MID-CONTINENT CAPITAL
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CONSILIUM*
Volume 54 ~ April 2023
*advice; judgment; resolution; wisdom

Potholes on the Road to Recovery

Following a very difficult year for equity and fixed income investors, driven by the Federal Reserve's relentless effort to tighten financial conditions and crush inflation, we entered 2023 with reason to believe the worst of the selling might be over. Put simply, inflation had almost certainly peaked, and a recession was increasingly likely—possibly even imminent. Either way, it was reasonable to believe that the markets had already reflected a great deal of bad news, and then to consider how investors might fare when the Fed inevitably changed course.

Market returns in the month of January certainly gave encouragement to the optimists, with the S&P 500 index rising 6.2% and the Nasdaq Composite rising 10.7%. Good market returns in January historically have been a harbinger of favorable full year results. Stronger-than-expected economic data slightly dented the story in February, but an end to the Fed tightening cycle remained only a question of "when", not "if".

Then, March arrived, and with it the unexpected collapse of Silicon Valley Bank. The most important questions in its wake are whether it is merely the first of a series of important bank failures, and whether it changes the outlook for the year as summarized above. On the first question, we believe strongly that the answer is "no". SVB was unique among banks of its size in its reliance on large, non-FDIC-insured deposits that could move elsewhere on short notice. It also held a large portfolio of government bonds that had fallen in value due to the historic rise in interest rates and could not be sold to satisfy potential withdrawals. In the wake of SVB, other regional banks facing heavy withdrawals are now able to pledge bonds to the Fed at their full face value in return for short-term liquidity. A brief spurt of deposit outflows thus has been brought under control, it appears.

We believe the answer to the second question is also "no", simply because this recent pressure on regional banks only increases the likelihood of recession and hastens a reversal in monetary policy. Even without SVB's difficulties spreading across the banking sector, we can expect, all else being equal: reduced lending activity and tighter lending terms to small- and medium-sized businesses (especially already-stressed commercial real estate developers); higher funding costs for banks and reduced profitability; and lower confidence in financial system overall. Goldman Sachs estimates that the effect on the economy will have been similar to the Fed unexpectedly increasing short-term interest rates by half a percentage point.

The *very* long run economic and market implications of yet another bank "bailout" (loosely defined) are much harder to specify, but the understandable instinct to protect *all* depositors (regardless of size or sophistication) will *eventually* come at a cost to the entire economy in terms of strength, efficiency, productivity, and innovation. Gigantic, "systemically important" financial institutions will become even larger (and fall under ever more government control), making their stability an even greater national imperative. As experts in forestry have observed for many years: a policy of total fire suppression raises, rather than lowers, the odds of a larger conflagration later. It may be decades before we know the ultimate cost of financial "safetyism".

It cannot be said enough: we are living through a market and economic cycle unlike anything ever experienced by today's investors, thanks to Covid-19 and our policymakers' response to it. It remains vitally important to keep an open mind about all potential outcomes and not become wedded to a narrative. As discussed at length in our last issue of *Consilium*, this includes overreliance on traditional "playbooks" for investing before and during recessions.

Sources: Goldman Sachs; FactSet