SIGNS OF STRESS

The surprise failure of Silicon Valley Bank (SVB) has brought fears of instability of the financial system, sending a shockwave of uncertainty across the capital markets. Very elevated volatility in Treasuries, including a dramatic drop in rates across the curve, highlight investor concerns regarding other potential "shoes to drop." Equity markets have been more resilient, perhaps acknowledging critical differences to the financial crisis 15 years ago.

We do not think this is the same situation as the financial crisis of 2008. SVB was a unique institution exposed to relatively unique risks. While its failure has exposed underappreciated vulnerabilities, there are critical differences compared to 2008. Far more capital and liquidity combined with much better oversight have dramatically reduced systemic risk. The issues at SVB were "hidden in plain sight", not accumulated through poor lending standards and off-balance-sheet or complex financial structures that magnified and obfuscated risks. Intervention from regulators to provide liquidity to banks should sufficiently protect the system, though financial markets will likely require the passage of time as proof.

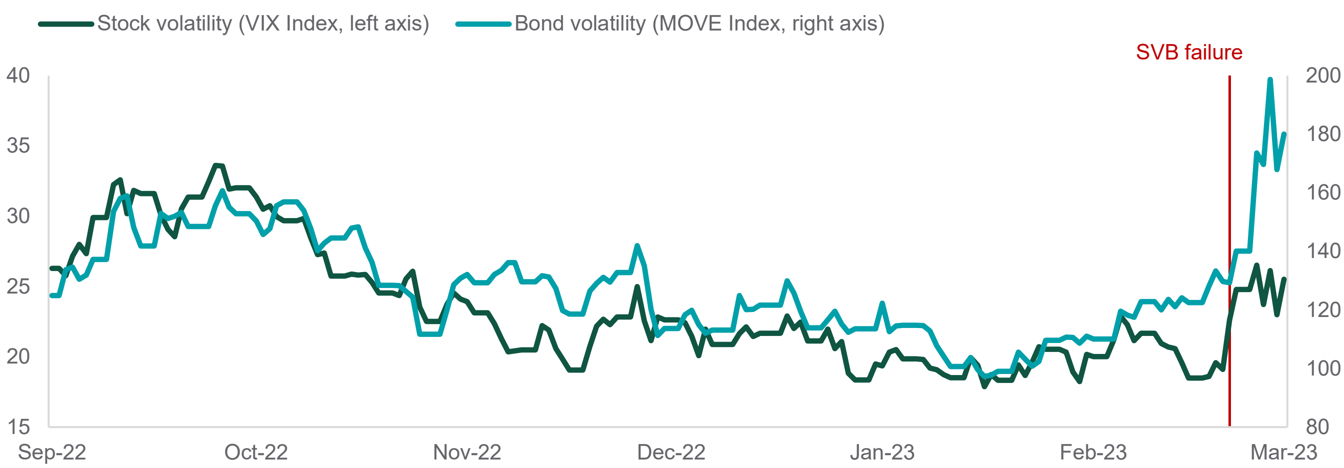
We expect global markets will cycle through a list of potential worries, keeping volatility high in the near term. Stocks have held up surprisingly well in aggregate, perhaps aided by the drop in rates and changing expectations regarding the path for the Fed, as it and other central banks walk the tightrope of maintaining vigilance on inflation while preserving financial stability.

The duration of this period of uncertainty will have implications on future growth and inflation – the longer this takes to resolve, the larger the drag as businesses and consumers wait out the storm. Meanwhile, the labor market remained strong in February with over 300k new jobs added while wage growth cooled. Producer prices came in lower than expected, hopefully a leading indicator of continued disinflation. In the absence of SVB's issues, investors would likely have greeted all of this favorably.

We tilted portfolios to be slightly more defensive this month but see a restoration of market confidence as the base case. We think markets have priced in too negative an outcome in the fixed income markets, and thus kept our target weight to investment grade bonds.

UNCERTAINTY

The SVB failure drove significant volatility in the bond markets. Stock volatility was elevated but notably more contained.



Source: Northern Trust Asset Management, Bloomberg. Silicon Valley Bank (SVB) failure on 3/10/2023. Data from 9/17/2022 through 3/17/2023.

BASE CASE EXPECTATIONS

Dented Confidence

The Silicon Valley Bank failure will likely have a small effect on the supply and demand for credit (small banks lending a bit less and borrowers showing hesitation given uncertainty) but may also have a small effect on the Fed's willingness to continue aggressive rate increases.

Monetary Tightrope

Given concerns regarding financial stability from unexpectedly rapid rate increases, the Fed will likely resort to a slower path of monetary tightening. But inflation has remained sticky, likely necessitating further rate increases. We continue to believe the Fed is close to done raising rates, but will remain there throughout 2023.

RISK CASE SCENARIOS

Labor Market Durability

More persistent tightness in the labor market leads to more stubborn core inflation, necessitating an unexpected monetary policy response that is negative for financial markets.

Debt Dislocations

Further banking fallout (a risk heightened by the steeply inverted yield curve) and/or lack of progress on a debt ceiling deal (which would likely further invert the yield curve) hurts sentiment.

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