Please note: This is a transcription so there may be slight grammatical errors.

Markets are driven by powerful forces that often pull in opposite directions, but like a game of tug of war, sometimes the flag in the middle of the rope barely seems to move.

Despite dramatic headlines this year with both good and bad financial news, markets have delivered modest results with single digit returns for both stocks and bonds. These returns could suggest normal and steady conditions, but in fact, massive countervailing forces are at work. Pulling in one direction is the US Federal Reserve. The Fed's goal is to bring inflation under control gently without triggering a recession. Its actions so far have been aggressive, raising interest rates nine consecutive times, taking the Fed funds rate from zero to nearly 5% over the course of just a year. By raising rates this high and this fast, the Fed is digging in its heels and putting the full heft of the world's largest balance sheet on one side of the rope.

Tugging the rope along with the Fed is a remarkably tight labor market with job openings outnumbering people looking for work. The enormous pull of consumer spending is also on the team as US households continue to spend, buoyed by the strong job market. Pulling in the other direction is an equally formidable group, the capital markets. Investors, banks, financial institutions that make markets tick. These institutions and investors form the engine of America's prosperity by providing efficient sources of capital for business and the broader economy.

While the Fed remains concerned with inflation, markets seem to be convinced that a deep recession lies ahead. The debate over these opposite outcomes should or will only resolve as the year progresses, and more data reveals the true path ahead. So far in 2023, we've achieved a type of stalemate in the Fed versus the markets tug of war. That is until the middle of March when stresses began to show in the banking system, brought on by higher interest rates. Volatility briefly returned to markets as it seemed that the flag was beginning to move. You see, during the pandemic, banks were flooded with deposits fueled by stimulus programs. This caused them to do what banks have always done, seek profits by earning returns greater than what they pay to savers, the so-called net interest margin.

One way to increase this margin is to purchase longer dated bonds, which most banks in the country did. But when interest rates spiked in 2022, these bonds fell in price, setting the stage for bank losses and a liquidity crunch when consumers came looking for those deposits. One bank that catered to a specific clientele, high-tech startups and venture capital firms, experienced a run on the bank as depositors sought to withdraw their balances and mass. While you might be thinking about the bank run scene from It's a wonderful Life, the reality is that the smartphones in our pockets let customers move money much more quickly with just a tap on the screen.

These screen taps caused the bank's liquidity to evaporate quickly. The FDIC dramatically stepped in and took control of the bank and provided guarantees to the bank's depositors. The result was the second-largest bank failure in US history. This failure and subsequent takeover created shock waves throughout the financial system. Depositors began to question whether other banks could slip and fall. Then just two days after the failure of the first, another bank that likewise catered to a specialized clientele also failed and a third faced significant financial stress. During those tense moments, it seemed that the capital markets had indeed begun to lose ground and that the Fed's actions may have triggered a broader panic. This began to move the rope towards recession and even possibly deflation.

However, investors quickly regained their footing as conditions stabilized and more widespread problems in the banking system were avoided. At CAPTRUST, we have been monitoring the situation closely to evaluate risks to investors. This work is ongoing, but we feel confident that client assets are safe and well-kept due to the quick response from regulators and policy makers. Today, this tug of war seems to have reached a state of tense equilibrium as each side waits for the other to flinch. Despite the back and forth, the stock and bond markets have been surprisingly calm, but beneath the surface, more subtle indicators show great controversy and a wide range of opinions of what the rest of this year may actually hold.

Will the Fed pause its aggressive rate hikes and allow the impact of higher rates to sink in? Will banks reassess their willingness to lend or will the Federal Open Market Committee, the FOMC, continue to pull hard on their side of the rope, maintaining their primary concern about the potential threat from higher inflation? It's important to point out that in this match, both sides want the same thing, an economy that reaches its full potential without the damaging effects of inflation or a painful recession. As we enter the second quarter of the year, the contest is far from decided, and as it plays out, we will likely see volatility return to markets. But as the game unfolds, diversification will again prove to be investors' most powerful ally. While it's impossible to keep the flag completely still, a diversified portfolio may help keep it between the lines and shelter investor assets as this epic tug of war plays out.

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