RESTRICTIVE RATE CYCLE IN THE BACKGROUND

Market Review **MARCH 2023**

March gave new insight into the restrictive rate cycle currently in force. Conditions are tight due to consumer price inflation. There are no easy answers on how to regain stable prices. Inflation is very much a monetary problem rooted in the behavior of psychology. However, investors providing loans should not accept a return lower than the future inflation rate. As a result, bondholders will adjust interest rates until a fair return emerges that investors can depend on. Therefore, inflation is what necessitates the restrictive rate cycle.

A tight rate cycle should gradually remove money from circulation, and that process is currently in motion. This country's broad measure of money supply, recognized as the M2 supply, has begun to shrink after many years of expansion. Account balances representing money started to diminish a year ago. The volume of currency created during the pandemic era was massive compared to what has come back out in the last twelve months. How much more needs to come out before prices and wages normalize predictably? That is one macro-related risk that the Federal Reserve is likely monitoring.

Of course, there are unintended consequences in every rate cycle. The consequences can go both ways. When deflationary expectations are present, wasteful spending and speculative asset bubbles can formulate. On the other hand, inflation can bring on deposit destruction and slower growth. Last month, investors witnessed deposit destruction firsthand in March's regional bank crisis. Fortunately, no hard-working American with a bank deposit lost money. The Federal Deposit Insurance Corp. backstopped deposits above the standard regulatory limit. However, the stock and bondholders of failed regional banks and banks acquired by a stronger competitor will receive losses from the weaker institutions. But at least the crisis remains contained inside the private sector, with minimal assistance needed from the public sector. A private consortium of eleven banks raised thirty trillion to prevent a third bank failure from happening in March.

Higher interest rates can quickly help reveal where the toxic assets live and who made poor investment allocations. Maybe this is what the saying "when the tide goes out, investors get to see who's swimming naked" is meant to convey. The two regional banks that failed in March are possibly gone due to poor investment decisions and mismanagement of matching creditor liabilities. When expectations cause interest rates to

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increase, the value of the loans representing bank assets are no longer accurate and can cause serious problems if interest rate risk isn't properly hedged. One of Fed Chair Powell's statements in March noted that the Federal Open Market Committee has been entirely transparent about the institution's intentions since restrictive policies started. Regardless, a deterioration in bank collateral based on standards of quality or marketability forced depositors (creditors) to withdraw money from weaker banks, leading to the recent bank failures.

In addition to substandard conditions related to bank assets, elevated interest rates on short-term maturity government debt are likely another factor taking bank deposits out of the monetary system. The current attractiveness of relatively safe debt is removing some of the loanable capital from private sector use. The higher interest rates are helping to finance public deficits. Consequently, the government may gain in size due to the growing debt and create less room for the private sector to pursue innovation. The government can try to use deficits to encourage growth. However, if debt costs rise to unsustainable deficit levels, it can dramatically increase the uncertainty of the future price level because unsustainable spending can lead to further deficits down the road. Fortunately, other powerful forces allow the US to finance budget deficits, such as the current account trade imbalance.

This ongoing restrictive rate cycle seems to be starting to show its age. Money balances have retraced by a small margin and private-sector deposit growth seems to be slowing in response. A common narrative is that the restrictive monetary policy will result in a recession that will force the Federal Reserve to reverse course and ease rates. As a result, long-duration bonds and technology stocks are regaining popularity in anticipation that restrictive policies will end and create excessive disinflation. Soft landing or not, the economic implications are not totally clear yet. With that said, proper diversification and disciplined investment processes are key investing principles in this current financial landscape.

Asset Categories	US STOCKS	FOREIGN STOCKS	US BONDS	FOREIGN BONDS	HARD ASSETS	HYBRIDS
Monthly	-1.35%	2.09%	1.62%	1.73%	1.97%	-2.95%
Year to Date	4.08%	6.53%	3.03%	2.20%	3.66%	1.53%

*DATA USED IS SOURCED FROM MORNINGSTAR®, DATE ENDING MARCH 31, 2023

US STOCKS

US Stocks experienced aggregate losses in March due to weakness in the small and mid-cap category averages. The large-cap category average performed well, earning 2.42% for investors last month. Large caps possess 5.67% year-to-date as a category return. Regional bank stocks are more common in small and mid-cap categories, which may explain why investors sold those business risks last month. Small-caps declined -4.27%, and mid-caps fell -2.19% in March, but both categories have returned approximately 3.30% since the beginning of the year.

FOREIGN STOCKS

Foreign Stocks performed well in March despite troubles associated with international bank shares. The Developed large-cap category average earned 2.58% in March, raising the year-to-date return to 7.79%. Small-cap categories also performed, generating 1.04% in March and 6.95% year-to-date. Finally, the emerging market category average produced 2.66% last month and 4.83% year-to-date. Foreign stocks have generally outperformed the US counterparts more recently, which is a new trend relative to the last several years.

US BONDS

US Bonds returns moved higher in March, beyond the income return. Quality assets came into favor last month; the government and corporate category averages captured 2.29% and 2.46%, respectively. Year-to-date returns are 2.67% for the government category average and 3.53% representing corporate fixed income. However, the income returns on high yield helped the asset obtain 0.84% in March and 3.15% year-to-date. Despite this time of decelerating inflation, inflation-protected bonds performed well last month as well.

FOREIGN BONDS

Foreign Bonds were another category of strength in March. The Global bond category average returned 2.70% on a total return basis. Global bond returns remain positive this year, with 2.58% as the year-to-date return. Emerging market category averages grew 0.77%. The elevated interest income yield from emerging market debt is helping to sustain positive total return this year. Year-to-date returns on the emerging market category average are now 1.82%.

HARD ASSETS

Hard Assets returned 1.97% in March. However, the gains are entirely attributable to a 13.51% monthly return in the precious metals category average. In addition, last month's change to precious metal prices has advanced the category average to 10.16% year-to-date gains. Real estate category averages were among the biggest losers in March, declining roughly -2.45%. The energy category average stayed relatively flat. Real estate and energy have experienced modest year-to-date gains this year.

HYBRIDS

Hybrid Assets suffered in March due to the preferred stock sector, since financial institutions are the primary issuers of preferred stock. Unfortunately, the preferred stock asset wasn't immune to the sector's cumulative losses. The preferred category average lost -6.00% in March and, as a result, its year-to-date returns slimmed to 0.40%. The convertible bond category average, however, ended last month flat, maintaining year-to-date returns of 2.67%.

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