Market Commentary

March 2023

"Time to pay the piper"

Sooner or later we were bound to see consequences from the unprecedented levels of fiscal and monetary stimulus injected into the U.S. economy in response to the pandemic-driven recession in 2020. Over the past two years, the prices of goods and services jumped due to supply and demand imbalances and excess cash in the economy. Inflation soared from 1.4% in January 2021 to a peak of 9.1% in June 2022. Inflation has moderated somewhat since the middle of last year but remains stubbornly high with February's inflation reading coming in at 6%.

With inflation well above the Federal Reserve's longer run target of 2%, the Fed has continued to tighten monetary policy, raising interest rates by 4-1/2 percentage points over the past year. In response, yields have risen across the yield curve. The 10-year Treasury yield recently closed at 3.55% compared to 1.66% at the beginning of 2022. And the rise in the 2-year Treasury yield is even more dramatic, recently closing at 4.03% versus 77 basis points at the start of 2022.

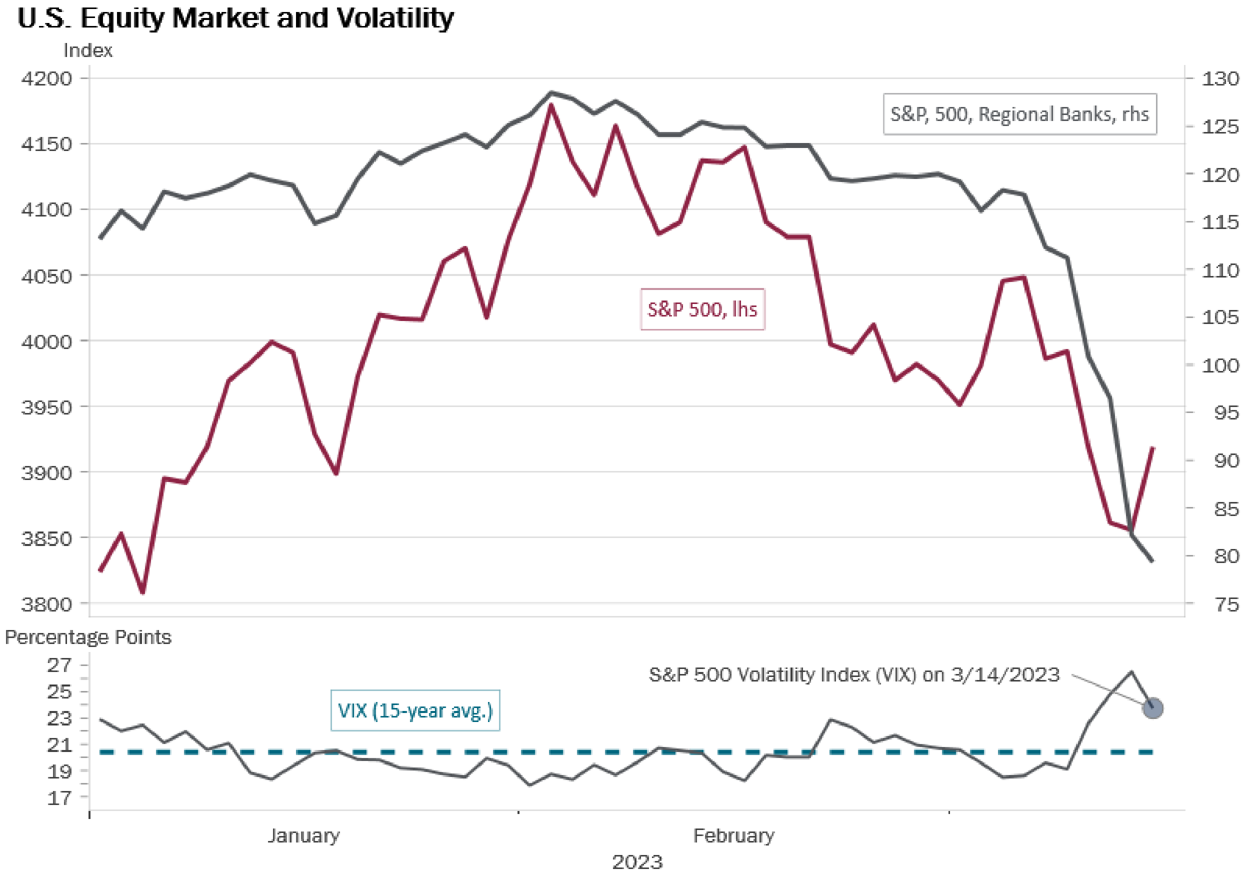
In his semiannual testimony before Congress last week, Fed Chair Jerome Powell indicated the process of getting inflation back down to 2% has a long way to go, and the ultimate level of interest rates is likely to be higher than previously anticipated.

With that backdrop, we began to see the makings of a regional bank crisis with the failure of Silicon Valley Bank (SVB) at the end of last week—it was the second-biggest collapse in U.S. history. In a nutshell, SVB suffered from a mismatch between assets (investments) and liabilities (deposits), which was exacerbated by the rapid rise in interest rates over the past year. SVB's investments were deemed relatively risk-free from a credit quality standpoint, but they were not immune to interest rate risk. There were growing concerns that SVB's collapse would spill over to other regional banks if investors and depositors lost confidence. Over the weekend, the Fed, Department of Treasury, and Federal Deposit Insurance Corporation (FDIC) announced additional funding to eligible depository institutions to help assure banks have the ability to meet the needs of all their depositors.

The U.S. stock market rallied in January on hopes that moderating inflation data would cause the Fed to pause on further interest rate hikes, but stronger than expected economic data drove investors to temper their optimism in February. The S&P 500 is now closer to where it started the year and up only 2.1% year-to-date. The regional banking crisis further eroded investor confidence, and the S&P 500 Regional Bank Index tanked over the past week—the index is down 29.7% year-to date. We are also seeing a pick-up in stock market volatility as measured by the S&P 500 Volatility Index (VIX), the so-called "fear index". See chart on next page.

The Fed's dual mandate is to promote maximum employment and stable prices, but the Fed has to be concerned now with financial stability. The Fed is balancing the risk of not tightening monetary policy enough to get inflation under control with the risk of tightening too much and causing a severe recession. This balancing act has become even more challenging as the Fed factors in the impact of its policy decisions on financial stability.

We expect to see heightened volatility in the stock and bond markets over the next several months as the Fed interprets and reacts to economic data and financial conditions. Given this greater degree of uncertainty, we remain neutral-weight risk assets relative to our longer-term, strategic asset allocation targets.



Source: PeoplesBank, Macrobond, S&P Global, Chicago Board Options Exchange (CBOE)