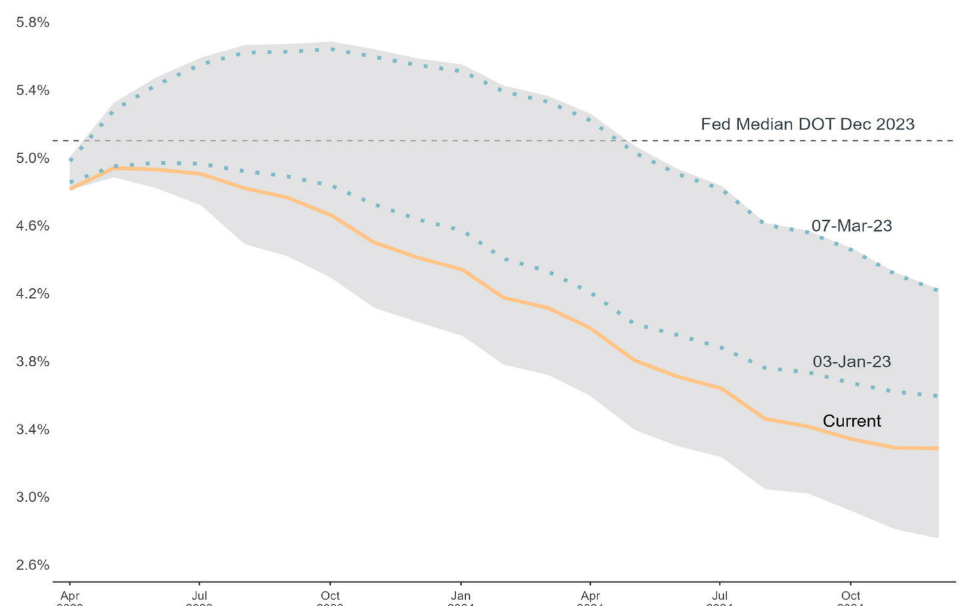
FIXED INCOME

Bonds posted a second consecutive positive quarter, with the Bloomberg US Aggregate Bond Index up 3.0%. However, the ride was far from smooth, as the index whipsawed between positive and negative territory during the period. The three-consecutive months of moves represent a magnitude not seen since 1982 when the Fed funds rate was in the double digits. That description may not do the volatility justice as the MOVE Index - a measure of implied volatility in the Treasury market - surpassed its Covid-era highs to reach levels last seen during the global financial crisis in 2008.

The bond market's outlook shifted significantly over the quarter. After a strong start to the year on hopes of 'soft landing', a series of economic releases in early February showing a surprisingly resilient economy had the narrative reverting to a 'higher for longer' rates regime. Yields climbed steadily over the next month,

Figure 8. The Fed funds market implied rate path whipsawed as expectations rapidly shifted



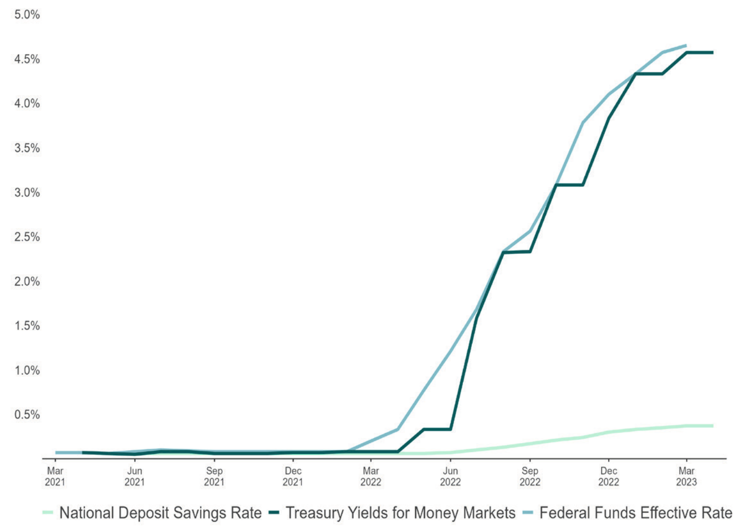
Note: Shaded region represents the upper and lower bounds of Fed funds futures pricing from January 3 to March 31. On March 8, SVB announced a capital raise plan before quickly collapsing by the end of the week.
Source: RockCreek, Federal Reserve, Bloomberg. As of March 31, 2023.

with the 10-year rising 68 basis points to a peak of 4.08% in the early days of March. The real action was in the front end though as the 2-year gained nearly a full percentage point, rising to 5.05%, as the market priced a terminal fed funds of 5.75%, up from 4.5% a month prior (Figure 8).

This was before 'AFS' and 'HTM' became widely known acronyms. As covered earlier in the letter, the failure of SVB put a spotlight on the liquidity challenges banks would have if forced to realize losses in their longer duration securities portfolios to meet deposit withdrawals. In a five-day span in mid-March, the 2-year Treasury yield dropped 112 basis points to 3.93% as the narrative again shifted to an impending credit crunch that would precipitate the Fed 'pivot.'

At the same time, depositors of all types became highly attuned to cash management. Yield and security, which have been overlooked in recent years, came back into the spotlight as investors moved out of low-yielding bank deposits and into money market securities (Figure 9). This only exacerbated the problem for banks, leading to a tap in Fed liquidity sources to a historic extent. It wasn't long ago that there was a cash glut and banks were turning away deposits due to an absence of productive uses. What is yet to be seen is the second order effects of this cash flight. While the immediate liquidity impulse has been accommodative, in the medium- to long-term, the money multiplier will be constrained as savings are not converted to loans. Consistent with the Fed's objectives, this should reflect in "real economy" data (e.g., employment) in time.

Figure 9. Deposit rates have lagged behind Fed funds rate and yields offered to money market funds



Source: RockCreek, FDIC.

We wrote last quarter about the environments in which the yield curve normalizes. While the inversion only deepened during the first quarter, these cracks in the banking system look like the first stage of 'normalization' whereby the yield curve begins to bull steepen in response to financial conditions that are sufficiently tight to slow economic activity.