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First Quarter 2023 Commentary

An Oxford Harriman & Company Market Commentary

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Strong, but Volatile, Start to 2023

First quarter economic data indicate the U.S. economy entered 2023 with considerable momentum, despite the Federal Reserve's interest rate hikes throughout 2022. Fourth quarter 2022 GDP data showed the U.S. economy grew at a 2.6% rate.* In our view, this growth was largely driven by a resilient consumer, inventory replenishing, and increased government spending. This helped offset reduced business spending and a weakening housing market. Additionally, jobs remain plentiful with job openings significantly above pre-pandemic levels, inflation may have shown some signs of leveling off, and consumer spending remained strong. In the face of higher interest rates, the economy remained resilient.

Financial markets experienced increased volatility during the month of March due to many factors including regional bank sector activity. The U.S. Treasury bond market participated in this volatility as investors debated whether the Federal Reserve would continue to raise interest rates or hold at current levels. Indeed, the yield on the 10-year treasury bond reached a 2023 high of 4.07% in early March, only to decline as low as 3.38% three weeks later. This quarter's commentary discusses the recent banking activity, including concerns about financial stability, and provides an update on year-to-date stock and bond returns.

Regional Bank Sector Stress

We are attaching a Wells Fargo Investment Institute titled Regulators Coordinate Support to the Banking System. This is a good summary of the recent bank stress.

Navigating the Volatile Interest Rate Landscape

The Treasury market continues to be volatile because of conflicting signals about the strength of the U.S. economy and the Federal Reserve's policy plans. Strong economic data in January indicated the U.S. economy coping well with rising interest rates, suggesting the Federal Reserve may need to keep increasing rates longer than anticipated to ease inflation. During early March congressional testimony, Federal Reserve Chair Jerome Powell spooked markets by suggesting the central bank would need to raise interest rates higher than initially thought and then keep interest rates higher for longer. The warning caused Treasury yields to rise and bonds to trade lower. Less than one week after Powell testified, the bank stress mentioned above occurred, causing worries about the U.S. financial system's stability. Treasury yields reversed course and declined, as bonds traded higher. The two conflicting themes have resulted in volatile price swings in the Treasury market as traders place bets on the likelihood of future rate cuts.

Projections for interest rates at the end of 2024 range from 3.4% to 5.6%, while the 2025 projected range is 2.4% to 5.6%.

Investors realize the Federal Reserve faces a tough set of choices. The Fed is attempting to balance bringing inflation under control with minimizing damage to the U.S. economy. One factor complicating the Fed's work and contributing to interest rate volatility is the lagged effect of monetary policy – it is difficult to model how 2022's interest rate hikes already have and will impact the economy. As a result, there is little consensus inside the Fed on the path of monetary policy. The Fed's Summary of Economic Projections, which provides forecasts for key economic indicators and offers insights into the future direction of monetary policy, shows a wide range of interest rate projections. Projections for interest rates at the end of 2024 range from 3.4% to 5.6%, while the 2025 projected range is 2.4% to 5.6%. With even the Federal Reserve uncertain about policy, interest rates could remain volatile in the coming quarters.

How Does Volatility Impact Businesses, Consumers, And Investors?

For businesses and consumers, this could mean higher financing costs and more difficulty obtaining loans. For investors, this could mean borrowers are unable to refinance their maturing bonds and end up defaulting on their principal and interest payments.

Treasury securities are considered safe-haven assets, used as collateral for loans and other debts, and serve as a benchmark for pricing other financial securities, such as corporate & municipal bonds, mortgages, and money market instruments. Increased volatility can disrupt the flow of credit, making it more challenging to price loans and various other financial products. While current volatility is linked to uncertainty about Federal Reserve policy rather than financial system stress, the risk is interest rate volatility spreads to other areas of the markets. For businesses and consumers, this could mean higher financing costs and more difficulty obtaining loans. For investors, this could mean borrowers are unable to refinance their maturing bonds and end up defaulting on their principal and interest payments.

Equity Market Recap – A Reversal in Performance Trends During the First Quarter of 2023

Stocks traded higher in January before giving up some of their gains in February and March only to then rally higher during the final week of the quarter. The S&P 500 Index of large cap stocks ended the first quarter up 7.4%, outperforming the Russell 2000 Index's 2.7% return. Most of the S&P 500's relative outperformance occurred in March as investors de-risked their portfolios following the bank stress at the end of the quarter. Additionally, several mega-cap technology stocks had strong gains to start the year. This shift towards growth stocks as the quarter closed was clearly evident as the Russell 1000 Growth Index gained 14.3% during the first quarter, outperforming Russell 1000 Value's 0.9% return. Growth stocks tend to be higher quality businesses with stronger fundamentals, and recent bank failures may have motivated investors to rotate into higher quality companies. Regardless of the cause, Growth's outperformance is a significant change from 2022 when the Federal Reserve's interest rate increases weighed on expensive stock valuations.

International stocks posted positive returns during the first quarter. The MSCI EAFE Index of developed market stocks gained 9.0%, outperforming the MSCI Emerging Market Index's 4.1% return. Europe was the top performing international region and boosted developed markets' performance.

Turning to global markets, international stocks posted positive returns during the first quarter. The MSCI EAFE Index of developed market stocks gained 9.0%, outperforming the MSCI Emerging Market Index's 4.1% return. Europe was the top performing international region and boosted developed markets' performance. The region managed to avoid a major energy crisis during the winter months due to unseasonably warm weather and efforts to secure alternative natural gas sources after Russia cut off most of its supply. This was one of our concerns in our fourth quarter 2022 commentary, and the mild winter was helpful in avoiding this potential shortage and rationing of natural gas. Nonetheless, European utility bills remain high, causing financial stress for many. In Asia, the focus remains on China as the country reopens after relaxing its Covid-zero restrictions. The reopening is expected to boost China's economy, and potentially the global economy, but it is unclear how strong or lasting the growth will be.

Bond Market Recap – A Volatile Quarter Due to Concerns About Refinancing Risk

Bonds prices were volatile in both directions during the first quarter, initially trading higher in anticipation of the end of the tightening cycle before trading back lower as the Federal Reserve hinted at higher interest rates for longer. Corporate investment grade bonds ended the first quarter with a 4.6% total return. Like equities, investment grade's outperformance primarily occurred in March after bank failures raised concerns of increased default risk.

With recent bank stress causing banks to question the stability of deposits, we believe banks may adopt an even more cautious approach to lending and reduce the total amount of credit offered to consumers and riskier smaller businesses.

As we begin the second quarter, tighter bank lending standards are becoming a concern in the bond markets. For perspective, banks aggressively tightened lending standards during the last 12 months in anticipation of the Federal Reserve's interest rate hikes slowing economic growth. With recent bank stress causing banks to question the stability of deposits, we believe banks may adopt an even more cautious approach to lending and reduce the total amount of credit offered to consumers and riskier smaller businesses. The decreased credit supply and access to credit could have a domino effect, impacting the economy and financial markets over time. Borrowers, specifically high-yield issuers, could default on their debt if it becomes difficult and too expensive to refinance their maturing loans. Credit markets will be watching for signs of refinancing stress in the coming months.

Second Quarter Outlook – Focusing on the Fundamentals

The outlook is not clear as financial markets close out the first quarter of 2023. Some investors believe the Federal Reserve's actions will slow economic growth and tip the U.S. economy into a recession. The continued yield curve inversion we wrote about in early April reinforces this theme. Some believe the recent bank failures are a warning sign that higher interest rates will have a negative impact on the economy and financial markets. Conversely, some investors believe the U.S. economy is strong enough to withstand the Fed's actions. This group points to first quarter economic data as a sign of strength and banking regulators' swift actions as an indication the U.S. financial system is functioning as intended.

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This debate is likely to continue until some of the market's most pressing questions are answered. Key questions include the direction of Federal Reserve policy, the stability of the U.S. banking sector, inflation's stickiness, corporate earnings growth, and the strength of the U.S. economy. Our team will be monitoring the answers to these questions in coming months to help guide investment portfolio positioning, with first quarter earnings season scheduled to start in mid-April.

We greatly appreciate the trust you have placed with us and are available at your convenience to answer any questions you may have.

Sincerely,

Dennis P. Barba, Jr.
CEO & Managing Partner

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Sources:

*www.cnbc.com

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Regulators coordinate support to the banking system

Key takeaways

- A joint statement released on March 12 by the Federal Deposit Insurance Corporation (FDIC), the U.S. Treasury, and the Federal Reserve (Fed) announced measures to protect depositors at banks that failed within the past week, and to provide support to the banking system.
- We view these measures as strong positives, insofar as there may be other banks that have duration (a measure of a bond's interest rate sensitivity) mismatches in their balance sheets.

What it may mean for investors

- The economy is slowing, liquidity is becoming more limited in the banking sector, and we still expect short-term interest rates to rise further. Consequently, we continue to favor defensive portfolio positioning, as we laid out in our report of March 12.[1]

A joint statement released on Sunday by the FDIC, the U.S. Treasury, and the Fed announced that depositors in two failed banks will be made whole and will have full access to their deposits beginning March 13.[2] The move should shore up confidence and block spillover effects after California regulators closed a bank on Friday and the New York state chartering agency did the same for a small bank in New York City on Sunday.

According to the plan, taxpayers will bear none of the losses. Instead, a $100-billion fund that banks pay into regularly will backstop the depositor protection. Regulators also have removed senior management at these two banks. Any losses to the FDIC to support uninsured depositors will be replaced by a special assessment on banks, according to law.

1. Wells Fargo Investment Institute, "Stay defensive as bank sector comes under pressure," *Institute Alert*, March 12, 2023.
2. "Joint Statement by the Department of the Treasury, Federal Reserve and FDIC," March 12, 2023.

To reinforce confidence in the system, the same joint statement announced that the Federal Reserve Board will provide additional funding to banks to help ensure that they can meet the needs of depositors. The new program, which the Fed calls the “Bank Term Funding Program,” will offer loans to any bank under easier terms than are available at the Fed’s usual funding mechanism, known as the discount window.[3]

Typically, banks can borrow from the Fed by pledging securities, and the Fed lends a fraction of the collateral’s market value. In this new program, the Fed will accept U.S. Treasuries and other high-quality securities, and a bank can borrow for one year at up to the full collateral value and at an attractive rate. According to Bloomberg, Fed officials on a conference call on Sunday noted that the program will be large enough to protect deposits not already covered by the FDIC.[4] For banks that cannot repay after one year, the Treasury will make available up to $25 billion from its Exchange Stabilization Fund, as an additional backstop.

Our perspective

As we explained in our report of March 12, deposit flows into banks were strong over the 2019-2021 period. Some banks have not managed their mix of assets and liabilities well and have developed excessively large exposures to long-dated U.S. Treasuries or mortgage-backed securities — all long-duration assets whose values have declined on paper since interest rates have risen. Higher interest rates have another effect. As depositors come in looking to transfer their funds to higher-paying money market rates, some banks must sell their long-duration assets to raise cash for depositor withdrawals. These sales recognize losses that previously had only been on paper. Some banks will be obliged to write-down capital, and the latest bank failure on March 12 raises the potential that other banks may have some of the same problems.

We believe the banking system as a whole has a more diversified balance sheet and should be much less vulnerable to rising interest rates than the failed banks. However, the risk of some additional failures could weaken confidence in the banking system and cause a disproportionately large public concern. These steps by the banking regulators address that concern directly.

Still, as we laid out in our March 12 report, we continue to favor defensive positioning in portfolios. The economy is slowing, and Fed policy makers likely will continue to hike rates in smaller increments. We expect a quarter-point (0.25%) hike at the March 21-22 meeting.

Looking beyond the next meeting, we believe the Fed has a narrower path to walk. Rate hikes are a big part of the Fed’s anti-inflation strategy. Yet, the large spread between short-term rates, which the Fed controls, and longer-term rates likely will have bank depositors considering all options available for their liquid capital. As liquidity in the banking system continues to decline, banks are likely to have less cash available to lend. This prospect reinforces our expectation that the economy will slow further.

3. Such a program can be invoked under the Fed’s emergency authority, under approval by the U.S. Treasury Department.

4. Craig Torres and Christopher Condon, “U.S. Says All SVB Deposits Safe, Creates New Backstop for Banks,” Bloomberg, March 12, 2023.

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