The Cobblestone Advisor

Investment Brief

April 2023

COBBLESTONE
CAPITAL ADVISORS

Lagged Effects of Monetary Policy

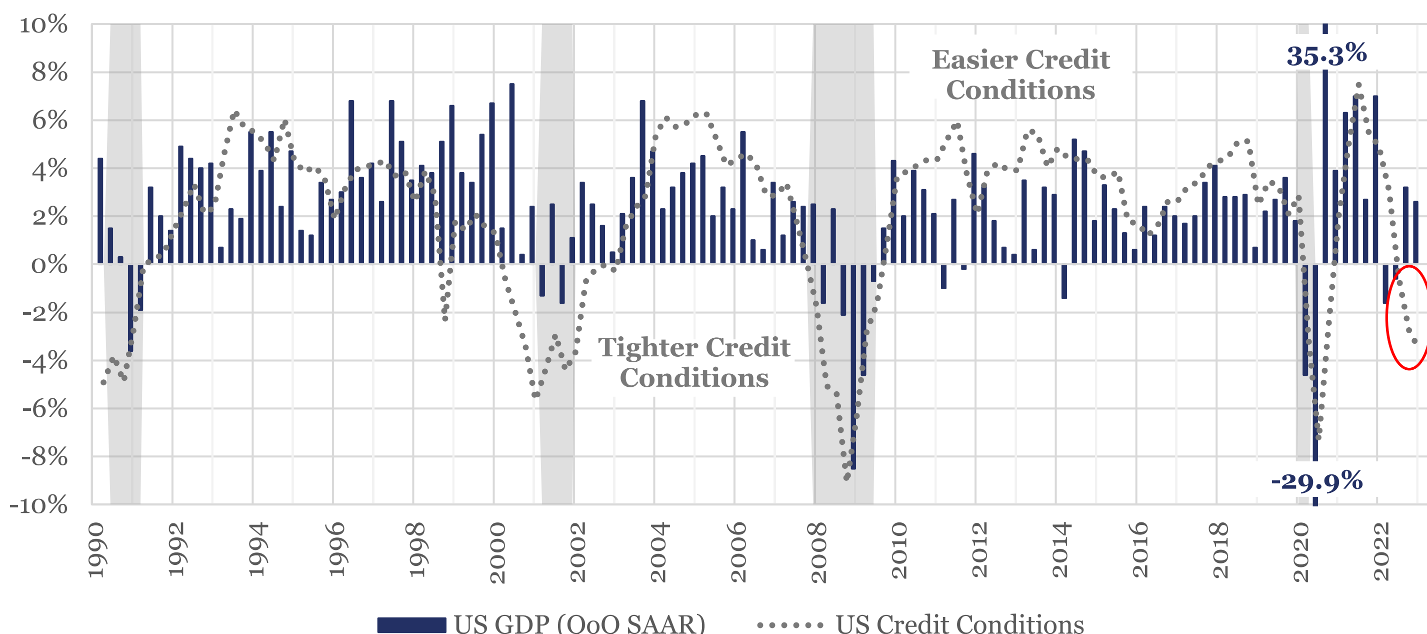
The state of the US and global economy remains in focus as investors attempt to determine how the synchronized tightening cycle imposed by global central banks in their effort to stamp out inflation is affecting the trajectory of economic growth. During the first quarter, weak but better-than-feared economic data increased investor hopes that policymakers will be able to rein in inflation without tipping the economy into recession. But volatility resurfaced in early March amid the failures of Silicon Valley Bank and Signature Bank, the second and third largest bank failures in US history, respectively (the largest bank failure—Washington Mutual—occurred in 2008).

Despite this banking turmoil, US stocks and bonds both delivered strong returns, with the S&P 500 up +7.5% and the Bloomberg Aggregate Index up +3.0%. As a result of both asset classes starting 2023 off on positive footing, a US benchmark portfolio comprised of 60% stocks and 40% bonds experienced a promising start to the year, delivering a return of +5.7% during the first quarter, far exceeding the first-quarter historical average return of +1.7%.

With US inflation and inflationary pressures subsiding in recent months—and following the banking challenges that materialized—investors have recalibrated their outlook for monetary policy over the quarters ahead. As of early March, market pricing indicated that the federal funds target rate would reach a high of 5.75% in June and remain there until at least early 2024. Current expectations are that Federal Reserve policymakers will conclude their rate hike cycle following—at most—only one more 25 basis point increase in the fed funds rate, which would bring the rate to a high of 5.25% in May, before cutting rates two to three times by early 2024. An important caveat is that market expectations have not always been a reliable predictor of Fed policy.

Nonetheless, a decrease in the peak expected rate and more accommodating monetary policy in the coming months would be a welcome development. Yet it is important to recognize that credit conditions—or the availability and cost of credit—have already tightened considerably (as seen in the below chart). The recent bank failures and resulting capital outflows from regional banks are likely to lead to a further tightening in credit conditions, raising concerns that the US economy will continue to slow or perhaps fall into a recession.

(Continued on page 2)



Source: Bureau of Economic Analysis, US Federal Reserve, Bloomberg.

Tel. 585-473-3333 500 Linden Oaks, Suite 210, Rochester NY 14625 cobblestonecap.com

Tune In To Our Podcast!

Join Cobblestone's Jesse Cramer and Gabe Chodak on

The Trusted Partner Podcast

where they chat with experts in investing, financial planning, and other areas of wealth management specific to Cobblestone's clients' needs.

You can listen to **The Trusted Partner Podcast** on Spotify, Apple Podcasts, and Cobblestone's website.

It is worth noting that not all periods of tightening credit conditions have led to a recession. Policymakers have tools at their disposal to mitigate the impact of tightening credit conditions, such as reducing interest rates or implementing fiscal stimulus measures to boost investment and spending. Even so, a significant tightening in credit conditions is generally viewed as unfavorable for the economy. When credit becomes more difficult to obtain, both businesses and individuals tend to curtail their spending and investment, which can have a cascading impact on the broader economy. Throughout history, a significant tightening in credit conditions has often resulted in an economic slowdown, or even full-blown recession. If credit conditions continue to tighten in the months ahead, it is probable that this will exert further downward pressure on economic growth.

Monetary policy also tends to work with a lag, and a large body of research shows that it can take up to 18 months or more to see the effects of tighter policy. Given that the Fed's rate hike campaign just began in March 2022, we are likely in the very initial stages of observing the lagged effects that may arise from the tightening cycle, the impact of which may not be fully realized for some time.

Given the ongoing economic uncertainty, elevated risk of a recession, and sharp rise in interest rate volatility of late, we expect that both stock and bond markets will remain volatile. While bonds are better positioned to withstand volatility following the sharp rise in yields throughout 2022, it is important to be prepared for a wide range of outcomes within equity markets until there is further clarity on inflation, interest rates, and the overall economic outlook. In such an environment, investors should keep a long-term perspective and ensure that allocations are consistent with their financial objectives and risk tolerance levels.

For stock allocations, we recommend that portfolios target investments in durable, high-quality, cash-flowing companies that are diversified by geography and size, have healthy balance sheets, and are priced below their intrinsic value. This approach aims to provide investors with long-term growth opportunities while mitigating downside risk. Fixed income allocations should consist of diversified, high-quality bonds that contribute to both near-term liquidity and long-term growth, with a focus on generating income as a driver of return. This approach is designed to offer a steady stream of income to investors while maintaining a balanced level of risk. Investors should also incorporate alternative sources of risk and return—including private investments—comprised of asset class exposures that are uncorrelated or have low correlation to financial markets and the economic cycle. Incorporating alternatives can help smooth out portfolio returns, mitigate risk of the overall portfolio, and maximize potential return.

Total Return (%), Ending 3/31/2023				Annualized		
	Qtr	YTD	1 Year	3 Years	5 Years	10 Years
S&P 500 Stock Index	7.5	7.5	-7.8	18.6	11.7	12.2
Russell 2000 (Small-Cap Stocks)	2.7	2.7	-11.6	17.5	5.2	8.0
MSCI EAFE (International Stocks)	8.5	8.5	-1.4	13.0	3.5	5.0
MSCI EM (Emerging Markets)	4.0	4.0	-10.7	7.8	-0.9	2.0
Bloomberg US Aggregate Bond Index	3.0	3.0	-4.8	-2.8	0.9	1.4
Dow Jones US Select REIT	2.8	2.8	-21.0	11.3	4.9	5.3
Consumer Price Index (% Chg over Period)	1.7	1.7	5.0	5.4	3.9	2.6

This communication may include opinions and forward-looking statements. All statements other than statements of historical fact are opinions and/or forward-looking statements (including words such as "believe," "estimate," "anticipate," "may," "will," "should," and "expect"). Although we believe that the beliefs and expectations reflected in such forward-looking statements are reasonable, we can give no assurance that such beliefs and expectations will prove to be correct. Various factors could cause actual results or performance to differ materially from those discussed in such forward-looking statements. All expressions of opinion are subject to change. You are cautioned not to place undue reliance on these forward-looking statements. Any dated information is published as of its date only. Dated and forward-looking statements speak only as of the date on which they are made. We undertake no obligation to update publicly or revise any dated or forward-looking statements. Past performance is not indicative of future results. Investment in securities, including mutual funds and ETFs, may result in loss of income and/or principal. Nothing in this article is intended to be or should be construed as individualized investment advice. Investors should consult their Cobblestone advisors for tailored advice. Any references to third-party data or opinions are listed for informational purposes only and have not been verified for accuracy by the Advisor.