CHIEF INVESTMENT OFFICE

Investment Insights

The Steps To Eventual Stability

March 2023

All data, projections and opinions are as of the date of this report and subject to change.

AUTHORED BY:

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Data as of March 15, 2023

The chain of events of the past week has created a cascading effect around the globe. Financial market stress and concerns over liquidity have increased significantly. Market volatility has spiked sharply while "stress" indicators have widened out. This has happened in a matter of days. There were numerous examples of episodes like this in the past few decades. After a period of time, volatility subsided, key indicators settled down to more normal levels, and the derisking episode ultimately ended. Below, we highlight five general steps needed, as well as key indicators to watch, for stability to eventually develop and the next upturn to begin. During this time of outsized concern, we believe it is an opportune time to reassess your investment and portfolio strategy and have plans ready for steadier times ahead.

Step One: Liquidity

- The authorities in the U.S. have already recently deployed some of their monetary tools to provide the necessary liquidity if needed.
- The Bank Term Funding Program (BTFP) was created to support eligible depository institutions and their balance sheets by creating an orderly asset pledging process if capital needs to be raised.
- This, is in our view, is the first step to instill confidence and provide the appropriate liquidity which helps stabilize asset prices from a market perspective.
- We believe similar facilities are likely to be created outside the U.S.
- Longer-term, private market liquidity in the form of investor segments will likely become the liquidity providers as asset prices settle down to more stable and attractive prices given the level of risk.

Step Two: Clear Communication

- The monetary authorities, led by the U.S. Federal Reserve (Fed), are walking on a tightrope regarding price stability on the one hand and financial stability on the other.
- In the coming weeks and over the course of the next few meetings, the Fed will likely lay out a path that attempts to manage both "mandates".
- The sudden financial stress could lead to a sharper fall in inflation in the coming months as financial conditions tighten more acutely. Longer-term, inflation could rise back above the Fed's target due to wider deficits.
- Clear, concise messaging on an ongoing basis will be needed, in our opinion, to help with both "mandates".

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Step Three: Portfolio Repositioning To Subside

- The recent chain of financial stress events has created derisking events across asset classes, capital and currency markets.
- This is occurring as rates have sharply increased in the past year and the yield curve deeply inverted (short rates rose above longer-term rates).
- Derisking leads to changes in overall portfolio positioning in which a period of risk-off ensues. This is happening now.
- Episodes like this can have significant effects on the level of yields, valuation, changes to sector composition in Equities, and the cost of protecting risk.
- Portfolio repositioning that is too sharp can also have an opportunity cost if the stress environment ends abruptly without clarity.
- We expect the current volatility induced repositioning to subside initially in the next few weeks, but we believe the next period could build, albeit with less stress, as the economic effect is fully assessed.

Step Four: Understanding The Impact

- After derisking episodes, generally, a period of impact assessment occurs over the course of the year.
- Assessing the impact to capital flows is important
  - From the banking system to capital markets
  - Private market financing and funding
  - Investment flows across risk assets and sub-asset classes
- Economic impact
  - The impact to the level of overall growth and the type of potential recession
  - Financial conditions more broadly
  - The shift in inflation dynamics
  - Employment trends
- Profit forecasts
  - The impact to earnings in the “new” environment
  - Corporate margin trends
  - An assessment of the leaders of the next cycle

Step Five: Reset Ends

- From derisking and assessment to the creation of a new cycle
- Negative estimate revisions end
- Yield curve becomes more normal
- Leading indicators bottom out
- The next upturn builds with new leaders as investors climb the “wall of worry”

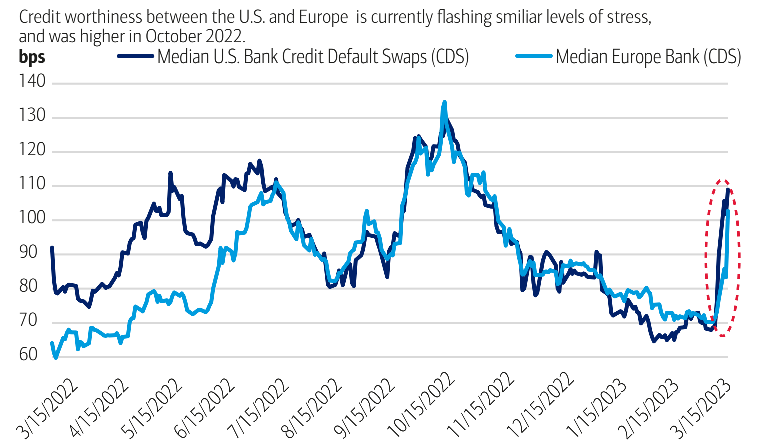
Through the evolution of these five steps, we expect markets to be under various degrees of fragility. We would wait for the outsized volatility to subside before increasing risk in general. However, we do believe now is not the time to take outsized risks and we continue to emphasize a more measured approach to asset allocation.

The following key indicators and gauges can help assess where we are in the five steps and ultimately a potential timeframe before stability develops and the capital markets return to some level of normalcy. We continue to emphasize higher-quality investments within Equities and Fixed Income and a high level of diversification overall. As the uncertainty fades, we expect a new long-term bull market to be created as corporate earnings growth turns positive, investor sentiment shifts for the better, and asset prices are at more attractive levels.

Exhibit 1A: Bloomberg Short-term Bank Yield vs. Overnight Index Swaps.

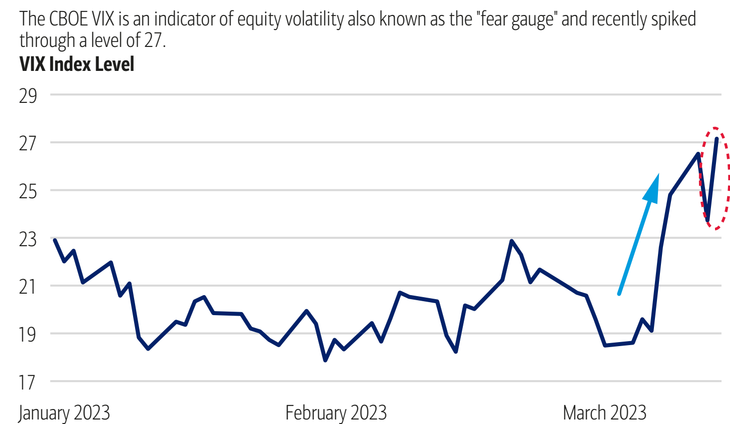
Source: Bloomberg. Data as of March 15, 2023.

Exhibit 1B: Bank Credit Default Swaps: U.S. vs. Europe.



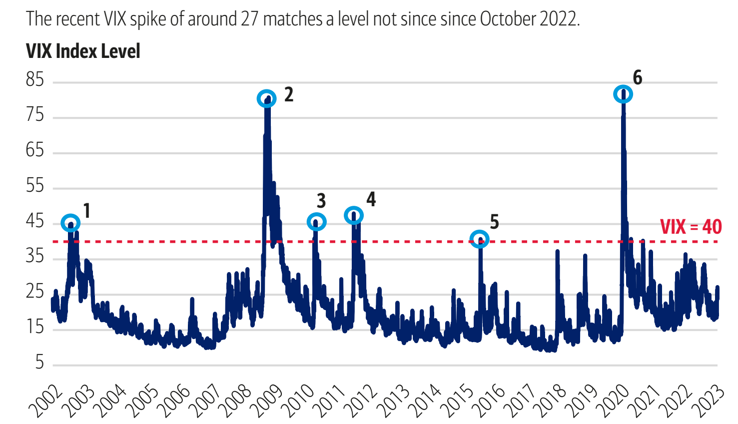
Median aggregates are six largest banks. U.S. median aggregate: Bank of America, Wells Fargo, JPMorgan, Citigroup, Morgan Stanley and Goldman Sachs. Europe median aggregate: Barclays, HSBC, Credit Suisse, Societe Generale, Deutsche Bank, BNP Paribas. Source: Bloomberg. Data as of March 15, 2023.

Exhibit 2A: A Recent Spike In The CBOE VIX*.



*Chicago Board Options Exchange Volatility Index. Source: Bloomberg. Data as of March 15, 2023. Data would differ if a different time period was displayed. Short-term performance shown to illustrate more recent trend. **Indexes are unmanaged and do not take into account fees or expenses. It is not possible to invest directly in an index. Please see index definitions at the end of this presentation. Past performance is no guarantee of future results.**

Exhibit 2B: A Longer-term View Confirms The VIX Spikes Around Significant Events.

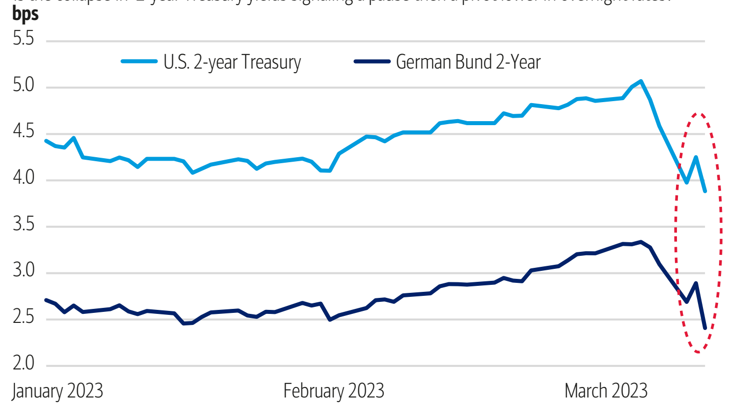


Note: The numbered bear markets correspond to the following events: 1) Post dot-com bubble, 2) Global financial crisis, 3) Europe sovereign debt crisis, 4) U.S. credit downgrade, 5) China currency devaluation, 6) Pandemic. Sources: Bloomberg; Yardeni. Data as of March 15, 2023. **Please see index definitions at the end of this presentation. Past performance is no guarantee of future results.**

Exhibit 3A: Oil Hits The Lowest Level This Year.

New York Mercantile Exchange CL1 Commodity Ticker. Source: Bloomberg. Data as of March 15, 2023. Data would differ if a different time period was displayed. Short-term performance shown to illustrate more recent trend. **Please see index definitions at the end of this presentation. Past performance is no guarantee of future results.**

Exhibit 3B: Year-to-Date 2-year Treasury and 2-year German Bunds.



Source: Bloomberg. Data as of March 15, 2023. Data would differ if a different time period was displayed. Short-term performance shown to illustrate more recent trend **Please see index definitions at the end of this presentation. Past performance is no guarantee of future results.**

Index Definitions

Securities indexes assume reinvestment of all distributions and interest payments. Indexes are unmanaged and do not take into account fees or expenses. It is not possible to invest directly in an index. Indexes are all based in U.S. dollars.

S&P 500 Index includes a representative sample of 500 leading companies in leading industries of the U.S. economy. Although the index focuses on the large-cap segment of the market, with approximately 75% coverage of U.S. equities, it is also an ideal proxy for the total market.

Bloomberg Short-term Bank Yield provides a series of credit sensitive reference rates that incorporate bank credit spreads and defines a forward term structure.

Overnight Index Swaps is an interest rate swap over some given term.

Chicago Board Options Exchange Volatility Index is a real-time market index representing the market's expectations for volatility over the coming 30 days.

2-year Treasury/Bloomberg U.S. Treasury Bond Index is an unmanaged index of prices of U.S. Treasury bonds with maturities of 1 to 30 years.

2-year German Bunds is a fixed-interest, euro-denominated security issued by Germany's federal government to fund its debt.

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