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# Market Review and Outlook

- Growth and inflation through the first two months of this past quarter proved to be far more resilient than previously seen, resulting in a steady upward re-rating of the expected fed funds terminal rate.
- These rate expectations were soon trounced following the collapse of Silicon Valley Bank (SVB).
- The bank's downfall has acted like a stress test for certain areas of the banking system, exposing vulnerabilities within specific organizations, but remains a situation markedly different from the systemic issues posed in 2008-2009. The episode could further tighten financial conditions and increases the probability of a recession.
- Historically, cyclical downturns increase volatility and are disruptive for investors, but are ultimately temporary and often represent attractive entry points for active investors.
- Better economic management among the emerging market economies has so far cushioned them from their historical sensitivity to rising U.S. interest rates and the stronger dollar, while the milder winter has been a saving grace for Europeans.
- Geopolitically, the world's tectonic plates continue to widen, sending tremors across the globe, and these disruptions remain an ongoing concern.

## Bank Failures, Volatility, Growth, and the Fed

With the collapse of SVB (as well as Signature Bank and the forced merger of the systemically important Credit Suisse with UBS) sucking most of the oxygen out of the room during March, it is easy to forget exactly what was happening through January and February, which, looking back, seems like ages ago now.

In reality, investor sentiment at the start of the quarter was a little more positive following the sharp corrections that occurred in 2022. And while expectations around economic growth centered on whether *"the most forecast recession in history"* was going to be a mild or hard one, this recession outlook also started to be questioned in the face of much-stronger-than-expected retail sales, employment growth, and inflation.

Nonfarm payrolls, for example, for the month of January came in at a stunning 517,000 (later revised to 504,000) compared to the expected 189,000 increase, and a further 311,000 in February; consumer spending rose 3.2% in January (the fastest monthly change since March 2021); and where January's inflation figures had been expected to show a deceleration to 6.2%, they came in at 6.4%—still far too strong, and a significant disappointment.

Market expectations around the ultimate peak in interest rates were steadily re-rated upward, with the expected terminal rate rising from 4.9% at the start of February to 5.7% by early March following the release of the February employment report (exhibit 1). This more hawkish market sentiment was echoed by the Fed in subsequent appearances by Fed Chair Powell and other members of the FOMC—with some FOMC members even suggesting rates might need to be pushed as high as 6%.

And then SVB dissolved, sparking early fears and causing rate expectations to plunge almost 100 basis points.

The 16th-largest U.S. bank, it turns out, was unique in its concentrated depositor base (the tech start-up community, which effectively acted as one unified depositor, following the depositor-in-chief in pulling their deposits when the alarm was sounded across social media) and inexcusably negligent with regard to its risk management practices (in not hedging its duration risk); this was not representative of the situation across the wider community of banks. Nevertheless, the response was swift and decisive from the Fed, the Treasury, and the FDIC, which over a weekend unveiled yet another new special lending facility, guaranteed both insured and uninsured deposits, and effectively ended any need for depositor flight.

SVB's downfall, however, has reminded investors of the importance of FDIC (Federal Deposit Insurance Corporation) and potential vulnerabilities among riskier banks, including their lower capital requirements (which Congress deemed appropriate to reduce in 2018), the quirks of held-to-maturity securities, and their reluctance to increase deposit rates at certain institutions. **What is FDIC insurance?** *The FDIC insures cash deposits at a bank (checking, savings, bank deposit accounts) of up to $250,000*

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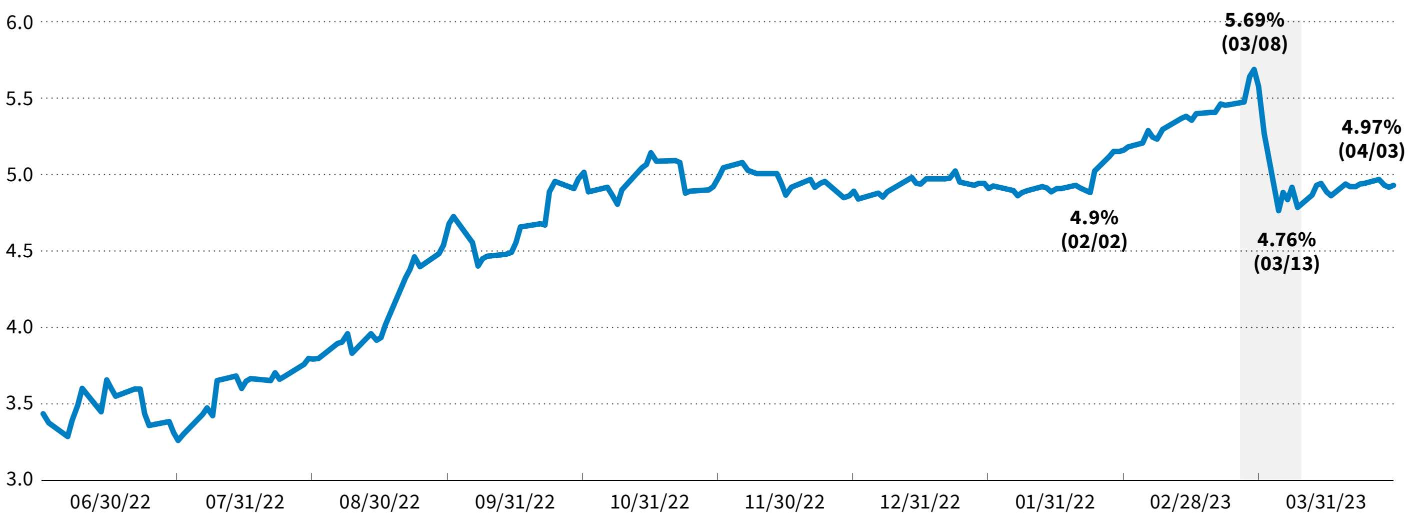
EXHIBIT 1

Progression of Futures Market Expectations for the Peak Fed Funds Rate

(Expected Peak in Fed Funds Rate Between 2023-2024, %)




Sources: Bloomberg, William Blair Equity Research

*per individual. The FDIC is backed by the full strength and credit of the U.S. government. In addition, William Blair clients have access to our Bank Deposit Sweep Program, in which individual ownership accounts are covered up to $2,500,000, and joint ownership accounts are covered up to $5,000,000. Entity accounts (i.e., corporate accounts) are also covered up to $2,500,000. Read more on Custody and Safekeeping.*

There are also three important points worth making about this episode that contrast it to the globally systemic banking crisis of 2008-2009, even though its impact will have implications for years to come.

The first is that the largest banks are very well capitalized, well regulated, and hold far more high-quality liquid assets (HQLA) than was the case previously. What this crisis has not been about is junk assets that were believed safe, rated AAA, and used as collateral to leverage balance sheets up 30/40-1, thereby virtually guaranteeing a banking collapse the moment the wind blew in the other direction. The fact that the banks today are holding plenty of HQLA also means that when interest rates fall, these assets will revalue and ultimately can be redeemed at par value when they reach maturity.

Secondly, even if these assets are underwater and selling them would potentially crystalize an unrealized capital loss, the banks can now avoid this liquidity risk following the establishment of the Fed's new BTFP facility, where it will happily swap these HQLA assets at par value for cash whenever needed. While this is a temporary facility established for one year, it sets an incredibly powerful precedent for what might be achievable whenever the next disruption rolls around.

Lastly, there has been a lot of fearmongering among market participants with regard to FDIC published data on the large unrealized capital losses the banks are carrying on their books. While there is no reason to dispute this data, it is, however, worth noting that these "losses" are reported as gross amounts that will largely (but not entirely) have been offset by hedged interest rate swap positions, which are very much in the money. Such hedging is standard practice among bank treasury departments, making it all the more astounding that these hedges were abandoned by SVB a year before its collapse.

The reality is that with the Fed having increased rates by 20 times their starting level in the space of just 12

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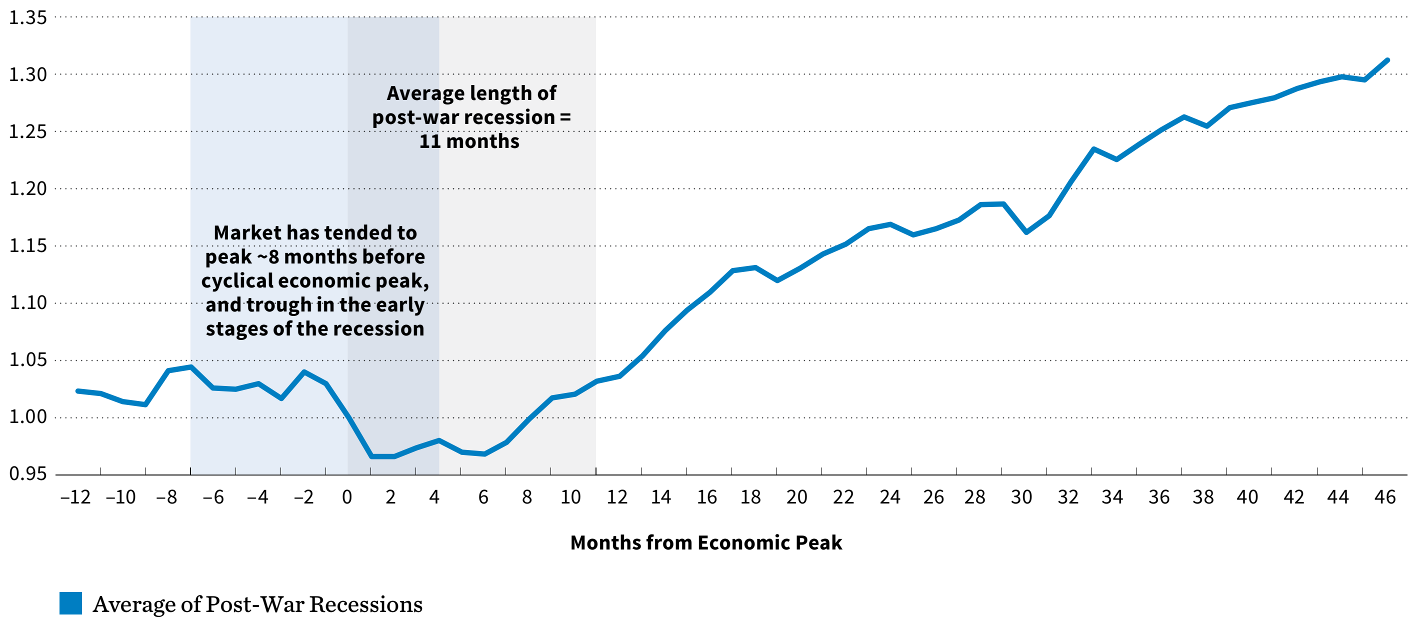
EXHIBIT 2

S&P 500 Index Around Recessions

Average Behavior of Index for all Recessions Since 1945 (Index rebased to 1 and Economic Peak)




Sources: NBER, Bloomberg, William Blair Equity Research

months—making it the fastest tightening cycle since at least 1970—it has also resulted in one of the sharpest drawdowns on record for U.S. Treasury securities. Given that these are the world's benchmark risk-free assets, in light of such fluctuations it was almost inevitable something would break. Yet, with SVB seemingly not being a systemic event, it should be a salutary episode: helping to act as a stress test to expose weaknesses, but ultimately further strengthening the banking system.

## The Stock Market and Recessions

What does recession mean for the market? Exhibit 2, which depicts the average stock market performance around recessions, highlights two key points about the stock market and recessions.

The first is that the stock market tends to peak around 8 months prior to the start of an economic recession, and trough in the early stages of the downturn, i.e., once the recession becomes more obvious and the market starts to price in falling interest rates to compensate. Hence, volatility around cyclical turning points should be expected.

The second, however, is that over time markets rise, and for longer-term investors, these periods of disruption and dislocation often represent exceptional opportunities for active managers to acquire quality assets and find bargain prices.

## Global Growth Better Than Feared, Though Geopolitical Risks Remain Elevated

Global growth continues to hold up exceptionally well despite two key historically disruptive catalysts—higher U.S. interest rates and a much stronger dollar. Both of these in the past have proved highly disruptive to many emerging markets that peg their currencies to the dollar and also issue dollar-denominated debt. Today, these markets have proved to be more adept at managing these risks. In addition, China's great reopening from its draconian lockdowns has—so far—failed to result in the surge in prices for energy and other commodities that had caused similar concern.

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Meanwhile, in Europe, it has been encouraging that the much-feared cold winter that would bring Europeans to their knees through higher energy prices failed to materialize. The result has been that natural gas storage levels continue to be at the top of their normal seasonal levels, and prices have helpfully continued to moderate. This allowed monetary policymakers room to tighten rates further, and fiscal policymakers to proceed with other measures to recover some of the costs associated with previous pandemic support.

Geopolitically, both the hot war in Ukraine and the cold war between China and the West continue. Both of these represent significant risks to global economic stability, and both have the potential to be highly disruptive to financial markets, and therefore they will continue to be closely monitored. Meanwhile, the recent move by OPEC at the end of the quarter to cut production is clearly provocative and could exacerbate still-high inflation in the very near term; however, ultimately it is likely to be more disinflationary than inflationary given that higher energy prices act as a tax on consumption.

## Wealth Planning Tip

Each year, you can make prior-year IRA contributions up until the IRS tax filing date of the current year. It is still possible to make an IRA contribution for the 2022 tax year until April 18, 2023. Three states, Georgia, Iowa, and Mississippi, offer a state income tax deduction or credit for 529 plan contributions that can be applied to the prior tax year through the filing date (or in Iowa, the end of April).

| Index | | YTD | Q1 | 1Y |
|---|---|---|---|---|
| **S&P 500** | US Large Cap | 7.50 | 7.50 | –7.73 |
| **DJIA** | US Large Cap | 0.93 | 0.93 | –1.98 |
| **Russell 3000** | US All Cap | 7.18 | 7.18 | –8.58 |
| **Russell 2000** | US Small Cap | 2.74 | 2.74 | –11.61 |
| **MSCI EAFE** | Developed International | 8.47 | 8.47 | –1.38 |
| **MSCI EM** | Emerging Markets | 3.96 | 3.96 | –10.70 |
| **Bloomberg Barclays US HY** | US High Yield | 3.57 | 3.57 | –3.34 |
| **Bloomberg Barclays US Agg** | US Core Bond | 2.96 | 2.96 | –4.78 |
| **Bloomberg Barclays Muni** | US Muni Bond | 2.78 | 2.78 | 0.26 |
| **MSCI US REIT GR** | US Real Estate | 2.73 | 2.73 | –19.17 |

Source: Bloomberg