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Market volatility is like a pendulum that swings between fear and greed, and it's up to investors to maintain their balance.

-Sir John Templeton

Dear Clients:

The pioneering investor, Sir John Templeton, advised that maintaining one's balance in the face of market volatility is the secret to successful investing. Finding that equilibrium has been a challenge over the last two years as we have experienced the pendulum-like swing from greed in 2021 to fear in 2022. If that weren't enough, during the first quarter of 2023, that cycle repeated once again.

Last quarter we highlighted that the equity and fixed income markets were driven in 2022, almost exclusively, by the Federal Reserve's interest rate tightening policy. The result was a year in which investors had no place to hide as fear of rising interest rates drove all markets down.

This year began with investors anticipating that the Fed was nearing an end to its tightening regime, only to be surprised by stronger than expected economic data that suggested interest rates might have to be raised higher and maintained for longer than previously expected. The equity and bond market swings of January and February appeared to be a further continuation of the volatility of 2022 as investors could not predict when the tightening cycle might end. That was until March.

When central banks raise interest rates to moderate strong economic conditions they speak as if they are conducting monetary policy with the precision robotic laser surgery. The reality is more akin to performing an operation with the accuracy of a butcher's knife. While the policy goal is to slow the economy with as little collateral damage as possible, tightening regimes often cause unintended consequences. These frequently manifest themselves in the financial sector as the economic conditions that allowed for their successful business strategies are significantly disrupted.

Ironically, it is precisely these types of major financial disruptions that answer the most important question that investors have been asking for the last year: when might the Fed stop raising interest rates?

Looking back at interest rate tightening induced financial disruptions of the last 50+ years, we can see that central bankers are more likely than not to alter their previous policy to help contain crises. The following table captures each major financial shock and the subsequent policy reaction by the Federal Reserve. In all but one, the Fed eased monetary conditions to help act as a cushion for the global economy.

Financial Shock/Crisis	Fed Reaction
1971 Penn Central	Eased
1974 Franklin Nation	Eased
1984 Continental Illinois	Eased
1987 Black Monday	Eased
1990 S&L Crisis	Eased
1994 Tequila Crisis	Eased
1997 Asia	Paused
1998 Russia/LTCM	Eased
2000 Tech Bubble	Eased
2007 GFC	Eased
2012 Eurozone Crisis	More QE
2016 Oil collapse	Eased
2023 SVB	???

Source: Evercore ISI

It is too early to tell what the Fed's reaction will be in the wake of SVB's collapse but the equity and bond markets are already anticipating that the steep rate hikes of the last 12 months are all but over.

The pendulum swinging to fear in mid-March and the subsequent rally in equities and fixed income into the close of the first quarter is precisely why Sir John advocated maintaining balance and not overreacting to the sentiment of the moment. With all the anxiety of the quarter, equity indices delivered positive returns, though they varied widely. The technology heavy NASDAQ far outperformed the industrial heavy Dow Jones Index, as cash rich tech stalwarts became a safe-haven and more economically sensitive energy and financial stocks lagged. In fact, just two stocks, Apple and Microsoft, currently account for 13% of the S&P 500 Index's value, which is an historic extreme. The strength of these two stocks more than offset all the losses that occurred in the financial sector and helped the index appear to perform better than was the case.

As we have been counseling for quite a while, the reintroduction of real interest rates (those in excess of inflation) is likely to cause continued equity and bond market volatility as the economy adjusts to this new reality. We continue to advise our clients to "maintain their balance" as, ultimately, well-managed companies take advantage of the opportunities that are inevitably created. Should you feel "unbalanced" in your asset allocation, please reach out to us so we may help ensure that you are properly positioned to achieve your financial goals subject to your risk tolerance.

Thank you for your trust and confidence.

Sincerely,

The Partners of CANNELL & CO.