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March 2023 Crescent Commentary

During the month of March, turmoil in the banking sector stole the financial headlines. Not since 2008 have we had bank rescues orchestrated and announced over the weekend. And yet what happened last month differs substantially and importantly from what happened in 2008. In this Commentary, we'll provide an overview of what happened in March and also give our recommendation for how you should allocate your assets today given the current economic climate.

The Federal Reserve began increasing interest rates one year ago in March of 2022. Since that time, we've seen various bubbles burst according to different timelines. As expected, publicly traded assets declined first. U.S. stocks declined 20% to 30% last year, depending on the market. The bond market fell 15%. Cryptocurrency crashed 67%. From our standpoint, the failure of Silicon Valley Bank represents the latest bubble to burst as a result of the Fed's interest rate increases. When chronic stimulus is withdrawn, it takes time for an economy to work through the reversal. Bubbles will not burst at the same time. We saw this in the 2000's, when the technology stock bubble burst from 2000 to 2003, followed by the real estate crash in 2007. A similar dynamic played out in the 1920s, with a nationwide real estate bubble bursting in 1926, followed by the stock market crash in 1929. We are not pointing out these time periods in an attempt to draw parallels to the present time. 2008 was a unique bubble and we don't expect what happens now to resemble 2008. Having said that, it's certainly possible that other bubbles may deflate over time as the impact of withdrawn economic stimulus continues to work its way through the economy.[1][2][3][4]

As you may know, four well-known banks either failed or were rescued last month. Silicon Valley Bank (SVB) was the second largest bank failure in the U.S. However, its operations consisted of a very specific line of business. Essentially, SVB banked startup businesses that conservative banks wouldn't bank. Many young businesses consume cash every year rather than generating cash. Providing banking services to businesses like these worked fine during the glory days of stimulus — startup businesses had plentiful access to financing in public and private markets during the times of peak economic stimulus and exuberant financial markets. As we pointed out above, that all changed when the Fed started to raise interest rates last year. But because many startup businesses still need cash to fund operations, they had to withdraw deposits from SVB in order to fund their operations. SVB had invested

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the deposits in bonds. But as we mentioned above, the U.S. bond market fell 15% last year when the Fed increased interest rates. So SVB had to sell bonds at losses in order to provide funds to their depositors. When SVB reported these losses, panic ensued and SVB experienced an old-fashioned bank run.(1)

Two other banks that collapsed last month were Signature Bank and Silvergate Bank. Both of these banks collapsed as a result of dealings with cryptocurrency clients.(5)(6)

Finally, Credit Suisse was rescued by the Swiss government and acquired by a rival bank. Credit Suisse had problems going back two years, which stemmed from lending money and placing client funds with two failed hedge funds (one of which committed fraud). The Credit Suisse problems were quite different from the crypto and Silicon Valley related issues of the other banks that failed.(7)

With all of this discussion of bank failure, why will the current situation end differently than the Great Recession of 2008? The reasons that led to failure of the four banks mentioned above were very specific and isolated. SVB lent to young businesses that conservative banks wouldn't get involved with. Signature and Silvergate serviced cryptocurrency clients. Credit Suisse lent funds to a fraud. By contrast, the 2008 recession resulted from a crash in home prices, which touched every corner of the U.S. economy. There are other examples we can point to of widespread banking crises that didn't lead to economic collapse on the scale of 2008. The most recent example is the savings and loan crisis of the 1980s and 1990s. This was a widespread banking crisis yet didn't lead to widespread economic collapse. We would similarly expect the current banking turmoil to remain contained in its economic impact.(8)

There's no questioning the challenges our economy and financial markets have faced over the past year. Inflation at a 40-year high, the Fed increasing interest rates, the war in Ukraine, and now banking turmoil. And as we mentioned above, more bubbles may burst as time goes by. Considering all of this, how should you allocate your assets for today's challenged economy? In looking for parallels to today's economy, we have to go all the way back to the 1970s to find the last time period of elevated inflation and rising interest rates. The 1970s were certainly a challenging economic period, and U.S. stocks reflected those challenges. From 1972 to 1982, the Dow Jones stock index returned nothing. It Ended those ten years at the same level it started. Yet investors who reinvested their dividends over those ten years earned a 69% return. Applying those learnings to today's similar circumstances of high inflation and rising interest rates, we can see the importance of owning investments with strong cash flows that pay stable and rising dividends to shareholders.(9)

At the same time that we see the need for strong dividend-paying investments, we also recognize that last year's market decline has created opportunity to find value in specific investments meeting certain criteria. Some strong businesses have fallen a lot in price, and this does present opportunity. We have added and will continue to add measured amounts of these strong businesses at reduced prices.

We will continue to work with you to ensure that you have the asset allocation needed to navigate future volatility from a position of strength, while also positioning yourself for future growth when it resumes.

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Sources:

(1) CNBC
(2) Yahoo Finance
(3) Forbes
(4) Harvard Business School
(5) Baron's
(6) Reuters
(7) The Wall Street Journal
(8) CNN
(9) Roger Thomas

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