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March 20, 2023 – Investment Commentary

"March Madness"

2023 is the year we continue to see the lagged and variable effects of fast and large "risk free" rate increases. The immediate negative impact has been more easily seen on speculative SPACs, meme stocks, nonprofitable technology, certain interest rate-sensitive sectors such as housing, and poorly managed banks domestically and abroad. Until the week of March 6th, the Fed's primary objective was to tighten financial conditions sufficiently to slow growth, job creation and, ultimately, inflation. Despite the Federal Reserve's aggressive rate hikes, the U.S. economy added 311,000 jobs in February, though unemployment ticked up to 3.6%. Even with this slight increase and growing layoffs, the jobless rate remains near its lowest level in more than 50 years, creating an increasingly complex challenge for the Fed to solve for inflation, growth and financial stability.

Last week's U.S. inflation data showed that consumer prices are still hot, still broadening and embedding themselves in the core. Fed measures like the month-over-month "trimmed mean" and "sticky" CPI are not encouraging. However, last week also brought the biggest move tighter in the Bloomberg U.S. Financial Conditions Index since the height of the COVID-19 pandemic. We believe the market signal is that financial institutions' funding costs have risen substantially while lending standards will be raised aggressively.

Despite some upward progress for markets early in the year, the S&P 500 Index gave up nearly all its gains for the year after Silicon Valley Bank failed, the second-largest bank collapse in U.S. history. Yields on U.S. Treasuries also tumbled. U.S. small-cap stocks (as represented by the Russell 2000 Index) are currently trading at a 40% discount relative to large-cap stocks (represented by the S&P 500 Index) on a trailing 12-month price/earnings basis. This is the cheapest they've been since 1990. This relative discount is in part driven by the relative overweight of financials in the small cap index in the S&P 500 and the current perceived higher stress in U.S. small cap financials. However, we believe valuation is just one aspect of what makes a good investment, and the cheapest stocks don't necessarily make the best investments. It's therefore worth considering other aspects, including the potential "catalyst(s)" to change the markets view of "cheap" to help avoid a "value trap."

Market Stats

United States

1. Last Friday, all major US equity indices closed lower; Nasdaq -0.7%, S&P 500 -1.1%, DJIA -1.2%, and Russell 2000 -2.6%.
2. Week-over-week, US equity indices closed mixed on the week; Nasdaq +4.4%, S&P 500 +1.4%, DJIA -0.1%, and Russell 2000 -2.6%.
3. Last Friday,2yr US govt bonds closed Friday -33bps/3.81% yield, 5yr -28bps/3.44% yield, 10yr -17bps/3.39% yield, and 30yr bonds closed -9bps/3.62% yield (price up, yield down)
4. Week-over-week, 2yr US govt bonds -79bps, 5yr -52bps, 10yr -31bps, and 30yr -8bps (price up, yield down).

Europe

1. Last Friday, all major European equity indices closed lower; UK -1.0%, Germany -1.3%, France -1.4%, Italy -1.6%, and Spain -1.9%.
2. Week-over-week, all major European equity indices closed lower on the week; France -4.1%, Germany -4.3%, UK -5.3%, Spain -6.1%, and Italy -6.6%.
3. Last Friday, 10yr European govt bonds closed higher; Germany -18bps, UK -15bps, Spain -12bps, and Italy/France -10bps (price up, yield down).
4. Week-over-week, major 10yr European govt bonds closed higher on the week; Germany -38bps, UK -36bps, France -31bps, Spain -28bps, and Italy -26bps (price up, yield down).

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European Banking Developments

In a package engineered by Swiss regulators on Sunday, UBS Group AG (UBSG.S) will pay 3 billion Swiss francs ($3.23 billion) for 167-year-old Credit Suisse Group AG (CSGN.S) and assume up to $5.4 billion in losses. Investor focus has now shifted to the massive blow some Credit Suisse bondholders will take under the UBS acquisition, which has added to anxiety about other key risks, including contagion and the fragile state of U.S. regional banks. Under the deal, the Swiss regulator decided that Credit Suisse's additional tier-1 bonds - or AT1 bonds - with a notional value of $17 billion will be valued at zero, angering holders of the debt who thought they would be better protected than shareholders, who received a nominal amount of UBS shares as consideration, in the takeover deal announced on Sunday. We understand the AT1 documents considering the possibility of a “bail in” or full write down of their bonds and demonstrates the ultimate influence of the regulators in times when taxpayer support is required.

In the face of more potential market confidence issues, top central banks moved on Sunday to bolster the flow of cash around the world. In coordination with central banks elsewhere, the U.S. Federal Reserve offered daily currency swaps to ensure banks in Canada, Britain, Japan, Switzerland, and the euro zone would have the dollars needed to operate.

Without the proverbial crystal ball, the best course is to prepare. Do you have enough short-term liquidity to fund your goals during a period of volatility and financial uncertainty? Do you have a portfolio that is focused on quality stocks and fixed income? Finally, we believe its prudent to intentionally allocate short-term liquidity consistent with best practices to mitigate counterparty risk by optimizing FDIC and money market rules.