

## March 27, 2023 – Investment Commentary

### “Hut, Hut, Hike!”

Sometimes, the football phrase the Quarterback typically shouts at the beginning of each play indicates an audible (change in a play called at the line of scrimmage to adjust to a troubling defensive scheme). The financial markets over the last several weeks were guessing Fed Chair Powell (“Quarterback”) would play call 0, 25, or 50bps. Global central banks, from the European Central Bank last week to the Federal Reserve and the Bank of England, continue the path to restrictive policy while attempting to calm growing fears of a troubling macro scheme of financial instability. Coming into this meeting (line of scrimmage), the Federal Open Market Committee appeared to face a dilemma: hike rates into a period of uncertainty, knowing that tighter conditions might aggravate pressure on some U.S. banks, or pause, and risk conveying that threats to financial stability were more serious. In other words, continue to march down field with a pass or protect the ball with a more measured running play.

Given this sensitivity, the FOMC delivered a dovish, 25-basis-point hike to reach a 4.75-5.00% policy range, raising the policy rate but making clear in the commentary that the Fed is sensitive to emerging risks and prepared to use additional policy tools to stabilize a banking system. Recall that in the two weeks before the Fed’s decision, bank reserves increased by over USD300bn, thanks to the discount window use, Fed’s loans to failed banks and a modest uptake in the Fed’s new Bank Term Funding Program (BTFP). Meanwhile, the Federal Home Loan Bank (FHLB) system increased its debt issuance to USD304bn last week alone, with the FHLB’s outstanding advances now exceeding USD1tn, according to some estimates. It is possible that banks are using FHLB advances and Fed liquidity facilities at least partly out of precaution, meaning the scale of the deposit outflows may be smaller than the use of Fed liquidity facilities and FHLB’s advances.

The Investment Office is actively monitoring a number of “financial stability” indicators, including but not limited to increasing utilization of the BTFP/FHLB programs, increasing bank funding costs, increasing global bank credit default swap pricing (CDS, which is a contract between two parties in which one party purchases protection from another party against losses from the default of a borrower for a defined period of time.), increasing money market flows, declining investment grade and high yield capital market credit issuance since Silicon Valley Bank’s collapse. The high yield market saw no new issuance for a third consecutive week. Finally, the Investment Office is monitoring the resolution of failed banks such as SVB/First Citizens, UBS/Credit Suisse and potentially First Republic Bank.

### Markets

The longer financial instability persists, the less likely it will be that the Fed will be able to continue to raise rates and the Fed does have to pivot and possibly cut more quickly.

Treasury Yields. The two-year Treasury yield of 3.75% (on 3/24/23) is well below its peak of 5.05% earlier in early March 2023. The one-year yield of 4.32% (on 3/24/23) is also below its 5.25% peak earlier this month as the markets were increasingly focused on sticky inflation and a resilient economy ahead of the Silicon Valley Bank failure. The case to support declining rates are supported largely by a view that maintaining financial stability is becoming a greater issue than tackling inflation. Last week, Powell stated that Fed officials “don’t see rate cuts this year—they just don’t,” which appeared to lead to a decline in equity markets to end the day. Investors didn’t appear to take him at his word, however, and futures markets ended the week pricing in a 98.2% chance that rates would end the year lower, according to the CME FedWatch Tool—with a 94.8% chance that cuts would start this summer.

Bank Shares. While Fed actions and Treasury Secretary comments may have addressed tail risk concerns for now, it did little to halt the downward trend of regional banking share prices as investors focus not only on today’s liquidity concerns but potential commercial real estate, balance-sheet concerns and the profitability impact of future regulatory/supervisory reform as banks are likely in the near term to tighten credit availability.

US Equities. Last week, various benchmark returns varied widely as the banking industry and recession worries weighed on value stocks and small-caps, while large-cap growth stocks benefited from falling interest rates. The technology-heavy

Nasdaq Composite outperformed the small-cap Russell 2000 Index by 828 basis points (8.28 percentage points). Relatedly, financials underperformed for a third consecutive week, and the real estate sector suffered from worries about how stresses in the regional banking system would affect the commercial real market, where regional banks are the primary lenders.

Last week's declines also pushed the S&P MidCap 400 and Russell 2000 indexes into negative territory for the year to date. However, the CBOE Volatility Index (VIX), widely referred to as Wall Street's "fear gauge," hit its lowest level since March 9 last Thursday. The Investment Office is also monitoring the driver's of the S&P 500 Index, where Apple and Microsoft now comprise 13.3% of index, the highest concentration for just two stocks since the 1970s when IBM and AT&T were the two largest contributors.

European Equities. Last week, shares in Europe gained, despite weakness in bank stocks. In local currency terms, the pan-European STOXX Europe 600 Index ended 0.9% higher. Major stock indexes advanced as well. Italy's FTSE MIB climbed 1.6%, France's CAC 40 Index gained 1.3%, and Germany's DAX advanced 1.3%. The UK's FTSE 100 Index added 0.9%. Although there were no specific catalysts, bank stocks in the STOXX Europe 600 Index declined on renewed worries over the health of the financial sector. The decline reversed earlier gains on the news that UBS Group agreed to buy Credit Suisse in a deal brokered by the Swiss authorities.

## Risks and Opportunities

Investors are increasingly paying attention to counter party risk and liquidity risk. However, the Investment Office is also focused on reinvestment risk as rates decline and short-term holdings mature as lower yields. As a result, we encourage investors to consider their financial plan and explore the suitability of both public and private high quality credit solutions to help achieve their near-term and long-term goals.

### Disclosures

*Investment Commentary Sources: Bloomberg and <https://www.federalreserve.gov/newsevents/pressreleases/monetary20230312b.htm>*  
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