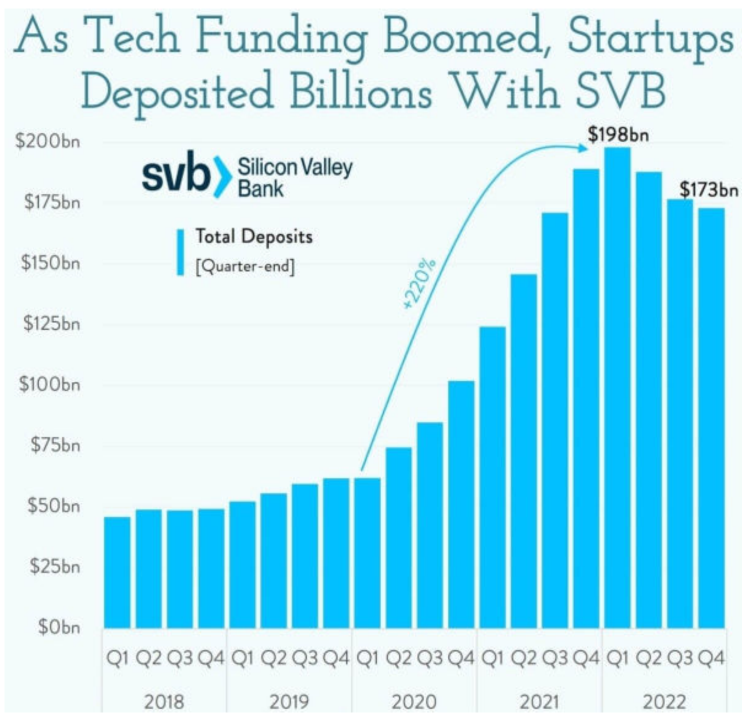
# Second Quarter 2023 Outlook and Commentary

In the world of finance, a "black swan[1]" is an almost entirely unforeseen, high impact event. A black swan hit financial markets last month when Silicon Valley Bank ("SVB"), the 16th largest bank in the U.S., collapsed over the course of 48 hours. Only a fraction of a bank's total deposits is kept in cash reserves. If a large percentage of depositors take their money out at the same time, cash reserves can be wiped out quickly. That's what happened to SVB; faced with a run on the bank, it ran out of cash.

As its name was meant to suggest, SVB was the go-to bank for Silicon Valley's venture capital community. When Covid-19 forced the world to rely on technology as never before, money flooded into Silicon Valley startups and SVB's deposits soared. The fact that deposits were becoming increasingly concentrated in one sector should have been a huge red flag, but just




Source: SVB Financial Group filings

when management ought to have been laser-focused on reducing its dependence on technology startups, it found a way to create additional risk in its bond portfolio. The bank invested around

[1] Black swans were presumed not to exist until Dutch explorers discovered them in western Australia in 1697. Around twenty years ago Nassim Nicholas Taleb popularized the use of the term to refer to unforeseen financial events with major consequences.

one hundred billion dollars of its new deposits in U.S. Treasury bonds and mortgage bonds, most of which weren't scheduled to mature for over ten years. As a result of the long maturities, these bonds offered extra income to SVB but would decline significantly in value if interest rates rose rapidly, which is exactly what happened in 2022. As SVB was suffering bond losses, the technology investment boom was waning and deposit balances of SVB's startup customers began to decline. With SVB's cash reserves down significantly, and under threat of a ratings downgrade, management decided to issue stock to bolster reserves. This move startled the venture capital community. Several prominent venture firms went into self-preservation mode, instructing their own startups to yank deposits as quickly as possible. That SVB's customers could take money out with the click of a mouse didn't help, and the end came quickly.

SVB's collapse caused depositors to question the health of other banks, including Signature Bank. Signature was the second leading provider of banking services to the cryptocurrency industry, which has been experiencing a long overdue shakeout. (The leading provider of banking services to the cryptocurrency industry, Silvergate Bank, had announced a voluntary liquidation only one week before.) With over a dozen small to mid-sized banks facing a troubling level of withdrawals, authorities closed Signature and moved quickly to prevent a broader banking crisis. The FDIC stepped in to waive the $250,000 FDIC insurance limit for SVB and Signature depositors. The Federal Reserve offered virtually unlimited liquidity on easy terms to banks under pressure. In Europe, Credit Suisse, which has been one of the most troubled large European banks for many years, began to teeter. Swiss authorities engineered a fire sale of Credit Suisse to the much healthier UBS. Regulators are keeping a close eye on a number of other banks in the U.S. and around the world. The situation seems to have stabilized but it's worth continued attention.

Fortunately, confidence in the very large U.S. banks, those subject to vigorous oversight including annual "stress tests," hasn't waned. J.P. Morgan Chase CEO Jamie Dimon put things well in his recently published shareholder letter. He cautioned that the recent bank collapses would have significant and long-lasting consequences but added, "importantly, recent events are nothing like what occurred during the 2008 global financial crisis (which barely affected regional banks)…At that time, there was enormous leverage virtually everywhere in the financial system…This current banking crisis involves far fewer financial players and fewer issues that need to be resolved."

Hundreds of small and mid-sized banks have experienced sharp deposit outflows and need to preserve capital. Not surprisingly, bank lending dropped by a record $105 billion in the last two weeks of March. Constrained lending introduces a major wild card in the Federal Reserve's attempts to bring inflation down to its target of 2%. Like interest rate increases, tighter lending slows the economy; unfortunately, no one knows how to quantify the impact. Some economists believe that the slowdown in lending, when combined with already completed rate hikes, will be more than enough to bring inflation down to the Fed's target of 2%. However, other economists believe the Fed will have to raise interest rates considerably further to finish the job.

Bond and stock markets have had strikingly different responses to the banking turmoil. U.S. Treasury bond yields are down dramatically, implying Federal Reserve interest rate cuts later this year, which would only happen in the event of a sharp economic contraction. The stock market, on the other hand, is up significantly on the year and higher than before SVB's collapse. Our base case scenario continues to be that the U.S. will soon enter a recession that is perhaps more prolonged than usual but mild. However, the chances of a more serious downturn are higher than they were six weeks ago.

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While the financial world was focused on ongoing efforts to prevent further bank failures and the Federal Reserve's decision to press forward with an additional interest rate hike, the Biden administration launched another volley in the so-called "chip wars." In a series of steps that may prove more consequential than almost anything else that has happened in recent years, President Biden has moved aggressively to bolster the U.S. semiconductor industry and constrain China's. The March announcement proposes restrictions on companies receiving money under the CHIPS and Science Act of 2022. The proposed rules, which would limit technologies those companies could utilize in their Chinese operations, were significantly tougher than anticipated. The administration has also imposed export controls on the semiconductor industry and rallied Japan and the Netherlands (home to ASML, a photolithography machine maker and the most important company you've never heard of) to do the same. Together with these allies, the U.S. controls 90 percent of the global market for semiconductor manufacturing equipment; these restrictions and controls could be game-changing.

Even before the chip wars heated up, companies around the world, hamstrung by broken supply chains, have been questioning whether they had become overly reliant on certain suppliers and certain countries. All of this has led pundits to talk about "deglobalization," a significant unwinding of the last several decades in which complex products are assembled from components built all over the world. It may be more accurate to say that the world is splitting into two blocs, a Chinese-led bloc and an American-led bloc. While there will likely be significant trading between the blocs, manufacturers of more complex goods may consolidate suppliers within their own bloc. Playing on the term "offshoring," introduced in the 1990s when companies rushed to moved production offshore, some analysts are calling the current wave of supply chain adjustments "friendshoring."

If the chip wars do cause the global economy to fracture into a U.S. bloc and a Chinese bloc, the split won't follow strictly geographical lines. Vietnam, for example, would be likely to be part of the U.S. bloc, while China's longstanding efforts to develop economic ties in Africa would keep much of that continent in their fold. India, which recently surpassed the United Kingdom to become the world's fifth largest economy, would likely try to keep one foot in both camps.

A split of the global economy into two blocs would not necessarily cause economic growth in either bloc to come to halt or even slow dramatically. But there will certainly be winners and losers—among both companies and countries—and the transition may not always be smooth. Country and region selection could end up being more important than in the past and reinforces why we like actively managed foreign stock strategies over passive index strategies. Active managers can more quickly react to changing data and circumstances while passive indexes are only rebalanced after the fact. If the global economy evolves into two blocs, it could be volatile but productive for strategies that get it right.

*Boston, MA*
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