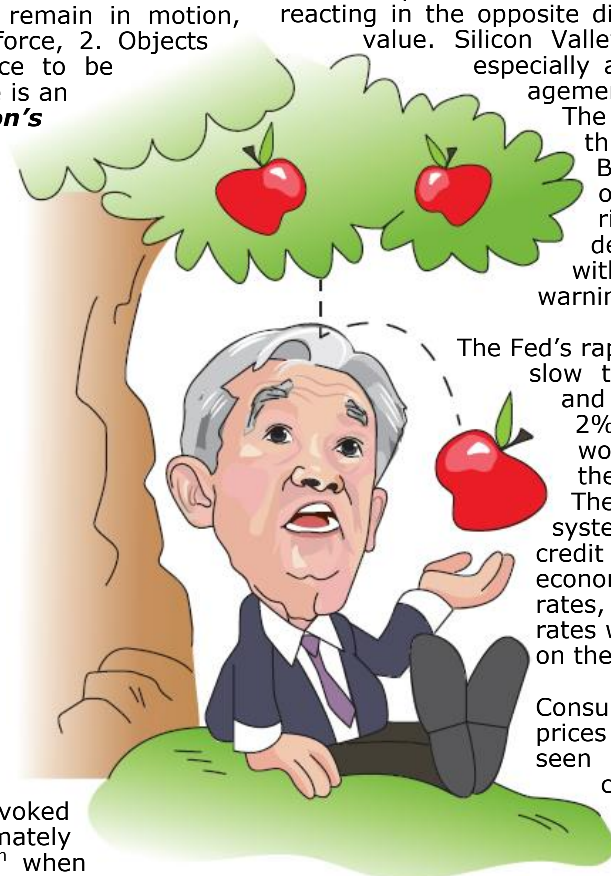
Investment Watch

1st Quarter, 2023

Sir Isaac Newton

Though physicist Sir Isaac Newton dealt with the laws of force and reactions in our physical world, he would have been stunned by the market's resiliency despite being rocked by violent forces few had foreseen. Americans began the year with optimism as their investments were finally rising and inflation appeared to slow, but a robust economy with surging new jobs crushed hopes that the Federal Reserve would slow rate hikes. However, even the collapse of two of the largest regional banks in March couldn't squelch the resilience of the markets which were more buoyant than investors imagined.

Sir Isaac Newton proved the three basic laws of force and motion: 1. Objects in motion remain in motion, unless acted upon by an exterior force, 2. Objects with more mass require more force to be moved, and 3. For every force, there is an equal and opposite reaction. ***Newton's Laws*** always hold true, and reactions of objects subjected to external forces are instantaneous! *Our Federal Reserve has applied huge forces to our economy, but unlike Newton's Laws, the economic reactions are inexact and slow to materialize.*



Federal Reserve Chairman Jerome Powell is catching a lot of heat lately. He won praise for his skillful leadership during the depths of the pandemic but was blindsided as inflation was not transient and proved to be far more sticky. To rein in this runaway inflation, the Fed acted forcibly raising rates from near zero to 5% over the past year. Reacting instantly, mortgage rates soared squelching the red-hot housing market, while elevated lending and credit card rates caused inflation juiced purchases to be even more expensive.

The aggressive Fed rate hikes provoked stress in the banking sector that ultimately reared its ugly head on March 10th when Silicon Valley Bank collapsed after a bank run the second-largest bank failure in the US. The collapse of Signature Bank (3rd largest) soon followed, and the effects were felt globally, evidenced by the forced merger of Swiss bank Credit Suisse into UBS Group AG. The Federal Reserve is stuck: either increase rates to tame prices or decrease rates to prop up a banking system in distress.

Unlike Newton's Laws, the effect of economic external forces takes time to work through the system or may not materialize at all. The source for today's high inflation and banking stress dates back to the coronavirus pandemic. The Federal Reserve lowered rates to zero while the government dolled out vast sums of money. These two epic forces combined to unleash a massive spending spree just when the pandemic-snarled supply chains restrained the distribution of goods.

Just as Newton's Law of gravity pulls objects toward each other, so too did these forces create a domino effect of supply and demand. Banks were flush with pandemic stimulus cash paying zero on deposits, while consumers, chasing too few goods, boosted prices rekindling long dormant inflation. Initially, these experimental economic polices stimulated growth during the COVID lockdowns; however, over time they resulted in an inflationary cycle with less savings.

During the pandemic, banks stocked up on longer-term government and federally backed mortgage bonds in search of yield. When the Fed raised rates, those bonds, reacting in the opposite direction of yields, tumbled in value. Silicon Valley Bank's bond losses were especially acute due to poor risk management, but it was hardly alone. The financial stress is rippling through the banking sector. Banks are squeezed between older low-yielding loans and rising rates resulting in higher deposit costs or are hit with withdrawals. Analysts are now warning of a credit crunch.

The Fed's rapid rate hikes are designed to slow the economy, cool demand, and shrink inflation down to the 2% target. So far, it hasn't worked with both inflation and the economy still running hot. The Fed hopes that the financial system turmoil could help tighten credit and therefore slow the economy without the need to raise rates, as they worry that higher rates would inflict even more stress on the banking system.

Consumers are angry about lofty prices due to soaring inflation not seen in decades, yet economists cite a slew of positive news indicating that the U.S. consumer remains in better shape than perceived. Real disposable income, which is adjusted for inflation, has been climbing since last June. The unemployment rate has hovered around 3.5%, a 50-year low, which, along with raises and strong job growth, suggests most Americans are getting regular and higher paychecks.

Powerful positive and negative forces are being exerted on our economy, but America's Gross Domestic Product is still expanding 2.5% per year. **Newton's First Law** states an object in motion tends to stay in motion. If the Fed is lucky, inflation will cool down while allowing the economy to grow. Let's hope no more apples fall.

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