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MARKET COMMENTARY

THE ONLY WAY OUT IS THROUGH

In our most recent *Market Commentary*, we described our outlook for 2023 as "a puddle of muddle." We highlighted that earnings forecasts seemed optimistic, valuations weren't particularly attractive and a recession appeared more likely than not. True, inflation was moderating, but was still in excess of the Fed Funds rate and thus hopes for a Fed Pivot struck us as premature. Consequently, we entered 2023 with "subdued expectations and a defensive posture."

By January, that caution seemed unwarranted as the S&P 500 rose 6% and the Nasdaq had its best start to a year since 2001. 10-Year US treasury rates had been in steady decline since October and inflation data could be categorized as 'less bad.' To many, that sounds an awful lot like a soft landing. To be clear, we've never said it was impossible, just unlikely, and whether it was a bear market bounce or the end of tax-loss selling, January felt as if Jay Powell, Chair of the Federal Reserve, might actually pull it off.

In February, inflation came in hotter than expected and jobs data rose sharply, both of which argue for more restrictive policy. Ever data dependent, Powell gave a speech that the Fed was considering hiking by 50 basis points, twice the increase of the previous meeting. Suddenly, the soft-landing narrative began to look a tad suspect.

March brought its own set of issues. Many economists are fond of saying that the Fed hikes until something breaks. It's difficult to identify a culprit ahead of the fact, but on March 8th, Silicon Valley Bank announced it had sold a sizable portion of its securities portfolio at a loss and was attempting to raise equity to improve liquidity. Interest rate mismanagement and persistent deposit outflows left a hole in their balance sheet. Depositors lost confidence, triggering a run that culminated in the largest bank failure since 2008. Over the next few days, several other regional banks required intervention and Credit Suisse found itself an involuntary participant in a fire sale.

Any bank failure is likely to invite comparison to 2008-2009, and while the causes were different (duration as opposed to credit) the reply is typically the same. Is this the beginning of a credit crisis? We don't think so. Many banks are facing deposit outflows and unrealized losses, but few are of the magnitude of those that failed. A more pertinent question is how will it impact the economy? We suspect it will curtail loan growth, tighten underwriting standards and reduce credit availability for borrowers large and small.

Pundits are eagerly hunting for the next shoe to drop, whether that's regional banking, commercial real estate or the leveraged loan market. While it's tempting to guess tomorrow's headlines, we prefer to spend our energy reviewing what we already own, diligently stress testing the balance sheets, liquidity profiles and interest rate sensitivity of our portfolios. Because access to credit may become more difficult, we prefer companies that control their own destiny and aren't reliant upon debt markets for their success.

Markets appear to have been anxiously awaiting a reprieve from rising interest rates, and many suspect bank failures could stay the Fed's hand. Expectations for future rate hikes have declined and major U.S. equity markets have been rising. While we do agree that we're closer to the end of the hiking cycle than the beginning, we're concerned that a pause in rate increases would coincide with a weaker economy and possibly end in a wash.

Complicating this math is that unemployment in January hit 3.4%, the lowest in five decades. While recessions are frequently accompanied by rising unemployment, a robust labor market suggests that the much-predicted recession could actually be quite mild. If that's the case, we believe it could turn out not to be a soft landing, but softish.

So, despite a lot happening in the past three months, our description of 2023 remains the same. We have subdued expectations and a defensive posture. Things can and do change quickly and we are actively filling our on-deck list with new ideas. While volatility rarely feels good in the moment, it often presents opportunities. You've heard us say that a long time horizon can be an investor's most significant advantage and we're investing your capital accordingly. We thank you for your business and should you have any questions, please don't hesitate to reach out to your Relationship Manager.

Sincerely,

Bridges Trust Investment Committee

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