



# CIO QUARTERLY COMMENTARY

Q1 2023

## March Madness

Recent market action calls to mind a quote attributed to Vladimir Lenin: “There are decades when nothing happens; and there are weeks where decades happen.” The past year and the past several weeks feel more significant than normal. We thought a brief recap of what got us here, where we are, and what the future might hold could be helpful. With events today moving fast, this letter will probably have a shorter shelf life than some of our other commentaries, except that you will forever be able to tease us for making projections of any sort in such a turbulent time.

### Where it started

We suggest the massive government spending programs that protected citizens and companies from financial ruin caused by COVID are what led us to today. Early support programs were – in our opinion – needed to avoid an economic depression. Some of the later programs were much less needed. The magnitude of excess money pumped into the system took interest rates down to extremely low levels and sowed the seeds of future inflation, mitigating the positives of earlier programs.

All of the money the government spread around during the pandemic had to go *somewhere*. In addition to real estate, where it created new highs, this money went into stocks, inventing meme stocks and sending markets to new highs. Bond prices, too, went to (you guessed it) new highs as interest rates globally went negative – something previously unimaginable – on as much as \$17tn of bonds. Private equity and venture capital raised record amounts of capital, which went into different places, including straight into bank deposits, with many billions of this VC money going to Silicon Valley Bank. Bank deposits grew rapidly in most regions and banks and especially at SVB: A posterchild for this era, SVB saw deposits grow from \$62bn at year-end 2019 to \$189bn in just two years!<sup>1</sup>

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<sup>1</sup> SVB Financial Group Form 10-K for the fiscal years ended December 31, 2019 and 2021, and Bloomberg.

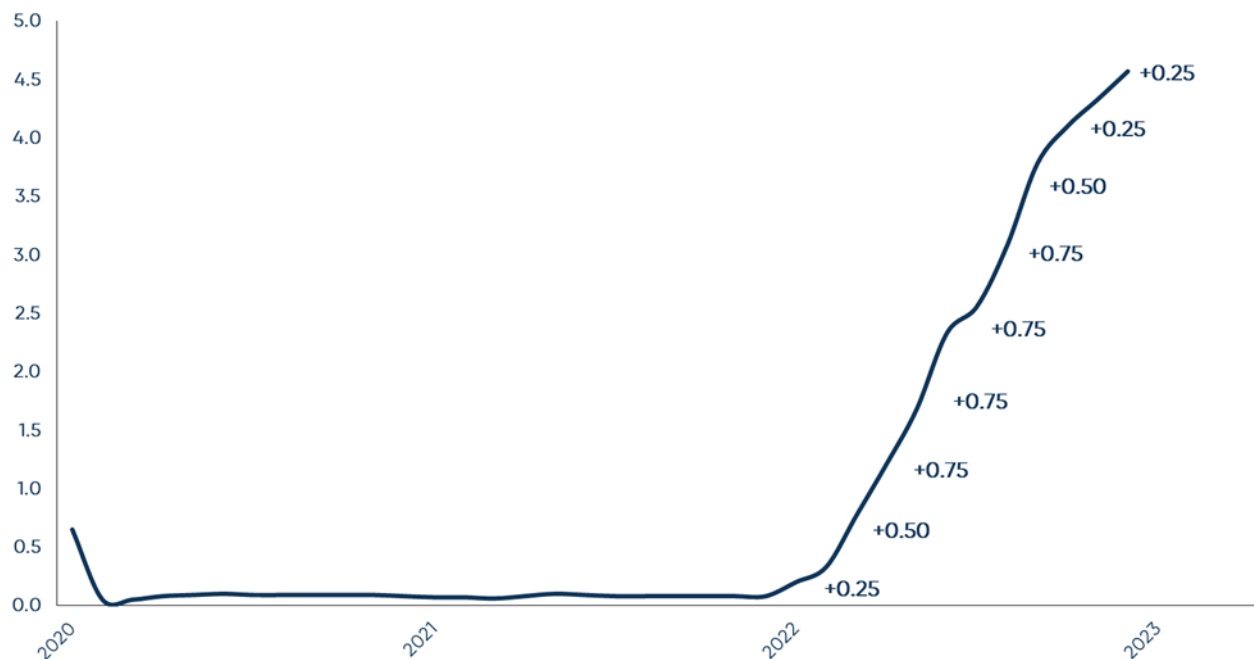




As we all know, banks don't hold all deposits in cash, available to withdraw upon request. They do hold some cash, but also make loans and buy other interest-bearing securities. What many of them did during this period was buy government-backed mortgages and Treasury Bills, Notes, and Bonds. During this period, yields on these instruments were quite low, but the Fed communicated that they would stay low for some time, so banks were more confident investing in long bonds than they should have been.

Once inflation started to surface, the Fed was overly confident it would not become a problem. Believing that the factors driving up inflation were "transitory,"<sup>2</sup> the Fed got a late start in fighting inflation and subsequently had to raise rates at the fastest pace in 40 years. This rapid rate increase worked its way out the yield curve, pushing 30-year interest rates above 4% – destroying enormous amounts of invested capital in the process. As a result, the Bloomberg US Aggregate Bond Index fell 13.0%<sup>3</sup> in 2022, its worst year in history.

#### Effective Fed Funds Rate and Rate Hikes (2020 to 2022)<sup>4</sup>



<sup>2</sup> Federal Reserve Federal Open Market Committee ("FOMC") Statement, April 28, 2021.

<sup>3</sup> Bloomberg. The second worst 12-month return was in March 1980, when it lost 9.2% in nominal terms. The index dates to 1972.

<sup>4</sup> Federal Reserve Economic Data ("FRED"); St. Louis Fed (stlouisfed.org).





The stress tests that regulators put banks through did not contemplate higher interest rates, but rather weakening credit in their loan portfolios. The tests covered such scenarios as, “If the economy contracts for the next 3 quarters and short rates end the period at 0.0% and 10-year Treasury rates end at 0.5%, will your capital base meet our requirements?”<sup>5</sup> Of course, the answer turned out to be “yes.” The unforeseen problem, not probed by regulators, was that interest rates on 10-year Treasury Bonds would not end at 0.5%, but rather at 3.5%. That “small” rate difference causes about a 30% difference in price!

Early in 2023, as the stresses on balance sheets resulting from the pace and size of rates hikes became clearer, doubts grew that depositors at SVB were fully insured. Several venture capital fund managers recommended that each company they supported move their deposits out of SVB, and many did. The large deposit outflows occurring at SVB forced the bank to sell debt securities to get capital to pay depositors, thereby realizing big losses. To support its balance sheet, SVB then attempted to raise capital, which raised further red flags – triggering more outflows and its ultimate take over by authorities. On March 9, the day before the bank was seized by the FDIC, \$42 billion of deposits were removed from the bank – over 20% of deposits in one day!<sup>6</sup> Thanks to the internet, the world moves faster today than ever before, creating new and unprecedented risks for trust-based institutions. Stated as succinctly as we can, rapid deposit growth invested in long-duration government

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bonds at generationally low yields just before rapid rate hikes led to large losses that SVB was forced to crystallize when its concentrated deposit base demanded capital. Fortunately, this fairly specific recipe for failure is not commonly found in most US banks.

As a result of three US bank failures (SVB, Signature, and Silvergate), concerns have mounted about the safety of uninsured deposits at other *non*-systemically important financial institutions (SIFIs). Other than at 8 US banks with the SIFI designation, deposits are only insured up to \$250k per depositor.<sup>7</sup>

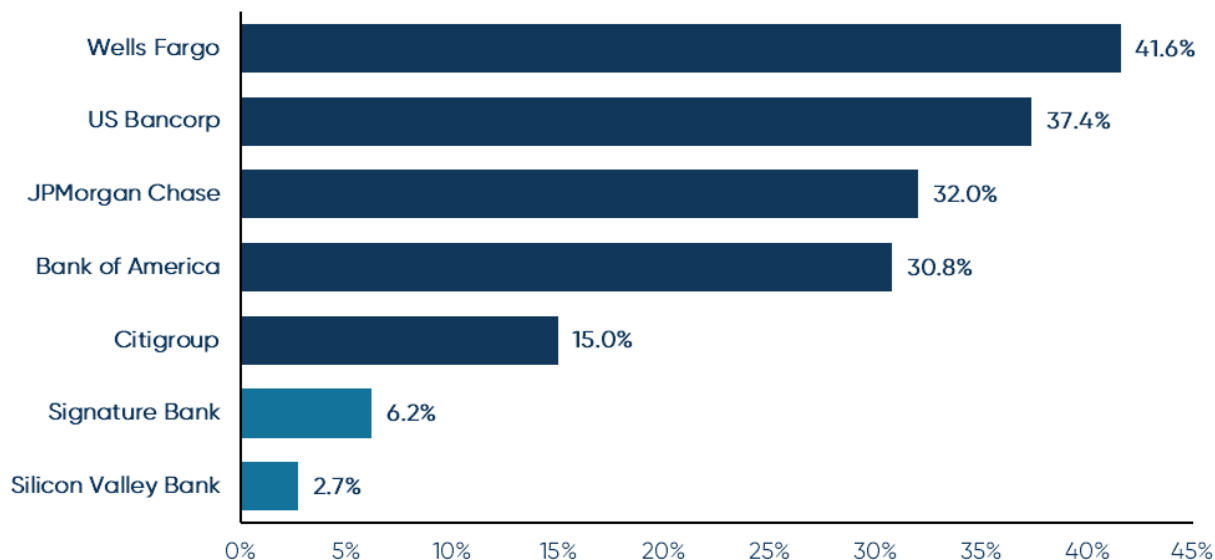
<sup>6</sup> State of California – Department of Protection and Innovation Regulatory Filing in the Matter of Silicon Valley Bank: Order Taking Possession of Property and Business, March 10, 2023.

<sup>7</sup> A Systematically Important Financial Institution is one that regulators feel would pose a material risk to the economy if it were to collapse – colloquially “too big to fail.” In 2022, the Financial Stability Board, an international body that monitors the global financial system, classified JP Morgan Chase, Bank of America, Citigroup, Goldman Sachs, Bank of New York Mellon, Morgan Stanley, State Street, and Wells Fargo as SIFIs. There are 30 SIFIs globally.





### Share of Deposits ≤\$250k as a Percentage of Total Deposits for Selected US Banks in Q4 2022<sup>8</sup>



In Congressional testimony, Secretary of the Treasury Janet Yellen made clear that depositors at each of these failed banks are fully covered regardless of deposit size, but that any potential future bank failures will be judged on their own merits as to whether they are systemically important or not. This testimony suggests that, in the future, depositors above the \$250k insured level at smaller banks will not be covered above this threshold. Yellen also said regulators would be open to considering broader deposit coverage – but that Congress would need to pass a law to make such a change.

This creates uncertainty and allows concerns about future bank runs and further instability to persist. However, what differentiates this financial episode from the Great Financial Crisis (GFC) is that today, the credit quality of bank assets is strong, with lots of government-backed bonds that have lost value as rates rose but are money good. During the GFC, banks owned collateralized debt obligations backed by worthless mortgages issued at the top of a housing bubble. Because much of today's bank assets are money good and easily valued and traded, the financial system should not seize up as it did during the GFC.

<sup>8</sup> Statista, with data from S&P Global Market Intelligence, March 13, 2023.





## Where are we today?

The Fed may or may not be done fighting inflation. At the March 22, 2023, Fed meeting, the committee voted to raise rates by 0.25% to a range of 4.75% to 5.00% and signaled their belief that the banking system is sound. If the inflation fight is ending and rate increases will soon be turning into rate cuts, then future changes in the value of bank securities are likely to be positive, helping to further ameliorate current stresses.

This inflation debate is ongoing. Recent economic data releases have been mixed, with payrolls staying firm as wages soften; PPI easing as CPI holds at 6%; the Conference Board US Leading Economic Index and U of Michigan Consumer Expectations Index declining as the S&P Global US manufacturing and Services Purchasing Managers Indices rise. Fixed income markets to date are behaving better, suggesting inflation is subsiding. Most everyone agrees that volatility is high and likely to remain so – at least until the current banking crisis gets sorted out, the question of hard or soft landing gets answered, and we all become more confident that inflation is trending toward the Fed's 2% target.

All of these issues are important to investors because they will greatly influence stock and bond returns. In what follows, we speculate at our peril about what might lie ahead. We will surely be wrong about some of this, but hopefully we can be close enough on the big questions to position our portfolios properly as these interesting times unfold. As most know, there is an old saying that stems from a belief that uninteresting times are usually filled with peace and harmony whereas interesting times can be filled with trouble. Let's hope the future becomes much less interesting as we exit the current environment.

We want to start by reminding everyone of our portfolio management approach, which is to find and partner with, in our view, the best equity and hedge fund managers in the world. These managers make the micro decisions about what to buy and sell, not us. Occasional rough spots can develop in our portfolios when different managers happen to share themes and ideas. We then must make portfolio construction decisions designed to optimize exposures and weights, especially around rebalancing. We try to keep portfolios approximately in line with the long-term allocations we and our board believe give non-profits the best long-term chance of achieving 5% real returns. From time to time, we uncover what we believe is an opportunity to over- or underweight an asset class, geography, market cap, or other factor that may be near an extreme and that we believe may show





performance meaningfully different from markets. This doesn't happen often, but we are always on the lookout for one of these "fat pitches." We don't see any particular fat pitches today, but do believe the current environment is the sort with above-average potential for creating them. Our antennae are up.

**What could happen in the near term – and what are we doing about it?**

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We continue to believe that one of three scenarios will occur:

1. The Fed will overtighten and push the economy into recession;
2. The Fed will somehow manage to engineer a soft-landing; or
3. The Fed will take their foot off the pedal too soon and inflation will re-emerge

We still think scenario No. 1 is the most likely. We expect a recession, and the sooner we get one the shallower it might be. In a recession, stocks are vulnerable to both earnings declines and multiple compression. This scenario could certainly provide an attractive buying opportunity, especially if investors overreact and sell equities down toward the 3000 level on the S&P 500 from its level of 4109 at March 31, 2023. The S&P level represents estimated earnings x a P/E ratio. Something like 190 x 16 could prove an attractive entry point. In a recession, we would also expect bonds to provide modest positive near-term returns. Rates across the curve could move lower, but short rates would likely move down more than long rates, suggesting the extra duration risk in long bonds may still not be worth the risk. That said, if rates on 10-year Treasuries rise above 4%, we may add some 10-years to our portfolios as a hedge against this outcome.

If the Fed is successful engineering a soft-landing, then all asset prices could move higher from here. Asset prices declined meaningfully last year and entered this year more attractively valued. If we experience a soft-landing, then today's equity valuations could rise, and bond yields could fall. A soft-landing would require the Fed to keep inflation on track to reach its 2% target by 2025, with positive but below-trend economic growth. Soft landings are always exceedingly hard to engineer, and with a banking crisis occurring at the same time that you're fighting the highest inflation in 40 years, the odds against one seem higher than usual.





The outcome that gives us the most pause is No. 3. There is great debate among investors about which elements of inflation are most important – whether you should look at the 12-month rate of change, the 3-month rate of change or even the most recent monthly change annualized – but investors don't get to pull the levers. The central bank pulls the levers, and as the Fed raised rates 25 bps in late March, they also told us that the fight against inflation remains a priority. If further instability in the banking system developed, priorities could of course change, but the Fed's comments indicated that they are resolute that the fight against inflation will continue until it is won.

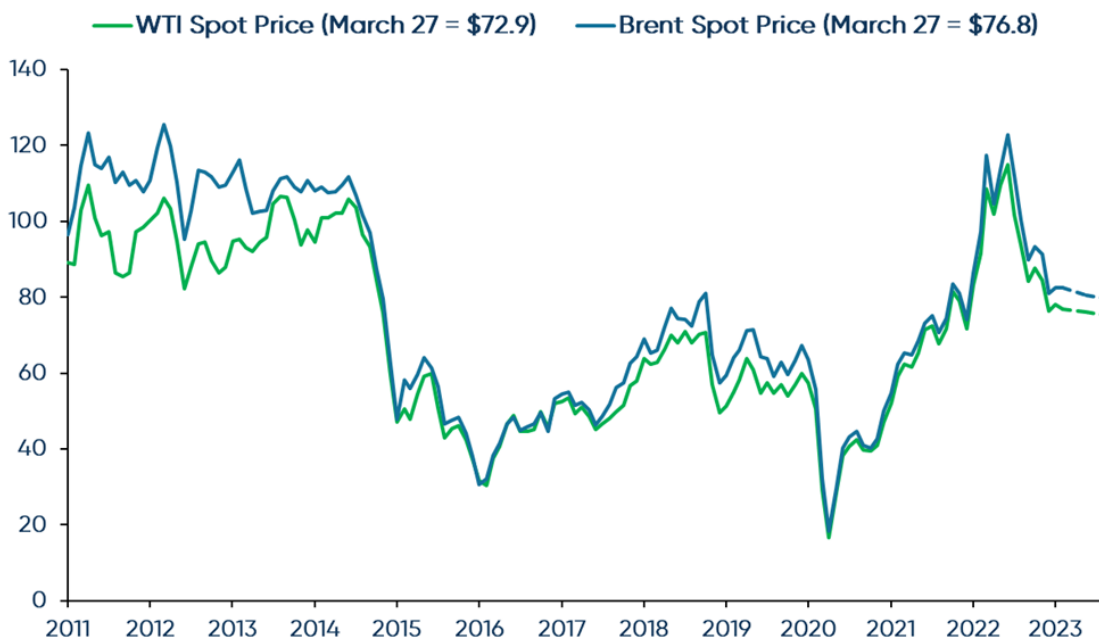
With Q1 2023 US GDP estimated to come in around 2.5%, ongoing concern about inflation is understandable. Though the Fed came to the inflation fight late, it has raised rates aggressively now for nine straight meetings. While others are more convinced inflation is/will roll over, we are inclined to side with the Fed: In addition to sticky wages, likely headwinds in the fight against inflation include re-shoring production, the green energy transition (fueled by the IRA and Chips Acts), and China re-opening. Allowing inflation to reassert itself from these higher levels would be the worst outcome for investment markets we can envisage (assuming that our banking system stabilizes and the debt ceiling is extended later this summer). If, as most investors believe, the Fed always raises rates until something breaks, let's hope that in addition to SVB, inflation also breaks.

That sums up our basic outlook. We have done little portfolio repositioning of major consequence as we try to sort out any real opportunities being created. We did widen our commodity hedge from the Bloomberg Commodity Index – Ex Energy to the straight BCOM, which includes Energy. The difference is small, but significant in our opinion, having the effect of replacing a 30% slice of metals and agricultural products with a 30% energy weight. If the global economy recovers this year as China re-opens, we expect increased energy demand could push prices higher.





## WTI and Brent Crude Oil Prices (\$ per Barrel; 2011 to 2023 Forecasted)<sup>9</sup>



Longer term, we expect that inflation will subside and interest rates will settle in near current levels. Short-term rates are unlikely to go back to zero, and bond investors should be allowed to earn positive real returns, though maybe not much above 1 to 2% real. Such an environment would be favorable for equity holders both public and private as companies will once again have access to fairly low-cost capital in a healthy economic environment. These are the conditions that usually persist. No more interesting times for us. Back to up and to the right for me.

As always, we very much appreciate the opportunity to help manage your capital and to help you achieve your organization’s goals. We are here to assist you in any way possible, so please reach out and let us know how we can help.

### Your TIFF Investment Team

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<sup>9</sup> “Energy Slideshow,” Federal Reserve Bank of Dallas, February 2023, and Bloomberg.

