

Recent market volatility and impact on the banking sector

Recent market events have caused heightened volatility in both the equity and bond markets. These include the Federal Reserve's (Fed's) hawkish comments on keeping interest rates restrictive for longer on February 12, contrary to prior market pricing, failures of several US regional banks (Signature Bank and Silicon Valley Bank) and bouts of issues in the European banking sector. Broader market implications are quickly unfolding, and we discuss our views based on current developments and potential impacts on global capital markets and Freedom portfolio positioning.

FREEDOM PORTFOLIO POSITIONING

Freedom portfolios are designed with well-diversified asset allocations that can endure volatile periods of market cycles, on the foundation of prudent risk management and enhanced by systematic manager selections. Freedom portfolios have attempted to maintain a lower-than-normal risk stance with an allocation in defensive sectors of the equity market and an overweight in the high-quality intermediate maturity bond sectors.

ARE WE LOOKING AT A REGIONAL BANKING CRISIS IN THE US?

It's always dangerous to say this time is different. However, the issue at present indeed rhymes a different tune than the traditional credit led crisis seen throughout US financial history. Rather than reckless lending, which caused lousy credit quality combined with insufficient capital reserve levels, the banking sector today have sound balance sheets and adequate reserve and capital status. The extreme cases of deposit concentration as well as gross mismanagement of short-term deposits and long-duration securities portfolio of select banks are not representative of wide-spread solvency issues. We believe the root of the issue lies on the profitability and liquidity side, where a combination of banks selling or collateralizing their securities portfolios and/or increase deposit rates could address during normal conditions.

KEY TAKEAWAYS

Freedom portfolios have attempted to maintain a lower-than-normal risk stance with an allocation in defensive sectors of the equity market and an overweight in the high-quality intermediate maturity bond sectors.

Rapid increases in interest rates have always had major impacts on the economy and the financial markets in past tightening cycles, this time especially so with the world accustomed to decades of easy monetary policy and flush liquidity.

But recent developments of the continued deposit outflows from regional banks is starting to show signs of impairment in both investor confidence and more broadly the lending function of the collective regional banking system. In the most recent week, banks borrowed a combined \$156 billion from the Federal Reserve (Fed) backstop facilities to fund their deposit redemption needs, which was second only to the high of \$440 billion seen during the 2008 financial crisis (Graph 1). At the same time, net inflows to US money market funds totaled more than \$120 billion in a single week as investors seek safer and higher yielding shelters for their cash. The bank failures exacerbated the trends already in place prior and could lead to a meaningful contraction of credit availability for small- to mid-sized companies, especially in residential and commercial real estate loans where they rely on localized and specialized lending sources in the community. The slowing in credit creation and business activities, despite still resilient consumer demand, will likely further dampen economic growth in the US in the next few quarters.

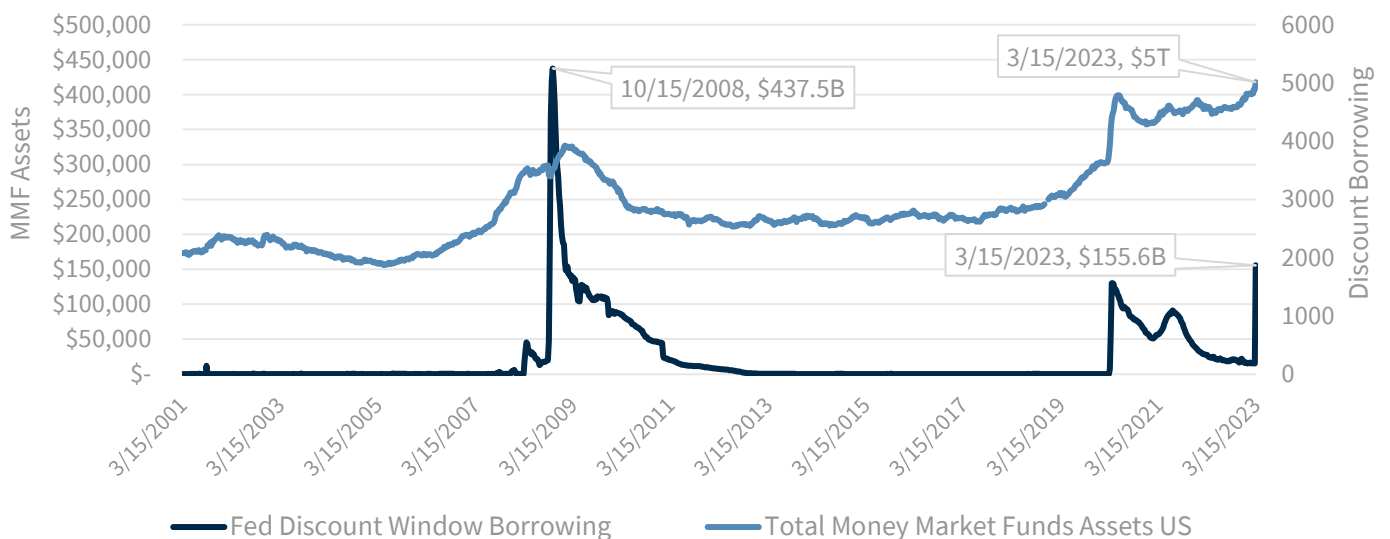
Confidence is gold, especially for the financial system which is built fundamentally on credit. We are seeing a divergence of the systematically important mega banks versus the regional banks as depositors flock to the former, realizing their role could involve credit risks if they choose to deposit with the “other banks” above the FDIC insurance limit of \$250,000. With much less short-term assets to deploy, the regional banks are faced with a confidence test as they continue to use the Fed’s program to meet redemption demands. The recently announced \$30 billion deposit into First Republic Bank from 11 big banks is a welcome

gesture, but we remain cautious as this does not quite address the root cause with depositors making the economical decision to move funds, particularly with the ease of electronic banking and much faster spread of information through social media compared to the last era of banking.

Rapid increases in interest rates have always had major impacts on the economy and the financial markets in past tightening cycles, this time especially so with the world accustomed to decades of easy monetary policy and flush liquidity. This is the reason behind the saying that the Fed will “hike until something breaks.” Companies with weak balance sheets and lax risk management measures will be at the forefront of higher financing costs and liquidity mismatch conditions as the monetary tide subsides.

The usual playbook points to a swift pivot in the Fed’s policy making where they will prioritize the financial stability issues since the stress itself would likely tighten financial conditions enough, and then embark on a rate cut journey. We do not view the current episode to be extreme in its current form and the playbook is slightly different as the Fed’s reaction function has changed. We’ve talked about the Fed being in a “Zugzwang,” which is a chess term describing a tough place to be, because they must choose to compromise one of their missions for the other – bring down economic growth to achieve low and stable inflation. With core and service inflation still stubbornly high despite headline inflation softness, we expect the window for the Fed to pause rate hikes to be later in the year rather than now.

Graph 1: Banks Borrowing to Meet Deposit Outflows



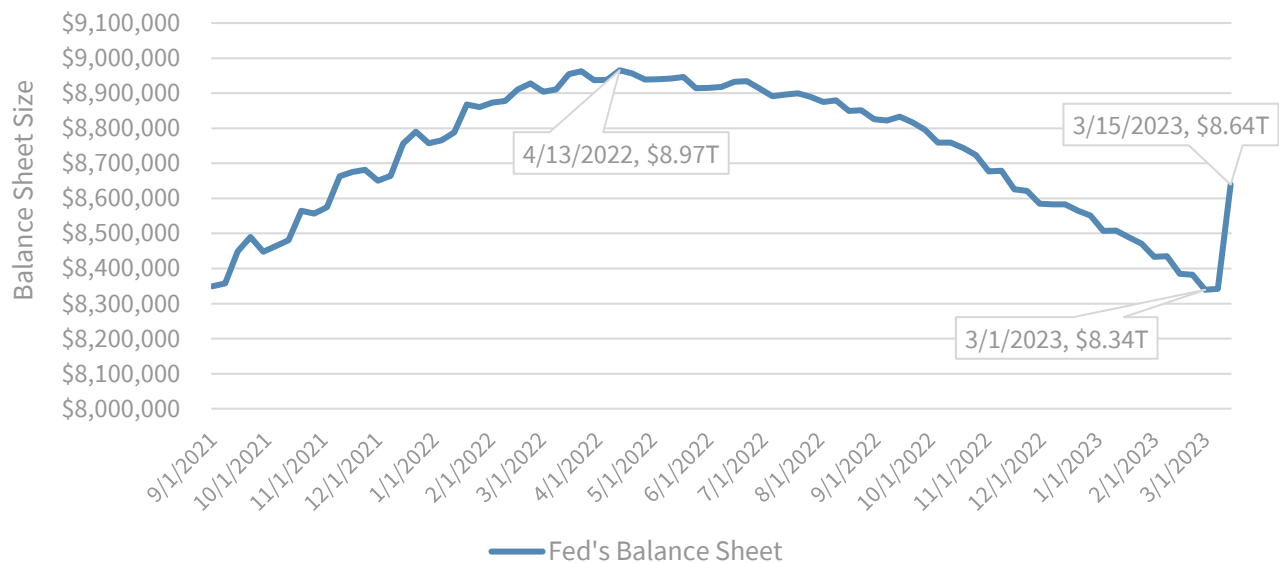
Graph source: Federal Reserve

Over the past week, the Federal Reserve's balance sheet ballooned almost \$300 billion as banks were posting securities for cash. This has reversed nearly half of all the quantitative tightening conducted in the past year (*Graph 2*). This shows both the ongoing need from regional banks as they face a liquidity crunch, as well as the counterintuitive support from the Fed as they use their balance sheet to provide liquidity and address stability issues despite an overall tight monetary policy stance.

The Fed hiked benchmark interest rates by another 0.25% this week as expected. We believe they are at or very close to a sufficiently restrictive monetary policy stance and they will potentially pause rate hikes and allow the restrictive conditions to work through the economy with time to bring down demand and

core inflation with it. The European Central Bank was faced with a similar challenge last week as they decided to hike rates 50 basis points while remaining committed to further data releases. The swift and unconventional merger of UBS and Credit Swiss Group AG over the weekend, along with increased dollar fundings between the Fed and five other major developed central banks have provided support and served as the major backstop to ease global funding stress. We believe recent events have magnified the difficulty for central banks to engineer soft landings, but the paths to travel there remain unchanged short of any sudden and severe further deterioration of global market conditions.

Graph 2: Federal Reserve's Balance Sheet



WHAT ARE LIKELY SCENARIOS AND HOW WILL IT IMPACT THE MARKET?

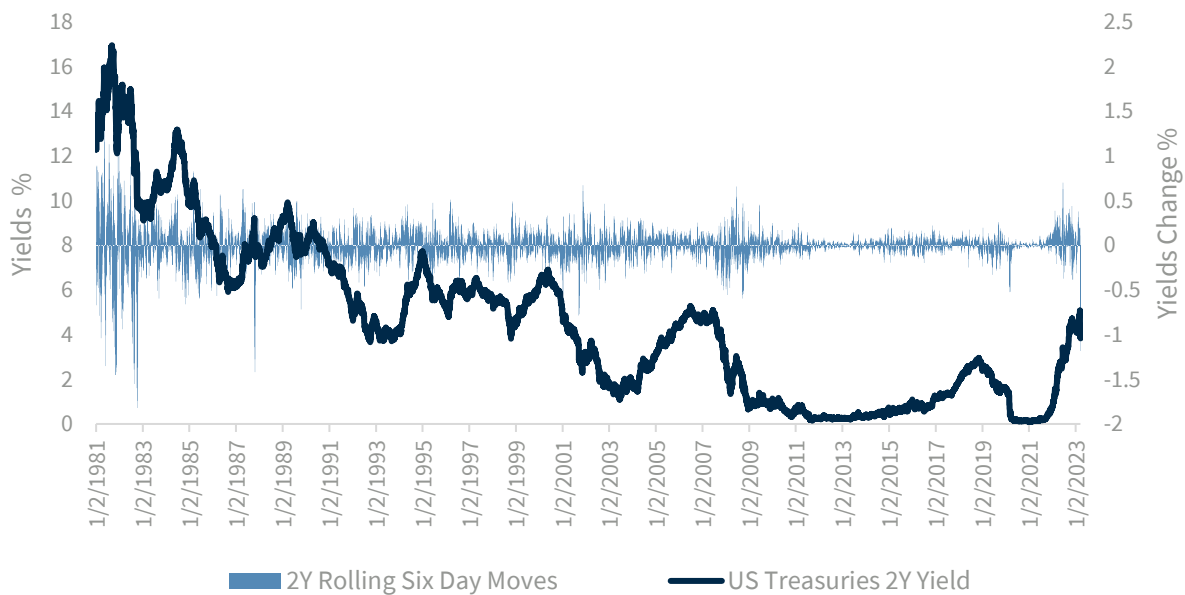
Absent a sudden reverse of deposit outflows, which we believe is less likely as confidence tends to have a self-fulfilling tendency and the short-term interest rates will probably remain higher than the average deposit rates offered, the current stress in the regional banking system will exert pressure in both economic activities and stability of the broader financial system. The bond market has reacted dramatically with US two-year Treasury rates dropping more than 100 basis points in six days, which was the biggest move since the week of 10/26/1987 remembered as the Black Monday (*Graph 3*). This move is exacerbated by the thin liquidity and extreme short positioning in the two-year bond

market, nevertheless, shows an increased risk premium for expected weakness ahead for the economy if this issue is left unchecked for an extended period.

Bond yields in major developed countries also dropped, pushing Treasuries security prices up along with safe-haven assets, such as gold. Equity market has been largely resilient with unusually wide intraday swings, which can be primarily attributed to the hope that monetary policy will be reverted to easy mode again. Secondary effects, such as trading of options with extremely short expirations, also played a role. However, the widening of credit spreads for corporate bonds and reversal of the yield curve steepness paints a cautionary sign for an increased probability of a recession later this year.

Graph source: Federal Reserve

Graph 3: US 2 Year Treasury Dropping the Most since 1987



We expect the mostly likely scenario to be further policy reactions should the current trends continue, which could include temporary measures that provide an implicit form of universal deposit insurance without the current \$250,000 limit, and potentially a collective effort by the banking sector to raise deposit rates to further attract funding and capital. Stop-gap measures could emerge in the interim but effective policies that address the root causes should be welcome, earlier rather than later. This will hurt the profitability of the banking sector over the longer term but could stem the leak and restore investor confidence.

We anticipate continued volatility and whipsaws of the market until the efficacy of additional policies kicks in. Despite the large underperformance of the banking sector, which saw a loss of 24% in excess of the broad S&P index since March, we are cautious in taking advantage of the cheapened valuation opportunity until catalysts emerge. Small- and mid-cap stocks, along with value stocks have been punished due to the higher concentration in the banking sector while growth stocks have been performing well as interest rates retreated. We expect with this cycle the Fed has a tough job where inflation remains the linchpin of their policy and

the bigger of two evils. Until core inflation decisively steps down, they will potentially resolve to ringfencing measures to isolate the cracks and stabilize the issues in the financial system as they emerge. Currently, the equity market offers a fair to slightly rich valuation for the risks imbedded, especially as earnings revisions continue to deteriorate.

Freedom portfolios continue to be positioned conservatively, especially after the most recent trades to trim the equity overweight to a neutral position and add to high quality US fixed income sectors. Historically, from the last rate hike throughout the pause period, the S&P enjoyed a healthy return of 5.5% while the bond market also returned an average of 4.8%.¹ Our investment committee continues to monitor incoming data to decide the best allocations and manager selections for all Freedom portfolios. Well-diversified, risk-managed portfolios and skilled managers investing in high quality companies weathering various market cycles, along with investor patience we expect to be rewarded in this volatile market. Please reach out to your financial advisor if you have any questions on your Freedom investments.

Graph source: Bloomberg

¹Average total return figures based on 10 instances when Fed hiked interest rates and then paused before lowering rates since 1974.

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