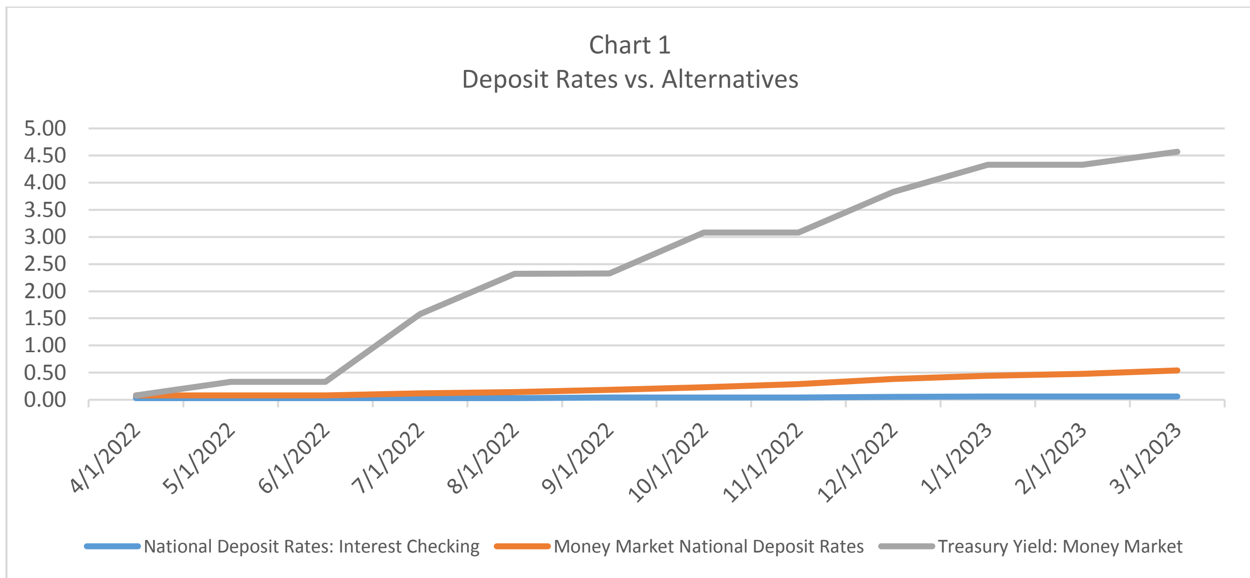
Birch Run
INVESTMENTS

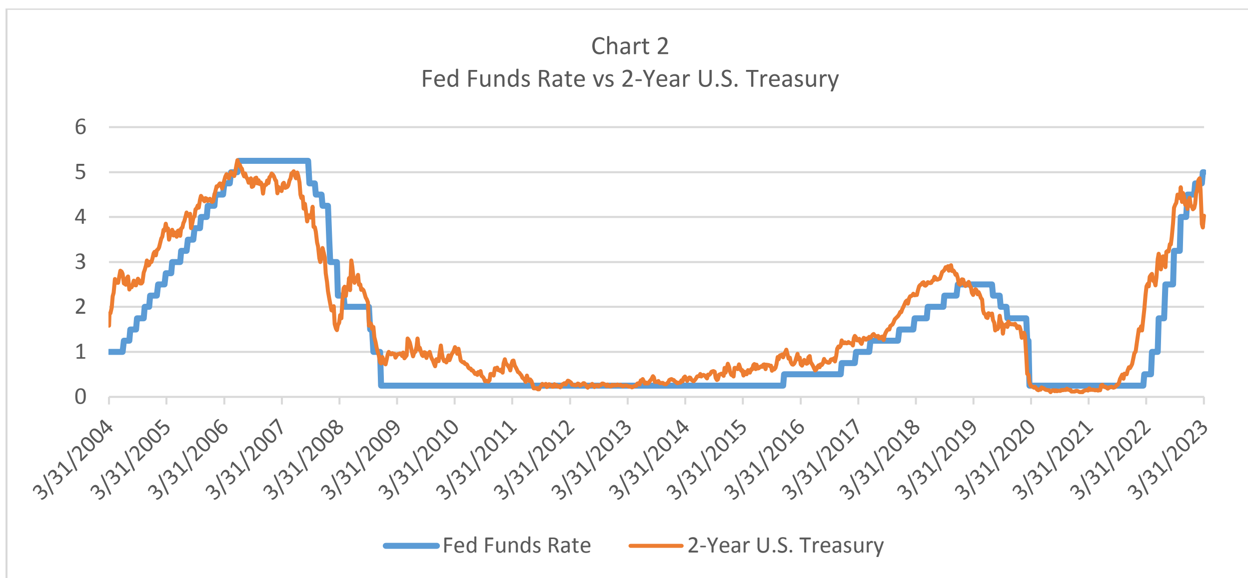
1Q2023 – Quarterly Update

Until recently the aggressive rate hikes delivered by the Federal Reserve to combat inflation have resulted in little consequence to the broader economy. During the most recent quarter, however, it became clear where the negative effects of higher interest rates have been most acute. Small and mid-sized regional banks have been experiencing large deposit outflows as depositors favor higher yielding money market alternatives, which have become an increasingly attractive alternative as short term yields have risen (see Chart 1). These withdrawals have drawn investor attention to large unrealized bond losses on the balance sheet of many of these institutions, which raises concern with respect to their regulatory capital requirements. During the first quarter, the strain of this deposit outflow resulted in the failure of Silicon Valley Bank and Signature Bank. In an emergency response, regulators implemented new facilities which will provide banks with more options in how they fund excess deposit withdrawals. While the government response has so far been effective in limiting any further loss of consumer confidence in the safety of the banking system, banks will nevertheless continue to face elevated earnings pressure as the costs to retain customer deposits increases.



Source: Federal Deposit Insurance Corporation

Prior to the events of the first quarter, expectations were that the Federal Reserve would slow the pace, but nonetheless continue along a path of raising the fed funds rate to a range of 5.5 to 6%. While inflation still remains above the level the Federal Reserve has been targeting, Chair Powell has indicated that the Fed could stop raising rates sooner than originally anticipated if pressures in the banking system were to result in a more pronounced slowdown in economic activity. Policymakers face a unique challenge in that they may choose to slow the pace of rate hikes or stop raising interest rates entirely due to these concerns, but if inflation does not continue along its decelerating pace they would be forced to re-engage more aggressively in future periods. Current pricing in the bond market is signaling a resounding vote of confidence that the effects of the banking crisis will mark the end of the current Fed rate hiking cycle and that policymakers will in fact soon reverse course and lower the fed funds rate, perhaps as early as this year.



Investor concern that the issues impacting the banking sector will constrain economic activity through tighter lending standards resulted in a dramatic decline in yields during the quarter. Since early March, when Silicon Valley Bank became a household name, the 2-Year U.S. Treasury yield declined 110 basis points to close the quarter at 4.0 percent while the 10-Year U.S. Treasury yield declined 68 basis points to end the quarter at 3.6 percent. For the first time since the prospect of a fed tightening cycle became prevalent to investors in 2021 the 2-Year U.S. Treasury yield is now trading below the target Fed Funds rate, historically an early indication of a near term economic downturn (see Chart 2). The differential between the 2-Year Treasury yield and the fed funds rate is now approaching a level last seen prior to the 2008 Global Financial Crisis.

Corporate bonds, particularly lower quality issues and many within the banking sector, underperformed in the weeks following the bank failures as investors demanded more yield premium on these bonds to compensate for the heightened risk and increased volatility. While this recent period of underperformance has modestly improved valuations broadly for both investment grade and below investment grade corporate bonds, the increasingly uncertain outlook leaves us still favoring a larger than normal allocation to U.S. Treasury securities as an alternative in the near term. Given the myriad of signals we follow that suggest a high probability of an economic downturn, we anticipate corporate bond valuations will weaken further providing a more attractive entry point for new investments.

Birch Run Investments, LLC
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