Rest of World Remains Attractive over US.** Europe has rallied to start 2023, while weakening USD should support Emerging Markets.

9. **Interest rate volatility still extended,** which makes sense given yield curve response to banking crisis and conflict between Fed and market over interest rate trajectory.



Source: Bloomberg

Major Takeaway

The Equity and Fixed Income markets continue to price in radically different outlooks. Equity markets have largely shrugged off the Banking Crisis to finish Q1 up 7.5%, which historically is bullish for the remainder of the calendar year. Seasonality Trends and a Third Year of a Presidential Cycle are also bullish for equities. The Fixed Income market, however, continues to flash warning signs of a Recession, from collapsing Treasury yields to severely inverted yield curves.

Ultimately, we suggest increasing the defensiveness of a portfolio for either scenario by allocating to Quality (i.e. High Free Cash Flow, Higher Credit Quality) and including smaller hedges in case the Fed is forced to cuts rates and we enter a Recession (i.e. Long-Term Treasuries).