# Doll's Deliberations

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## A Bumpy Quarter, But Risk Assets Perform Well Despite Banking Crisis

U.S. equities were higher in Q1 (second positive quarter in a row) with the S&P 500 up 7.0%. The NASDAQ was the standout (up 16.7%) snapping a four-quarter losing streak. Treasuries were stronger with the yield on the two-year note falling ~35bp to just over 4.0% and the yield on the ten-year note falling ~40bp to just under 3.50%. The dollar index was down 1% after losing more than 7.5% in the prior quarter. Gold gained 8.8%. WTI crude lost 5.7%. Positive factors included disinflation momentum, positive macro surprise momentum, soft landing expectations, an accelerated China reopening following the unexpected zero Covid pivot late last year, warmer weather in Europe that helped prevent an energy crisis, and one-off global liquidity injections that seemed to dampen some of the bite from the Fed's QT. Banking sector turmoil grabbed the headlines in March with the focus on the funding/liquidity pressures at the regional level from deposit flight and the impact of the Fed's aggressive tightening cycle on investment portfolios. Fed pivot expectations provided an outsized tailwind for big tech (and other growth/long duration plays).

The U.S. economy started out 2023 with momentum, but some cracks are appearing as we move into Q2. Initial jobless claims have moved up some, regional fed surveys have been weak, new orders are falling, and layoff announcements have continued. The shock to the banking system in March promises to further stall activity. Falling profits should restrain business spending generally. We are still dealing with the lagged effects of prior tightening, and continue to think a mild recession is in the cards. The bank shock may lower the terminal rate the Fed achieves this cycle, but inflation should remain firm enough for the Fed not to cut rates for the balance of 2023. The labor market is likely the next to crack, though that has not yet happened.

Global financial markets have moved past the shock from the abrupt failure of Silicon Valley Bank and a few other banks as well as the forced takeover of Credit Suisse. There will be lingering fears of additional fallout, since many financial institutions are sitting on portfolio losses arising from the cyclical rise in bond yields, not to mention worries about economic contagion. We envision some hit to confidence and consumer spending from the banking crisis. Business investment might slow if credit conditions tighten at the margin, but this will be partially offset by lower bond yields and rate expectations, at least for a while. Mortgage rates are now lower and the risk of Fed overkill has eased for the time being. Interest rate and potential central bank pauses are lifting risk asset prices as sentiment recovers. Nevertheless, we remain in a maturing economic cycle with still-elevated cyclical investment risks including falling, but unacceptable inflation.

The Silicon Valley Bank bust confirms that policy rates and bond yields cannot go much higher without breaking something major and triggering a recession. If there are no further banking issues and no real change in the economic and inflation trends, we expect global bond markets will reverse the recent decline in bond yields and rate expectations. Prolonging the economic expansion will further cement a floor under inflation, i.e., the current deceleration in inflation will level off well above pre-pandemic levels. The banking crisis is a reminder that the financial market landscape will remain risky for as long as the cost of money is rising. Policymakers' have indicated they will do whatever is needed to support the financial system and hopefully prevent a recession. In our view, they will ultimately fail, but have bought themselves more time.

In response to the banking crisis and the shift in tone from the Fed, ten and two-year Treasury yields fell 50 and 100 basis points from their respective peaks. This has led to the question of whether bad economic news will be good news for the equity market, in the sense that tighter lending standards could help achieve the Fed's inflation goals at a lower discount rate than would otherwise be the case.  Over the short term, it is possible that this view will prevail.  Rising interest rates have accounted for the majority of the decline in stock prices since the beginning of 2022, and the decline in bond yields is thus a positive development for some equity investors.  However, our sense is that this perspective is only likely to benefit stock prices until the effects of tighter lending standards begin to impact the real economy, as that will trigger a shift in investor focus from the discount rate to earnings and the equity risk premium.  The U.S. equity risk premium is not appropriately priced given the likelihood of a recession.  Stocks are still expensive assuming an average equity risk premium and the current level of real government bond yields.  In other words, the recent decline in government bond yields has merely rendered U.S. stocks less overvalued, not cheap.

We recommend underweighting risky assets versus government bonds and the events over the past month have strengthened our conviction that investors should be conservatively positioned.  We continue to expect that the U.S. economy will likely enter a recession over the coming year and that defensive positions are warranted within an equity portfolio.

## Key Observations:

1. There are consequences of raising interest rates from 0% to 4 ¾% in a twelve-month period.
2. While inflation has fallen from peak levels, headline CPI is still 6.0% y/y and core CPI is still 5.5% y/y.
3. Every tightening cycle has experienced a credit or liquidity problem ("bump in the night").
4. To date and unusually, interest rate risk has been a bigger problem than credit risk.
5. The Leading Economic Indicators (LEI) have fallen for eleven straight months.
6. The Fed is between a rock and a hard place.  (Simultaneously dealing with high inflation and a banking crisis.)
7. A recession has followed seven of the last nine tightening cycles (and, on average, started 14 months after the yield curve inverted).
8. The Fed will need to see much more evidence of falling inflation before it considers rate cuts.
9. Stocks tend to struggle most when the Fed begins cutting rates.
10. "The" bear market low has always occurred after a recession has started.

## Conclusions:

1. We expect the U.S. economy to slow sequentially each quarter this year.
2. We expect a mild recession to commence prior to year-end.
3. We expect the Fed to raise interest rates one more time this calendar year and keep rates flat for the balance of the year.
4. We expect inflation to continue to fall but not reach levels anywhere close to Fed targets.
5. We expect earnings estimates to continue to fall for this and next year.
6. We expect bonds to remain in a trading range, with some modest widening of credit spreads.
7. We expect stocks to breach the October low when recession and reduced earnings expectations sink in.
8. We expect non-U.S. markets to outperform the U.S. again this year.
9. We expect both bulls and bears to continue to be frustrated for the balance of this year.
10. We expect the domestic and global political environment to be somewhat chaotic.

Source: BCA Research, MRB Partners, FactSet