The Colony Group

OUR VIEW

APRIL 2023

At the beginning of last year, we shared our thinking behind our decisions to reduce equity risk and limit duration risk in portfolios - an un-accommodative Fed, the outbreak of war in Ukraine, increases in input costs (wages, energy, rent, raw materials, etc.), rising interest rates and the expectation of tighter credit conditions. In retrospect, we were right, but not entirely. Maintaining almost no duration within fixed income investments preserved capital very effectively; however, the portfolio's bias toward growth in equity allocations hurt performance even after having reduced overall equity exposure meaningfully. We do not think 2023 will be a repeat of last year, and so far, that is bearing out. There have been a number of winners this year, with the S&P 500 Index up 7.5%, the tech-heavy NASDAQ up 17.1% and the Bloomberg Aggregate Bond Index up 3.0% during the first quarter. Not surprisingly, bank stocks were not among them.

What Happened?

The Federal Reserve's initial misinterpretation of inflation as transitory and its subsequent aggressive push to get ahead of it had unintended consequences. Shortly after the voluntary closure of Silvergate Bank, Silicon Valley Bank (SVB) and Signature Bank of New York were seized by regulators. Importantly, these bank failures were largely distinctive. Silvergate was a primary lender to cryptocurrency-related businesses that decided to wind down operations citing both crypto market turmoil and regulatory developments. SVB, with an excess concentration of its deposit base from venture-backed companies in addition to a rapid rise in interest rates last year and the subsequent slowdown in venture-backed financings, saw a significant increase in withdrawals. What then started as a decline in deposits due to withdrawals by now cash-starved companies devolved into a run on the bank. Subsequently, nervous depositors were quick to pull their money from any bank that they deemed at risk. This led to the regulatory closure of Signature Bank and left other regional banks (e.g., First Republic Bank) struggling to survive.

Bank runs, by their nature, are psychological. Fundamental factors become secondary or even tertiary. Almost all banks have held-to-maturity portfolios, which can negatively impact an institution's balance sheet in a rising rate environment if measured at fair value. Few banks are subject to the same concentration risk as SVB, but a large and rapid demand on deposits could impair their ability to function normally. While investors can certainly look for clues, such as the percentage of deposits held above FDIC limits and/or fair value marks on held-to-maturity securities in portfolios or loan books, what drives a run on a bank is sentiment.

Credit Makes the World Go 'Round

Importantly, the recent bank failures have broader economic implications. There are two main participants in the flow of liquidity into the economy: the Fed and banks. For the last 15 months, the Fed has been reducing liquidity in the system while banks continued to actively (and profitably) lend at higher rates. The recent crisis however, will likely force banks to increase lending standards thereby reducing availability of credit even further (Chart 1). Less credit availability should be a headwind to both consumer spending (due to fewer auto loans, mortgages, etc.) and business spending (fewer commercial and industrial loans). Less spending equates to slower economic growth which is disinflationary. This evolving inflation outlook has impacted the stock and bond markets. Bonds have rallied pushing yields down, and after a brief decline over concerns about the stability of the banking sector, stocks rose. Simply stated, the bond and stock markets may be reaching consensus that a disinflationary trend is taking hold.

Slow Growth or Recession?

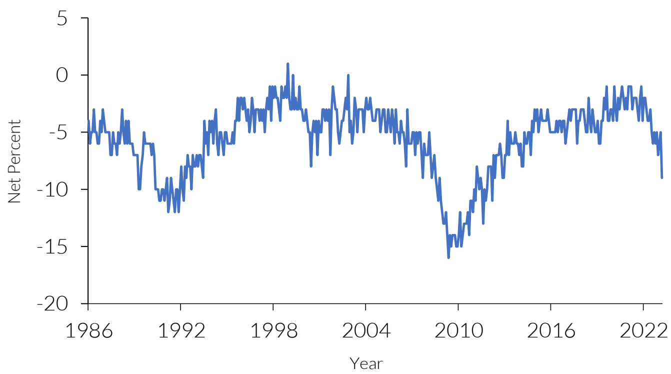
Slowing inflation may come at a price, however. The Fed has been clear that in raising interest rates it intends to reduce inflation and prevent the economy from overheating. Now, more stringent lending standards by banks as a result of the recent crisis may slow growth even further. The current challenge for the Fed is not allowing growth to slow too much. Rising bond prices and the corresponding decline in yields may suggest that growth will slow more than previously expected. Additionally, an inverted yield curve has historically been a predictor of an impending recession. However, as stocks and bonds continue to push higher, financial markets may now be looking through a widely anticipated slow growth/recessionary environment and focused on the economy's eventual recovery and a more accommodative Fed.

Portfolio Positioning

While financial markets performing well based on an eventual economic recovery would clearly support adding

Chart 1: Credit Conditions

Loan Availability Compared to Three Months Ago



Note: For the population borrowing at least once every three months 1/31/1986 to 3/31/2023.
Source: Bloomberg.

equity exposure to portfolios, we intend to maintain neutral allocations for the time being. The uncertainty surrounding Washington politics and the pending contentious debate re: an increase in the debt ceiling, remains a risk. Regarding traditional fixed income exposure, with higher rates available, we added duration risk to portfolios late last year.

Equity – We have a neutral position in equities with a bias to add exposure with continued disinflation and a resolution/increase in the federal debt ceiling. The U.S. and Asia, particularly India (The Base Case for India), remain our favored geographic areas.

Diversifiers –Investments that are uncorrelated to equites and traditional fixed income remain a valuable component of portfolios. Reducing risk with distinct drivers of return and low or no correlation to other asset classes can be additive. We wrote about these investments in a 2020 whitepaper, Pivoting Away from Traditional Fixed Income, and the timeliness of our recommendation remains applicable to owning diversifiers today.

Bonds – Having had almost no duration risk for years, we have recently added duration to our fixed income holdings.

Cash – We are currently comfortable holding above average cash levels as yields in short duration fixed income remain attractive. We intend to deploy cash when the market offers a compelling opportunity.

Final Thoughts

Today's turmoil is very different than what occurred during the Great Financial Crisis. Then, banks were much more levered and were sitting on trillions of dollars of impaired loans. Compared to today, banks have much stronger balance sheets and generally hold compelling loan portfolios. The assets they own that have declined in value are mostly relatively safe fixed income securities, such as government bonds and agency mortgages that have been marked lower due to rising interest rates. Paradoxically, the collapse of SVB may be a seminal event for financial markets. The Fed has struggled to contain inflation and the crisis may now provide help as banks pull back from lending. The stock and bond markets appear to agree and as a result, inflation should recede more quickly. Over the long-term, we believe this should continue to be a positive tailwind for financial markets and portfolios.