



Tick Tock

Q1, 2023

- Both U.S. and international equity markets rallied in the last few days of March to end the month (and the quarter) with positive returns.
- As long-term interest rates stabilized, U.S. bonds recovered most of February's losses, ending the quarter at January-month-end levels.
- Despite a barrage of economic and policy news, the quarter will be remembered most for the failures of Silicon Valley Bank and Signature Bank.
- Recent bank failures are more a symptom of the Fed's rapid rate hiking cycle than systemic solvency risk, but they are leading to a sharp contraction in lending that could increase the risks of a recession.

Overview

It certainly hasn't been a quiet start to the year. Markets started 2023 on a strong note. Both stocks and bonds ended January with decidedly positive returns. However, since then, things have taken a turn for the interesting. In February, most of the gains that stocks and bonds had made since the start of the year were wiped out. In fact, February was the fifth-worst monthly decline for bonds since 1993. Onto the third month of the quarter—March madness indeed. On March 10, Silicon Valley Bank (SVB), the 16th-largest bank in the U.S., collapsed, marking the second-largest bank failure in U.S. history. Two days later, Signature Bank, the 29th-largest U.S. bank, closed down, as customers rushed to withdraw deposits.¹ The speed at which these banks collapsed was unprecedented—a point captured well in a comment from Morgan Stanley CEO James Gorman:

"... with the click of an iPhone, \$42 billion left one bank in one day. To give you a sense of the order of magnitude, in the financial crisis of '08, one bank lost \$17 billion in a week, so the rate of withdrawal was 20 times what it was then."²

These sentiments were echoed by Federal Reserve Chairman Jerome Powell: "The question we were all asking ourselves over that first weekend was, 'How did this happen?'"³

It happened partly because banks were not offering competitive deposit rates relative to short-term U.S. Treasury rates. As a result, depositors started shifting their money out of bank deposits and into Treasuries while the value of many banks' assets were declining (also due to higher interest rates). Large banks typically have enough reserves to withstand these shifts, but smaller and more specialized banks struggled to cope with such large drops in their deposit levels, especially at a time when their investments were simultaneously sputtering. Even with these industry-wide headwinds, the largest culprit—at least in the case of SVB—was poor risk management.⁴

In response to the collapse of SVB and the subsequent closure of Signature Bank, the Federal Reserve eased access to its discount window, and banks were able to borrow more than \$152 billion from the Fed between March 11 and March 15. The last time

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banks made extensive use of the discount window was during the Global Financial Crisis, when approximately \$111 billion was borrowed at its peak. Following the recent instability in the U.S. financial system, the Fed created a new emergency loan facility, called the Bank Term Funding Program (BTFP). BTFP enables banks to take out loans for up to a year, secured by government bonds, with any collateral valued at par value rather than market prices.⁵ This program is designed to provide banks with the necessary liquidity to accommodate deposit withdrawals, which have occurred at an epic pace due to the significant yield differential between what banks are offering as deposit rates and what can be earned by investing in U.S. Treasury Bills.⁵ Notably, the average interest earned on a savings account is 0.24% while a three-month T-bill is at 4.77%.^{6,7} Throughout March, deposit withdrawals from commercial domestic banks totaled almost \$400 billion while a similar \$367 billion flowed into Treasury money markets.⁸



Just days after the recent bank collapses, on March 22, the Federal Reserve once again hiked interest rates while it maintained its pace of quantitative tightening

March 17 marked the one-year anniversary of the Fed's first rate hike of the current hiking cycle. Although it is slowly easing, inflation remains well above the Fed's 2% target. Throughout the past quarter, a strong labor market and robust spending rates continued to thwart the Fed's efforts to slow the economy enough to get inflation under control. To date, there are few signs that the labor market is easing. The unemployment rate has remained steady at 3.5%.⁹ Until recently, it was relatively easy for the Fed to react quickly to stresses in the economy or banking system since inflation had been historically low for decades. For instance, by the time that Bear Stearns collapsed in March 2008, the Fed had already lowered interest rates from 5.25% in August 2007 to 3.0% in March 2008.¹⁰ But times have changed. Just days after the recent bank collapses, on March 22, the Federal Reserve once again hiked interest rates (this time by 25 basis points to 5.0%) while it maintained its pace of quantitative tightening. This most recent rate hike, which happened despite signs that higher interest rates were starting to destabilize key parts of the economy, highlights the policy predicament that the Fed has put itself in. By waiting too long to address inflation, which started spiking in early 2022, the Fed must now decide

between two crucial mandates—price stability or financial stability. There is no viable path to fix both simultaneously.

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Another threat that is emerging more slowly, yet inexorably and potentially more significantly, is the U.S. consumer may be running out of spending dollars. This is significant because the U.S. is a consumer-driven economy. In fact, consumer spending accounts for more than 67% of U.S. economic activity.¹¹ During the height of the pandemic, government stimulus checks helped U.S. consumers amass more than \$2 trillion in excess savings. As the pandemic lifted, consumers began burning through those savings, and demand skyrocketed, lifting the economy out of recession. Buoyed by stimulus checks and cheap credit, consumers continued to spend, even as inflation hit 40-year highs in June 2022. Today, the easy money that bolstered consumer spending over the past two years is dwindling, yet inflation remains stubbornly high. This combination of higher interest rates, reduced fiscal stimulus, and a nascent economic slowdown is slowly but surely depleting pandemic-era savings.

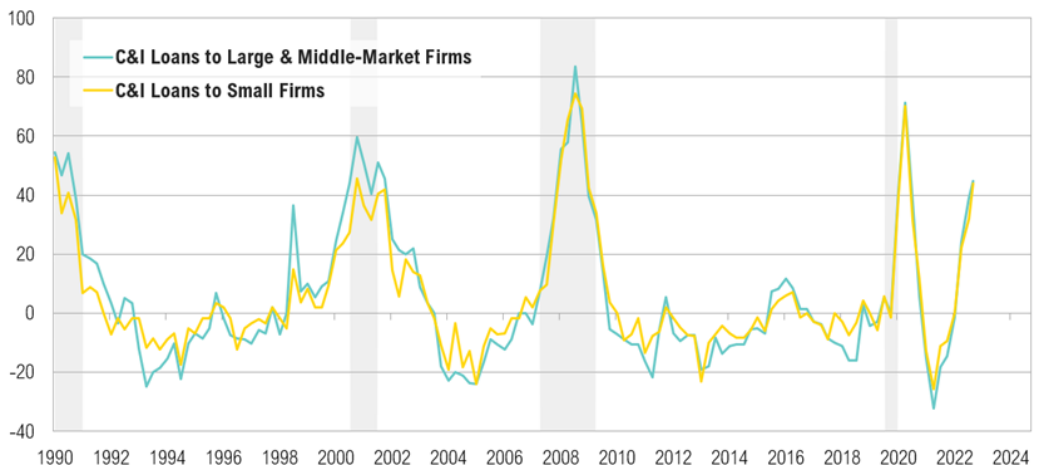
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This trend is evident in changes in the U.S. savings rate. In June 2022, when inflation reached a four-decade high of 9.1%, the personal saving rate dropped to 2.7%—the lowest level since 2007. As inflation has slowly moderated, the savings rate has crept upwards to 4.6%. While a notable improvement, it still remains well below the average savings rate of 8.9% since 1959.¹² Wages have also been unable to keep pace with inflation, as real wage growth has been negative since March 2021. This is the longest period of negative wage growth on record; the second-longest period was from April 2011 to June 2012. Even before the financial market turmoil caused by the collapse of SVB and Signature Bank, a key gauge for consumer sentiment in the U.S. fell for the first time in four months. The University of Michigan's Consumer Sentiment Index for March dropped from 67 to 63.¹³ Data from the same survey reveals that consumers are increasingly anticipating a recession and a sharp weakening in one-year business conditions.¹³ Yet for now, consumers are continuing to spend. Revolving consumer credit reached an all-time high of \$1.2 trillion in February, an increase of 15% year-over-year.¹⁴ Credit card delinquencies have also started to tick upwards since June 2022, and given that average credit card rates now surpass 20%, it seems likely that these delinquencies will continue.¹⁵

The rapid increase in credit card debt speaks to the precarious situation of the U.S. consumer

Banks Were Already Tightening Lending Prior to Banking Instability

Net % of Domestic Banks Reporting Tightening Lending Standards for Commercial and Industrial Loans



Source: Bloomberg

The rapid increase in credit card debt speaks to the precarious situation of the U.S. consumer. With the Fed still hiking rates and the consumer continuing to get squeezed by the higher cost of living, it seems like only a matter of time before the money will run out. Tighter lending standards may also mean that businesses will also have less access to credit. Throughout the first quarter of the year, approximately 44% of domestic banks in the U.S. tightened their lending standards for commercial and industrial loans to firms.¹⁶ The chart above shows that loan standards were tightening even before the collapse of SVB and Signature Bank. Since SVB's collapse, loan growth has been further curtailed.¹⁷ Over the past two weeks ending March 31, commercial real estate loans from U.S. banks declined by a record \$40 billion, and loans and leases declined by a record \$100 billion.¹⁷ These are the largest two-week changes since 1975.

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Although no one can accurately predict if and when a recession will start, leading economic indicators can offer useful insights. Over the first quarter of 2023, the Treasury yield curve—proxied by the difference in yield between the 2-year and 10-year Treasury notes—remained inverted. On average, it takes about 14 months from the initial point of inversion until a recession hits. Since 1956, an inverted yield curve has correctly predicted a recession within 14 months 90% of the time, with the only exception being in 1998, when the yield curve briefly inverted before correcting itself. At the end of March 2022, almost exactly one year ago, the yield curve inverted. We are now entering the 13th month from the initial point of inversion. If we are headed for recession, the clock is ticking.

Similarly, the Conference Board's Leading Economic Index (LEI), which is used to forecast future economic activity, has been signaling a looming recession since July 2022. A quote from Conference Board Senior Manager highlights the quandary for the U.S. economy:

*"While the rate of month-over-month declines in the LEI have moderated in recent months, the leading economic index still points to risk of recession in the US economy. The most recent financial turmoil in the US banking sector is not reflected in the LEI data but could have a negative impact on the outlook if it persists. Overall, The Conference Board forecasts rising interest rates paired with declining consumer spending will most likely push the US economy into recession in the near term."*¹⁸

Since 1988, the LEI has dropped below zero over a six-month period on 10 occasions. On five of those occasions, the LEI has dropped below -4%—signaling a recession every time. In May 2021, the LEI's six-month change dropped below zero, triggering a recession warning. On June 30, 2022, the index dropped below -4%... tick tock.

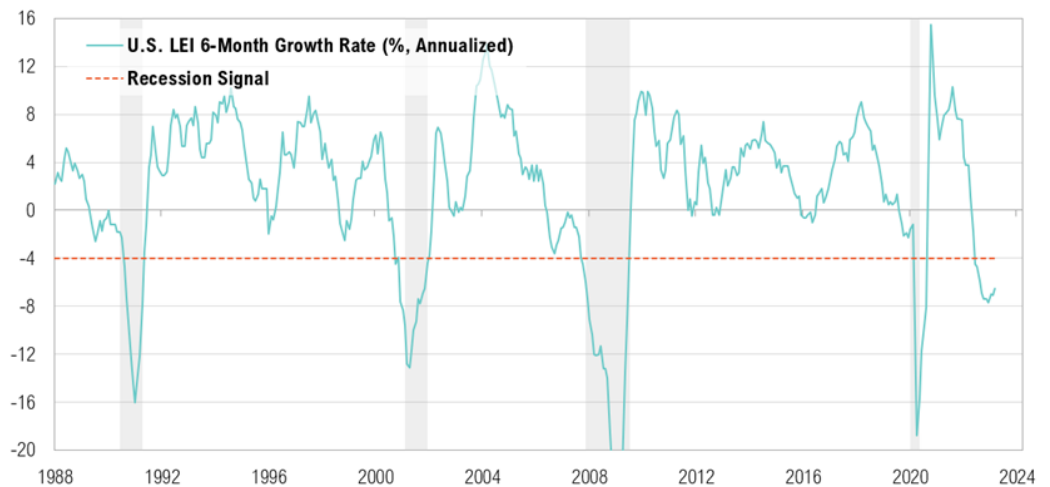
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To add even more intrigue, on January 26, the U.S. Treasury Department officially hit its statutory borrowing limit, otherwise known as the debt ceiling. So far the Treasury Department has been able to improve liquidity by activating extraordinary accounting measures but estimates indicate that it could run out of funds by July.¹⁹ Treasury issuance for the first quarter of 2023 was expected to be \$932 billion.²⁰ However, due to the debt ceiling, net issuance was only \$436 billion. As a result, the Treasury's cash balance has been worked down to \$177 billion, substantially lower than the \$500 billion in cash the Treasury had wanted to have on hand at the end of March.^{20,21} While the U.S. certainly has the resources to raise the debt ceiling, it's unclear by how much it will be raised or what political tradeoffs will be required to reach such an agreement. Notably, the MOVE Index (which measures implied volatility in the U.S. Treasury market) also remains elevated to levels of volatility not seen since the Global Financial Crisis in 2009.²² The U.S.

Treasury market will likely remain in this unusual state of elevated volatility as supply—especially longer-term debt—will be substantially increased once the debt ceiling is resolved.

Leading Economic Index Signals a Looming Recession

Conference Board LEI Composite Index 6-Month Growth Rate, %

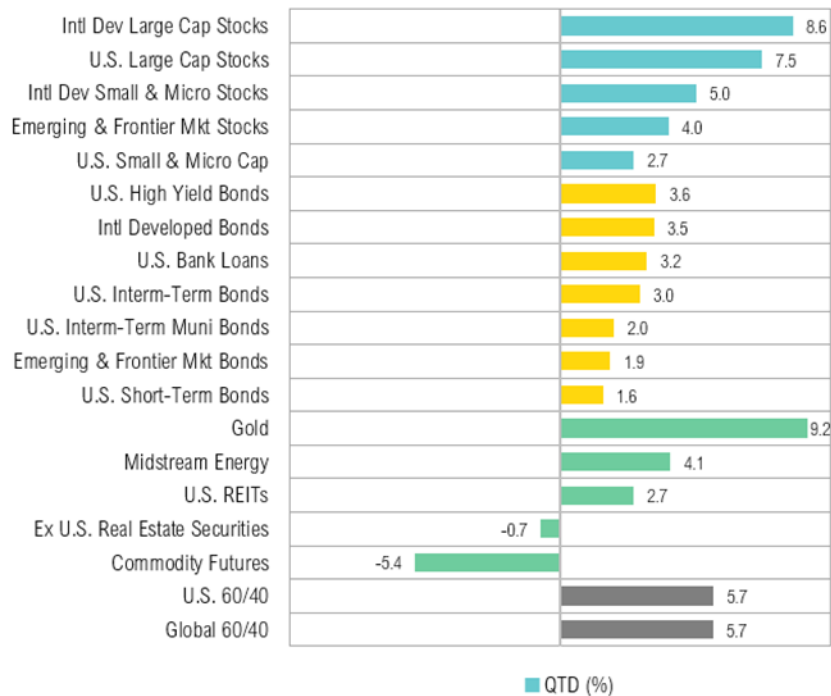


Source: The Conference Board

Markets

Both U.S. and international equity markets rallied in the last few days of March to end the month (and the quarter) in positive territory. The MSCI EAFE Index ended the quarter up 8.6%, and the S&P 500 posted a respectable 7.5% gain. As longer-term interest rates stabilized, fixed income markets recovered most of the losses made throughout February and ended the quarter at January levels. The Bloomberg U.S. Aggregate Bond Index closed the quarter up 3.0%, while international developed market bonds ended the quarter up 3.5%.

Q1 2023 Key Market Total Returns



Source: Bloomberg

A surprise cut in oil output by OPEC+ sent oil prices soaring by around 7%, to \$85 per barrel

Recent bank failures are causing a sharp contraction in lending, which could help trigger a recession

Credit Suisse, the global investment bank and Switzerland's second-largest bank by assets, finally ran out of time to restore itself as a viable financial institution. In May 2007, the company's stock price peaked at \$72, but from that point forward, it steadily declined. In June 2022, as investors increasingly demanded compensation from the beleaguered bank, Credit Suisse paid 9.75% in interest for a bond offering as a last-ditch effort to raise capital and attract customers.²³ Despite this, investors continued to lose confidence in the bank, and in March 2023, its stock price dropped by 70% to less than \$1. Subsequently, on March 19, Credit Suisse was bought out by rival bank UBS for 60% less than what the bank was worth two days prior.²⁴

On April 2, OPEC+ announced an unexpected cut in oil output of approximately 1.2 million barrels per day, starting in May.²⁵ The surprise announcement sent oil prices soaring by around 7%, to \$85 per barrel. OPEC+ and its allies have cited concerns about weak global demand, as economic growth starts to slow.²⁵ Meanwhile, the U.S. Strategic Petroleum Reserves have been depleted by more than 222 million barrels since the start of 2022, to a current four-decade low of 371 million barrels.²⁶

The new governor of the Bank of Japan, Kazuo Ueda, started his first term on April 8. The country's next monetary policy meeting is on April 27, and despite widespread speculation that at least some changes might be made to Japan's ultra-easy monetary policy stance, it seems that Ueda is determined to stick to his predecessor's stance, stating at a recent press conference that the bank "will be continuing the current easy monetary policy".²⁷ Over the past six months, the BoJ has spent over \$950 billion in quantitative easing efforts. Even with Japan's inflation reading at 3.5%, near the previous month's four-decade high, it seems that Japan's policy, which has remained virtually unchanged for more than two decades, is not yet out of time from a policymaker's perspective.

The clock was ticking elsewhere as the popular social media platform TikTok faced a possible ban in the U.S. On March 23, TikTok Chief Executive Officer Shou Chew was grilled before Congress by lawmakers who believed that the Chinese-owned app should be banned in the U.S., citing possible national security threats.²⁸ Ironically, just a few days later, in testimony to U.S. Senate Committee on Banking, Housing, and Urban Affairs on recent bank failures, Vice Chair for Supervision Michael S. Barr noted that social media contributed to the SVB deposit run by uninsured depositors.²⁹

Looking Forward

Recent bank failures are more of a symptom of the Fed's rapid rate hiking cycle than systemic solvency risk, but they are causing a sharp contraction in lending, which could help trigger a recession.

Due to persistently high inflation, the Fed has continued to hike interest rates, which has stressed the banking system and slowed the economy. To make matters worse, the Fed Funds futures markets currently projects a 70% chance that the Fed will raise interest rates an additional 25 basis points (to 5.25%) at the May 3 FOMC meeting.³⁰ Beyond that, predictions begin to shift, and markets anticipate a Fed pause, followed by rate cuts before the end of 2023.

Although there is no predefined path for policy or markets, we remain focused on downside risks. If we are wrong and the economic backdrop is stronger than current data

suggests, we will still likely participate in any upside, but to a muted degree. Further, higher short-term Treasury yields mean we are being paid to patiently wait while things play out. Most of all, if a recession does occur, we want to be able to take advantage of any opportunities if and when they arise.

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DEFINITIONS

Asset class performance was measured using the following benchmarks: U.S. Large Cap Stocks: S&P 500 TR Index; U.S. Small & Micro Cap: Russell 2000 TR Index; Intl Dev Large Cap Stocks: MSCI EAFE GR Index; Emerging & Frontier Market Stocks: MSCI Emerging Markets GR Index; U.S. Intermediate-Term Muni Bonds: Bloomberg Barclays 1-10 (1-12 Yr) Muni Bond TR Index; U.S. Intermediate-Term Bonds: Bloomberg Barclays U.S. Aggregate Bond TR Index; U.S. High Yield Bonds: Bloomberg Barclays U.S. Corporate High Yield TR Index; U.S. Bank Loans: S&P/LSTA U.S. Leveraged Loan Index; Intl Developed Bonds: Bloomberg Barclays Global Aggregate ex-U.S. Index; Emerging & Frontier Market Bonds: JPMorgan EMBI Global Diversified TR Index; U.S. REITs: MSCI U.S. REIT GR Index, Ex U.S. Real Estate Securities: S&P Global Ex-U.S. Property TR Index; Commodity Futures: Bloomberg Commodity TR Index; Midstream Energy: Alerian MLP TR Index; Gold: LBMA Gold Price, U.S. 60/40: 60% S&P 500 TR Index; 40% Bloomberg Barclays U.S. Aggregate Bond TR Index; Global 60/40: 60% MSCI ACWI GR Index; 40% Bloomberg Barclays Global Aggregate Bond TR Index.

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