Bellwether CONSULTING

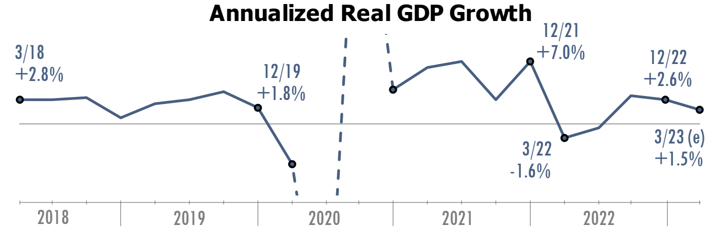
*Your Quarterly Update on the Financial Markets*
*March 31, 2023*

# MARKET Recap

## The US Economy: "Unintended(?) Consequences"

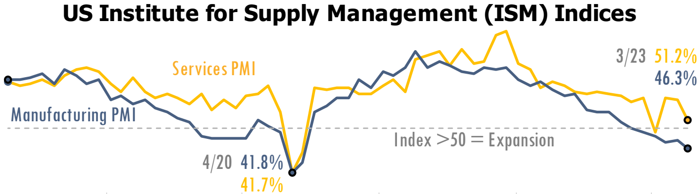
Real economic growth remained positive for the final quarter of 2022. Increases in consumer spending, inventory investment, and government spending drove the growth; however, one can read early signs of concern for manufacturers, as inventory investment was led by petroleum, coal products, and utilities. Consumer spending was focused on services, while spending on goods decreased.

**Annualized Real GDP Growth**

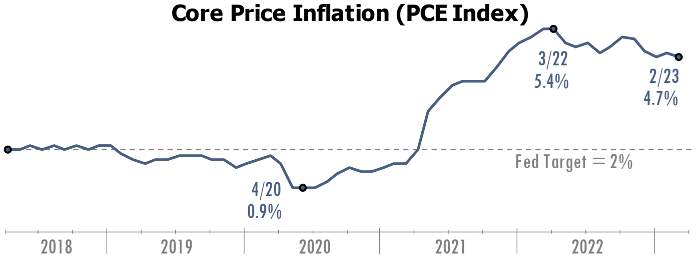



Conditions continued to tighten for manufacturers through March, with the ISM PMI Index registering a 4th consecutive month below 50 (indicating a contraction of activity). Personal consumption expenditures grew in February on a nominal basis but declined slightly on a real basis. The impact on manufacturers was magnified by order declines through the supply chains as companies braced for recession. Economic expansion continued in the more robust services sector, but at a decelerating pace. Layoffs in anticipation of recession spread beyond tech companies and COVID-impacted segments into other service industries but, due to severance programs, the impact on employment statistics will be delayed.

**US Institute for Supply Management (ISM) Indices**




**Core Price Inflation (PCE Index)**



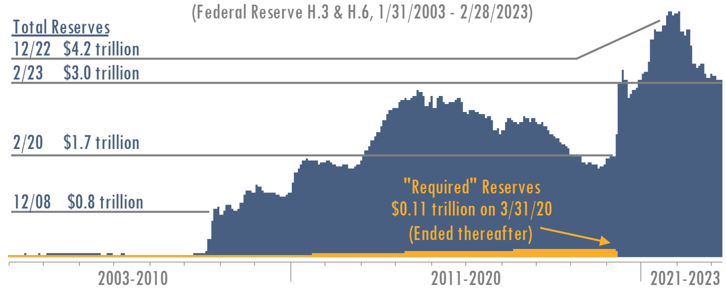

Although inflation statistics are lagging indicators, there are persistent inflationary forces at work through demographics and fiscal policy that make each additional unit of inflation control more difficult to achieve. Add to that an unwelcome announcement of production cuts by OPEC+ on April 3, setting a floor on global oil and gas prices. Although business conditions are softening, the Fed may have more work to do.

However, the collapse of Silicon Valley Bank has led markets to question whether the Fed can continue to tighten. In a word, the answer is yes. SVB was laid low not by capital losses, but by a depositor run on a scale no bank could survive. Banks in the US remain very well capitalized, largely as a result of support programs implemented in 2008 which bailed them out of the Great Financial Crisis. Bank reserves are enormous compared to historical norms. Not quite as large as the graph would indicate, since many of the bonds held by banks have not been marked to market, but enormous nonetheless.

Regulators will use any means to keep the banking system solvent. The particular means used to bail out SVB depositors established a framework by which the Fed will not only protect against depositor runs but may also ease the impact on bank earnings, as customers withdraw funds in search of higher money market rates. Banks can now borrow from the Fed to meet withdrawal demands and pledge their impaired bonds as collateral without marking them to market. Next year regulators will have to deal with the potential for banks recognizing severe losses as the program expires – so the program will never expire. Instead, it will be extended and allowed to run off very slowly, or the loans will simply be forgiven. This will complete the cycle of removing, through market losses, the "excess" reserves injected after 2008.

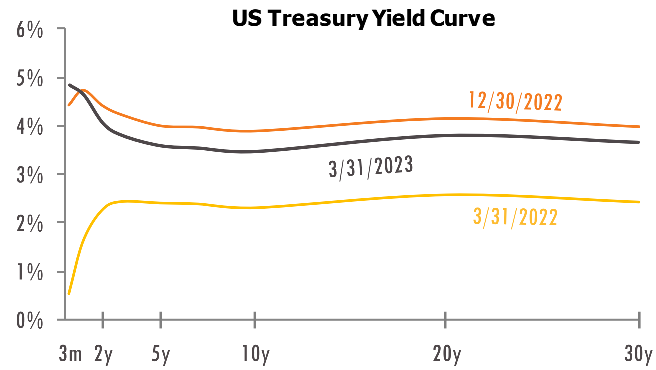
Clearly banks are struggling, even without solvency concerns. But to protect the system, it is US taxpayers, not bank stock-holders, that will be the ultimate bearers of solvency risk. This is a consequence of extreme swings in monetary policy, yet it is not an unintended consequence. It is the reason the Fed can, if it so chooses, continue to tighten the screws.

**Reserves of Depository Institutions**
(Federal Reserve H.3 & H.6, 1/31/2003 - 2/28/2023)



# The US Bond Market

Rates markets were reinvigorated with a second wind as a stereotypical "January effect" broadly pushed bond and stock prices higher. As the Federal Open Market Committee ("FOMC") policy rate approached the projected terminal point, all eyes remained on inflation, which showed signs of resurgence in the January data. After declining 36 basis points in January, renewed inflation fears pumped the 5-year Treasury rate up 71 bps, to a peak of 4.34% for the quarter, just before the regional banking crisis erupted. Despite the crisis, the Fed proceeded with a second rate hike of 25 bps (to 4.75-5.00%) in March. This marked the first time in a long time where the market did not reach consensus on what action the Fed would take by the time of the meeting.



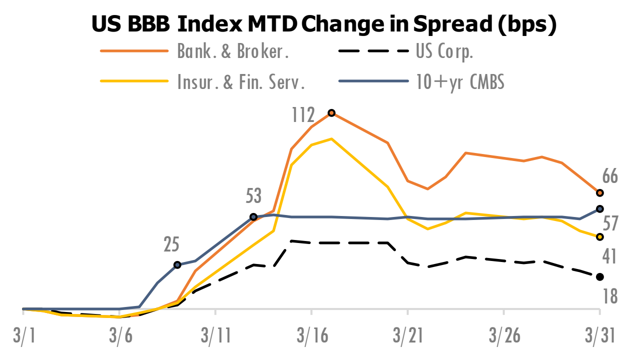

Continued inversion of the curve at the front end shows the market has gained further conviction in rate cuts later this year. The next FOMC meeting in May will likely mark the first pause, but an almost equal probability is being priced in for a final 25 bps hike. In contrast, Fed Funds futures in early March had been pricing an overnight rate near 5.50% by July.

| US Bond Index Returns | |
|---|---|
| **Bloomberg Idx** | **1Q23** |
| Aggregate | 2.96% |
| Short Gov't | 1.30% |
| Interm. Gov't | 2.26% |
| Long Gov't | 6.16% |
| TIPS | 3.34% |
| Municipal | 2.78% |
| Interm. Credit | 2.47% |
| Long Credit | 5.42% |
| High Yield | 3.57% |
| (CS) Lev. Loan | 3.11% |
| MBS | 2.53% |

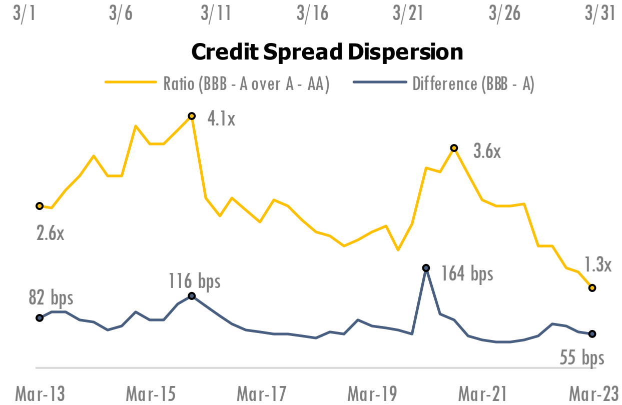
High yield debt performed well for the quarter, only behind long duration bonds according to the major sector returns. While investment grade spreads widened slightly, high yield spreads closed tighter for the quarter despite headline credit news – never a good thing. Spreads tightened in January, mostly holding in through February, but bursting back out with the collapse of Silicon Valley Bank. Through most of the second half of March, high yield spreads averaged more than 500 bps – indicating an elevated likelihood of defaults in the market. Yet, a strong rally brought high yield spreads back to 458 basis points during the last few days of March.

CMBS spreads also moved actively in March. Performance in the fourth quarter was marked by senior bond prices diverging from subordinated bond prices. Credit spreads on the benchmark 10-year conduit AAA-rated bond decreased 17 basis points in the Q4 2022, in step with the rally in broader markets. In contrast, credit spreads on more subordinated BBB-rated bonds increased 55 basis points. Investor concerns remain elevated in the face of real estate headwinds of economic contraction and higher interest rates. CMBS spreads widened a few days before the corporate banking and brokerage industry index weakness could be observed. After news hit about Silicon Valley Bank on March 13th, banking and brokerage credits jetted past CMBS spreads but came back to nearly converge [Guggenheim].

The most liquid and highest quality paper, US government bonds and agency mortgage-backed securities, lie at the center of the current banking tumult. The sudden collapse of Silicon Valley Bank resulted from massive purchases of these securities at historically low yields. These securities became worth significantly less as the Fed sharply raised interest rates. Normally, the FOMC would act to steady the global financial system by easing monetary policy; and this did start to price into the markets. The two-year US Treasury yield recorded its biggest one-day drop since 1987 on March 13th. Yet, the grinding push of inflation won out over the shove of recessionary threats. The Fed continued apace with another 25-bps hike.




The narrow range, or dispersion, between credit spreads across industries and credit qualities implies that the market is not fully priced for a downturn where large clusters of defaults will occur. The spread ratio of the BBB minus single-A to single-A minus AA is 1.3x currently, and the difference in spread levels is also narrow, at 55 bps.




Accommodative rate hikes are being anticipated for the second half of 2023. The predicted overnight policy rate at year end shifted 100 bps lower in March, according to Fed Funds futures. This is where the market and the Fed may again diverge. Though a mild-to-moderate recession seems impending, Fed hawkishness may not waver.

# The US Stock Market

US stocks notched a second quarter of positive returns across almost all of the major benchmark indices. However, the path to get there was choppy, influenced heavily by expectations of, or reactions to, the Fed and its ongoing battle to tame inflation. Strong returns in January were offset by negative returns in February before recovering in March in about half of the sectors. Overall, Q1 returns were surprisingly resilient given the continuing recession fears and the late-quarter banking crisis. While the stunning collapse of three regional banks might have started a contagion that spread across US markets, fallout was largely contained to the financials sector.

**US Stock Indices - Total Returns**

| **Largecap Stocks** | **1Q23** | **Midcap Stocks** | **1Q23** |
|---|---|---|---|
| S&P 500 | 7.50% | S&P Midcap 400 | 3.81% |
| Russell 1000 | 7.46% | Russell Midcap | 4.06% |
| Growth | 14.37% | Growth | 9.14% |
| Value | 1.01% | Value | 1.32% |
| **Broad Markets** | | **Smallcap Stocks** | |
| S&P 1500 | 7.16% | S&P Smallcap 600 | 2.57% |
| Russell 3000 | 7.18% | Russell 2000 | 2.74% |
| Growth | 13.85% | Growth | 6.07% |
| Value | 0.91% | Value | -0.66% |

Given that financials are a significant component of the value indices, it was no surprise to see growth outperform for the quarter, reversing 2022's value-over-growth trend with a vengeance. Buoyed by strong performance across market dominators (e.g., Apple, Microsoft, Alphabet, Meta, Amazon, and Tesla), large caps outperformed mid caps, which, in turn, outperformed small caps. While small and mid caps bested their large cap peers in January and February, there was no overcoming the swing to large caps in March.

**Market Dominators - Total Returns**

| **Communication Services** | **1Q23** |
|---|---|
| Alphabet (Class A) | 17.57% |
| Meta Platforms | 76.12% |
| **Consumer Discretionary** | |
| Amazon.com | 22.96% |
| Tesla | 68.42% |
| **Info Tech** | |
| Apple | 27.09% |
| Microsoft | 20.50% |

Significant performance dispersion continued across the sectors, prolonging the challenging environment for active managers who rely on positioning off of the benchmark to differentiate their strategies. In large caps, tech beat financials by over 27%. In small caps, consumer discretionary beat financials by over 24%. Once again, over- or underweighting sectors was likely to produce dramatic results.

But for the bank failures that pulled down financials, the energy sector would have been the worst performer in 1Q. The turnaround from 2022 came as fears of a "Russian winter" in Europe faded with the oncoming spring and oil prices dropped. However, energy's fall may be short-lived. OPEC+ announced substantial cuts in production on the opening day of Q2, and oil prices surged.

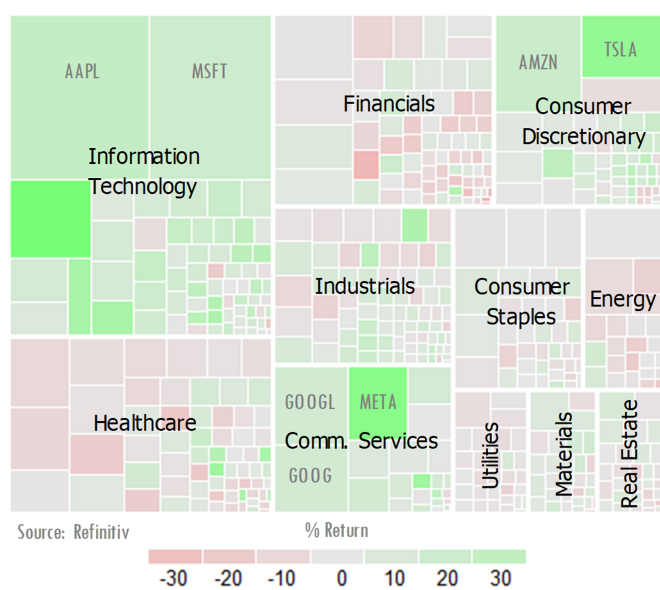
**S&P 500 Sector Components - Total Returns**

| **Sector** | **1Q23** | **Sector** | **1Q23** |
|---|---|---|---|
| Info Tech. | 21.82% | Consumer Stpls | 0.83% |
| Comm. Services | 20.50% | Utilities | -3.24% |
| Consumer Discr. | 16.13% | Health Care | -4.31% |
| Materials | 4.29% | Energy | -4.67% |
| Industrials | 3.47% | Financials | -5.56% |
| Real Estate | 1.95% | | |

Top-performing sectors for the quarter shared one thing in common – outperformance by marquee stocks. We have long been noting the outsized impact a handful of names have on the overall performance of the US stock market, and Q1 was no exception. Despite being spread across three sectors, Alphabet, Meta, Amazon, Tesla, Apple and Microsoft all behave like tech stocks and represent over 20% of the S&P 500 despite the losses they sustained last year. Apple and Microsoft alone would be one of the largest sectors behind tech and healthcare, about the same size as financials. While these names were beaten down in 2022's rising rate environment, disruption in the financials sector caused many investors to feel comfortable that a more accommodative environment was in the near future and position accordingly.

As always, corporate revenue and earnings were closely watched, with analysts lowering expectations for Q1 earnings on bank liquidity and recession concerns that developed over the quarter. The bottom-up EPS estimate (an aggregate number for all S&P 500 companies) in Q1 decreased by 6.3%. At the start of the quarter, a 0.3% decline was expected. The updated figure is more than twice the average decline over the past 5 years of 2.8% and well over the 10-year average decline of 3.3%. If the predicted Q1 decline materializes, it would be the largest for the index since 2Q20. Earnings for companies in the materials and healthcare sectors are expected to take the biggest hits, while consumer discretionary and industrials firms are projected to experience earnings growth [FactSet].

**1Q 2023 Returns in S&P 500 Companies**



# International Markets

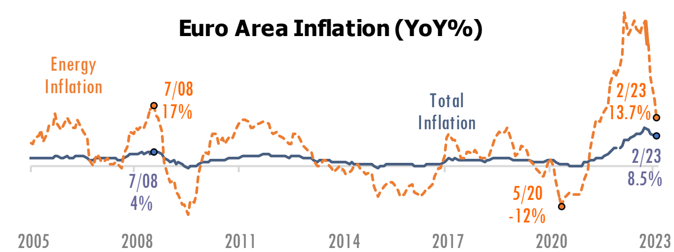
Global market performance remained positive in Q1, but more muted than the prior quarter. According to the OECD, global growth has slowed since the start of the war in Ukraine and is expected to remain below trend through 2024. Declining energy and food prices led to a modest improvement in global outlook. Headline inflation declined with the easing of food and energy prices and reflects the impact of a warm winter in Europe that helped to preserve gas supplies and lower energy consumption. Developed markets finished ahead of emerging markets.

**Unhedged Foreign Markets Indices - Total Returns**

| Stocks | 1Q23 | Bonds | 1Q23 |
|---|---|---|---|
| MSCI ACWI ex-US | 6.87% | Global Aggregate | 3.01% |
| EAFE (Developed) | 8.47% | Pan-Euro | 4.07% |
| Emerging Markets | 3.96% | Asian-Pacific | 1.86% |
| Europe | 10.56% | Eurodollar | 2.29% |
| Japan | 6.19% | Euro-Yen | 1.48% |
| China | 4.71% | Other Currencies | 8.01% |
| Latin America | 3.93% | | |

## Europe

The outlook for European GDP growth was revised up by 0.5% for 2023 as a result of knock-on effects from positive economic surprises in the second half of 2022 and an improving short-term outlook. A sharp downward adjustment in energy prices led to a significant reduction in price pressures resulting in expectations of a quicker drop in inflation. Energy inflation peaked above 40% in the fall, but is expected to turn negative in the second half of 2023 as commodity prices have fallen below pre-invasion levels. The ECB expects growth to strengthen throughout 2023, reflective of the waning of supply bottlenecks, an unwinding of supply shocks and improving confidence.



Source: Federal Reserve Bank of St. Louis

Headline inflation is expected to fall significantly over the course of the year while still remaining at elevated levels. Declining energy prices and a noticeable reduction in food inflation are expected to help drive inflation down to an average of 5.3% in 2023, before decreasing to 2.9% in 2024 and 2.1% in 2025. Core inflation (excluding food & energy) is also moderating as the effects of tighter monetary policy work through the economy. However, historically high wage growth will contribute to an elevated core inflation rate.

While the ECB paints an improving aggregate picture, individual countries continue to struggle. Inflation in France and Spain accelerated unexpectedly in February, jumping up by 0.1% to 9.3%. German inflation dipped in March, but the 7.4% reading was above expectations. PMI data showed declining French manufacturing output after strong performance in January.

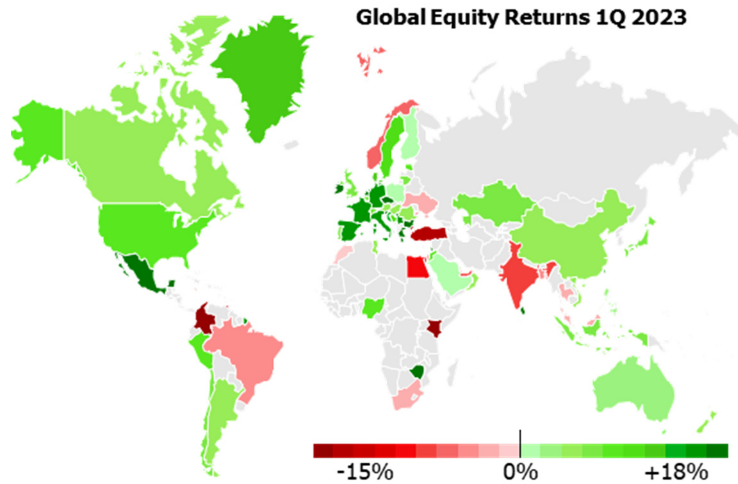
In mid-March, the ECB announced a rate hike of 50 basis points in the midst of turmoil in the global banking sector. The bank signaled that it stood ready to supply liquidity to banks if needed. The ECB had telegraphed its intent to raise rates as core inflation remained at 8.5%, stubbornly above the central bank's 2% target.

After a string of scandals and multi-billion-dollar losses over the last few years, Credit Suisse's new CEO was unable to win over investors, and clients began to take money out of the bank. After CHF 110bb ($119 bb) was pulled in Q4, the bank turned to equity investors for CHF 4bb. In March, Saudi Arabia, the bank's largest backer, informed Credit Suisse that it could not provide additional capital due to regulatory constraints. Through mid-March the bank had lost about one third of its market value since the start of the year and nearly 75% in the prior 12 months. Credit Suisse borrowed CHF 50bb from the Swiss National Bank in order to strengthen its liquidity, but the lifeline failed to reassure investors. When collapse became imminent, the Swiss government brokered a takeover of the bank by its larger rival, UBS.

As part of the deal, a decision was made by regulators to write-down CHF 16bb of Credit Suisse Bonds, known as Additional Tier 1 or AT1 debt, to zero. Under the deal, holders of Credit Suisse's AT1 bonds will get nothing, while shareholders, who typically rank below bondholders in the payment hierarchy when a bank or company goes bust, will receive CHF 3bb. News of the deal impacted AT1 bonds issued by other European Banks which came under increased selling pressure toward the end of the quarter.

AT1 bonds, also known as contingent convertibles or CoCo bonds, act as a shock absorber if a bank's capital level falls below a certain threshold. They can be converted into equity or written off. AT1 bonds make up part of a capital cushion that regulators require banks to hold as a backstop during periods of market volatility. When AT1s are converted into equity, they support a bank's balance sheet and provide for a "bail in," a way for banks to transfer risk to investors and away from taxpayers in the event of a collapse. AT1s normally rank higher than equity in a bank's capital structure. However, in

Switzerland, bond terms state that in the event of a restructuring, the financial regulators are under no obligation to adhere to the traditional capital structure, which is why Credit Suisse's AT1 bondholders lost everything.




## Asia

China's GDP grew by 3% in 2022, one of the country's weakest years for growth in decades. In the fourth quarter, the economy increased by 2.9%, a slowdown from the 3.9% growth in the prior quarter. The data released in the first quarter of this year is mixed so far and suggests that the economic recovery after the country emerged from almost three years of COVID-19 controls, is not yet guaranteed.

A pickup in retail sales suggests domestic consumption is taking over as the engine of growth while factories struggle with weak exports. Retail sales grew in the first two months, marking a good turnaround from the decline recorded in December. Consumption rebounded after COVID-related restrictions were removed which led to an increase in the Consumer Price Index in January. However, inflationary pressures eased in February as consumer prices gained just 1.0%.

The modest inflation figure casts fresh doubt over the strength of economic growth, which will likely have to continue to lean heavily on consumption this year as exports have weakened. During the pandemic, they had been a powerful engine behind the country's growth. As Western economies have lost momentum this year, exports are faltering. January recorded the largest decline since February 2020 (exports have since rebounded in February).

**China's Economy**

| Y/Y Statistics (%) | 12/2022 | 1/2023 | 2/2023 |
|---|---|---|---|
| Manufacturing PMI | 47.0 | 50.1 | 52.6 |
| Non-Manufacturing PMI | 41.6 | 54.4 | 56.3 |
| Industrial Output | 1.3 | | 2.4 |
| Unemployment | 5.5 | 5.5 | 5.6 |
| Producer Price Index | -0.7 | -0.8 | -1.4 |
| Consumer Price Index | 1.8 | 2.1 | 1.0 |
| Retail Sales | -1.8 | | 3.5 |
| Exports | -9.9 | -10.5 | -1.3 |
| Imports | -7.5 | -21.4 | 4.2 |

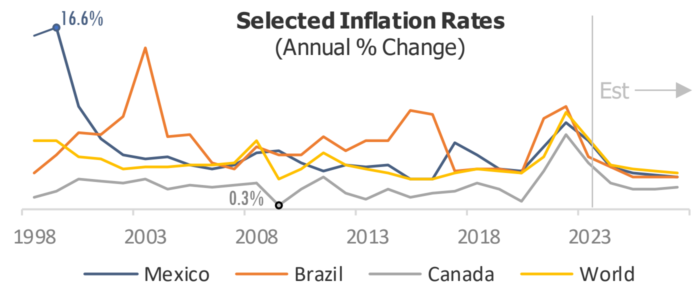
Source: National Bureau of Statistics of China

Even though industrial production has increased, the growth rate is still low when compared with that from prior years. The producer-price index dropped deeper into deflationary territory in February. Manufacturing PMI initially rebounded from a recessionary level in 4Q22 to 52.6 in February but then slowed down again in March as local businesses still cope with slow onshore and offshore demand. The service sector, however, continued to benefit from pent-up demand as reflected in a rebound in Non-Manufacturing PMI in February. Data shows that recovery so far has been largely skewed towards the services sector, but the strength of it is questionable as the unemployment rate increased slightly in February to 5.6%. The rise likely reflected seasonal factors as workers change jobs during the Lunar New Year holidays. Youth unemployment continued to remain high, with 18.1% of those surveyed aged 16 to 24 out of work.

Positive retail sales and manufacturing data released in February drove a temporary rally in Chinese shares, leading to a 5.11% return in the CSI 300 index. Unfortunately, weaker-than-expected inflation data released after that pointed to a sluggish economic recovery and the CSI 300 index declined 0.46% in March, finishing the quarter with a 4.63% return. However, this is still an improvement over the Q4 return of 1.75% and the Q3 return of -15.2%.


Japan narrowly avoided a recession in Q4, a sign that the economy remains weak due to inflationary pressures and an outlook for a global economic slowdown. GDP grew at an annualized rate of 0.1% in Q4, significantly below initial estimates and economic forecasts. Weaker consumer spending was the key driver, as people went out less during the most recent COVID wave and have reined in spending as prices have risen. Spending on services such as restaurants and hotels, and goods, were both down. Real wages have fallen for 10 consecutive months as prices remain elevated. Businesses have been pressured by the government to increase wages to boost household spending, but have struggled themselves in the face of rising prices and decreased demand. After pushing through a stimulus package last year, Prime Minister Fumio Kishida ordered additional measures to help combat rising energy prices. Given the data, it is widely believed that the BOJ will continue to keep its easy monetary policy in place.

### Americas




In a turnaround from the 0% growth in the last quarter of 2022, Canada's economy grew at an annualized rate of 2.5% in Q1. Canadian yields are also rising, closing the gap with US Treasuries and indicating that the BoC may delay cutting rates in the back half of this year. The unemployment rate held steady at 5% in February, remaining close to the record low of 4.9% observed in June and July 2022. This rate indicates a tight labor market and challenges the BoC's expectation that the recent weak economic growth would pressure the job market. With employment growth exceeding forecasts, alongside government income supports, consumers have resumed their high spending habits. This has raised the floor for GDP in Canada. In March, the BoC announced it would hold the key interest rate at 4.5% for the first time in over a year. The overnight rate is also maintained at 4.5% since the annual inflation rate in Canada fell to 5.2% in February of 2023, the least since January 2022 and below market expectations.

Mexico's economy experienced a moderate expansion in Q1, with a growth rate of 4.4% YoY. The unemployment rate also decreased to 4.8% as job opportunities expanded in sectors such as manufacturing and tourism. Inflation was at 6.86% in Q1, the lowest since October 2021. It continues to be a concern, however, as core inflation remains high at 8.09%. Amid a decline in energy prices, inflation also slowed for nonalcoholic beverages, housing and transportation. The Mexican peso's strength in recent months against the US dollar showed its "resilience" and Mexico's "prudence in terms of macroeconomic framework and monetary policy", said Mexico's central bank deputy governor.

Signs of a gradual recovery in Brazil's economy are emerging, with a projected GDP growth rate of 1.9% YoY. Brazil's inflation rate has decreased to 7.6% as a result of lower food prices and a stronger real. However, the unemployment rate still remains high at 12.08% with low job creation. Brazil's energy sector continues to be a concern, with ongoing debates over the privatization of state-owned companies and the government's management of the country's hydroelectric dams. As a result, while the economy is gradually recovering, challenges such as the high unemployment rate and energy policy continue to pose risks to its economic stability.

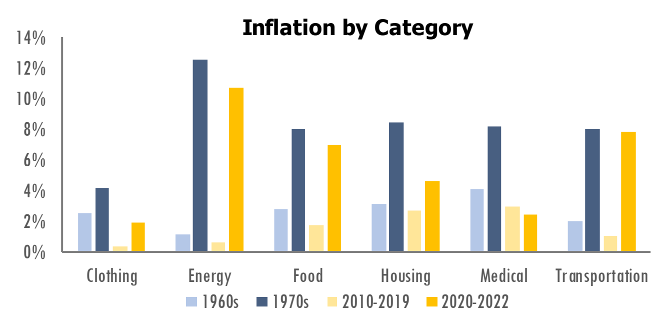
# Focus On: Inflation Then and Now

In the 1970s, inflation was rampant, and everyone was feeling the pinch. Long lines of cars snaking around gas stations became an everyday phenomenon across the US as people waited for hours to fill up their tanks. Gasoline was being rationed, and many people feared that the shortages would only get worse. Consumers struggled to cope with rising prices in an uncertain and unstable economy.

While today is somewhat reminiscent of the 1970s, the periods are, in fact, unique. The 1970s was a decade of high inflation (around 7.1%) largely caused by the Vietnam War, rising energy costs, and increased government spending. In contrast, the inflation we are seeing today was produced by back-to-back supply shocks from the pandemic shutdown and Russia's war with Ukraine.

### Drivers of Inflation Then and Now

Vietnam was a costly war, both in terms of lives lost and money spent, and the government borrowed heavily to pay for it. In addition, President Johnson's Great Society program, which aimed to eliminate poverty and racial injustice, also ramped up government spending. As government borrowing increased, so did the money supply. The cumulative effect of all the borrowing and spending was inflation. Rising energy costs exacerbated the situation as the Organization of the Petroleum Exporting Countries (OPEC) placed an oil embargo on the US in 1973 in response to its support of Israel during the Yom Kippur War. The resulting spike in oil prices led to higher prices for goods and services across the board, adding fuel to the fire.




Today's inflation is largely the result of government stimulus employed to mitigate economic damage wrought by the pandemic. In 2020, inflation was low, averaging 1.2% annually. This opened the door for the massive fiscal stimulus measures and easy monetary policy the government deployed to prevent deflation taking hold in the wake of a pandemic-driven economic contraction. The government passed the CARES Act, which, after many iterations and follow-up packages, amounted to $6 trillion in spending. The legislation provided direct payments to individuals and enhanced unemployment benefits to financially support more than 23 million Americans who had been laid off. It also helped businesses that had closed their doors due to the quarantine obtain business loans.

## Fiscal Policies

Keynesian economic policy and monetarism are two distinct theories that differ in their approach to managing the economy. On the one hand, Keynesian economic policy emphasizes active government intervention through fiscal policy to stimulate demand and increase employment. Monetarism emphasizes a more limited role for government spending and the importance of controlling the money supply to stabilize inflation and ensure long-term economic growth. Keynesians focus on increasing aggregate demand, while monetarists focus on improving the supply side of the economy through policies that encourage investment and productivity growth.

In the 1970s, high levels of inflation and unemployment in the US challenged the effectiveness of Keynesian economics. The Phillips Curve, which suggested an inverse relationship between unemployment and inflation, appeared to break down as both inflation and unemployment increased simultaneously, known as stagflation. This challenge elicited varied responses from economists and policymakers. One was to argue that Keynesian economics was fundamentally flawed and that government intervention in the economy was causing more harm than good. This view was advocated by many economists, including Milton Friedman, who asserted that governments should reduce intervention and let markets operate more freely.

Other economists argued that the problem was not with Keynesian theory itself, but rather with its implementation. Proponents of this view suggested that policymakers had not been using the theory in a targeted and nuanced way and that more sophisticated policy measures were needed to address the challenges of stagflation. These targeted and nuanced approaches included industry-specific policies, automatic stabilizers, and exchange rate policies.

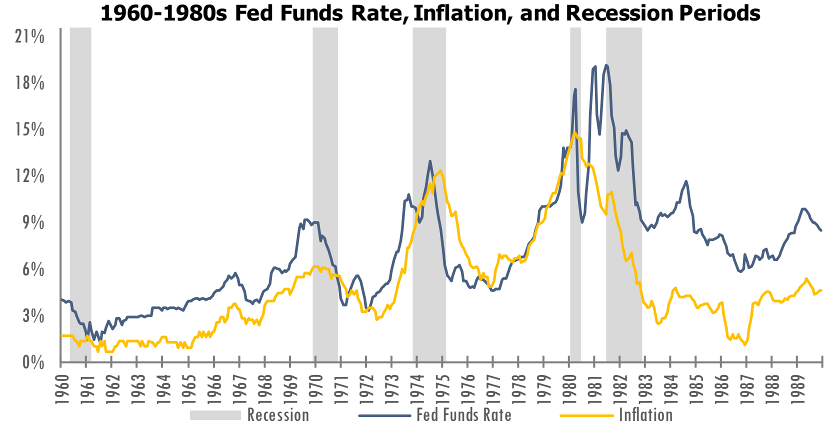
Policymakers used industry-specific policies to support both the development of new technologies and specific industries that were seen as key to promoting economic growth. For example, the US government provided subsidies and tax incentives to promote the development of the domestic solar industry, with the goal of reducing dependence on foreign oil and promoting a more sustainable energy mix. Automatic stabilizers included programs like unemployment insurance benefits, which automatically kicked in when an individual became unemployed and provided a source of income support during a downturn. Exchange rate policies were also utilized by the government to allow the value of the US dollar to depreciate in order to make exports more competitive, promote economic growth, and reduce trade deficits.

While the 1970s federal government used a hot-pot of fiscal policy to try to tame inflation, today's government has learned from that and employed a different approach. For the most part, politicians have taken a back seat and let the Fed do most of the work. However, in August 2022, Congress passed the Inflation Reduction Act ("IRA") in a weak attempt to aid the Fed in its fight. The act aimed to reduce costs for small businesses by maintaining lower healthcare costs, supporting energy-saving investments, and bolstering supply chain resiliency. It also promised to decrease the deficit by increasing taxes for the ultra-wealthy and large corporations. Despite the stated goals, the Wharton School of Business concluded that the IRA "would have no meaningful effect on inflation in the near term" and "would reduce inflation by around 0.1 percentage points by the middle of the first decade." Essentially, Congress left it to the Fed to bring inflation under control.

## Monetary Policies

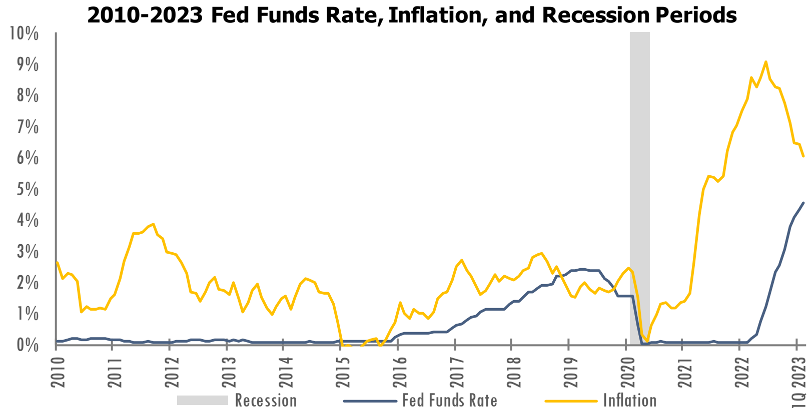
The Fed's dual mandates of maintaining price stability and supporting maximum employment are at odds by design. It is up to the Fed to balance monetary policy, sometimes on what must seem the tip of a needle. In the late 1970s, the Fed chose to prioritize inflation control over employment in its firm commitment to tightening monetary policy until inflation was defeated. The ensuing battle with inflation brought interest rates well into the teens and ushered in a period of economic contraction, but it was ultimately deemed a success.

**1960-1980s Fed Funds Rate, Inflation, and Recession Periods**




The modern Fed worries less about its competing mandates than it did in the early 1970s, more willingly prioritizing one mandate over the other when it feels it may be warranted. For the most part, President Biden has been letting the Federal Open Market Committee ("FOMC") take the lead in lowering inflation, and it has been hiking rates with historic rapidity. In December, as retail sales and manufacturing declined, the Fed slowed its pace.

While this seemed like good news for stocks and bonds, the Fed also indicated that it would continue to raise the funds rate, potentially above its original target of 5%, if it deemed necessary. In its March 2023 meeting, the Fed increased the rate by another 25 basis points when the market was pricing in a pause, and, more importantly, again indicated that it will continue to do so until it sees more recovery in the economy. This came as a surprise to analysts who expected the Fed not only to stop the increases but also, perhaps, to start decreasing rates, especially given the Silicon Valley Bank failure and a looming potential banking crisis.




## Inflation and Banking Crises

While according to Michael S. Barr, the Fed's Vice Chair for Supervision, "SVB failed because the bank's management did not effectively manage its interest rate and liquidity risk," not everyone agrees. Some analysts point to the Fed's aggressive rate hikes as the reason for the failure of SVB. Others cite the Fed's overcommunication of forward guidance as the proximate cause of market volatility and fear that led to a bank run at SVB.

The Silicon Valley Bank failure is reminiscent of the failure of Franklin National Bank in the 1970s. Both banks faced significant withdrawals and struggled to maintain adequate liquidity. In the case of SVB, management significantly increased their estimate for the pace of customer withdrawals causing the bank to liquidate the bulk of their Available for Sale ("AFS") securities at a $2 billion loss. Franklin National Bank also struggled to maintain liquidity due to large withdrawals and speculative practices including high-risk loans to foreign banks and foreign currency transactions. However, drivers of their liquidity issues differed. Silicon Valley Bank had an undiversified customer base dominated by technology start-ups and the venture capital firms that fund them, while Franklin National Bank engaged in speculative lending practices to finance international trade.

More notably, the policy response to the two failures differed. The FDIC put Silicon Valley Bank into receivership and insured all depositors' funds. In the case of Franklin National Bank, the Federal Reserve provided significant liquidity assistance to the bank and coordinated an orderly liquidation. The failure of Franklin National Bank was the first time that the federal regulators oversaw the wind-down of a major financial institution. While both failures involved liquidity issues and deposit withdrawals, the underlying causes and policy responses differed.

## Controlling Inflation and Preventing a Recession

Even though the Fed has been trying to tame inflation by increasing borrowing costs to slow economic growth and reduce demand for goods and services, there are other factors that impact prices such as geopolitical conflicts and natural disasters, which the Fed cannot control. For example, it could not limit the current bird flu outbreak which has driven up the price of eggs. The Fed also cannot stop corporations from taking action to maintain their profit margins. As the Fed's Vice Chair Lael Brainard pointed out, "final prices have risen by more than the increases in input prices."

The recent failures of Silicon Valley Bank and others have forced analysts to revise their recession forecasts. The banking crisis may lead to lasting damage for the US financial system, with some banks teetering on the brink. In addition, edgy markets and a promise of stricter regulation could lead to a credit crunch. The Fed faces a difficult choice between slowing down interest rate hikes or risking amplifying damage to the economy. Even if contagion from the bank collapses is contained, credit conditions may still tighten due to pressure from markets and regulators. Major banks, such as Goldman Sachs, have also downgraded their forecasts, warning of a severe blow to US economic growth. The current challenges resemble a "Wile E. Coyote moment," suddenly realizing we have run off a cliff.

However, people felt that way in the 1970s, only to see the high interest rates of the Volcker Fed and fiscal austerity of the Reagan Administration give way to a surge in growth, innovation, and wealth development remarkably free of inflation. Perhaps the greatest difference between now and the 1970s is that we have the lessons of the 70s to refer to.

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