Weekly market wrap

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Craig Fehr

‹ Weekly market wrap

One year on from the bank crisis:

What's changed?

Key Takeaways:

- *This time last year, markets were reacting to the bank crisis spurred by some high-profile bank failures.*
- *Stocks are up handsomely since then, with firming economic growth, tech sector enthusiasm and expectations for Fed rate cuts driving optimism.*
- *We don't expect a sequel to the bank crisis, but the stock market's sharp run higher, combined with low volatility and glimmers of what we'd describe as complacency, does make this market susceptible to knee-jerk reactions (dips) in response to any disappointing data or headlines. We'd treat any such pullbacks as compelling buying opportunities within what we view as a durable bull market.*

Last week marked the one-year anniversary of Silicon Valley Bank becoming a household name. Unfortunately, this was for all the wrong reasons as the collapse of the California bank sparked a brief bank crisis that continued over the following weeks, roiling financial markets and ultimately claiming a few additional regional bank victims.

What a difference a year makes. Then, we were fresh off of a bear market decline in the stock market and the worst calendar year on record for the bond market.[1] Now, we're in the throes of a vigorous bull market rally that has drawn comparisons to the run in the 1990s. If you needed another reminder of the importance (and benefit) of maintaining a level head and staying invested when others are panicking, look no further than the last 12 months. Given that, here are a few perspectives on what's changed since the bank crisis and what it may mean for the investment landscape ahead:

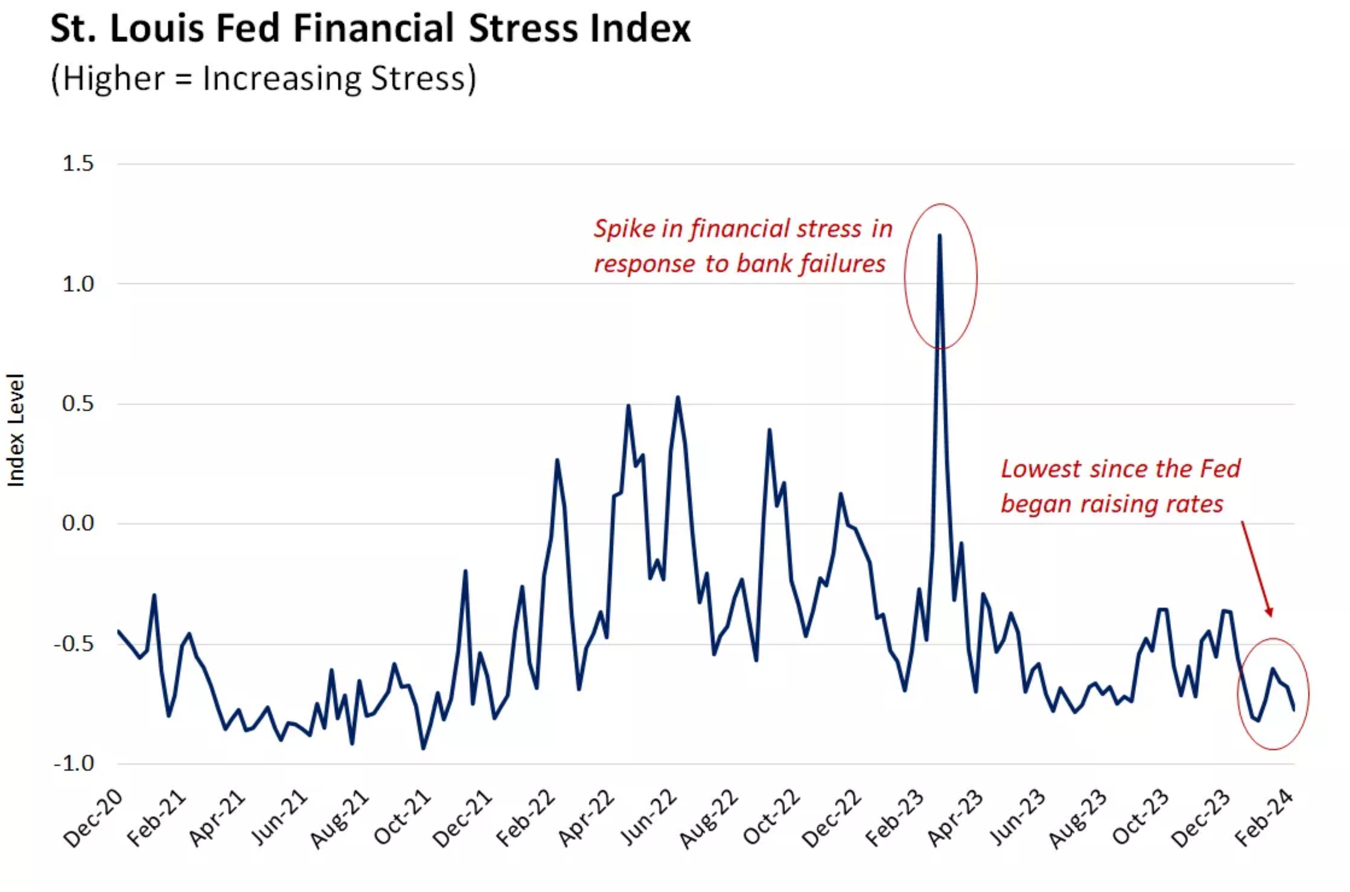
The banking system: A short-lived crisis

- **Then:** Aggressive Fed rate hikes in 2022 and rising longer-term interest rates pushed bond values lower, creating sizable unrealized losses on banks' securities holdings. This, in combination with declining deposits, created funding and capital challenges for certain banks that sparked worries of a modern-day bank run that could spill across the banking system. This led to the failure of a few notable banks (Silicon Valley Bank, Signature Bank, First Republic) and emergency policy responses from the Fed, Treasury and FDIC to shore up depositor confidence and banks' access to financing.
- **Now:** Interest rates have declined from their peak, relieving pressure on banks' unrealized losses in their bond portfolios which, alongside a healthy economy, has

put 2023's banking crisis well into the rearview mirror. The banking system still faces challenges, including signs of an uptick in loan delinquencies and defaults as well as commercial real estate uncertainties, but we'd characterize these as more traditional cyclical issues, not threats to the overall system. Lending standards have been tightened, but overall financial conditions have improved and loan growth has been positive, indicating demand from consumers and businesses along with an ability and willingness for banks to continue to extend loans.

- **What's changed:**
  - Unrealized losses on banks' securities portfolios declined 30% in the fourth quarter of 2023, where they had risen dramatically a year ago. At the same time, the amount of assets among the banks on the FDIC's "problem bank" list is currently one-third of the level coming into last year when the banking system worries emerged.
  - The shift in the Fed policy backdrop alongside a stabilization in longer-term interest rates presents a very different (more favorable) current for banks' capital and funding levels, which we think limits the chances of repeating last year's episode. We never viewed last year's bank failures as a fire that would spread across the entire banking system, and the outcome was a good reminder that every creak and crack in the markets doesn't become a bottomless cavern. We doubt another similar scare around deposits or unrealized losses will resurface, but looking ahead, we think commercial real estate exposure will present a potential new, albeit manageable, challenge for regional banks. But unlike last year's bank failures, this issue is unlikely to jump abruptly from the shadows and shock the market.

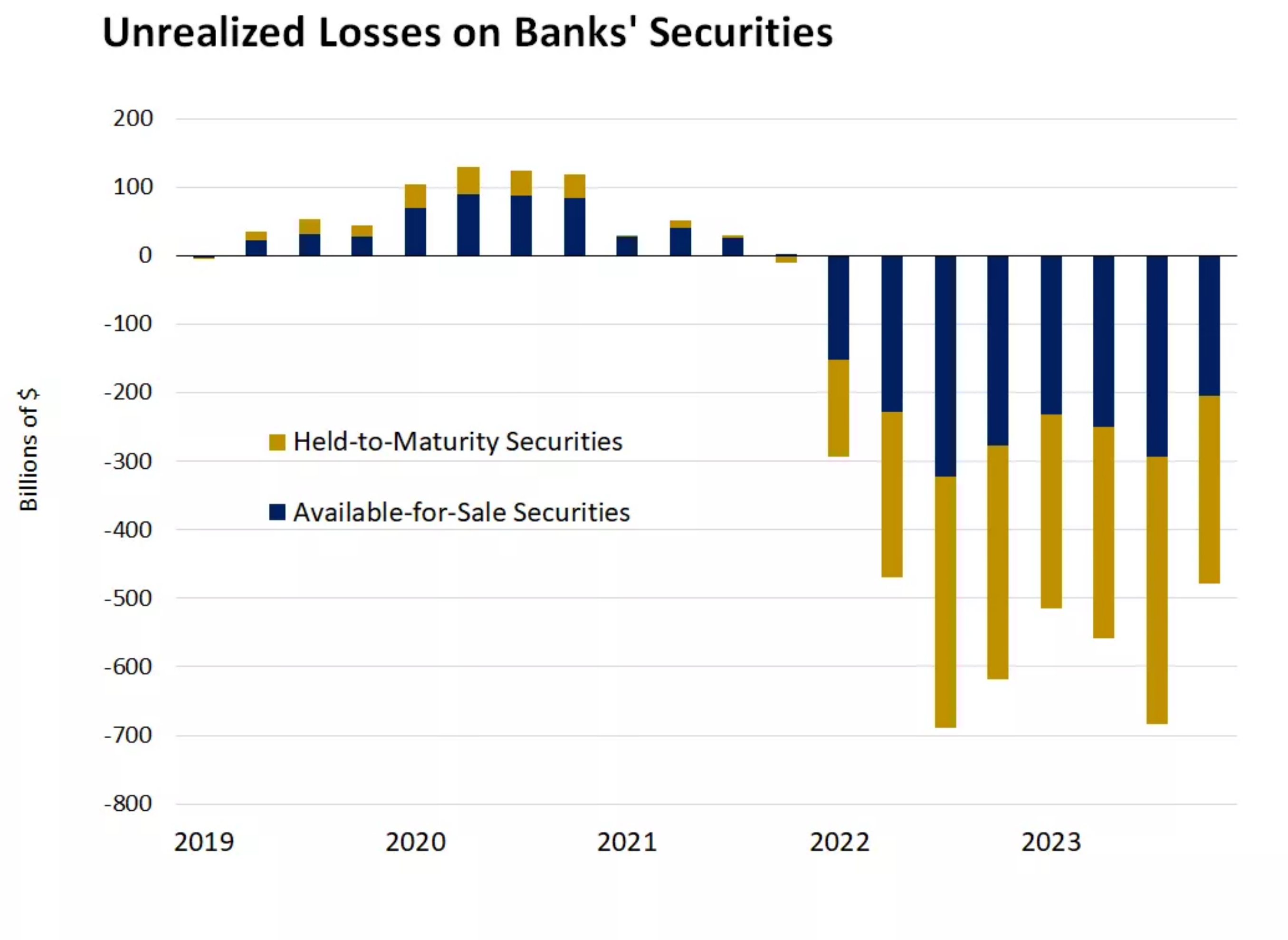
Financial stress spiked during the bank crisis and has improved significantly since then.



Source: St. Louis Fed.

Chart description

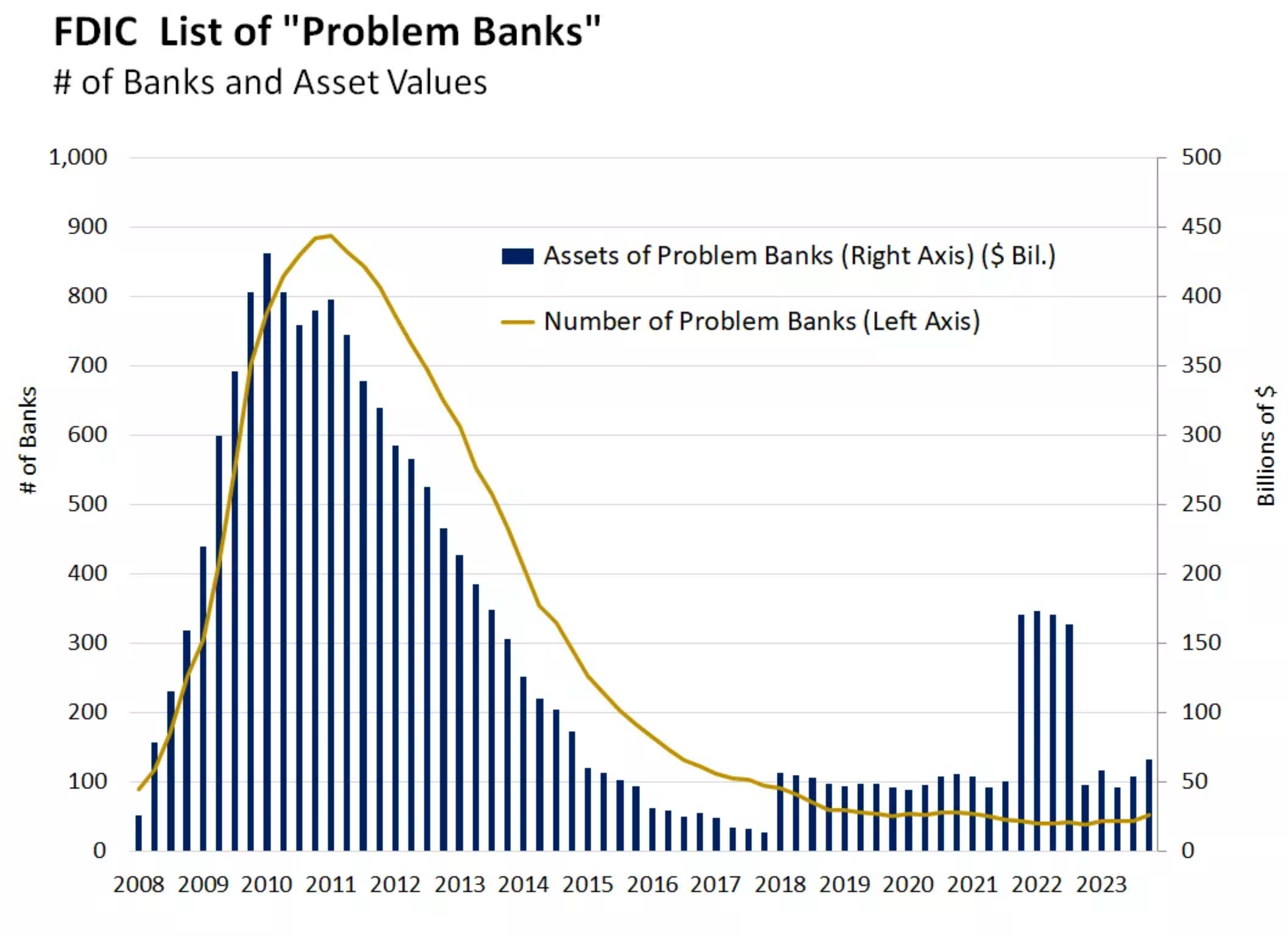
Banks' unrealized losses on bond holdings have improved but continue to reflect higher interest rates.



Source: St. Louis Fed.

Chart description

After the initial regional bank failures, less assets are exposed to "problem banks."

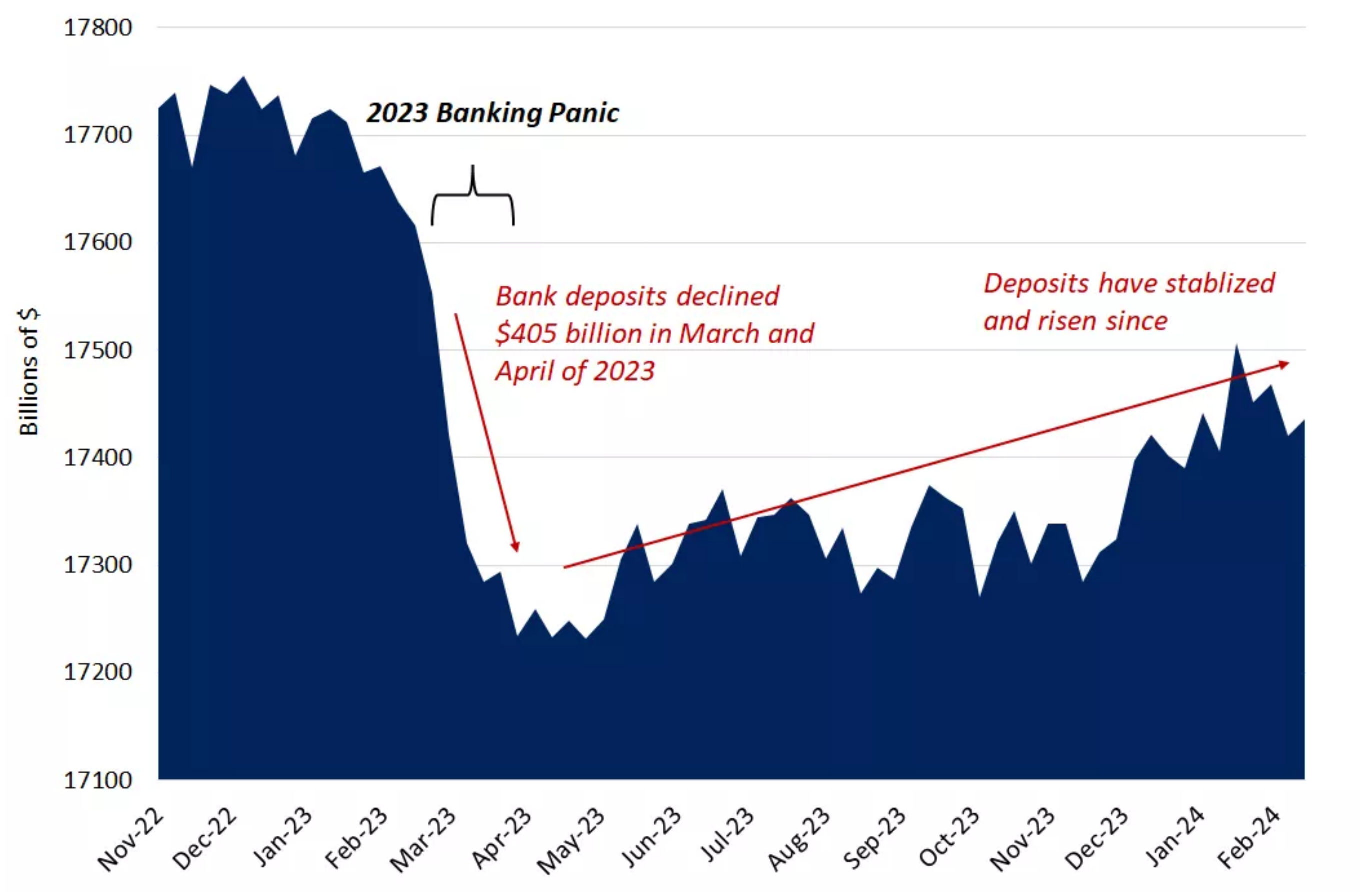


Source: FDIC.

Chart description

Bank deposits stabilized after the initial panic.

Deposits at All U.S. Commercial Banks



Source: St. Louis Fed.

Chart description

The stock market: From recovery to excitement

- **Then:** Stocks were several months into the recovery from the bear market, with the S&P 500 up 14% from the October 2022 lows to the beginning of February 2023.[1] That rally was powered by falling inflation and hopes that the Fed wouldn't be required to tighten the screws drastically further, but began to give some back through February after a string of very strong economic readings raised the expectations for additional rate hikes. The emergence of the bank crisis added to the weakness, sparking an additional bout of weakness that culminated in an 8% decline from February through mid-March.
- **Now:** The bull market has built a full head of steam, with the mood brightening into what is looking increasingly like full-blown optimism. Stocks are up more than 30% over the last 12 months and more than 40% from the 2022 bear market low.[1] Since last spring's dip, we've experienced only one notable phase of volatility, with equities seeing a 10% correction from August through October.[1] The S&P 500 h

new record high last week as stocks have ridden a wave of enthusiasm around technology, economic growth and approaching rate cuts.

- **What's changed:**
  - Moves in the market over the last year can be tightly tied to swings in expectations for moves in the Fed policy rate. Stock market weakness amid the bank crisis was quickly arrested by a dramatic shift in Fed policy expectations, as futures markets interpreted the financial system shock as a catalyst for the Fed to ease restrictive rates. That response did not come to fruition (nor should it have). This has been a regular routine over the last 12 months in which any strong economic data that argues for higher rates (or high rates for longer) has weighed on market returns, while data supporting an outlook for rate cuts has spurred equity rallies.
  - We doubt the markets will sever their tight and direct reactions to Fed rate expectations soon, but the underpinnings of the bull market have strengthened. Corporate earnings are on the rise and, in our view, should provide the support for further gains. Although the majority of last year's strong stock market return was attributed to a small number of mega-cap tech names, market leadership is also showing signs of broadening out, a healthy trend that we expect to continue this year.
  - We don't expect a sequel to the bank crisis, but the stock market's sharp run higher, combined with low volatility and glimmers of what we'd describe as complacency, does make this market susceptible to knee-jerk reactions (dips) in response to any disappointing data or headlines. Relative to this time last year when a recession appeared more probable, the fundamental backdrop of economic and corporate profit growth as well as eventual Fed rate cuts would, in our view, make any pullbacks a compelling buying opportunity for investors.

Stocks have rallied to new highs, driven primarily by optimism over coming Fed rate cuts.

Source: FactSet, S&P 500 Index.

Chart description

Stock returns have been strong over the last year, highlighting the opportunities created by temporary volatility like the bank crisis.

Stock Market 1-year Rolling Returns

Source: Bloomberg, Edward Jones. S&P 500 Price Return Index.

Chart description

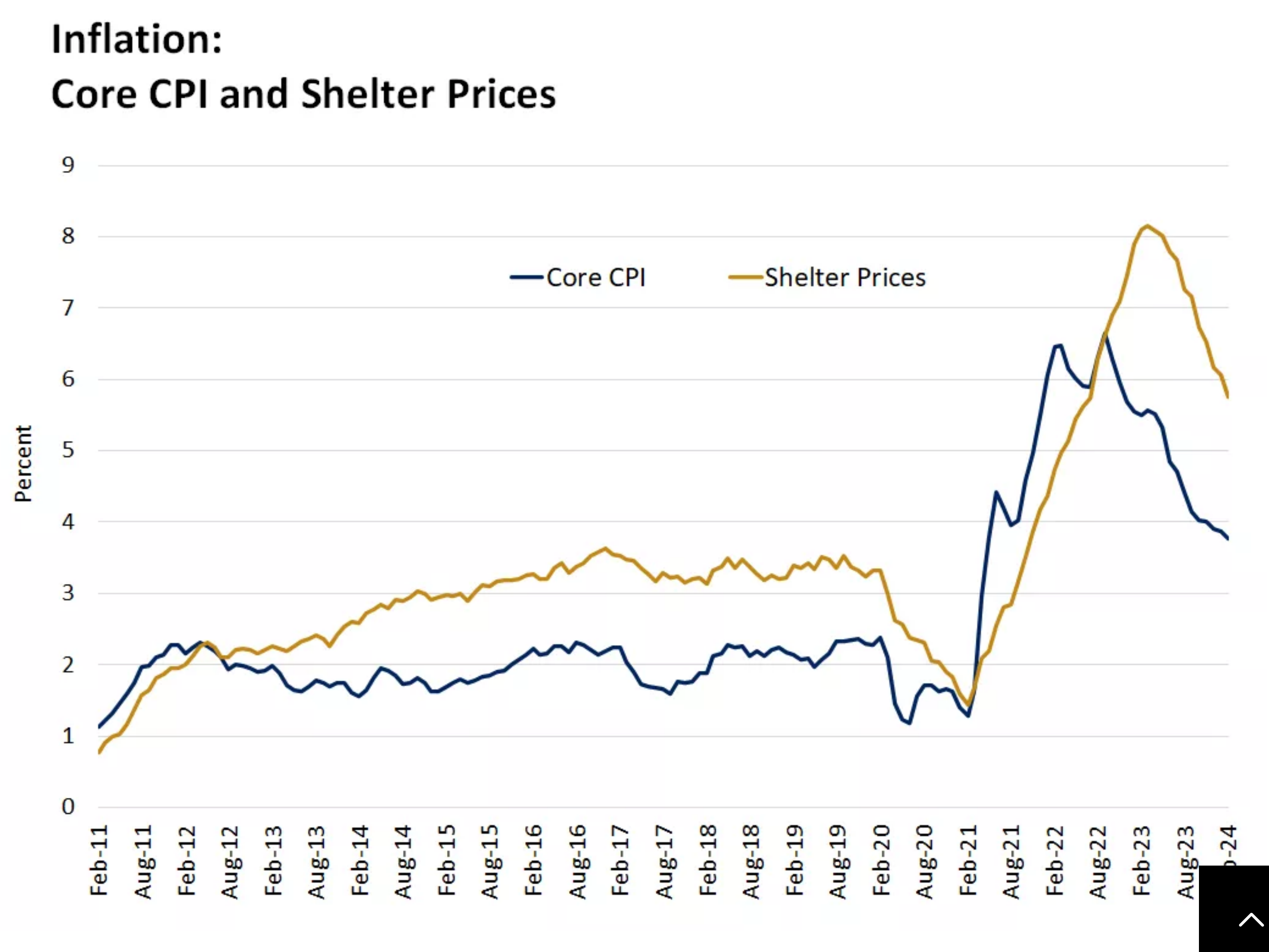
Inflation and interest rates: A very different Fed

- **Then:** The Fed was in the throes of its rate-hiking cycle, with the policy rate above 4.5% after more than 400 basis points (4%) of hikes in the preceding 12 months. Core inflation was at 5.5%, having started its descent from the September 2022 peak but still high enough to keep the Fed's eyes on additional policy tightening.[1] Ten-year benchmark interest rates were on a broader path higher, sitting near 3.5%, but experienced a sharp-but-brief drop in response to the emergence of the banking turmoil.
- **Now:** The Fed has rates on pause, with the policy rate 75 basis points (0.75%) higher than this time last year, but the outlook has pivoted from hikes to cuts. Inflation is notably lower, though still too high for comfort. Longer-term interest rates are markedly below their October 2023 peak, with the 10-year yield bouncing around above the 4% mark.
- **What's changed:**
  - Inflation is materially lower. The consumer price index (CPI) report release last week showed core CPI is nearly two percentage points lower today (3.8%)

than it was this time last year (5.7%). The pace of progress has begun to slow, however, with the month-over-month readings coming in hotter than expected for the last two months, suggesting the last leg lower toward the Fed's 2% target may prove to be more prolonged. Shelter prices moderated again last month but remain the fly in the falling-inflation ointment. Nevertheless, consumer prices remain in a downtrend that we think will broadly persist, with a few bumps along the way.

- The most sizable difference today versus last year is the monetary policy backdrop. Last year the Fed was still increasing its pressure on the brake as the downtrend in inflation was still young. Today, the Fed is eyeballing rate cuts, setting a very different tone for the financial markets and longer-term interest rates. We think last week's CPI report further solidifies our longstanding view that the Fed can and will begin to cut rates this year, but still-elevated inflation will prevent them from doing so until the summer.

Inflation continues to moderate but remains too high for comfort in large part due to shelter prices.



Source: St. Louis Fed. Year-over-year percent change in U.S. Core CPI and the shelter index of CPI.

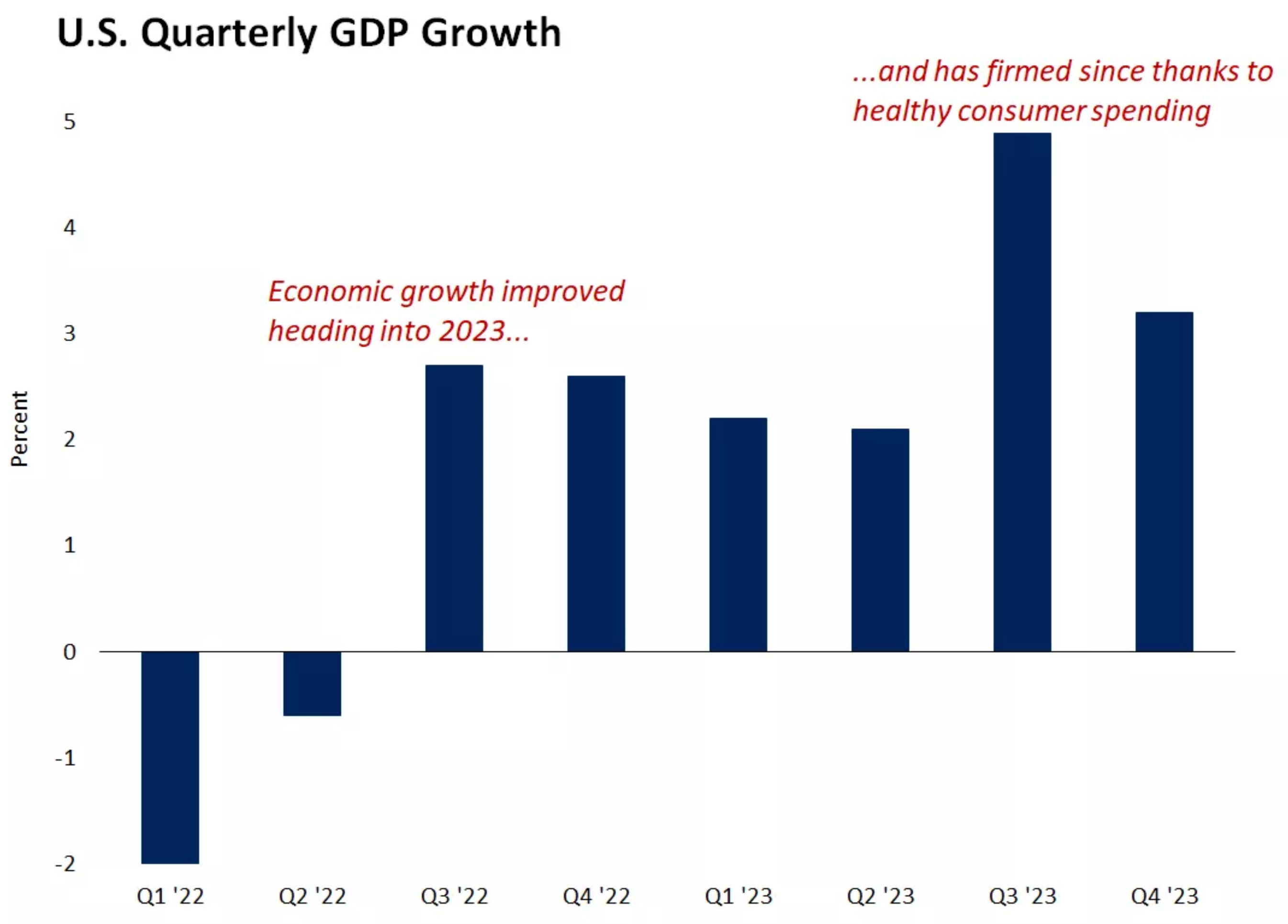
Chart description

The economy: Defying rate-hike gravity but potentially coming back down to Earth

- **Then:** The economy was gaining some traction in early 2023. While quarterly GDP growth averaged just 0.7% for all of 2022, momentum was picking up, with GDP growth running around 2.5% in the final quarter of 2022 and first quarter of 2023.[1] The labor market was providing the bulk of the fuel, with unemployment in January 2023 at the lowest since 1969, supporting healthy consumer spending. Nevertheless, recession worries were still high in anticipation of a downturn stemming from the lagged impacts of the Fed's sharp rate hikes.
- **Now:** Recession calls have faded as the economy gained additional steam in the second half of 2023 with quarterly GDP growth averaging 4%. The strong labor market remains the centerpiece, though employment conditions are showing signs of softness, with the unemployment rate ticking up slightly, job openings declining and wage growth moderating over the past year.
- **What's changed:**
    - The spike in restrictive financial conditions during the bank crisis sparked by worries that banks would pull back to protect capital positions proved to be short-lived, with the St. Louis Fed's Financial Stress Index now back near the lowest levels since 2021. The credit cycle has matured, with loan delinquencies rising, but this presents a more traditional risk within the banking sector relative to the shock to the system last year stemming from bank failures.
    - Tighter monetary policy has filtered its way through the economy but has been much less punitive than feared. We suspect the combination of excess savings, above-average wage growth and historically low household leverage (debt relative to income and assets) has made consumers somewhat less vulnerable to this latest Fed rate hike campaign, relative to prior tightening cycles – less vulnerable, but not impervious. Last week's release of the latest retail sales figures revealed what we'd characterize as some early signs of consumer fatigue that align with our view that the labor market is softening a bit.
    - We think the economy is in better shape now than it was this time last year, with encouraging signs that improving capital spending, manufacturing output and housing investment can help offset some of the impact of what we anticipate will be slower consumer spending growth ahead. We think it's t optimistic to presume the economy will completely glide past the effects of

higher Fed policy rates, but the prospects of further moderation in inflation suggest the economy should benefit from rate cuts later this year.

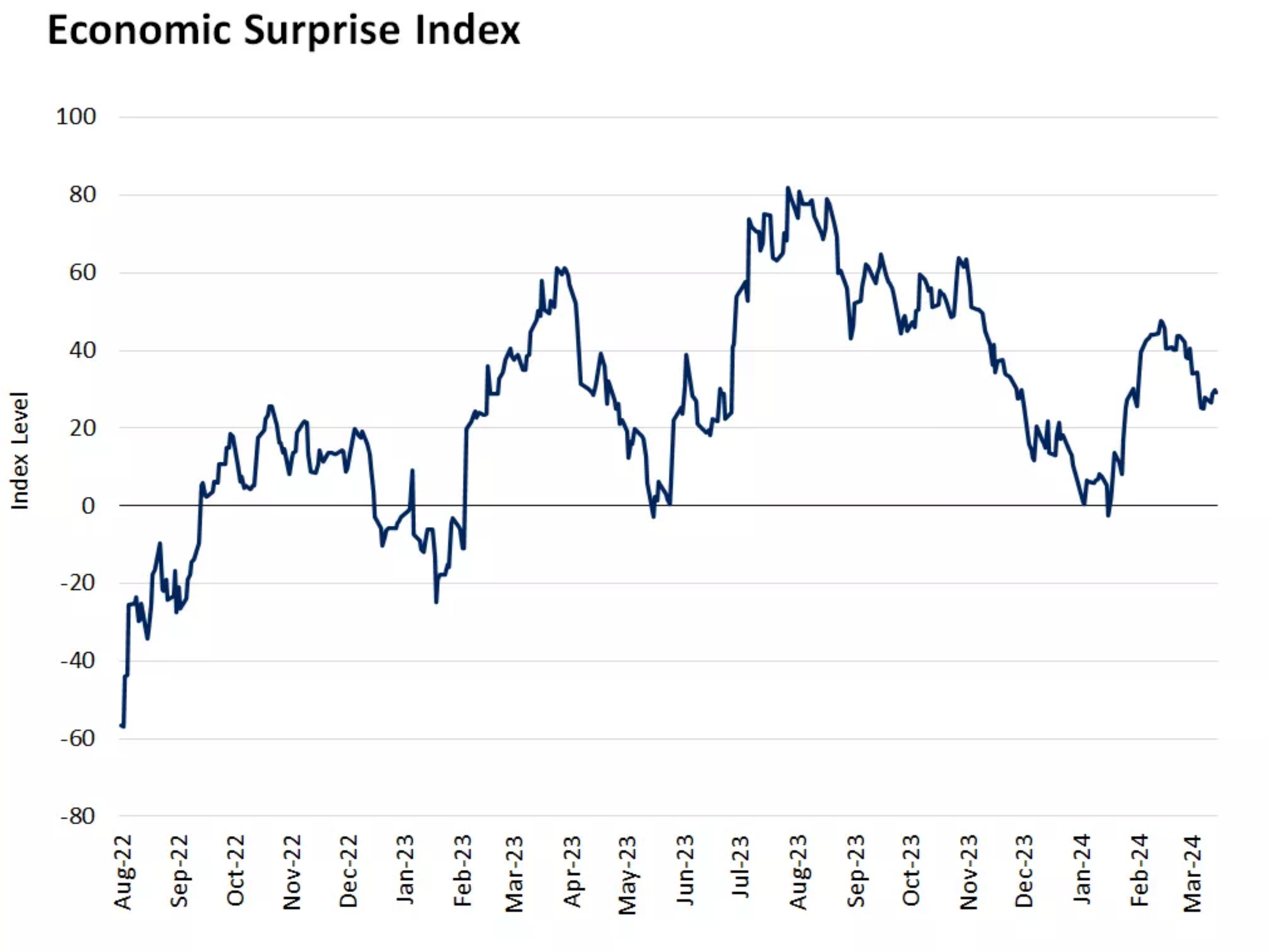
Economic growth has improved over the last year.



Source: St. Louis Fed. U.S. quarter-over-quarter seasonally adjusted annualized real GDP growth.

Chart description

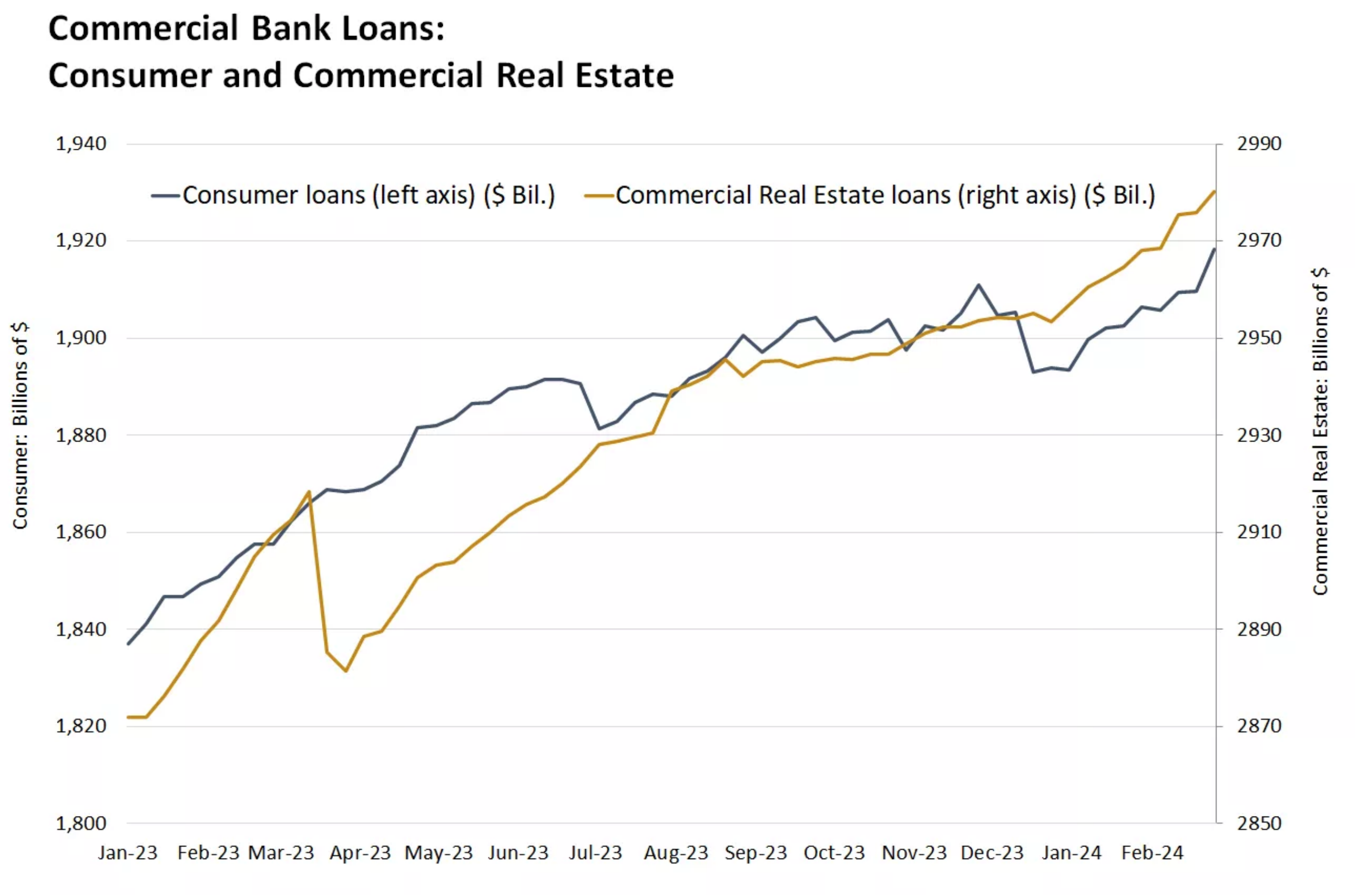
Economic data has generally come in ahead of expectations lately.



Source: FactSet. Citi U.S. Economic Surprise Index.

Chart description

Loan growth has reflected ongoing demand as well as banks' willingness to extend loans after the bank crisis.



Source: St. Louis Fed.

Chart description

Craig Fehr, CFA
Investment Strategy

Sources: 1. FactSet

Weekly market stats

INDEX	CLOSE	WEEK	YTD
Dow Jones Industrial Average	38,715	0.0%	2.7%
S&P 500 Index	5,117	-0.1%	7.3%
NASDAQ	15,973	-0.7%	6.4%
MSCI EAFE*	2,325.12	-1.4%	4.0%
10-yr Treasury Yield	4.31%	0.2%	0.4%

INDEX	CLOSE	WEEK	YTD
Oil ($/bbl)	$81.02	3.9%	13.1%
Bonds	$97.10	-1.2%	-1.6%

*Source: FactSet, 3/15/2024. Bonds represented by the iShares Core U.S. Aggregate Bond ETF. Past performance does not guarantee future results. *Morningstar Direct 3/17/2024.*

The week ahead

Important economic data being released this week includes February housing starts and the FOMC meeting.

Review last week's weekly market update.

Craig Fehr

Craig Fehr is a principal and the leader of investment strategy for Edward Jones. Craig is responsible for analyzing and interpreting economic trends and market conditions, along with constructing investment strategies and asset allocation guidance designed to help investors reach their financial goals.

He has been featured in *Barron's, The Wall Street Journal*, the *Financial Times, SmartMoney* magazine, *MarketWatch*, the *Financial Post*, Yahoo! Finance, Bloomberg News, Reuters, CNBC and Investment Executive TV.

Craig holds a master's degree in finance from Harvard University, an MBA with an emphasis in economics from Saint Louis University and a graduate certificate in economics from Harvard.

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