

ECONOMIC OUTLOOK

Summary

With the highest inflation seen in four decades persisting, market participants have expected the Fed would hike until inflation subsides or “something breaks.” Unfortunately, the latter occurred in early March with the failures of Silicon Valley Bank (the 16th largest bank in the country) and Signature Bank. In truth, the real culprit for both banks’ failures was poor management, but the rapid pace at which the Fed hiked the overnight rate exacerbated their issues. It’s fair to wonder, in times like these, whether there will be any economic fallout moving forward.

The crisis earlier this month shined a light on uninsured deposits, which represent the amount an individual, couple or business has in the bank exceeding the FDIC insurance limit of \$250,000. Realizing the risk a bank failure could pose to their net worth, many have viewed this as a wake-up call to move those funds into safer assets (e.g., U.S. Treasuries) or to diversify through multiple banks. This trend has caused net outflows at small and medium banks, while some larger “too-big-to-fail” banks have reaped the benefits.

Many of those small-sized to medium-sized banks are now likely to have significantly smaller asset bases than previously reported. That alone could skew liquidity ratios, which would require an increase of capital. Additionally, regulations around banks are likely to become more stringent in the coming months. The result is likely to be a period of bank recapitalization where both commercial and private lending becomes subdued, profit margins decline and the cost of capital increases. This is often referred to as a credit crunch.

Historically, the implications of a credit crunch have been slow economic growth and/or recession. Typically, credit standards at the banks are tightened, and loan rates are generally increased to offset the smaller number of borrowers. Due to these factors, individuals can’t spend as much as they would

otherwise prefer, leading to fewer cars being purchased, delayed home improvement or repair projects, etc. Businesses also lose easy access to funds and are often forced to scale back rather than hire new employees or expand their footprint. This is all in addition to the negative economic impacts that naturally occur as the Fed keeps the overnight rate in restrictive territory.

The recent banking crisis only complicates the Fed’s task of balancing the overnight rate, labor market and overall economy in order to reduce inflation. While they are still trying to assess the potential impact of an ensuing credit crunch, and though the immediate crisis has subsided, the Fed’s job has become more difficult.

Positives

Core PCE inflation readings were lower than expected for February (0.3% vs. 0.4% est.)

Personal income exceeded expectations (0.3% vs. 0.2% est.)

The labor force remains strong as March payrolls beat expectations (236k) and the unemployment rate fell (3.5%)

Negatives

GDP for 4Q22 was revised lower due to weaker personal consumption than previously expected (2.6%)

Retail sales have been negative three out of the last four months (-0.4%)

Durable goods new orders have been negative for the past two months (currently -1.0%)

EQUITY OUTLOOK

Summary

We entered 2023 with a high degree of uncertainty regarding a wide range of macroeconomic and geopolitical market drivers. A couple of high profile bank failures in March added a new layer of uncertainty to the mix. The immediate concern was if the banking contagion would spread into a full-blown crisis. However with each passing week it seems more and more likely banking problems can be contained.

Concerns over the banking industry pressured equity markets early in March but the S&P 500 recovered and eventually added 3.7% for the month. Sector and style performance was fairly mixed in March. The technology sector was the best performer climbing 10.9% and led the way for growth stocks. Value stocks underperformed partly because financials were the worst performing sector falling 9.6%. The higher allocation to finance also pressured mid-cap and small-cap indexes. International markets were broadly higher in March.

The banking scare likely moved the Federal Reserve closer to the end of the current tightening cycle. Hopes that the Fed might pause or even pivot policy were one reason the markets recovered in spite of the uncertainty. It can be argued that constrained bank lending conditions tend to slow economic activity, which the Fed was working to accomplish.

Corporations will begin reporting first-quarter earnings results later this month with expectations having been continually reset

lower. Much attention will focus on the banking industry looking specifically at the financial health of regional banks which are generally at higher risk than the larger money-center banks. Stocks will likely continue to be volatile. However, if a wider bank crisis can be avoided and the Fed is nearing a pause or pivot, it is setting up to be a relatively healthy environment for equity investors for the balance of the year.

Positives

Fed may be finished hiking

Aggressive cost cutting could provide a positive earnings surprise in specific economic sectors

Negatives

Bank failures and risk of contagion

Risk of Ukraine war escalation

Unknowns

2023 recession

FIXED INCOME OUTLOOK

Summary

There is nothing like a good ole banking crisis to send yields plummeting and credit spreads skyrocketing. Historically, when the Fed embarks on a rate-hiking cycle, they continue until something breaks. And that is what happened in March as the FDIC was forced to take over and shut down two sizable regional banks that experienced significant withdrawals. In today's digital world, nervousness can spread quickly and deposits can leave even quicker. The closure of Silicon Valley Bank spread fear to other regional banks. The Fed stepped in with a new program to provide liquidity when ironically their rapid pace of rate increases was one of the main sources of trouble for these banks.

Before the banks collapsed, interest rates had been on an upward trend since early February fueled by a series of stronger economic and inflation reports. Investors reset their expectations for rate policy as they looked for up to four additional rate hikes and also removed their expectations for rate cuts this year. Yields continued to rise through the first week of March, but that all changed quickly with the largest bank failure since 2008. Interest rates declined across the curve in the wake of the turbulence in the banking sector. Still, even in the face of the turmoil for banks and new economic uncertainty, the Fed followed through on their promise to fight inflation at all costs by increasing the overnight rate by 25 basis points (bps) on March 22. By the end of the month, yields rebounded off these panic lows and credit spreads retraced about half of their increase. Overall, for many of the bond market indexes, March delivered one of the top 10 monthly returns over the past 30 years.

This new wave of bank distress is certain to restrict access to capital even more as banks focus on maintaining the liquidity needed for survival. With local and regional banks providing much of the funding for small businesses and about 70% of

commercial real estate loans, the economic impact is likely to materially increase the probability of a recession. Accordingly, investors have again recalibrated their forecast for the Fed's overnight lending rate. Instead of multiple rate increases this year, the market is now about 50/50 on a May increase and then expects three rate cuts by year's end. This might be a bit aggressive but if the economy slows more quickly than the Fed is currently expecting, they will be forced to moderate their fight against inflation to save the banking system and the economy. As long as the trend of inflation is still downward, they can claim victory even though the road to 2% inflation will be uncomfortably long. The multiyear bear market for bond investors is likely over.

Positives

The banking system cannot take much higher rates, the Fed is nearly done

Overall inflation data is easing albeit slowly

U.S. corporate bond spreads are attractive but selection is critical

Negatives

Fed chatter remains hawkish

Unknowns

Additional bank runs due to liquidity concerns

Geopolitical tensions with China; Russia/Ukraine war
