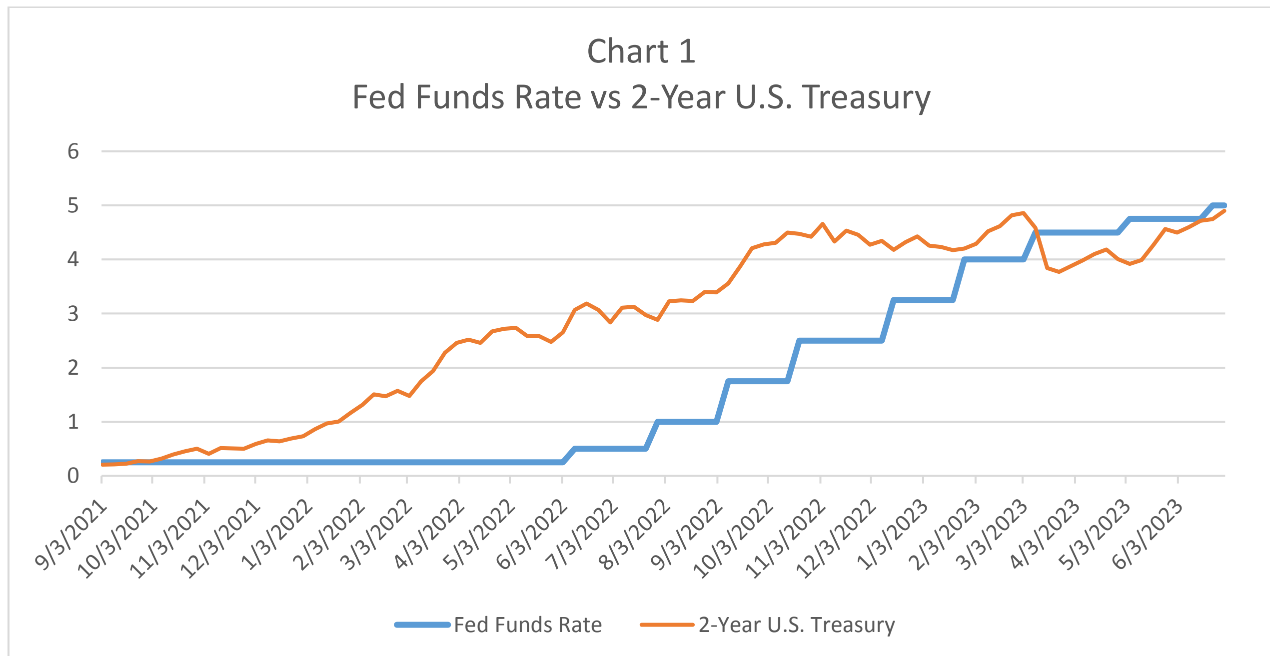
Birch Run
INVESTMENTS

2Q2023 – Quarterly Commentary

Contrary to the market consensus during the first quarter that the bank failures witnessed in March would prompt the Federal Reserve to pause the rate hiking cycle, the Fed once again raised the target Fed Funds rate in early May to 5.25%. The Fed elected to pause at the subsequent meeting in June, however, the committee did indicate that a resumption of rate hikes perhaps as early as the next meeting was very likely. Despite the historic pace of rate increases seen over the past fifteen months, the economy continues to display impressive resilience in large part due to the exceptionally strong labor market. While job growth in the economy has decelerated over the past year, the unemployment rate is still historically low and job openings remain plentiful, which is providing meaningful support to the health of consumer balance sheets. This unexpected outcome so far into the current tightening cycle has led many economists and forecasters to increase the probability that the Federal Reserve will be successful in achieving the elusive goal of an economic soft landing. Recently revised first quarter GDP aligns with this more positive outlook. Although a deceleration from the 2.6% growth rate reported in the fourth quarter of 2022 recently revised first quarter GDP was reported to have advanced at a stronger than expected pace of 2.0% while at the same time inflation continues to decelerate moving closer to the Feds long term goal.



The dramatic decline in yields following the bank failures have now mostly reversed as economic momentum quickly eliminated any expectation that the events of the first quarter would prompt the Fed to shift to a more accommodative policy stance. The 2-Year U.S. Treasury yield increased to 4.90% during the quarter, closing in on the high for the current cycle which was 5.07% seen in early March. The 10-Year U.S. Treasury experienced a more modest increase during the quarter to 3.84%. Despite the recent sharp increase in yields, similar to the first quarter, the 2-Year U.S Treasury yield continues to remain below the current Fed Funds target of 5.25% which is an indication that investors still believe

the Fed is nearing the end of this tightening campaign and will soon reverse course and begin the process of lowering short term interest rate (See Chart 1).

The positive momentum seen in the economy has supported risker segments of the bond market, in particular investment grade and high yield corporate bonds, both of which outperformed safe haven U.S. Treasuries for the quarter. Growing evidence that a recession is far from imminent, if not avoidable, led us to modestly increase portfolio exposure to this segment of the market during the quarter. However, similar to investments made over the past year, we continue to focus on issuers of a higher average credit quality that are less sensitive to a potential economic downturn. Likewise, we also continue to maintain an above average allocation to U.S. Treasury securities which provides ample liquidity to respond opportunistically to an ever changing economic landscape.

Birch Run investments, LLC
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