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History Doesn't Repeat, But It Rhymes

In an uncertain economic environment, investor sentiment can change quickly. In a matter of days, near certainty around 'monetary tightening' outlook, quickly transitioned to predictions for 'monetary easing'. Expectations for the U.S. Federal Fund rate above 5% through 2023, have been replaced by predictions for nearly 50 basis points in cuts by year end. Global central banks, market participants and others are caught in a financial policy tug of war. While the Federal Reserve still needs to reduce inflation to its target levels of 2%, it now also needs to address financial stability concerns driven by recent bank failures.

Just like the COVID stimulus driven demand was unprecedented, so too was the speed and pace of interest rates hikes used to cool inflation. However, it's clear that this has ultimately helped lead to unintended consequences with three bank failures in the U.S. to date. Banks require confidence and at the end of the day when confidence is lost, no bank can survive. In Silicon Valley Bank's case (the 16th largest bank in the U.S. with over $200 billion in assets prior to its failure), depositors fled to the tune of $42 billion in a single day; to put that in perspective, Washington Mutual faced $17 billion in withdrawals over two weeks in 2008. The speed today is simply breathtaking. Lessons learned in the past have led regulators to move fast to prevent failures at one banking institution from spilling over to the entire banking sector, and ultimately the broader economy. While today's banking crisis is asset-related and not credit-related, regulators have still swiftly stepped in and provided assurances and guarantees in their effort to avoid further contagion; this contrasts with the 2008 financial crisis, when emergency policy measures took months to unfold.

Looking ahead our views remain unchanged. It is the things we are not talking about that surprise the market and therefore we do not try to guess tomorrow. Lower expectations for economic growth, stickier than expected inflation, and broader geopolitical concerns have all impacted general risk appetite as evidenced by a non-existent IPO market for the past 18 months (see - Gravity Still Rules blog). Broadly speaking, the probability of an impending recession is running at recent highs, but it's also arguably the most widely anticipated recession in the modern era. The prognosticators could be right at some point, but would it be this year, next year or beyond, and how deep would it be?

What are we doing? At the risk of sounding repetitive – we are doing more of the same (see – Defense Wins Championships blog). Given that we do not know the Fed's terminal rate and when the U.S. could hit a recession, we continue to "double down" on our Beyond Privileged and Resilient ("BP&R") companies while intensifying our due diligence around each investment's "pricing power", competitive moat, business quality and cash flows as we head into the second quarter and beyond. In 2022, almost all companies received nominal price increases given the inflationary backdrop, but as we move into a slower growth environment, real price and growth above market will be coveted. As Leo Tolstoy wrote, "the strongest of all warriors are these two – Time and Patience". This market will not reward excess risk-taking, and we continue to stick to "what we know".