

Banking Disorder

This year has already seen the failure and subsequent takeover of 4 high profile banks: First Republic, Silicon Valley Bank (SVB), Signature, and Credit Suisse.

First Republic, SVB and Signature represented the second, third and fourth largest bank failures in the history of the United States, only eclipsed by the 2008 failure of Washington Mutual.

What Happened?

It was not a case of loans going bad, rather a duration mismatch between deposits and long-term bonds purchased at low interest rates. Many of these bonds were long duration U.S. treasuries and mortgage-backed securities that were characterized and accounted for as "held to maturity" as the banks did not envision having to sell them. Under such bank accounting, losses incurred from last year's rising interest rates were not reflected on bank income statements or balance sheets.

Remember: When rates rise, bond prices fall. The problem arose when bank customers grew concerned and withdrew their deposits. It was an old-fashioned run on the bank. To fund withdrawals, these banks had to sell their longer-dated (low interest rate) bonds and recognize losses.

The bank fallout appears to be contained. The Fed responded with a new program called the Bank Term Funding Program (BTFP). It allows banks to borrow short term from the Fed using bonds as collateral based on par values; not lower market values after interest rates have risen. This new program allows banks to keep "held to maturity" securities and still fund deposits.

KEY DATES

- 6.13 May CPI
- 6.14 FOMC Press Conference
- 6.19 Juneteenth
Stock Market Closed
- 7.4 Independence Day
Stock Market Closed
- 7.7 Unemployment Report
- 7.12 June CPI
- 7.26 FOMC Press Conference
- 7.27 GDP 2Q Advance Estimate
- 8.4 Unemployment Report
- 8.30 GDP 2Q Second Estimate



Fed's Next Move

The banking condition leads to higher deposit costs for banks and higher borrowing costs for consumers and businesses. As shown in the chart, banks were tightening lending standards before stress in the banking system emerged. With the recent banking crisis, banks, especially regionals, have increased lending costs due to deposit withdrawals and a murky economic outlook. Decreased bank activity typically slows inflation 4-6 quarters after the effect.

Reported inflation has already moderated from last summer's peak. Annualizing the most recent March increase of 0.3% would represent annual inflation of 3.6%. Food inflation continues to run hot with an 8.5% increase over last year.

Within services, the shelter component, accounting for roughly a third of the entire index, remains stubbornly high. The reason is the owner's equivalent rent calculations tend to lag other price movements. Also, housing prices remain high due to low inventories available for sale. The low inventory of houses available in many markets lowers the likelihood of a near term plunge in housing prices.

Tightening credit and deceleration of inflation should slow the Fed's rate hikes. One more hike of 25 basis points could happen in June. However, we don't expect a cut this year considering the stickiness of inflation and economic laggards yet to be played out.

It Looks Familiar

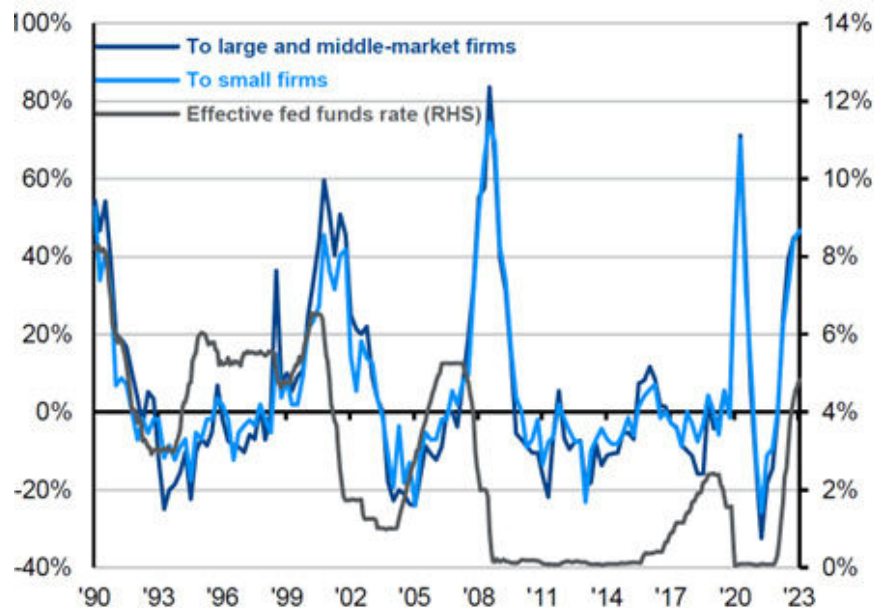
There are various multi-year cycles for equity investment categories like growth vs value, small and mid-cap vs mega and large-cap, and indexing vs active management. Given how extended some investment cycles have become and the recent triggering of underlying catalysts (e.g., inflation, interest rates, collapsing banks), several cycles appear to be at major multi-year inflection points.

When the Dow Jones Industrial Average (DJIA) reached 1,000 with the surging Nifty 50 in 1972, investors had to own mega, and large-cap stocks (like Kodak, Polaroid and Xerox) at any price. They were considered to be the high-performing leaders of the next century. Ten years later, the DJIA returned to 1,000, concluding a regretful decade for large-cap index investors. Similarly, mega and large-caps dominated the S&P 500 at its peak in the year 2000. Four of the six largest companies in that index were Cisco Systems, Coca-Cola, GE and Intel. They have lower stock prices today. That horrid 23-year track record hurt loyal large-cap investors.

For the last 10 to 12 years, mega and large-caps generally have experienced another impressive run.

Banks continue to tighten lending standards

Net % of domestic banks tightening standards for C&I loans



SOURCE: Federal Reserve, J.P. Morgan Asset Management.

Can They Keep Going?

Since last October, the large-cap focused S&P 500 is outperforming the small-cap S&P 600.

In today's tightening credit environment, investors should increasingly focus on primary fundamentals. GAAP earnings, valuation, cash flow and balance sheet strength are regaining respect. Financial market leadership is changing from a free money, more speculative, long-duration asset cycle to a tight money, cash focused, disciplined era.

Dividends Add to Total Returns

Over the last century, approximately HALF of stock market returns were from dividends.

Last year, stocks paying dividends outperformed both non-dividend stocks and bonds. In fact, S&P 500 cash dividends totaled approximately \$564 billion, up 10% from \$511 billion in 2021, according to S&P Global Indices. Dividends will likely increase again this year despite a questionable economy.

For long-term investors, dividend-paying stocks are an essential strategy to build, grow and protect wealth. For current and future retirees, dividends:

- Support spending, annual withdrawals and required minimum distributions, enabling portfolios to grow without invading principal
- Help offset inflation, especially firms that increase their dividends annually
- Provide more favorable tax efficiencies than U.S. Treasuries and corporate bonds

CMC Cash Cow Model Portfolio Dividend Yields

S&P 500 yield was 1.6% as of May 31, 2023

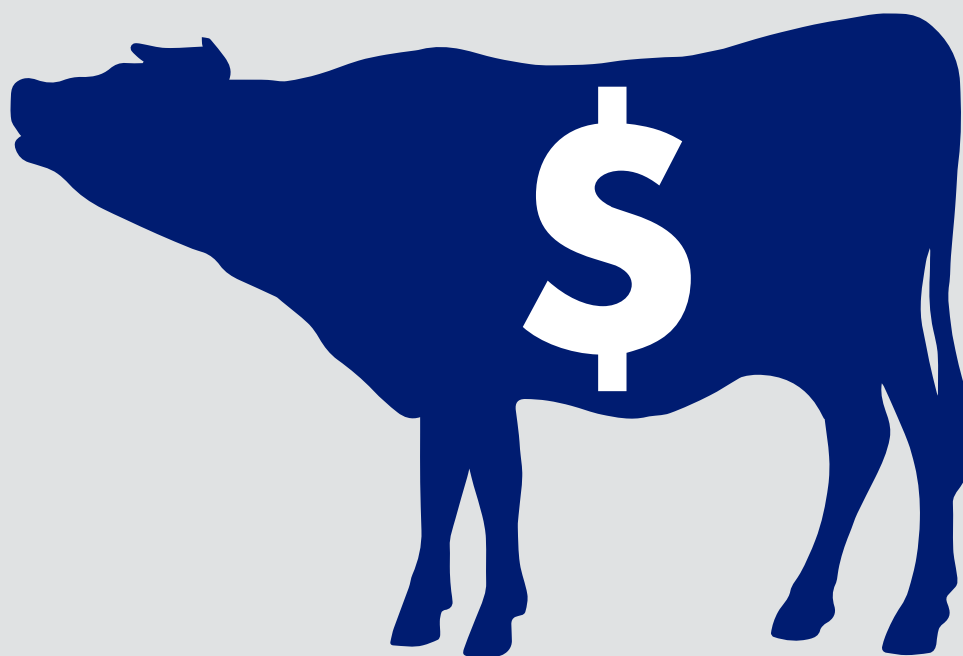
+5.0%
Growth & Income

+4.2%
DVD
(Dividend Appreciation)

+2.7%
SMID
(Small & Mid-Cap)

+3.0%
Growth

+2.4%
Alpha



Frequently Asked Question

Q: How will the debt ceiling bill affect the market?

A: *Inflation has been the headlining story for quite some time. For the last 30-45 days, it took a back seat to debt ceiling negotiations. We received questions about the debt ceiling deal prior to it being passed. What would happen to the market if it didn't get passed? A default on U.S. debt would be catastrophic, which is why there has never been a default.*

Debt ceiling negotiations tend to end with agreements that slow government spending and indebtedness. However, federal debt will still increase. Meanwhile, fewer central banks are buying U.S. Treasuries and Social Security is spending its Treasury reserves. The increased supply of federal debt (i.e., U.S. Treasury bonds) and decreased central bank demand for bonds should result in higher bond interest rates.

As bond interest rates rise, we recommend bond portfolios remain in short-duration securities. The average stock tends to decline during debt ceiling negotiations. We were able to purchase attractive stocks on sale. Subsequent legislation can usher in clarity and a stock market rebound.



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