2023 has started where 2022 left off, with a roller coaster ride in financial markets. As the year began, recession fears dominated markets, which faded as very strong economic data in January and February led to a rally in equities. This data also led to a rise in interest rates towards autumn highs, as sticky inflation once again became the focus of investors. These February inflation fears were forgotten almost overnight in early March, as the sudden failure of U.S. regional banks Silicon Valley Bank and Signature Bank, and the hasty acquisition of the distressed Swiss megabank Credit Suisse by its chief rival UBS, led to global fear of banking contagion and a repeat of the Great Financial Crisis of 2008. Despite these problems in the banking sector and turbulence in the bond market, the S&P 500 rose for the second straight quarter, following a strong gain in the fourth quarter of 2022. However, the lack of breadth this quarter has some investors concerned moving forward. The market cap weighted S&P 500 index returned 7.5%, dramatically outperforming the equal weighted index (2.9% total return), a signal that most of the gains were seen in a small number of the largest stocks, which are perceived as safe. The last time the market cap weighted index rose more than its equal weighted counterpart by such a large margin was in the fourth quarter of 1999; generally, investors like to see more broad-based gains amongst smaller companies to indicate true economic momentum.

The collapse of Silicon Valley Bank was a classic example of an old-fashioned bank run with a modern twist. The bank had been growing quickly during the COVID-era boom in the technology and venture capital industries and found itself with more deposits than it anticipated and needed. Without enough attractive lending options, SVB invested a large portion of its new deposit base in fixed income securities. As interest rates quickly rose last year, the value of these fixed income holdings declined, leaving the bank with unrealized losses. In order to help shore up its balance sheet, the bank tried to raise capital, but the ensuing reaction to the capital raise was panic among depositors. Unlike almost every other bank in the United States, the depositors of SVB were very concentrated within a small number of technology companies that held very large, mostly uninsured deposits. As panic spread amid the relatively tight knit companies of Silicon Valley, these deposits quickly were transferred to banks deemed safer than SVB, namely money center banks that are deemed “too big to fail” such as Bank of American and JPMorgan Chase. Banking is a game of confidence, and once that is gone, the game can be up very quickly.

In the midst of the banking panic, the yield of the 2-year Treasury bond, a closely watched benchmark of where investors believe the Fed’s hiking cycle will end, fell a full percentage point in 3 days, from about 5% to 4%. This was the steepest three-day decline in the 2-year rate since 1987, which followed the Black Monday stock market crash. Today, the massive drop in the 2-year rate has been interpreted to mean that the Fed’s hiking cycle will be coming to an end sooner than previously believed, as financial stability concerns start to outweigh inflation concerns. The current economic situation remains delicate for the Federal Reserve, as the U.S. economy continues to show strength. Real time trackers of U.S. economic growth continue to show strong momentum in the first quarter and global growth remains supported by the continued reopening of China from its zero COVID policies. There have been very few signals of weakness in the labor market, with initial jobless claims not yet rising off current low levels. Inflation remains elevated, with the February CPI rising 6% year over year. Ordinarily this might point the Fed in the direction of continued interest rate hikes, however there are now growing reasons to think that the Fed is at or near the end of this tightening cycle. First, the aforementioned bank stress. Many investors over the past year have observed that the Fed will raise rates until they “break something” in the economy. This past month, that unknown “something” may have been the banking sector. The panic deposit flight in the wake of SVB may be over, but deposits will continue to leave banks for cash alternatives such as money market funds, which now pay north of 4.5%. Even in the absence of further large bank failures, the squeeze in profitability will likely cause banks to “hunker down”, slowing loan growth and the broader economy. The Fed is also very attuned to the impact of the interest rate hikes that have already occurred. History tells us that monetary policy works with a lag, and it often takes months, and in some cases, years before the full impact is felt. In

the runup to the Great Financial Crisis, the Fed started to raise short term rates in June 2004, ultimately reaching a peak of 5.25% in June 2006, 2 years later. The Fed then paused and kept rates at that level for an additional year, before its first cut in September 2007. It took another year from the first cut before Lehman Brothers collapsed in September 2008. This is not to suggest that we expect a replay of the GFC, far from it. It is merely an illustrative example of how long it often can take before the full force of high interest rates can impact the economy.

The stock market, despite all of the intervening volatility, has mostly been trading in a range for the last year after spending the first 4 months of 2022 falling from all-time highs. The S&P 500 has spent 81% of trading days of the last 11 months with a closing price within 5% of 4,000, near where the index sits today. By many measures market sentiment is at multi-year lows, and investor positioning and sentiment can often be the driver of short and intermediate term moves. When everyone is bearish for the same known reasons, frequently the opposite occurs. The Bank of America "Sell Side Indicator" which tracks asset allocations recommended by strategists at various firms, is close to the level which indicates stocks are attractive, as counterintuitively it has been a bullish signal when Wall Street strategists are extremely bearish historically. The strange mix of bullish and bearish signals in this range bound market, is summed by well by Morgan Stanley Chief Strategist Mike Wilson who recently stated, "Bear markets are like a hall of mirrors, designed to confuse investors and take their money." We remain cautious within client portfolios, but not so cautious as to miss a rally should the "worst fears" not play out. Luckily for investors, there are alternatives to equities, as bonds and cash both have attractive yields as the economy and markets search for a "clearer path" forward.