April 2023

Dear Donor,

First Quarter Review and Second Quarter Outlook

For a few weeks back in January it seemed like mid-year 2021 all over again. Junky growth stocks with no earnings in the foreseeable future soared, cryptocurrencies began their improbable comeback and interest rates across the yield curve fell solidly below the overnight Fed funds rate. All that was missing from this montage of market mania was a gaggle of celebrities hyping illiquid NFTs on late night talk shows. The underlying catalyst for this return to peak exuberance was a couple of milder-than-expected inflation reports showing that the core (ex-food and energy) consumer price index eased a bit at the end of 2022 from the levels seen earlier in the fall. But the exuberance was fragile, and it wilted under the pressure of yet another reminder by the Fed, in early February, that the fight against inflation was ongoing and that rates would not be coming down any time soon. Once again markets tried to fight the Fed, and once again the Fed won.

But the volatility around monetary policy, interest rates and the health of the financial sector was only beginning. During the first week of March word started going around that Silicon Valley Bank, the financial beating heart of Silicon Valley’s ecosystem of start-up companies and venture capital firms, was having trouble raising cash to redeem depositors withdrawing funds. On Thursday of that week a tsunami-level $42 billion worth of deposits left the bank, and the next day the regulators formally declared that it had failed – the largest US bank failure since the dark days of the 2008 financial crisis. Two other US banks, both heavily involved in cryptocurrencies, also failed. Then the stakes rose even higher as Credit Suisse, a Zurich, Switzerland-based global financial colossus, took its turn at the center of a growing storm calling into question the stability of the entire banking system. Financial regulators suddenly found themselves thrown off message in their year-long fight against inflation, and back in their familiar role as rescuers, supplying liquidity to the system to prevent a widespread global panic by depositors.

The emergency measures appear for now to have worked. Deposit outflows have stabilized, and banks for the most part do not appear to be taking desperate measures to obtain liquidity (which was what brought SVB down when it sold off high-quality assets at a steep discount to fund deposit withdrawals). The regulators were more surgical in their provision of liquidity facilities than was the case in 2008 – deposits in Silicon Valley Bank were made whole but shareholders and bondholders were left out of the rescue efforts, so this was not a classic bailout per se. But the stabilization measures were not without controversy, particularly in the Credit Suisse case, where the Swiss regulators not only enforced a shotgun wedding-like takeover of the troubled bank by its longstanding rival UBS, but in the process also chose to wipe out an entire class of bondholders while compensating common stock holders to the tune of $3.5 billion. Common shareholders are supposed to have the most junior claim on the assets of a failed company, so the Swiss regulators’ move was highly irregular and is being contested in court.

There are still problems with the banks, though. One is a lack of regulatory clarity on what the policy for deposit insurance will be going forward. The message seems to be that cases will be dealt with as they come up, but that hardly assures depositors in, say, small community banks that they would get the same treatment as the mostly wealthy and politically well-connected individuals did in the SVB instance. The lack of clarity keeps alive the potential for another sudden shock. The other main consequence we can expect in the coming weeks is an organic credit contraction as banks tighten their lending standards and focus on shoring up their liquidity and capital reserves. This has the potential to speed up the timeline for a recession as credit becomes harder to obtain. On the positive side, it can also help take the edge off inflation and give the Fed more leeway to hold rates close to where they are now rather than a further protracted series of hikes.

The market response to all this has been interesting, to say the least. Most of the drama, with an unusually high level of volatility, has been in the bond market. Treasury yields have dropped sharply across all maturities, with bond investors apparently convinced that the Fed plans to start cutting rates as soon as this coming summer. This despite the endless affirmations from Jay Powell and his colleagues that rate hikes are not in the central bank’s base case planning for 2023. In other words, the market is fighting the Fed yet again, for a whole different set of reasons than those driving the narrative back in January. In a twist to the way these things usually work, it is the stock market that seems to be the more rational of the two major asset classes. Equities have mostly trended higher since the bank troubles began in early March, and had a very strong end to the first quarter, but with considerably less intraday volatility than we have seen in bonds.

We still don’t think it is a good idea to fight the Fed, and we see the potential for bond yields to trend higher as the second quarter moves along. For equities, we think a big part of the story will be about earnings: growth and profit margins. We see a growing number of signs indicating consumer fatigue, as continued inflation and perhaps now a softening in the hitherto strong labor market make households more resistant to accepting the higher prices consumer-facing companies try to pass on to them. While we do not see elevated risks for a dramatic decline in equity prices, weaker earnings could keep directional upside in check.

With warm regards,

Masood Vojdani

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