MARKET COMMENTARY

BALANCING ACT: STABILITY, RISK & THE LIQUIDITY DILEMMA

While the market may appear calm, it's important to recognize the potential risks that could disrupt this tranquility. The combination of inflated valuations and a surge in liquidity is a potential catalyst for inflation and reckless investing. It's crucial to maintain a state of vigilance as the situation could rapidly deteriorate, a lesson history has taught us.

FIRE, MEET FUEL

By the end of 2022, America's fortunes had ballooned. At $136 trillion, household net worth was twice what it was a decade earlier. The unemployment rate was at 3.6%, a 53-year low. And economists at the Bureau of Economic Analysis estimated the U.S. economy to be $26 trillion, well beyond what other economists at the Congressional Budget Office estimated to be sustainable ($22 trillion). This wealthy, employed, and large economy was so hot that the Fed had "slammed on the brakes" in 2022 to cool things down by raising interest rates. Despite their best intentions, conditions soon emerged to fan the flames of risk appetite and inflation.

In the spring of 2023, a series of bank troubles began. Silicon Valley Bank, Signature Bank, and First Republic Bank were the first to buckle under the weight of inadequate risk management and higher rates. Other banks would follow. Suddenly, regulators and the Fed had to confront an awkward trade-off: How to provide liquidity to potentially vulnerable banks while keeping policy restrictive enough to bring down inflation. One part of that puzzle was already in place — the Federal Reserve's existing reverse repo facility.

REVERSE REPO 101

When banks need cash, the Fed can provide it by temporarily exchanging needed cash for assets. This exchange is called a "repo." When banks have too much cash and need assets, the Fed can provide that, too. All that happens is the Fed temporarily takes bank cash in exchange for assets such as Treasury securities.

As 'repos' increased, the Fed injected more cash into the system. Conversely, as 'reverse repos' grew, the Fed drained cash from the system. By 2021, banks were flush with cash (deposits from COVID-era stimulus checks) and needed collateral (assets) instead. The 'reverse repo' was a strategic move as it allowed the Fed to provide those assets while draining excess cash from the system, thereby managing liquidity and inflation.

By removing excess cash, the money supply would grow more slowly, which would also help cool inflation. The goal of bringing inflation down was necessary because the money supply had surged a record 40% in the two-and-a-half years following the pandemic's onset, helping drive a 16% cumulative price rise in the Consumer Price Index (CPI).

However, all this went into reverse once banks started to struggle in early 2023.

FULL REVERSE!

Out of the blue, headlines emerged in the spring of 2023 that some American banks were in trouble. Silicon Valley Bank, Signature Bank, and First Republic failed following a record rise in interest rates in 2022. Instead of removing cash from the banks to address inflation, the Federal Reserve coordinated with banks and others to provide liquidity. The $2.5 trillion of reserves accumulated in the Fed's Reverse Repo Facility began to decline. Initially designed to absorb liquidity, reverse repos now provide liquidity to banks and non-banks, likely contributing to higher-than-would-be-otherwise levels of risk-taking in markets. Today, we see the facility has seen outflows of $1.8 trillion in the past year, providing ample liquidity to the system (Chart A, page 4).

Shortly after the Fed's facility began to run in reverse, signals of bank stress faded, and financial markets suddenly began to embrace risk. Risk assets rose strongly, and premiums for assuming risk began to shrink.

Today, credit and equity risk premiums are near cycle lows. And inflation has stopped falling, too. After inflation expectations fell to under 2% last summer, they have climbed to almost 4% through last month. The steady progress in the consumer price index from 9% to around 3% has also stalled. It is hard to imagine that surging risk appetite, inflation forecasts, and liquidity are not fundamentally connected.

PROGNOSTICATORS IN A PICKLE

Amid the dual challenges of fighting inflation while maintaining market order, policymakers need help to make predictions (Chart B, page 4). In 2021, the Fed failed to predict surging inflation and interest rates in 2022. In mid-2023, the Treasury did not anticipate that surging long-term Treasury rates would force them to do an "about face" on plans to issue more long-term U.S. debt. And just four months ago, the Fed was signaling to markets that rate cuts were just around the corner. But now that is off the table. As Fed Chairman Powell admitted in an April 16 speech, stubborn inflation has caused the Fed to "push off" planned rate cuts.

So, the nation's leading policymakers and prognosticators need to be more knowledgeable about what will happen next, but markets and the economy are just too complex and vexing. Along these lines, JPMorgan Chase Bank's Chairman and CEO, Jamie Dimon, told shareholders last week that investors should prepare for ". . . a very broad range of interest rates, from 2% to 8% or even more, with equally wide-ranging economic outcomes . . ."

PAID FOR RISK?

As you can see, the financial markets are in a complex situation. On the one hand, valuations appear full. Stock valuations are up, causing the equity risk premium to plumb new lows, and optimistic credit markets are helping companies finance business under very attractive terms. (Note: The equity risk premium in Chart C on page 5 is the orange line and it measures the difference between the "earnings yield" and the 10-year Treasury yield. The credit spread is the blue line, and it measures the difference between the yield on the Moody's Baa bond index and the 10-year Treasury yield. In both cases, lower numbers imply less compensation for risk taken, all else being equal).

On the other hand, there seems to be a wider-than-normal range of uncertainty over the future path for inflation, interest rates, and the economy. The juxtaposition of narrow equity and credit risk premiums against widening uncertainty about such crucial assumptions is striking.

WHAT TO DO

We want you to know that Washington Crossing Advisors is prepared for many possible scenarios. Perhaps inflation fails to cool as expected. Maybe interest rates are not done advancing. Or maybe the economy will suffer a slowdown or recession and prices will fall. Politics, trade, energy challenges, and geopolitical risk all can upset the applecart. We know that all of these are plausible outcomes for which we need to be prepared, come what may. So, whether the economy continues to plug along, either with or without inflation, or we hit a bump in the road, we must maintain a relentless focus on finding durable, flexible, and predictable companies that can weather the storm. This is a strategy that has proven itself over time and in tough markets. We think a focus on quality above all else is the best way to navigate whatever comes next.

CHART A | FED'S REVERSE REPO FACILITY (YEAR CHANGE) Source: Federal Reserve, WCA

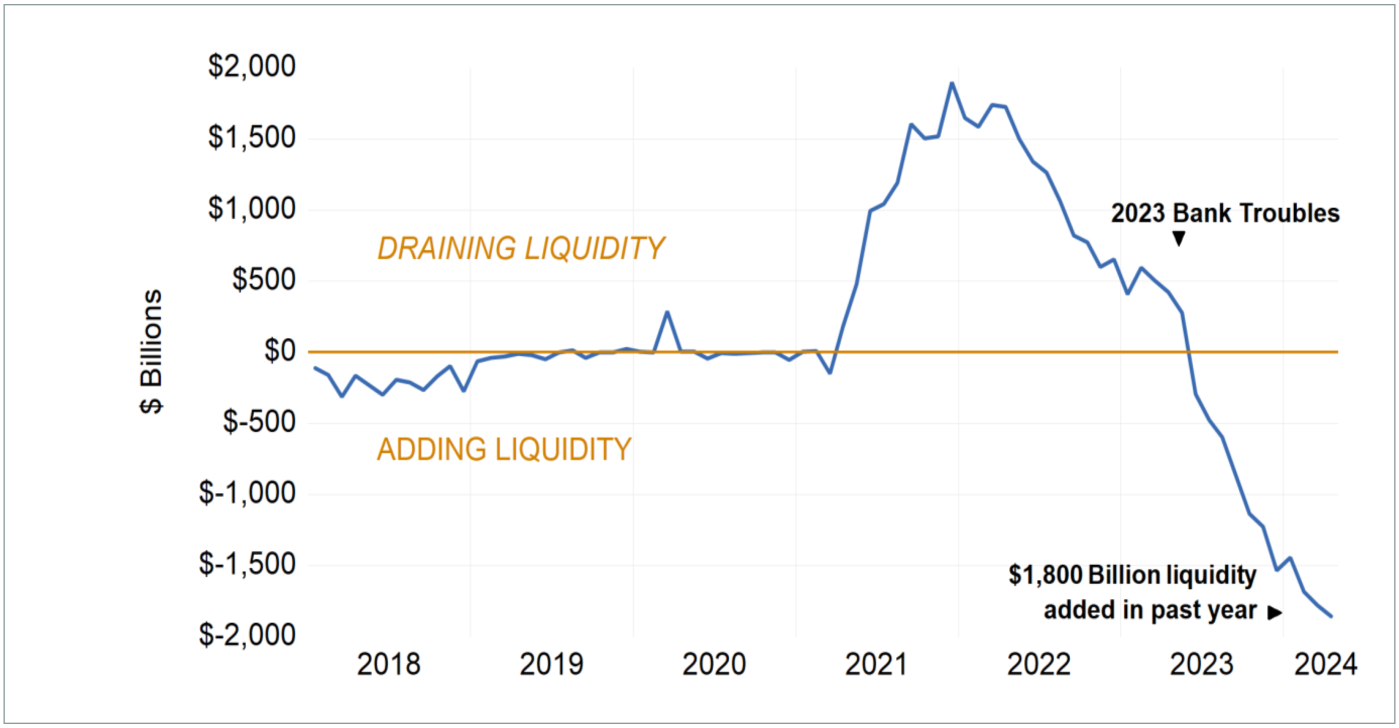


CHART B | 10-YEAR U.S. TREASURY YIELD Source: U.S. Treasury. Federal Reserve, Bloomberg, WCA

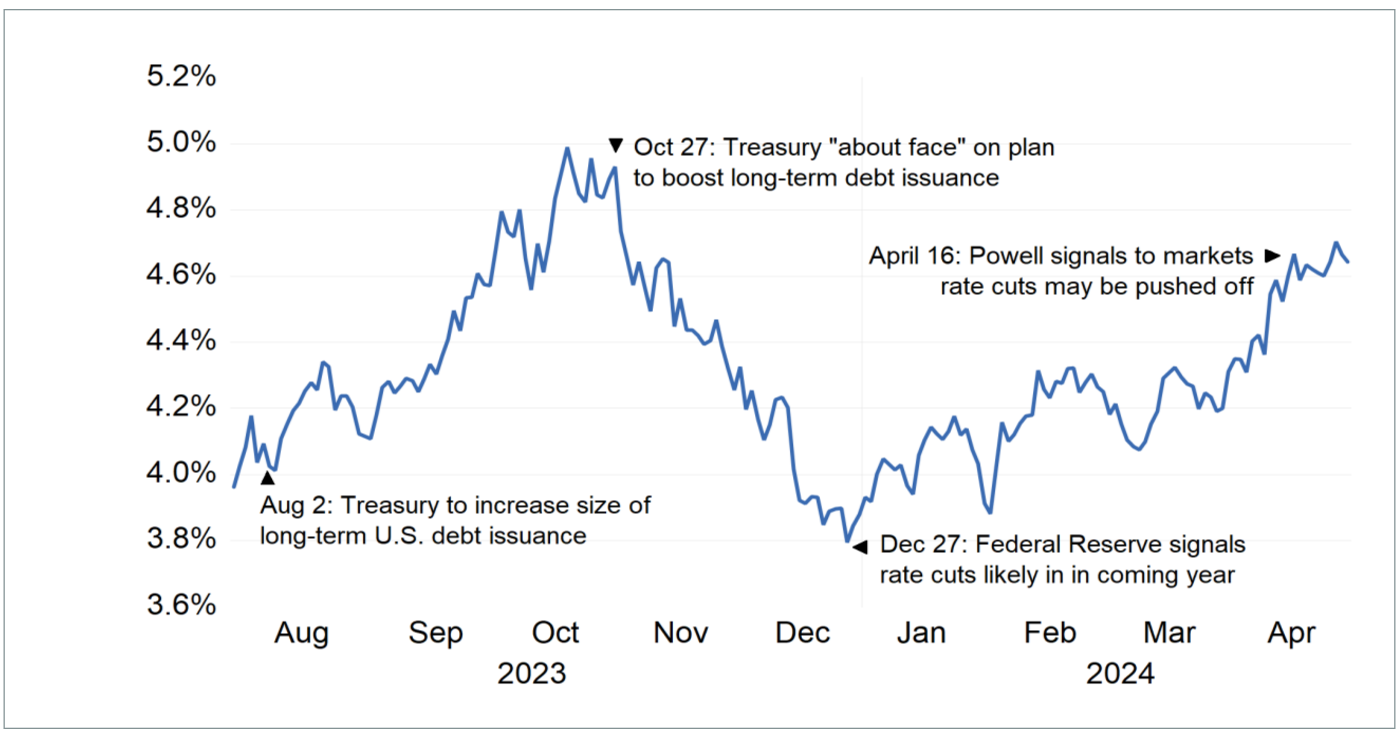
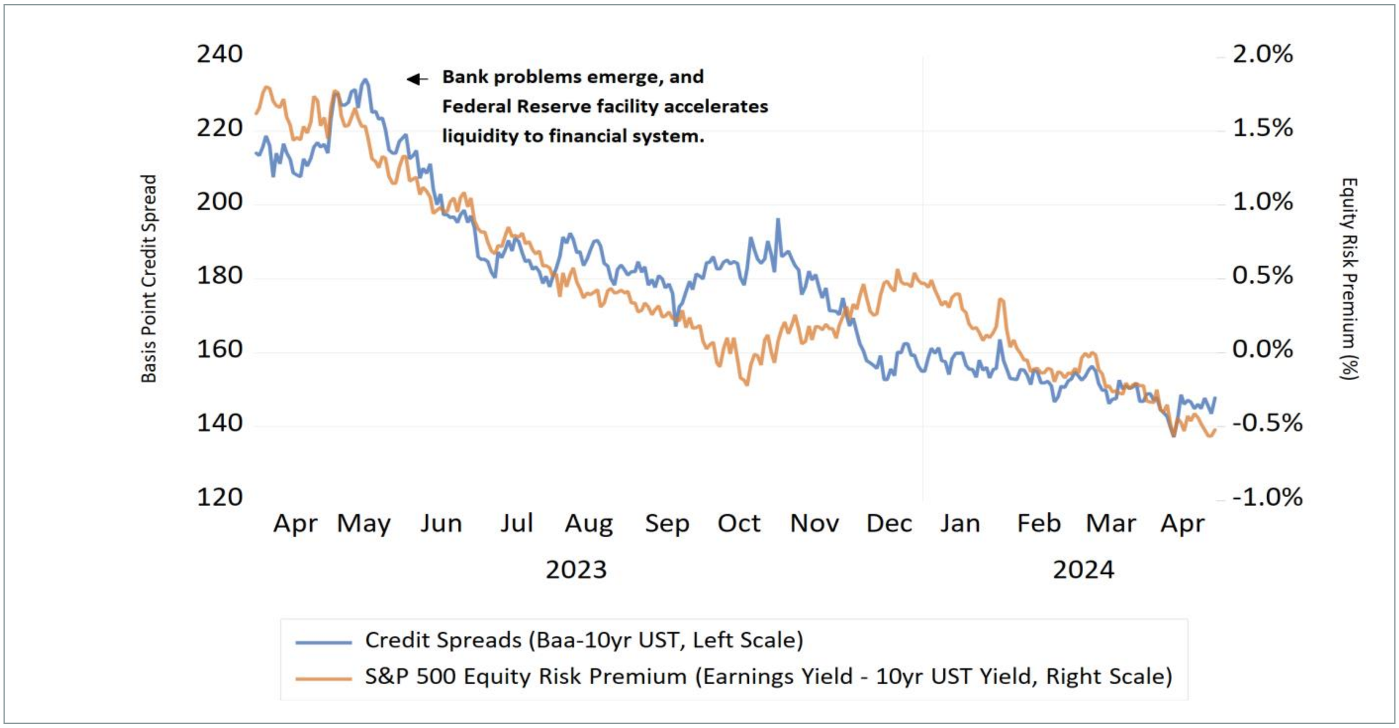


CHART C | MARKETS EMBRACE RISK AS FED BOOSTS SYSTEM LIQUIDITY Source: WCA



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Beta is a measure of the volatility, or systematic risk, of a security or a portfolio relative to the market as a whole. A beta of one is considered as risky as the benchmark and is therefore likely to provide expected returns approximate to those of the benchmark during both up and down periods. A portfolio with a beta of two would move approximately twice as much as the benchmark.

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