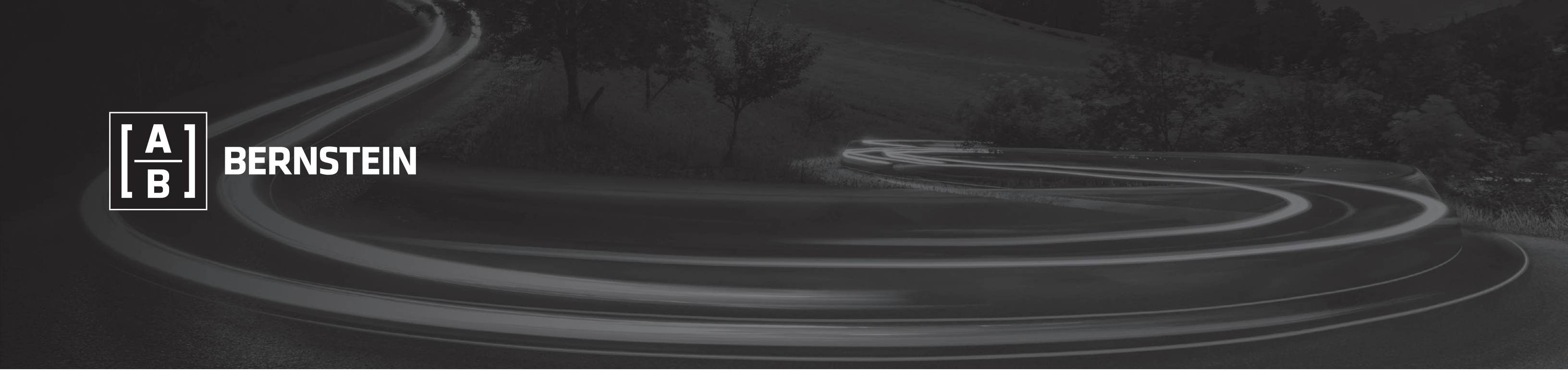


Seeing Around Corners

If you've ever gone camping, you know you prepare for everything. You bring food, fuel, clothing, and equipment. Forgetting or breaking something just adds pressure to everything else. Didn't bring enough gas? It's hard to cook, no matter how wonderful the meal you planned. If the tent leaks, it's challenging to stay warm and dry, despite all the clothes you brought. You get the idea. Markets act the same way. When something breaks, it puts pressure on everything else.

In March, a few things broke—namely banks. Two banks in the US entered receivership while one in Europe was rescued by a competitor, with backing from a central bank. Bank failures in any market are worrisome. In a market hyper-concerned about a potential recession fueled by interest rate hikes, it can get downright edgy. Given this added stress, the Fed is still working to ensure that the most important parts of the economy and financial system don't fracture. At the same time, they continue to apply pressure to other areas of the economy where a contraction remains their overarching goal.

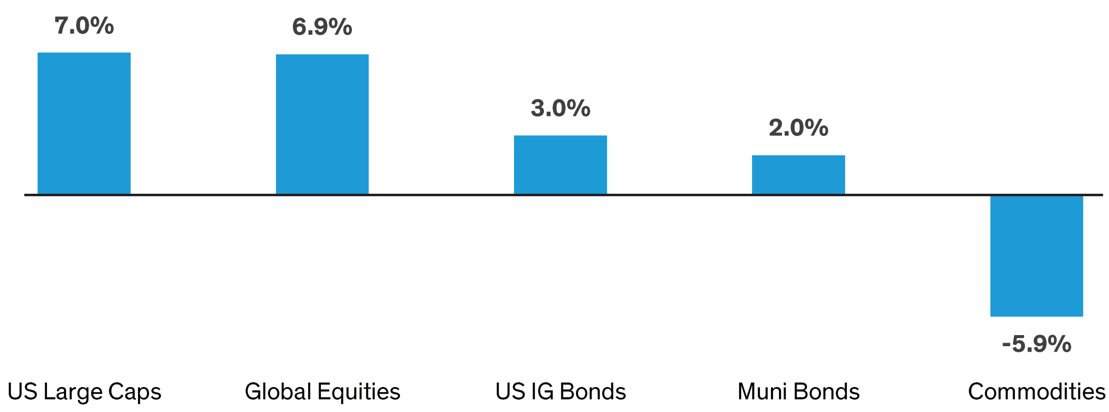
Aside from the recent bank failures, most of the economic data in the past few months has continued to reflect a robust, perhaps even strengthening, economy. And that's all in the face of interest rate hikes. Yet we remain cautious as we look toward the back half of the year, as the lagging effect of rate hikes could begin taking a bigger bite out of the economy.

Strong Winds Blowing

The first quarter of 2023 was punctuated by volatility, with both stocks and bonds moving sharply up and down. At quarter-end, most asset classes had performed well. US large caps and global equities returned 7.0% and 6.9%, respectively. The 10-year Treasury yield fell by 41 basis points, helping municipal bonds deliver 2.0% while investment grade US bonds came in at 3.0%. Meanwhile, commodity prices fell by 6%. The question ahead becomes how much reserve is left in the tank, given the surprisingly strong start to the year (**Display**).

Q1 PERFORMANCE BY ASSET CLASS

Percent



Source: Bloomberg and Bernstein analysis

What Went Wrong with the Banks?

Unlike the Global Financial Crisis, or the Savings and Loan Crisis that scarred many of today's investors and consumers, recent bank turmoil was precipitated not by credit issues but interest rate hikes. This was not a situation in which banks misjudged risk and over-lent.

The prevailing narrative of where we are in the economic cycle was sharply disrupted in March by the wind-down of Silvergate Bank, the failures of Silicon Valley Bank and Signature Bank, and UBSs' rescue of Credit Suisse. While the reasons varied slightly from one bank to another, they were united by a common theme of declining deposit balances and anxious customers.

What led to these downfalls? Silvergate and Signature Bank were a bit unusual, as two of the main banks used by companies in the crypto ecosystem. They already faced the risk of unstable deposits given the volatility in that sector. Then the FTX blowup and its aftermath turned up the heat—Silvergate saw its deposits cut in half from $13.2 bil. at the end of Q3 to $6.3 bil. by the end of Q4.

At Silicon Valley Bank, the causes differed somewhat. Exposure to the venture/growth capital ecosystem—and a weakened fundraising environment tied to the sell-off in growth stocks—prompted their deposits to decline from a peak of $198 bil. in the first quarter of 2022 to $173 bil. by the end of the year. More importantly, management piled into fixed-rate assets earmarked as "held to maturity" over the course of 2021, growing them from $17 bil. to over $90 bil. To compound matters, they didn't hedge their interest rate exposure. So, as interest rates spiked, the market value of those bonds deteriorated, which proved to be management's most costly error. While those paper losses wouldn't normally count until the bonds were sold, the bank was on the brink of becoming a forced seller, realizing those losses and depleting its capital buffer in the process.

Perhaps they could have made it through. But miscommunication surrounding a stock issuance intended to shore up their balance sheet—along with a downgrade from Moody's—spooked the market and the bank's depositors, prompting one of the worst bank runs in history. While events have moved quickly since our mid-March recording, **this webinar** with our banking analysts provides more of the backstory behind SVB's failure, if you're interested in learning more.

Across the Atlantic, Credit Suisse's issues date back years. However, they too had lost a surprising amount of liquidity in recent months, even after an October capital raise designed to give them a buffer as they executed a multi-year restructuring. In the wake of the bank stresses in the US, investors and depositors were unnerved once again, resulting in a swift, government-driven take-under by their Swiss rival, UBS.

Interestingly, while the S&P 500 largely shrugged off the bank stresses, real estate investment trusts absorbed the impact, falling by around 10% before largely rallying back in late March. We've been eyeing the potential for a real estate shakeout and continue to monitor that market closely.

Meanwhile, as we go to press with this letter, tensions in the system have eased, though they still linger. Trust takes time to return. Looking ahead, we anticipate this strain is likely to impact banks' willingness to lend capital, undermining economic growth. For those with capital who can step into that breach, we see even more attractive investment opportunities emerging.

Steering the Economy

In early March, after a streak of hot economic data, all eyes turned toward the Fed in anticipation of either a 25 or 50 basis point hike at their next meeting. However, amid the upheaval in the banking system, the chances of a 50 b.p. hike dropped like a stone. Some economists argued that we'd now hit the peak rate in the cycle, while others took it one step further, suggesting the Fed should begin cutting already.

In the end, the Fed felt comfortable with the backdrop, even after accounting for the pressures on banks, and opted not to surprise the market either way. Ultimately, they raised rates by 25 b.p. and slightly tweaked their messaging and forecasts. While we've been saying for months that the Fed would need to become even more data-dependent as the level of macroeconomic uncertainty increased—that is now truer than ever. We expect that stance to stoke ongoing volatility in markets as each datapoint remains crucial.

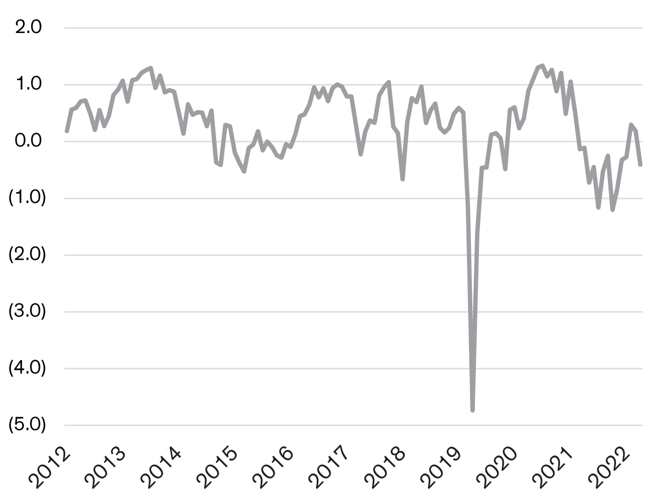
While we don't view the banking sector's current issues as systemic, these kinds of strains are not surprising to see in the later stages of an economic cycle. Such a stage is often marked by conditions that appear to improve—much like recent economic data indicates—until they suddenly turn definitively south. Those late stages can be prolonged, as in the decade-long expansion after the Global Financial Crisis. But they can also turn sharply. That's what makes it so hard to see around the corner. With that said, even when you can't predict, you can prepare.

Like us, the Fed seems to believe that recent unease in the financial system will impact banks' lending, which will do some of the Fed's work in tightening financial conditions. Their goal remains to bring down inflation and the lens they are using to do so flows through the labor markets. What they're seeking, in the simplest terms, is a rise in the unemployment rate. And they're counting on higher interest rates, reduced bank lending, and softer consumer and corporate sentiment to usher it in. By weakening the labor market, the Fed believes they can keep inflation trending back toward their 2% target. Yet they run the risk that once such a cycle takes hold, it can rapidly snowball into a worsening recession. It's nearly impossible for a central bank to be overly precise in managing the economy (**Display**).

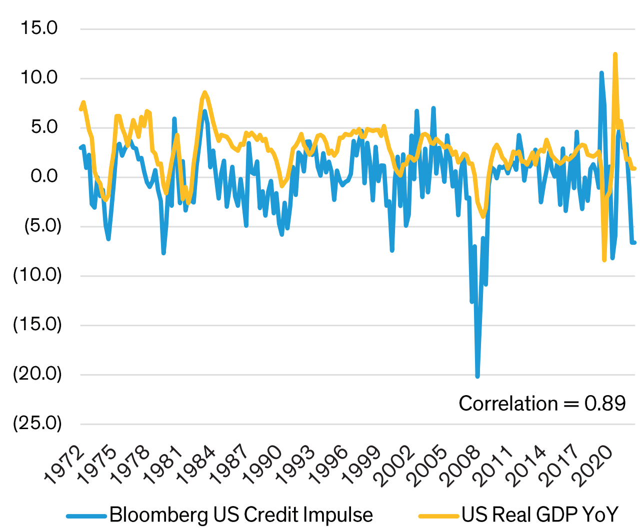
In the near term, we expect interest rates to remain elevated. If the Fed succeeds in achieving a smooth-ish landing, then they may be able to ease interest rates in a few quarters. If the economy falters, rate cuts will come faster and sharper, assuming inflation is in check. In that case, investors counting on lower interest rates to justify prices for stocks and bonds may not like the catalyst for the rate cuts. Indeed, the start of a rate cutting cycle has historically been one of the mile markers for an impending recession.

THE CHANGES IN FINANCIAL CONDITIONS AND CREDIT GROWTH WILL IMPACT ECONOMIC GROWTH

Bloomberg US Financial Conditions Index
Index Level



Bloomberg US Credit Impulse and US Real GDP YoY
Percent



Source: Source: Bloomberg, Bureau of Economic Analysis, and Bernstein analysis

Navigating from Here

Few could have predicted the specific bank failures and strains so far this year. Yet, the general picture for the global economy and markets remains in line with what we mapped out in our 2023 outlook, **Landing the Plane in the Fog**. We chose that title to convey the difficulty the Fed would have in settling the economy onto its targeted track.

As ever, we remain focused on the long term, emphasizing a soundly diversified portfolio. Should more volatility emerge throughout the remainder of the year, investors with well-balanced portfolios are likely to operate from a position of strength, taking advantage of market unease. In recent years, we've stressed the value and opportunity set in private markets in addition to public markets and we continue to believe private market allocations are advantageous for investors. We thank you as always for your continued trust in us and will continue to act as responsible stewards of your investments.

Alex Chaloff

Beata Kirr

Alex Chaloff and Beata Kirr are Co-heads of the Investment Strategy team at Bernstein, a group of senior investment professionals who develop our investment advice and are responsible for investment outcomes. The team oversees Bernstein's investment offerings, ensuring that our asset allocation advice, suite of strategies, and development of new investment ideas are continuously focused on moving our clients forward with strong after-tax risk-adjusted returns. Both Alex and Beata have spent their Bernstein careers refining our investment platform, listening to clients, and conducting deep research into investment topics that are critical to achieving clients' goals.

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