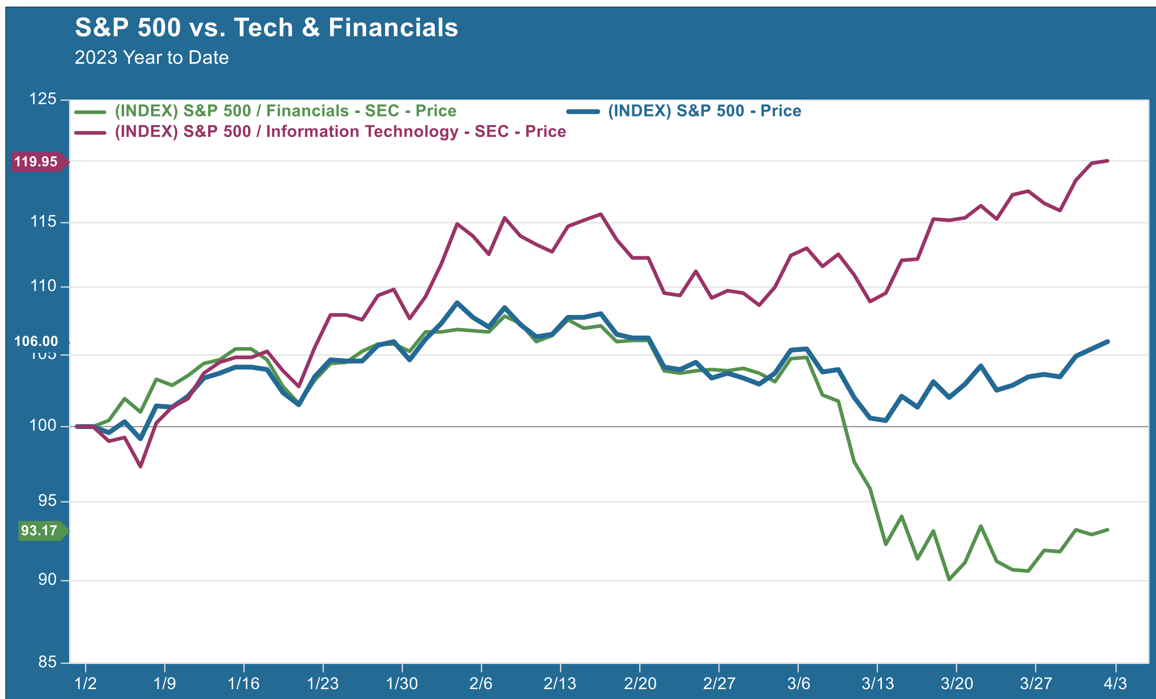
MV CAPITAL MANAGEMENT

Weekly Market Flash

Two Cheers for the Rally, and a Caveat

March 31, 2023

Today is the last day of the first quarter of 2023 (where, oh where, does the time go?). If there's a simple way to sum it up from a stock market perspective then here it is: tech good, banks bad.



Source: MVF Research, FactSet

There in one single picture is the fallout from the banking sector troubles that began in the first week of this month with the collapse of Silicon Valley Bank and a couple crypto-centric banks, then led to the strange (and highly questionable from a capital structure standpoint) drama of Credit Suisse's swan song as an independent organization. Bank shares plunged in the wake of the SVB meltdown, for understandable reasons, while Big Tech was off to the races, for reasons we will explore in further detail below.

Happily for investors, the math for this arrangement works in our favor. The financial sector accounts for about 12.5 percent of the total market capitalization of the S&P 500. The tech sector makes up 25.8 percent of the index; however, when you add in a few names from other sectors that tend to move as tech does – Alphabet (Google), Meta (Facebook), Netflix, Amazon and Tesla – the combined market cap rises to 36 percent of the total S&P 500. In other words, the gains enjoyed by tech more than compensated for the hit taken by the banks.

The Tech Formula for Growth

But why, you might ask, do tech firms benefit from trouble in the banking sector? There are a couple reasons. The first – and we would argue the single biggest catalyst behind the upside in tech shares over the past few weeks – is interest rates. The intervention by the Fed, Treasury Department and FDIC to

backstop the uninsured deposits of Silicon Valley Bank had the immediate effect of changing market perceptions on the Fed's inflation-fighting monetary policy. Treasury yields came down across the board, with the Fed-sensitive 2-year yield plunging from a pre-SVB high of 5.06 percent to a low of 3.77 percent before rebounding a bit. Think about it – that represents a change of more than 25 percent from the high to the low, in just a matter of days. Indeed, the bond market has been more volatile than the stock market over much of the past three weeks.

Stock price valuations are heavily influenced by interest rates, and a reduction in rates will, simply as a matter of discounted cash flow math, raise share values. Companies with a higher proportion of growth taking place farther out in future time periods react even more to interest rate changes (again, math). In that sense it was sort of like 2020 all over again.

In another sense, though, the rally in Q1 2023 has been quite a bit more selective than the anything-goes mania of that earlier bull run. This rally has been highly concentrated in the largest of the large cap tech names, which gets us to the second reason for how the banking sector has helped tech stocks. Market observers looking ahead anticipate, correctly we believe, that credit conditions are due to tighten as banks become more selective in their lending standards and focus on shoring up their capital and liquidity reserves. These conditions will be tolerable for the mega-cap companies with relatively low (or negative) net debt to equity ratios and loads of cash on their balance sheets. The conditions will be tougher for smaller, unproven, profitless names with a shrinking number of options for obtaining external financing.

Now for the Caveat

In our title for this piece we said "two cheers" as opposed to the more customary formula "three cheers," and that is because in place of the third cheer we see a caveat, a buyer-beware element to the rally. The dramatic decline in interest rates is for the most part premised on something we consider highly unlikely; namely, that the Fed will start a series of interest rate cuts as early as this summer. In other words – yet another instance of the market fighting the Fed. Powell once again reiterated at the FOMC press conference on March 22 that the Committee's base case plans for 2023 involve no rate cuts. Zero. The fight against inflation continues.

That's not set in stone, of course. But consider that even if the Fed makes just one additional 0.25 percent increase to the Fed funds rate and holds it there for the rest of the year, that still means that the rest of the yield curve will be tethered to a Fed funds rate range of 5 to 5.25 percent. Currently only the 6-month Treasury yield, at 4.9 percent, is even within striking distance of that highly probable future Fed funds rate. The 2-year yield is still down around 4.1 percent If bond yields reprice upwards, which we think is likely, then stock valuations will follow suit (again, math). It's been a good ride to finish out the year's first quarter. But there will be plenty to deal with in the three to come.

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