Wealth Management

Viewpoint: In Brief | April 2023

Arvest Wealth Management Viewpoint: In Brief *is a summary of our traditional monthly research publication, The Viewpoint. The sections below are excerpts and adaptations. For the complete outlook please refer to the full April Viewpoint report.*

Asset Allocation Strategy: Bank Tremors–The Add-on Risk
It may be too soon to say that we are completely clear of banking stresses. Yet, each week we do not see fresh banking bank closures means we are closer to putting the bank turmoil behind us.

For now, we're off the knife's edge of a banking crisis, but not fully out of the woods. The next major concern on our radar is the follow-on of the bank stress. While the duration mismatch risks remain and are being addressed, bankers are still highly likely to look towards reducing portfolio risks. This will largely take the form of tightening lending standards, i.e., reduced willingness to lend, particularly to the marginally credit-worthy borrowers. The U.S. financial engine relies heavily on the "gasoline" of credit. Constraining credit chokes growth.

This means a recession is 1) more likely overall, 2) more likely to be deeper than anticipated by many forecasters, and 3) more likely to begin sooner than previously anticipated.

The issue is that corporate earnings drop materially during recessions and take time to recover to previous levels. Analysts have already been adjusting earnings estimates lower, but the margin compression likely in a deeper recession does not appear to be reflected in share prices. Additionally, corporate credit, particularly high yield/junk bonds, still reside at lofty relative prices. We assess that both of these risk assets have more downside price risk in the short-to-intermediate term.

While each investor situation is unique, the general advice of our portfolio management team is to reduce risk broadly in portfolios by:

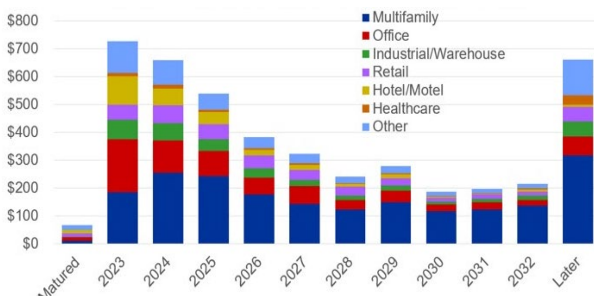
- reducing allocations to equity to bring them slightly below strategic targets
- reducing corporate bond exposure and particularly high yield/junk bonds
- for investors in retirement and those who are supplementing income with withdrawals from investment portfolios, consider raising cash during times of market strength to cover a number of months living expenses and thereby avoid the potential of selling assets to fund living expenses when prices are suppressed

Economic Outlook: A Shoe Has Dropped
For several months we have urged clients to exercise caution in the current environment as we believe central bankers were late to address inflationary pressures, resulting in aggressive monetary policy.

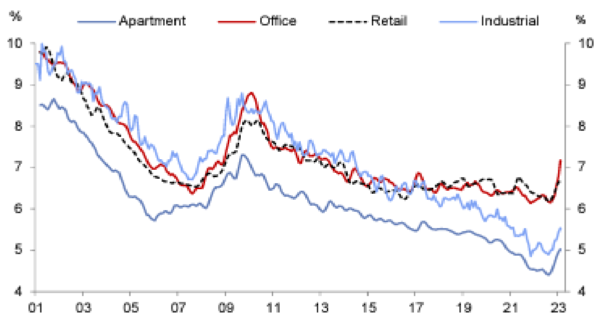
In some ways the current economic turmoil was straightforward to understand. The sectors of the economy that are most sensitive to interest rates have been the ones that have responded first to the aggressive rise in interest rates (i.e., residential real estate; single family homes and mortgage market).

Commercial real estate (CRE) is now squarely in the crosshairs of higher rates due to structural financing reasons. The bulk of commercial real estate loans are structured with 5-to-10-year terms but are typically amortized (if not structured as interest-only) over 25-year terms leaving the borrower with a potentially sizable balloon payment at the end of the term (chart below; left) which will need to be refinanced (assuming the property owner does not possess sufficient liquidity to meet the balloon payment). In addition, the rapid run up in CRE valuations (chart below; right) over the past two years (due to low rates) has made the asset class particularly vulnerable as net operating income from rent growth declines and vacancy rates rise.

CRE Maturity Distribution (by property type & CRE Valuations



Source: Mortgage Bankers Association



Source: RCA, Goldman Sachs Investment Research

On the surface, this would imply that banks and thrifts may be particularly vulnerable to a wave of defaults in the event that capitalization rates (calculated as the net operating income of a property divided by the market value) begin to edge higher causing property owners to realize refinance losses.

While we believe these to be valid risks, we also must acknowledge that headwinds in the CRE sector have not been felt evenly among property types. The office and retail sectors have been dealing with the difficulties of elevated vacancy rates since the pandemic began (and the latter with a secular shift in consumer taste years in the making), while multifamily has been largely buffered by significant growth in net operating income (NOI) over 2020 and 2021, thereby extending the runway for defaults. Still, overall defaults are at historic lows, despite the small uptick in office and retail. The bottom line is that there appears to be an outsized risk that the office sector could experience a greater wave of delinquencies, given the rapid rise in interest rates exacerbating an already fragile environment for capital. This risk can be reasonably expected to be born by smaller banks, as 70% of CRE loans reside on the balance sheets of banks that are not in the top twenty-five by assets.

One obvious outcome of the recent banking turmoil is the tightening in credit availability and lending standards that will likely accelerate. We believe the first economic shoe has dropped (and there are risks on the horizon) and the FOMC should proceed with any further tightening with caution. We see unambiguous evidence that the economy is nearing an inflection point and with it an ultimate end to the current tightening cycle.

Bond Market: The Fed Broke Something

As is well known, the Fed pushed ahead with a 25-basis point increase in its overnight lending rate last month. Additionally, the market (as of this writing on the evening of April 12, 2023) is pricing roughly a 74% chance of another 25-basis point hike in May. Nevertheless, the anticipated peak (blue line in the chart above) in the Fed Funds rate remains well below what it was prior to the events of March 7 (initiation of the banking tremors).

The bond market seems to have coalesced around the notion that a recessionary environment is highly likely to develop. Additionally, the bond market seems to have formed a consensus that the recessionary environment will develop quickly and be sharp enough to force the Fed to begin cutting rates as early as 4Q2022. We believe this is additionally illustrated in the continued deep inversion that exists within the yield curve.

Yield Curve Inversions Imply Significant Economic Concerns

Source: Bloomberg; Copyright 2023 Bloomberg Finance L.P.

We understand the inflation environment remains challenging for the Federal Reserve, as the core consumer price index has risen by a hot +4.7% annualized over the past six months, and the so-called “super core” is up by a +3.8% annualized over the same period. Nevertheless, the six-month annualized rate of change for both of the series has fallen markedly in recent months. Moreover, we would humbly remind investors that services inflation is a component of the Index of Lagging Economic Indicators. As such, a narrow focus on the inflation environment without taking into account the impact of the March Bank Madness episode upon credit formation and availability would be shortsighted in terms of policy development.

Given the amount of uncertainties that abound and our lack of hard conviction with respect to the immediate future path for interest rate levels, we continue to adhere to our “close to home” strategy for portfolios managed versus the Bloomberg Aggregate and Intermediate Aggregate indices. As such, our duration band of 95% to 100% of the benchmark duration levels remains in place.

Equity Market: Earnings Season and Forward-Looking Markets

The S&P 500 was up 3.7% in March and produced a total return of 7.5% in the first quarter of 2023. However, first quarter earnings reporting is about to start, and the projection is for a decline in earnings of 5.2% from the first quarter of 2022. While earnings are expected to fall, revenue for Q1 2023 is expected to grow by 1.6%, indicating margin compression due to the inflation experienced over the past year.

The timeline for recession keeps getting pushed out, though that does not make the risk of a downturn any less real. However, even if a recession occurs in 2023, this may already be somewhat baked into the current earnings forecasts. It also remains to be seen how a recession will affect stock valuations (the forward price-to-earnings ratio). For example, when COVID and a recession hit in 2020, S&P 500 earnings dropped by 14%, but the market returned a positive 15% during that year. The valuation multiple expanded, anticipating a recovery in earnings. Earnings did recover in 2021, growing by nearly 50%. We are now in a similar situation with weak earnings expected in 2023, but for recovery and double-digit percentage growth expected in 2024. This may stop valuations from dropping too much even if a recession occurs in 2023, as markets are forward looking.

Market Indices Performance

	Trailing Returns (Price + Dividends)						10-Year	
Index	YTD	1-Month	3-Month	12-Month	Yield	Forward P/E	Avg Forward P/E	2023 EPS Growth (est.)
S&P 500	7.48	3.67	7.48	-7.75	1.77	18.3	17.0	-0.1%
S&P 400	3.79	-3.21	3.79	-5.17	1.99	14.2	17.7	-9.6%
S&P 600	2.54	-5.16	2.54	-8.88	1.75	13.7	18.1	-11.0%
MSCI World ex-US	8.21	2.35	8.21	-2.13	3.42	13.1	14.5	+0.7%
MSCI EM	3.97	3.04	3.97	-10.39	3.74	11.8	10.7	+3.9%

Source: Bloomberg, I/B/E/S data from Refinitiv, as of 3/31/2023

When looking across global stock markets and varying capitalizations, U.S. Large-Caps remain richly valued comparatively. And considering the outsized gains of the largest domestic company shares over the better part of the past decade, one may be inclined to keep allocations tilted in that direction. In our opinion, ignoring opportunities in both overseas and smaller cap companies is increasing the risk of an equity portfolio at this time. Historically, those segments have traded at valuations much more closely (and even higher than in some cases) aligned with the S&P 500 Index. As of now they are exhibiting a discount of some 20% - 30%, with forward earnings outlooks that aren't all that dissimilar. One would expect a reversion to the mean over the coming years, which would result in a compression in valuations (share prices moving at a pace lower than earnings) for S&P 500 stocks OR multiple expansion for others.

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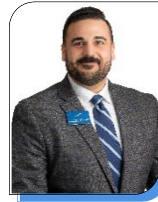
Clay is responsible for the strategic investment direction of the investment models and portfolios managed by Arvest Wealth Management Portfolio Management and Research and Arvest Bank Trust. He has completed Columbia University's Academy of Certified Portfolio Management and is a member of the Chartered Financial Analyst Institute and Kansas City Society of Chartered Financial Analysts.



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Emil manages fixed-income separate account portfolios for Arvest Wealth Management Trust and Arvest Wealth Management Portfolio Management and Research clients. Additionally, he contributes to fixed-income investment strategy and outlooks, as well as client and advisor communications and presentations. A graduate of the University of Illinois, Emil is a CFA Charterholder, a member of the Chartered Financial Analyst Institute and CFA Society of Kansas City.

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Bret supports the management of investment portfolios through research, analysis, and trading, specializing in equity securities. He joined Arvest Wealth Management in 2010 as a member of the Retirement Plan Services Group before transitioning to portfolio management and research. Bret has a BSBA in economics and finance and MBA. He previously taught courses in accounting and economics at Northwest Arkansas Community College. Bret is a CFA charterholder and a member of the CFA Society of Arkansas.

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