FOLLOWING THE FUNDAMENTALS

3RD QUARTER 2023: ISSUE 27

A Quarterly Market Update from The Volrath Castle Group at Morgan Stanley

BRING ON THE RAIN

BY AARON CASTLE, *Financial Advisor & Portfolio Manager*

Last month, I was lucky enough to get out of the office for a few days and play in some local Member/Guest golf tournaments. For readers located locally in Iowa & Illinois, it's not going to come as a surprise that the local golf courses I played were dry and full of browning grass due to the lack of rain the area had in the early summer months. The lack of rain and the effect on local conditions has not gone unnoticed by clients and it has been a common topic of discussion during meetings this summer. As much as I love talking about the weather, I'm happy for another reason when this conversation comes up because it has allowed a smooth transition into a conversation regarding a completely different type of liquidity that appears to be drying up.

As we published last quarter's Following the Fundamentals, multiple banking closures were happening simultaneously in the US. Due to the lack of information, we only briefly covered the banking closures and Morgan Stanley's estimates of how those closures could affect economic growth over the next 24 months. Now that time has passed and more information is available, this quarterly update will take a deeper dive into the current conditions of the banking sector and the potential consequences of the increasingly tighter lending standards we are seeing from the banks. Unfortunately, tightening lending standards from banks doesn't historically lead to positive future market returns. Afterall, much like grass and flowers need rain to flourish, we believe the economy needs a healthy and liquid banking system to prosper.

IN THIS ISSUE WE'RE COVERING

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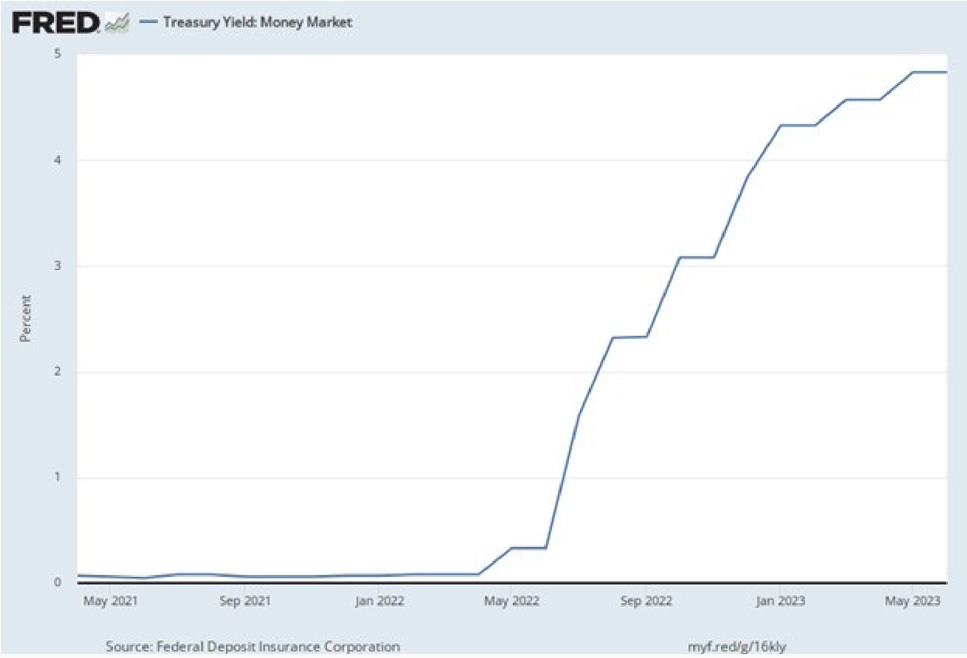
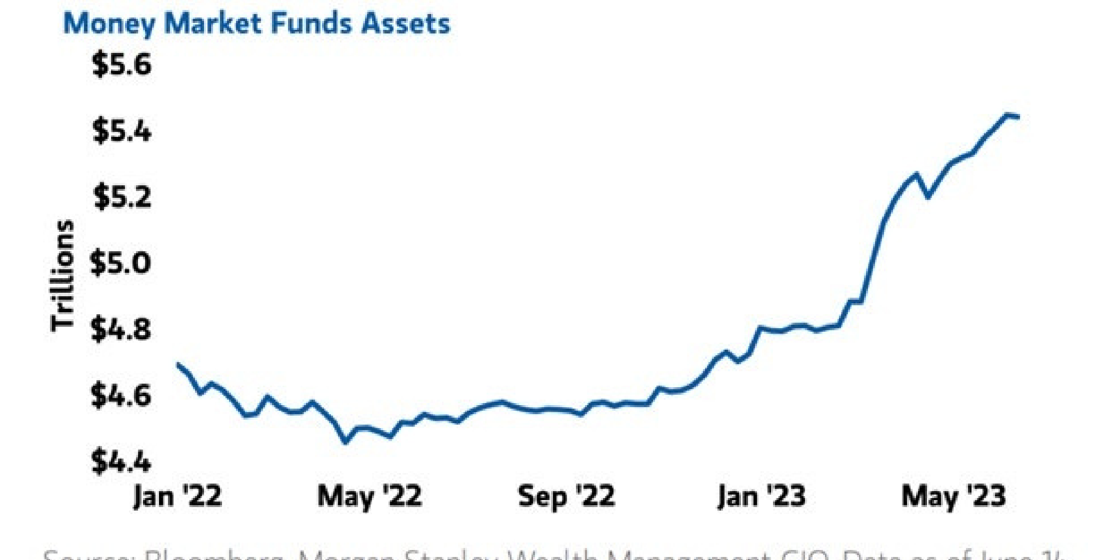
MONEY MARKET FUND FLOWS VS BANK DEPOSITS

In last quarter's Following the Fundamentals update, we covered the historically fast pace that the Federal Reserve has raised interest rates beginning in March of 2022. As short-term interest rates have risen, so has the yield being paid to investors in Money Market Funds. As seen below, the current yield on Money Market funds has risen from 0% to nearly 5% in less than 18 months.



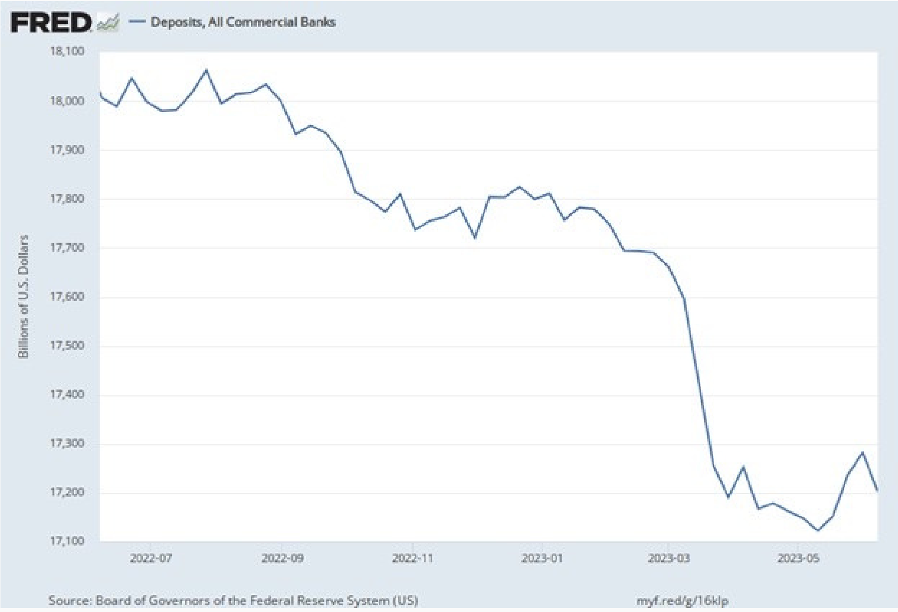
Federal Deposit Insurance Corporation, Treasury Yield: Money Market (MMTY), retrieved from Fred, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/MMTY, June 20,2023

With the yields of Money Market Funds dramatically increasing, investors have taken notice and started transitioning assets into Money Market Funds. As seen below, flows into Money Market Funds have increased by nearly $1 trillion since the Federal Reserve started raising rates in March of 2022.



Source: Bloomberg, Morgan Stanley Wealth Management GIO. Data as of June 14, 2023.

While Money Market Funds have increased yields as rates have gone up, bank savings accounts have not adjusted rates at the same pace. According to Bankrate.com, as of June 14th, the national average for bank savings accounts was 0.25% (Bankrate.com) With savings rates at banks not keeping up with Money Market Funds, it's not a surprise that deposits are moving out of commercial banks as seen below.



Federal Deposit Insurance Corporation, Treasury Yield: Money Market [MMTY], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/MMTY, June 20, 2023

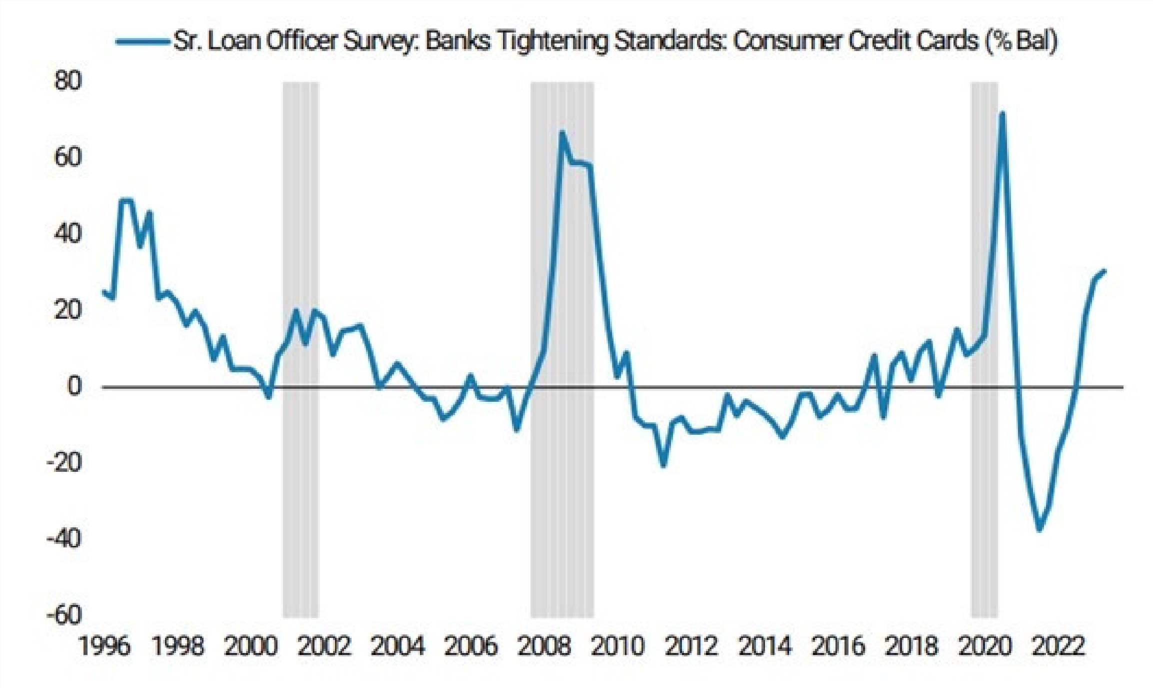
ARE BANKS DRYING UP?

With banks losing deposits, their capital base to make loans is getting smaller and banks have started to tighten lending standards. The following charts are from the Senior Loan Officer Opinion Survey that is conducted quarterly by the Federal Reserve. The most recent survey was conducted in April shortly after the bank closures in March.

The percentage of loan officers tightening loan standards to Commercial & Industrial firms is at a level that has historically aligned with recessionary economic levels.

Source: Haver Analytics, Morgan Stanley Research

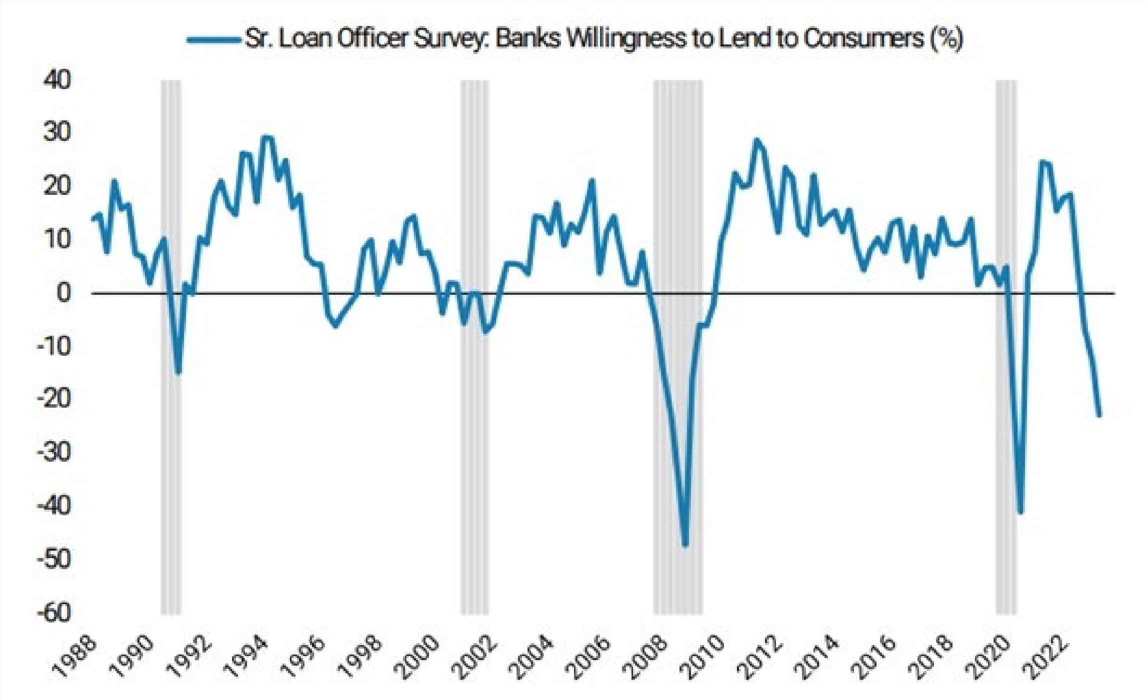
Loan officers aren't just tightening loan standards for Commercial and Industrial use. They are also tightening loan standards on the consumer. Below are the survey results for consumer credit cards as well as consumer credit ex-credit cards.



Source: Haver Analytics, Morgan Stanley Research

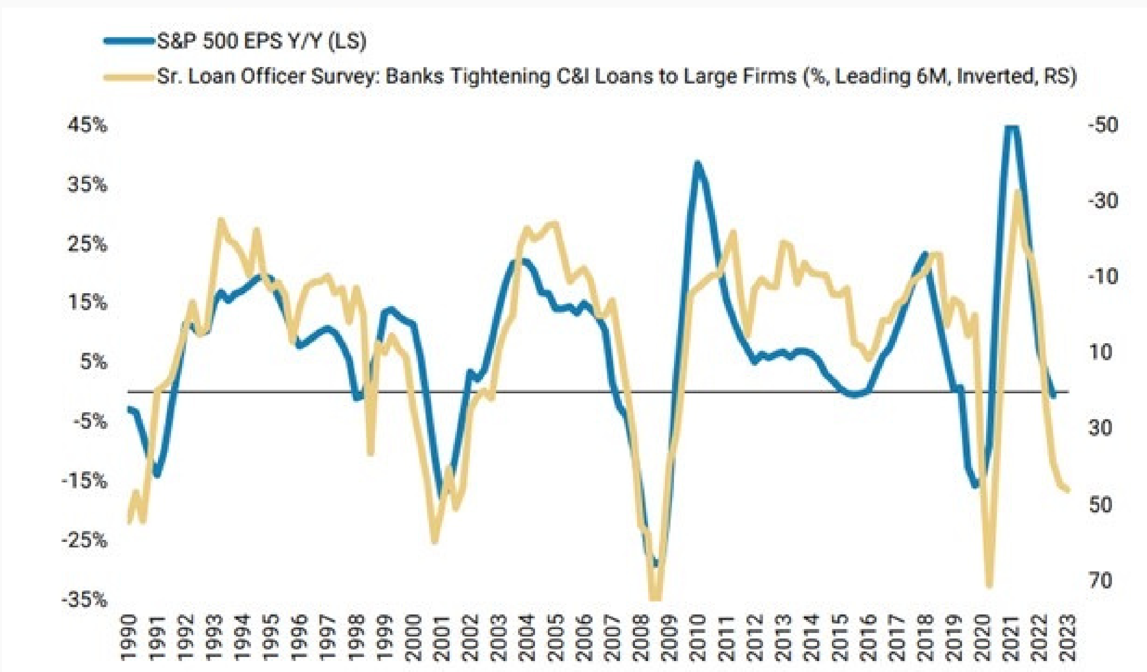
Source: Haver Analytics, Morgan Stanley Research

To expand on that, banks unwillingness to lend credit to consumers in general, is at levels not seen outside of a recession when looking at the past 30+ years.



Source: Haver Analytics, Morgan Stanley Research

Unfortunately, when we look back at history, when banks start tightening their lending standards to businesses it does not bode well for S&P 500 Earnings/Share growth. The below chart shows the inverse correlation between the Senior Loan Officer Opinion Survey and the future growth of S&P 500 earnings

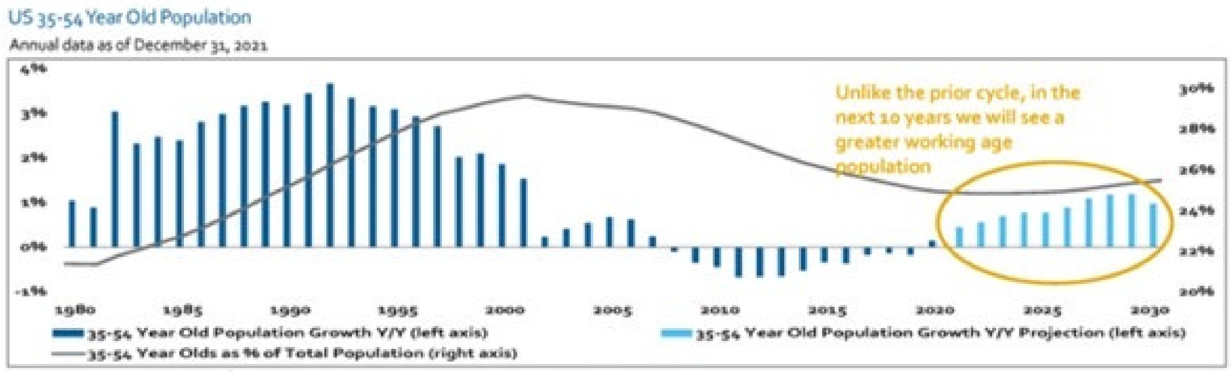


Source: Haver Analytics, FactSet, Morgan Stanley Research.

CONCLUSION

Over the past 15-18, months we have expressed our concerns about the short term returns of the S&P 500 and have remained cautious in the portfolios that we manage. As of the publication of this note, we have not seen any data to change that long-held opinion and we expect conditions to worsen over the next 6-9 months as the economy and S&P 500 companies digest the recent banking issues and economic slowdown.

However, we also want to highlight the chart below as one of the many reasons we feel much better about the stock market and the economy in the future. As seen below, the 35–54-year-old working age population in the United States is expected to grow significantly over the next few decades as the Gen Y and Gen Z mature. This is a significant difference in demographics from what we saw between the years 2000 and 2015 as we suffered through the previous secular bear market. As this population gains employment, forms families, and builds homes, we believe the economy of the US will see significant growth leading to growth of earnings for the companies we invest in. It’s key to remember that the market will move based on short term headlines, but ultimately, the direction of the stock market is guided by economic and corporate earnings expansion or contraction.



Source: Haver Analytics, Morgan Stanley Wealth Management GIC. *Estimates by the Census Bureau from 2020 on.

JOIN OUR WEBINAR

Enjoy this content? We'll be hosting our quarterly webinar on July 20 at 12:00 PM CST. We won't ask you to turn your camera on, but you'll be able to see us! Your name will also be hidden for complete client confidentiality.

Email allie.girardin@morganstanley.com for the Invitation and Registration Link

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The Standard & Poor's (S&P) 500 Index tracks the performance of 500 widely held, large-capitalization US stocks. An investment cannot be made directly in a market index.
Investors should carefully consider the investment objectives and risks as well as charges and expenses of a mutual fund before investing. To obtain a prospectus, contact your Financial Advisor or visit the fund company's website. The prospectus contains this and other important information about the mutual fund. Read the prospectus carefully before investing.

Treasury and Government Money Market: You could lose money by investing in the Fund. Although the Fund seeks to preserve your investment at $1.00 per share, it cannot guarantee it will do so. An investment in the Fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. The Fund’s sponsor has no legal obligation to provide financial support to the Fund, and you should not expect that the sponsor will provide financial support to the Fund at any time.

You could lose money by investing in a Money Market Fund. Because the share price of the Fund will fluctuate, when you sell your shares they may be worth more or less than what you originally paid for them. The Fund may impose a fee upon sale of your shares or may temporarily suspend your ability to sell shares if the Fund’s liquidity falls below required minimums because of market conditions or other factors. An investment in the Fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. The Fund’s sponsor has no legal obligation to provide financial support to the Fund, and you should not expect that the sponsor will provide financial support to the Fund at any time.

Because of their narrow focus, sector investments tend to be more volatile than investments that diversify across many sectors and companies.

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