COMMENTARY
Q1 2023

The major story of the end of the first quarter of 2023 has been the concern surrounding the health of the banking sector after the collapse of two US banks and the purchase of Credit Suisse by UBS. The crisis has its roots (as does most financial news from the past year) in the Federal Reserve's interest rate hikes. The long term bonds that banks hold on their balance sheets are the assets hurt most by the rate hikes, creating a severe mismatch with bank liabilities that tend to be much shorter term. Once concerns arose there were massive withdraws of deposits forcing the sale of the devalued assets and exacerbating the problems. The prime example was Silicon Valley Bank (SVB). Not heeding the lessons from the Savings and Loan crisis in the 1990s, SVB purchased longer term assets (US Treasuries) and borrowed shorter term at a time of dramatically rising interest rates. The result for SVB was being forced to sell $21 billion of longer-term US Treasuries at a $1.8 billion loss to cover liquidity requirements. State regulators stepped in to take over operations and backstopped all deposits, both insured and uninsured, and the Federal Reserve created the Bank Term Funding Program to support that backstop for SVB and other struggling banks. Challenges remain for financial institutions, but unlike what we saw in 2008, there seems to be less threat of contagion to the broader financial system.

The first quarter of 2023 witnessed an uneven but positive return for both equity and fixed income markets. Within the equity markets, the overachieving sector of the 2019-2021 time period and subsequent laggard of 2022, was the standout of 2023 to date i.e., large technology companies. Equity markets have now performed well over the last two quarters after a correction during the first nine months of 2022. Contributions to strong equity growth in the first quarter of 2023 included the disinflation narrative exacerbated by continued Federal Reserve tightening coupled with the banking crisis. It's hypothesized that the crisis will be able to do what the Fed has struggled to – slow the economy more quickly through tighter lending practices. This may alleviate the need for more draconian interest hiking measures, a guidepost that equities are anxiously awaiting. Beyond the Federal Reserve's federal fund rate changes during the quarter (50 basis points), the yield curve dropped precipitously. The two year Treasury had its largest 3 day interest rate drop since 1987's Black Monday (100 basis points or 1%). Europe was slower to react to inflation and the European Central Bank (ECB) interest rate is 3% versus 4.75-5% in the U.S. and inflation remains 3% above the U.S.

The U.S. economy remained strong with the unemployment rate at 3.6%, non-farm payrolls increasing by over 1 million employees in the past three months, and inflation falling to under 6%. We are well on our way through the rate hike cycle, and the Fed is now unwinding their balance sheet as $90 billion of treasuries roll off monthly. The warm weather in Europe not only reduced the cost of energy but also averted a significant supply problem exacerbated by the Russia-Ukraine war. Lesson: We should read the Farmer's Almanac more and read headline news less.