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Markets Show Resilience To Start 2023 Despite Continued Uncertainty

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If 2021's predominant market theme was inflation and 2022's was the impact of rising interest rates on asset prices in response, the theme so far in 2023 has been volatility. Boosted by the U.S. Bureau of Labor Statistics' report of continuing declines in inflation at the end of 2022, markets began 2023 with strong gains in January.[1] This decline in price pressures was accompanied by surprisingly resilient economic data, particularly in the labor

[1] https://www.bls.gov/news.release/archives/cpi_01122023.htm

market. These forces combined to increase investors' hopes that the Fed could engineer an economic soft landing, a tricky balancing act whereby the economy slows and inflation moderates but not enough to trigger a recession.

In February, however, hopes for an economic soft landing suffered a setback as the decline in inflation stalled and the labor market remained tight.[2] This led investors to price in the expectation that substantially higher interest rates would be required to combat inflation in the coming months, which weighed on both stock and bond prices.[3]

The final month of the first quarter began with investors still focused on inflation and potential interest rate hikes, but the sudden failure of Silicon Valley Bank shifted investor focus to the health of the banking system. When Signature Bank of New York failed just days later, sparking fears of a widening crisis, the Federal Reserve and the Treasury Department created new lending programs aimed at shoring up regional banks and preventing bank runs. But concerns about the health of the banking system persisted and those fears weighed on markets through the middle of March.[4] However, while the Federal Reserve hiked interest rates again at the March meeting, policy makers signaled that they are very close to ending the current rate hike campaign.[5] That admission, combined with no additional large bank failures, eased concerns about a wider crisis at quarter end.

As the old saying goes, it takes a difference of opinions to make a market. Given that markets were impressively resilient in the face of the most serious risk to financial stability and the banking system since the start of the pandemic, it's no wonder that there are a wide range of opinions as to whether the worst is behind us and what Q1's rebound in asset prices means for the remainder of 2023. The ultimate answer lies in the fallout from the regional banking crisis, inflation's trajectory, and Fed policy.

A month ago, central banks faced a dilemma: how to fight inflation without undue damage to the economy and jobs. Now they face a more complicated trilemma: how to achieve those two objectives while also keeping the banking system stable. This is a tall task, and while headwinds remain in place with elevated volatility likely as the data is digested, there remains a path for future positive returns.

Despite breathless comparisons in the financial media between this year's banking crisis and the Financial Crisis of 2008, there are important differences between the two periods and regulators have already demonstrated their commitment to ensuring we do not experience a repeat of those trying times. As we begin the new quarter, there is reason for hope that this crisis has been contained by their efforts. Whether or not that's true, regulators and government officials have shown they are ready and willing to use any and all tools

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[2] https://apnews.com/article/inflation-federal-reserve-system-business-cb7f80cdf0a55088a85cc3da20a8b155

https://blog.dol.gov/2023/02/03/january-2023-jobs-report-more-strong-steady-growth#

https://www.bls.gov/news.release/archives/cpi_02142023.htm

[3] https://www.nytimes.com/2023/02/17/business/stock-market-economy.html

[4] https://www.federalreserve.gov/newsevents/pressreleases/monetary20230312a.htm

[5] https://www.federalreserve.gov/mediacenter/files/FOMCpresconf20230322.pdf

at their disposal to prevent a broader loss of confidence in the banking system. That's an important, and positive, difference from 2008.

Looking beyond the banking crisis, inflation remains a major longer-term influence on the markets and the economy, and whether or not inflation resumes its decline this quarter will be very important for the path forward. More specifically, the decline in inflation stalled a bit in the January and February data, but if inflation resumes its decline in the second quarter, that should provide a powerful tailwind for both stocks and bonds. If it persists, that is likely to weigh on asset prices just as it did in February.

Finally, after one of the most rapid policy-rate-tightening campaigns in recent memory, the Fed has signaled that it's close to being done with interest rate increases, thereby removing a material headwind on the economy.[6] Assuming they deliver on that expectation, the odds of a soft landing improve.

Portfolio volatility is stressful for all of us, but if you zoom out to keep a long-term perspective, it's easier to see why author Morgan Housel in *The Psychology of Money* describes volatility as a "fee" and not a fine. Volatility is sometimes the cost of investing—not an indication that investors are doing anything wrong. More importantly, that fee is not paid unless you sell your investments. We could see more bad news in the coming weeks and months, but history tells us that having a plan to stay invested through volatility can benefit investors over the long run.

Thank you for your trust and partnership. Please do not hesitate to contact us with any questions, comments, or to schedule a portfolio review.

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[6] https://www.federalreserve.gov/mediacenter/files/FOMCpresconf20230322.pdf

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