March 20, 2023

MARKET COMMENTARY

The Increasing Likelihood of Unlikely Events

We learned a few things about the US economy over the last week:

1. Despite passing the one-year anniversary of Fed rate hikes, inflation remains embedded in the economy at 5-6%. Signs of disinflation have eroded since late 2022.
2. Economic growth remains robust and above trend. Now model estimates annualized real GDP growth of 3.2% for January-March 2023.
3. The labor market shows very little sign of loosening. Initial jobless claims remain at historically low levels.
4. Housing starts, a leading indicator for the economy, continue to rebound.

In isolation, current economic data would indicate a 50bps rate hike at the Fed's meeting next week and hawkish rhetoric from Chair Powell. But, as everyone knows, high growth and inflation are no longer operating in isolation.

Financial Stability > Price Stability (for now)

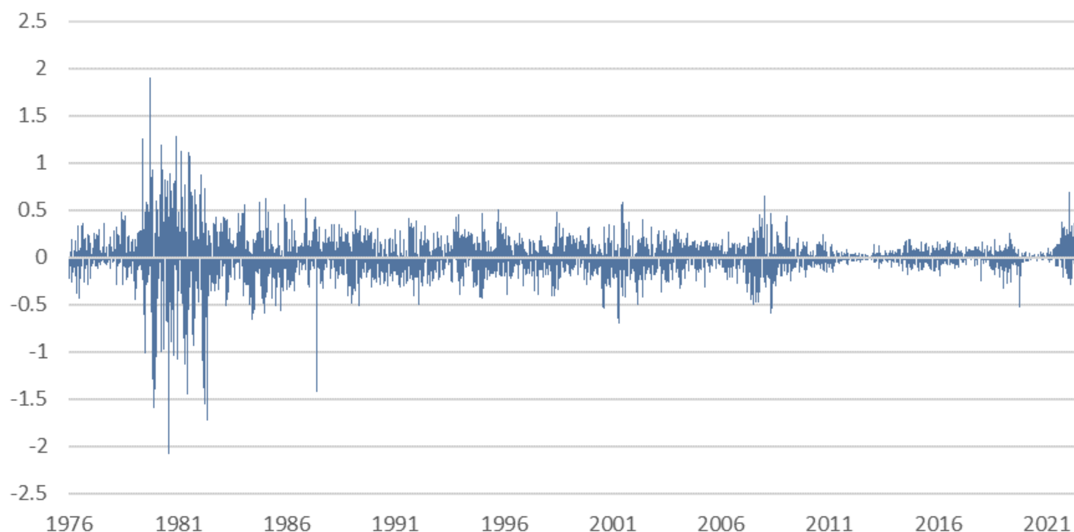
The ongoing stress in the banking system will likely lead the Fed not to hike or only hike 25bps this week to promote financial stability. This doesn't mean hikes are over and there is precedent for a temporary pause during a hiking cycle. In 1994, Alan Greenspan oversaw a 75bps hike in November, did not raise rates in December, and then hiked another 50bps in February 1995. At the time, he said:

"All in all, if we decided that we needed to move the funds rate up at this meeting, which I don't support I must say, I doubt very much that that would have a negative effect on economic activity. I think the economy's momentum is still quite strong. I do worry, however, with or without the Orange County turmoil and the usual end-of-year problems, whether we would be taking undue risks in endeavoring to tighten in this environment. I think that the odds that we are going to have to move shortly after the first of the year…"

That being said, the Fed has taken great pains to separate its price stability (inflation) and financial stability (banking) policies over the last 28 years. Should Powell want to keep hiking rates, European Central Bank President Christine Lagarde paved the way last week by making a clear statement that there "is no tradeoff between price stability and financial stability" while hiking policy rates 50bps.

...and there are weeks where decades happen.

Fig. 1: Five-day yield change
Two-year Treasury Note



Source: Bloomberg, Mill Creek.

The yield on the two-year Treasury Note fell by 1.2% over the five trading days between March 8 and March 15. This was the largest move in the two-year Treasury Note since the mid-1980s and completely unprecedented considering current yields are quite a bit lower than they were in the 1970s and 1980s. Statistically, it was a seven-sigma move – something that should only happen once every billion years or so.

Other parts of the investment world experienced "unlikely" events as well. For example, an index of funds operating trend-following strategies (typically called *managed futures*) declined nearly 8%. This was the second-worst five-day performance since the index was created in January 2000. Trend-following strategies try to ride the momentum of the market and take long positions in assets doing well and short positions in assets doing poorly. Such strategies can do well in certain environments (the same index was up 20% in 2022), but typically struggle when markets shift quickly.

Going forward, we should expect more of these "unlikely events" as market participants and policymakers negotiate competing priorities. An environment of high GDP growth, high inflation, *and* bank failures is without historical precedent and there are seemingly few easy paths remaining for the Fed. They will likely choose between persistent inflation, recession, or a combination of both — and at this point, they are trying to sort out the least painful option.

A Note About FDIC Coverage and Bank Deposits

Speaking of unlikely events, we've received quite a few questions about the safety of bank deposits and FDIC insurance coverage.

The Federal Deposit Insurance Corporation (FDIC) is an independent agency of the United States government that provides insurance coverage for deposits in member banks. The purpose of FDIC insurance is to protect depositors in the event that their bank fails.

Here are some key points to know about FDIC insurance coverage:

1. The standard insurance amount is $250,000 per depositor, per insured bank, for each account ownership category.
2. Deposit accounts covered by FDIC insurance include checking accounts, savings accounts, money market deposit accounts (MMDAs), and certificates of deposit (CDs).
3. FDIC insurance does not cover investments in stocks, bonds, mutual funds, life insurance policies, annuities, or municipal securities.
4. FDIC insurance coverage is automatic and does not require depositors to apply for coverage.
5. FDIC insurance covers both principal and any accrued interest up to the insurance limit.
6. FDIC insurance is backed by the full faith and credit of the United States government.
7. Deposits at different branches of the same bank are not separately insured.
8. Payable-on-death (POD) accounts are covered by FDIC insurance up to the standard insurance amount of $250,000 per depositor, per insured bank, for each account ownership category. It's important to note that if multiple beneficiaries are named on a POD account, the insurance coverage is based on the proportion of the account balance each beneficiary is entitled to receive.

The FDIC and US Treasury invoked the "systemic risk exception" to guarantee all deposits at Silicon Valley Bank and Signature Bank, but last week Treasury Secretary Yellen made it clear at the Senate Banking Committee that such an exception would not necessarily apply to all regional and community banks. It seems doubtful that the FDIC would protect depositors at Silicon Valley Bank (mainly venture capitalists and the tech industry that spent the weekend lobbying for a bailout) and Signature Bank (who had former chairman of the House Financial Services Committee Barney Frank on the board), but not depositors at similarly sized institutions servicing farmers or those without deep political connections, but we should take Secretary Yellen at her word.

Related to concerns about bank deposits, we find that the term *money market* is used far too imprecisely when discussing investment products. Money market deposit accounts and money market funds are very different animals. MMDAs are bank deposit accounts insured by the FDIC, while money market funds are investment products that are not insured. The main risk in a money market fund is the underlying investment risk – typically short-term, low-risk securities such as government bonds, certificates of deposit, and commercial paper.

We generally segment cash holdings into *transactional cash* and *investment cash*. Transactional cash can be accessed immediately: checking, savings, and money market deposit accounts. They are generally covered by FDIC insurance but are underlying credit risks of the issuing institution. Investment cash options are money market funds, exchange-traded funds, and mutual funds that hold short-term low-risk securities. Investment cash options do not have FDIC insurance but are also not subject to the creditworthiness of an issuing bank.

Our investment officers monitor cash positions within client accounts daily and are always available to discuss the various trade-offs inherent in holding cash balances.

QUICK LINKS

- House View Summary
- Move Quickly and Break Things
- Private Remains Resilient Amid Tech Sector Downturn (White Paper)
- March Update: Pivot (again?)

This week's contributor: Michael Crook, CAIA

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