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2023 First Quarter Review
Fast and Furious – The Fed Version

Although not on anyone's list of top Oscar picks, the very lucrative "Fast and Furious" movie franchise is set for the release of the tenth (and supposedly final) installment in the series next month. Arguably not as exciting to watch as the dramatic car chases from the movies, the Federal Reserve Board (the Fed) has been furiously raising interest rates at the fastest pace in history, with a series of hikes that have caused many sweaty palms and racing heart rates for investors. They both (mercifully) are likely to come to an end next month.

It's an old saying on Wall Street that, once started, the Fed usually "tightens until something breaks." After a year of raising rates at a rapid pace, something finally broke. During the first quarter we saw the second and third largest bank failures in the nation's history. Silicon Valley Bank and Signature Bank of New York will soon be no more. Although their depositors will apparently suffer no loss, the value of their stock will be wiped out. The Fed and the Treasury Department moved quickly to quell fears of a domino effect leading to further bank failures. In spite of this turmoil, stocks and bonds have so far fared relatively well as the S&P500 advanced about 7% for the quarter, the Dow Jones Industrial Average slipped 2.5%, and the value of long-term Treasury bonds rose slightly. Cryptocurrencies bounced back sharply in response to the banking crisis, and precious metals moved to their highest levels in over a year. An odd feature of the recent advance in the S&P500 market index is that the entire gain for the year so far is attributable to just a handful of the large and well-known stocks such as Amazon, Google, Microsoft, and Apple. Excluding those few stocks, the index would actually have declined. This "narrowing" of the advance is often thought to be a sign of vulnerability to subsequent market weakness. That can be added to a list of reasons, including higher rates and an "inverted" yield curve, to be wary of breaking out the party hats just yet.

The Fed is in a tough situation, partly of their own making. After the Great Financial Crisis of 2008, the Fed had a number of years during which they could have raised interest rates closer to normal levels. However, in an effort to energize what looked like a tepid recovery, they kept rates too low for too long. Then came the pandemic and rates were brought back down to 0% again. Simultaneously huge influxes of cash were transferred to the populace and businesses to avoid a depression. The Fed then argued that inflation would not be a problem. It would be "transitory." When inflation subsequently ran to record levels, the Fed panicked and finally started raising rates early last year. Once started, they raised them at the fastest rate on record, going from 0% to 5% in one year. This was quite a shock to an economy that had become used to the "sugar high" of easy money and low interest rates.

The Fed raised rates to combat inflation. Actions like raising interest rates operate with a lag effect on the economy. That lag is usually estimated to be about 6 months. Although the financial press may still be highlighting inflation, the truth is that inflation rates have begun to decline. Many commodity prices have actually dropped, and service inflation shows signs of slowing. These developments are, by themselves, good for stocks as well as bonds. The bad news is that they are accompanied by an increased probability of an economic recession which is decidedly not good for stocks. Corporate earnings tend to fall along with stock prices.

Investors currently appear to be breathing a sigh of relief that the banking crisis has not spread, that inflation may be abating, and that the Fed is close to ending the rate hikes. However, history shows that we may not be in the clear yet. The banking crisis may bring on a classic "credit crunch" in the economy as higher rates take effect and banks raise lending standards, thereby causing ripple effects in the broader economy and other asset classes. One area of potential problems could be commercial real estate. Lower occupancy rates (from more remote workers) coupled with higher mortgage costs may lead to lower asset prices. Regional banks have a great deal of exposure to those assets, and some may find their balance sheets impaired. The "knock-on" effects of such a development could easily spread beyond that industry and into the broader economy.

The US economy hasn't had a "normal" recession in 15 years (covid was not normal). Many investors have not been through one and have not seen that stocks often bottom after the recession has started, after the Fed has paused, and even after interest rates have been cut. Since we are not that far along in this cycle, we shouldn't be surprised by a market and economy that begins to behave like one going into a recession.

The good news is that the banking crisis may be "the beginning of the end" of this bear market cycle, if the bear market is not already over with the low in October. The banking crisis has put a damper on inflation worries and will likely signal the end of the "fast and furious" rate hikes. This could lead to a final market bottom and lay the foundation for a new bull market, of which we hope to take full advantage.

Please review your reports at your leisure and contact us with any questions or suggestions that you may have. We are happy to provide your tax information directly to your tax preparer if you have not already done so. In the meantime, we will continue to work to preserve your assets while looking for opportunities provided by a tumultuous and volatile market.

Best regards,

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