Q1 MARKET INSIGHTS

Spring 2023

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Markets were quite resilient in the first quarter as investor optimism, stemming from declining inflation data and the possible end to Federal Reserve (the "Fed") rate hikes, were offset by the sudden failures of Silicon Valley Bank (the 16th largest bank in the U.S. with more than $200 billion in assets) and Signature Bank of New York (with more than $100 billion in assets). Quick and effective actions by government officials in response to these bank failures helped shore up confidence in the banking system which led to modest gains for both stocks and bonds in the quarter. The S&P 500® Index finished the quarter up 7.48%. On the international front, nearly all foreign markets realized positive returns for the quarter. Foreign developed markets outperformed relative to the S&P 500 through the first three months of the year as economic data reported in Europe was better than expected. Foreign developed markets, represented by the MSCI EAFE Index, rose 8.65% during the first quarter. Emerging markets logged modestly positive returns through March yet underperformed the S&P 500 due to ongoing geopolitical tensions, with the MSCI Emerging Markets Index returning 3.97% for the quarter. Switching to fixed income markets, the leading benchmark for bonds (the Bloomberg Barclays US Aggregate Bond Index) returned 2.96% for the quarter as bond investors also welcomed the prospects of declining inflation and peaking interest rates.

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THE UNINTENDED CONSEQUENCES OF FISCAL AND MONETARY POLICY

Looking ahead, the Fed continues to face the challenging task of trying to tame inflation without causing a severe slowdown in economic activity. After embarking on one of the most aggressive Fed rate hiking campaigns ever last year, inflation has shown definitive signs of peaking and declining. The Consumer Price Index ("CPI") has fallen from a high of 9.1% last June to 6.0% in February, while other metrics of inflation have registered similar declines. Many economists are forecasting the CPI to be near 4% by mid-year. As a result, expectations are that the Fed is near the end of its rate hiking cycle (based on the futures market, investors are pricing in a 58% chance of one more rate increase). Despite this progress, inflation remains above the Fed's target rate of 2%. Recently, in an effort to maintain the Fed's credibility relative to fighting inflation, Chairman Jerome Powell stated that interest rates will remain "higher for longer." The issue, however, is that these rate hikes can take time to flow through and impact the economy. 2022 saw the largest increase of Fed rate hikes ever in a single calendar year, and have risen 4.75% since they began raising rates last March. Given the speed at which the Fed raised rates, we are starting to see more cracks in the economy. It started last year with the U.K. pension crisis, and has now expanded into the banking system here in the U.S. with the recent bank failures.

Before we get into more detail about what happened to the banks, let's take a step back and examine how banks function. When you deposit money into a bank account, it doesn't get locked away in a bank vault for safekeeping. You are, in effect, lending your cash to the bank. It is a loan transaction, with you as lender and the bank as borrower. Your deposit appears as a liability on the bank's balance sheet. In simple terms, the bank borrows money from you and then lends it to someone else. If all goes well, the bank profits from the difference between its cost of funds (the interest it pays to you, the depositor) and interest received on the loans it makes. Those loans support small businesses and help consumers

buy cars, houses, appliances, etc. Banks also loan money to the Federal government by purchasing Treasury securities. Running a bank is a balancing act because the assets (loans) and liabilities (deposits) have different maturities. People can demand their cash any time but the bank can't call in its loans (at least not quickly). The system works because most people leave their balances in place most of the time, so it helps to have a loyal, diversified depositor base.

The failure of Silicon Valley Bank ("SVB") had its origins in the fiscal and monetary responses to the COVID crisis. The massive fiscal stimulus, combined with the Fed's rate cuts and its quantitative easing program, spurred a hot global economy. With low financing costs, venture capital investments in technology and startup companies grew significantly. SVB, a bank that specialized in catering to venture capital funds and their related venture-backed startups, saw its deposits rise 179% from the end of the first quarter of 2020 until the end of 2022. Despite the large influx of deposits, there was not enough loan demand, so SVB invested the remaining money it received from its depositors into low-yielding U.S. Treasuries and Agency bonds. With the Fed raising interest rates, the market value of those securities held by SVB fell in value (remember as interest rates rise, the value of bonds fall). Then, as financial conditions tightened and venture activity slowed significantly, many of those start-up companies began to draw on their deposits to meet cash flow needs, forcing SVB to sell some of its bond holdings at a loss in order to meet customer demand. To offset this loss, the company announced that it would be raising money by issuing new shares of stock so it could maintain its capital requirements. This caused concerns surrounding the bank's ability to meet depositor demand, and a "run on the bank" ensued as depositors (especially those with more than $250,000 in deposits- which is the Federal Deposit Insurance Corporation, or "FDIC", insurance limit) were anxious about the overall health of the bank. Given the panic, the fundraising efforts failed, and in order to protect depositors and preserve the assets and operations of SVB, the FDIC seized the assets of the bank. In addition, the Fed guaranteed all deposits (not just those within the FDIC limits) to avoid a broader bank run on other banks. This represented the second largest bank failure in U.S. history and was the biggest since 2008.

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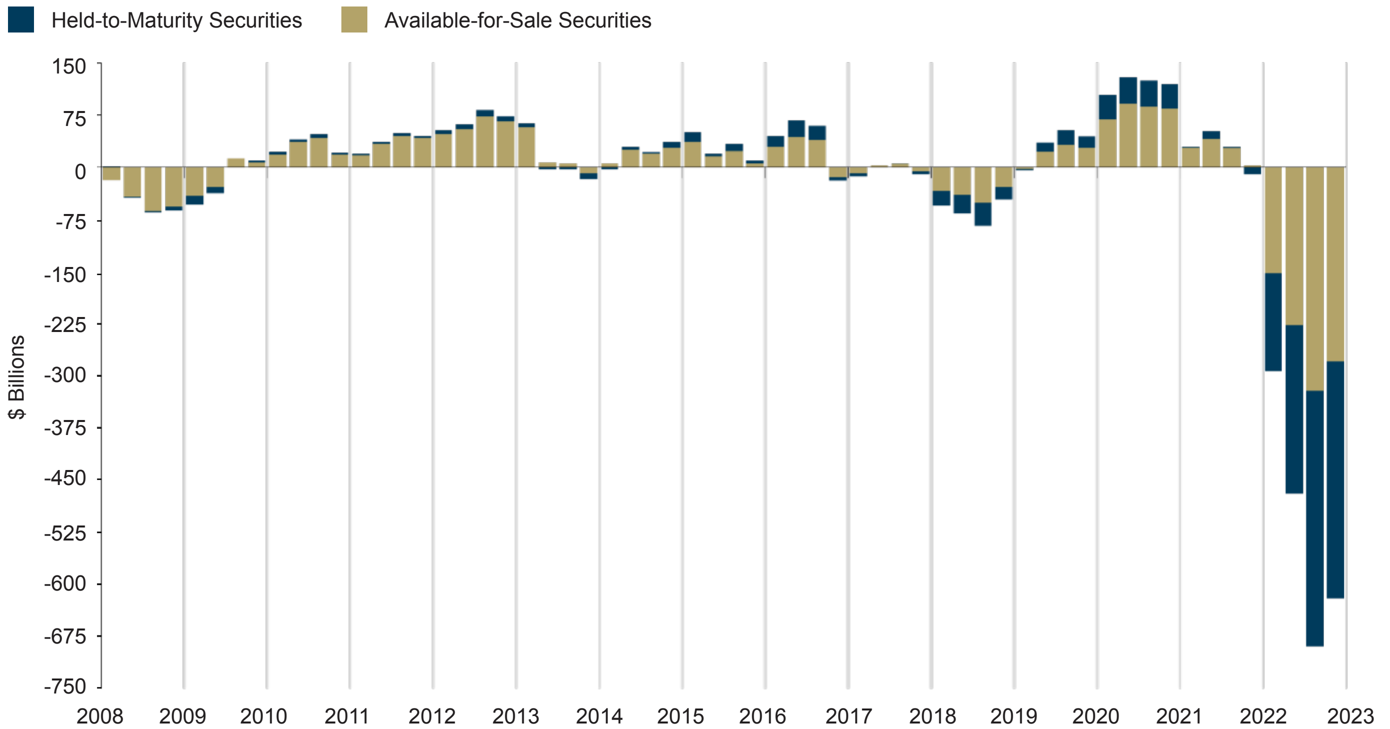
While it is true that SVB did not have a very diversified depositor base (over 90% were venture capital funds and start-ups), and that 97% of their depositors had balances of more than $250,000 (which exacerbated the issue), this problem is not solely limited to SVB. Signature Bank of New York was also shut down by the FDIC during the quarter. The issue is with the Fed raising rates, banks are currently unable to offer competitive interest rates on deposits. With short term U.S. Treasury rates well over 4%, customers are withdrawing their deposits and investing that money into Treasuries and money market accounts as the yields are much higher than those being offered by most banks. In addition, many banks hold a large amount of low-yield U.S. Treasury and Agency bonds on their balance sheets which have fallen in value (because of rising rates). According to the FDIC, U.S. banks are sitting on unrealized losses of $620 billion as of the end of 2022 (see chart on next page for perspective). Therefore, in an effort to minimize the risk of a run on the banks, the Fed created a backstop lending program, providing banks with the funding they need to avoid selling their bonds and realizing these losses (by providing loans at the face value of the collateral, and not the market value).

While a financial crisis has been avoided, at least for now, the failures of SVB and Signature Bank highlight the unintended consequences of Fed policy. Reversing years of easy monetary policy are fraught with difficulty, as the lagged effect of tighter monetary policy takes time to be fully reflected in the economy. The Fed and other developed market central banks are in a precarious position as there is tension between their dual objectives of ensuring financial stability and reining in inflation. In previous quarterly updates we have cautioned that the Fed is walking a tightrope between hiking too much (risking recession) and hiking too little (allowing inflation to run hot). Our concern was that the Fed might overdo it, and something would break. Our hope is that the collapse of SVB and Signature Bank are not the start of a longer list of casualties from the Fed's historic shift in policy.

Unrealized Gains (Losses) on Investment Securities



Source: FDIC
Note: Insured Call Report filers only

We cannot say with certainty that we will experience a recession in the months ahead, however, we believe the odds of one occurring has increased given the aggressive rate at which the Fed has raised rates. Despite Chairman Powell's steadfast commitment to fighting inflation, we think the Fed will have no choice but to reverse course and ease conditions (this could include cutting interest rates, ending quantitative tightening, or re-starting quantitative easing) at the first sign of a recession. A pivot by the Fed would likely be supportive for equities, as lower interest rates would theoretically improve valuation multiples. It would also help solve the current problem in the banking system, as the value of the bonds held by banks would increase.

STOCKS TO FOLLOW EARNINGS

During 2022, equity markets were adversely affected by increasing interest rates, but now that the Fed is close to the end of its rate hiking campaign, we believe that corporate earnings will be a key determinant of the future direction of equity markets. In theory, earnings drive market performance. The chart on the next page shows the year-over-year change in earnings per share for the S&P 500 (gold line) versus the year-over-year price change in the S&P 500 (green line) on a quarterly basis going back to the beginning of 1990. As you can see, the price change of the S&P 500 has typically followed the same direction as earnings. The reason why they do not mirror each other perfectly is likely due to changes in valuation multiples (like the price/earnings, or

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"P/E" multiple). For example, if you buy a stock today with a P/E of 18 and sell it thirty years later at the same P/E, then your return will be the same as that company's earnings growth. P/E multiples can be impacted by both interest rates and inflation (the higher the interest rate, after adjusting for inflation, the lower the multiple, and vice-versa), so with the current Fed hiking cycle close to being complete, and Fed commentary that rates will remain at these levels for some time, earnings should drive future returns.

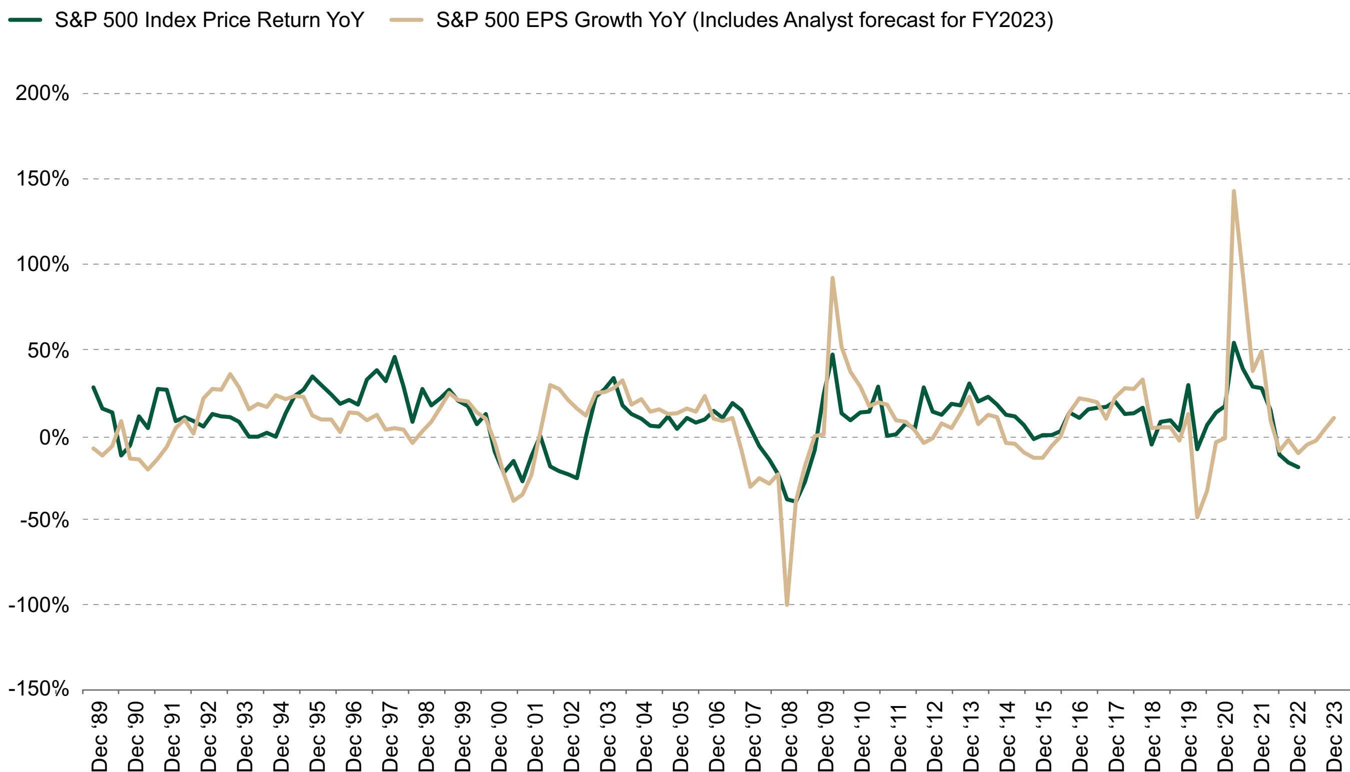
According to FactSet, analysts are currently estimating that earnings for the S&P 500 are going to grow 1.9% in 2023. However, investors may need to temper their earnings expectations for 2023 as current estimates leave little room for disappointing news on the economic front. If one were to take a closer look at these expectations by examining them on a quarterly basis, you will see that this number is "back-end loaded" as analysts are expecting earnings growth of 9.7% in the fourth quarter (See table at right).

In our opinion, there is a level of uncertainty as to whether or not the S&P can achieve 9.7% earnings growth by the fourth quarter. Despite the Fed providing a temporary backstop for the banks, we anticipate a decline in lending as well as tighter loan standards. This could make it more difficult for people to buy cars and homes, and harder for businesses to expand and invest. Furthermore, heightened concerns of a possible recession also risk turning households more cautious about spending and businesses wary of expanding payrolls or pursuing capital investments. Overall, stocks like profits, but periods of earnings uncertainty are often met with increased market volatility. Until we get more clarity about the ultimate impact Fed policy will have on the economy, we expect equity markets to remain volatile, and would not be surprised to see a market decline should a recession occur and earnings fall.

S&P 500 EPS Growth Estimates

Quarter	Growth
Q1 '23	-6.1%
Q2 '23	-3.8%
Q3 '23	2.9%
Q4 '23	9.7%
FY2023	**1.9%**

Year-over-Year (YoY) Change in the S&P 500 Index Price and EPS (on a quarterly basis)

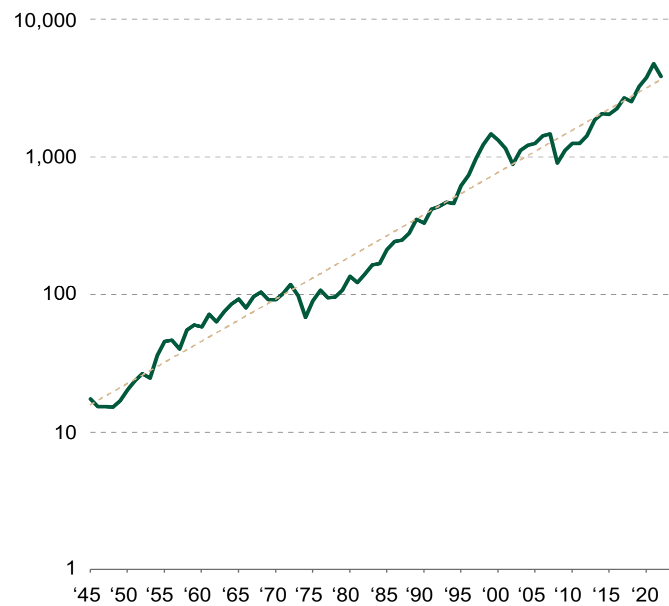


Source: Bloomberg, S&P Global, FactSet

HAVING A PROPER PERSPECTIVE

Volatility and market declines can be unsettling for investors, but we must remember that markets are cyclical and bear markets/corrections are a normal part of investing. The plot twists surrounding the banking system have been riveting, and the urge to react has been intense. Therefore, we'd like to offer some perspective. The chart to the right traces the path of the S&P 500 from the end of 1945 through the end of 2022. It is plotted annually (only one datapoint per year; the value at each year-end), in order to remove the gyrations that occur between each January 1st and December 31st. The chart shows that the S&P 500 has risen at a persistent, year-over-year pace on a trend basis (gold dashed line) from the end of WWII through 2022. While there are plenty of ups and downs, the rising trend of stock prices is clearly evident over the seventy-seven year time span and remarkably consistent over twenty year stretches.

S&P 500 Index Since 1945



Source: Bloomberg

One can easily spot some of the most challenging bear markets. For example, in 1973–1974 the accompanying recession turned much of industrial America into the "Rust Belt"; the "tech wreck" from 2000 to 2003; and the financial crisis of 2008–2009. Nevertheless, it is surprising how many of the other bear markets over that stretch (there were nine of them), not to mention other memorable market corrections, are hard to see or outright invisible from this perspective.

Consider the following:

- The Korean War from mid-1950 to mid-1953, including the participation of the Chinese Red Army.
- The seven month stretch in 1962 starting with the Kennedy steel price rollbacks and finishing with the Cuban Missile Crisis.
- The collapse of oil prices and much of the heavily indebted oil and gas sector together with the Latin American debt default/bailout saga that played out through the mid-1980s.
- The 1987 market crash that sent a number of Wall Street firms into insolvency.
- The savings and loan crisis that festered from the mid-1980s into the 1990s and saw about one-third of these institutions collapse, necessitating a massive government bailout of the industry. At the time, these were the largest sources of mortgage lending in the U.S.
- The Mexican government debt bailout of 1995.
- The emerging market currency crisis that began in mid-1997 and featured some of the steepest weekly declines in share prices ever recorded. It morphed in 1998 into the Russian debt default and the collapse/bailout of Long-Term Capital Management.
- The European sovereign debt crisis, which followed the financial crisis and wasn't resolved until 2012.
- The COVID-19 pandemic, which saw share prices plummet by 31% in less than six weeks in 2020.

Each of these events are largely or entirely invisible on this chart. In fact, an investor only had to be patient for about a year before most market downturns resolved back into uptrends. Market corrections happen and, in many cases, are inevitable. Investors that expect them and put them in proper perspective should have better long-term success.

Again, it is not 100% certain that we will have a recession, therefore it is important to maintain an asset allocation that corresponds to your financial situation, risk tolerance, and investment timeline. Successful investing is a marathon, not a sprint. Even during periods of intense volatility it is always critical to remain patient and adhere to the asset allocation set up to meet your long-term investment goals.

We thank you for your ongoing confidence and trust. Please rest assured that our entire team remains dedicated to helping you successfully navigate these financial markets.

Happy Spring!

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Past performance is no indication of future results

Definitions:

S&P 500® Index is a registered trademark of Standard & Poor's Financial Services LLC, a division of S&P Global ("S&P"). S&P 500 Index is an unmanaged index used as a measurement of change in U.S. equity markets. Performance numbers for the index are total return with dividends reinvested in the index.

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The MSCI EAFE Index is a stock market index that is designed to measure the equity market performance of developed markets (Europe, Australasia, Far East), excluding the US & Canada. The MSCI EAFE Index is an equity index which captures large and mid-cap representation across Developed Markets countries around the world, excluding the US and Canada. With 913 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country. Indices are not managed and do not incur fees or expenses. Performance numbers for the index are total return with dividends reinvested in the index.

The MSCI Emerging Markets Index captures large and mid-cap representation across 24 Emerging Markets (EM) countries*. With 838 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country. Performance numbers for the index are total return with dividends reinvested in the index.

The Bloomberg Barclays US Aggregate Bond Index provides a measure of the total return performance of the U.S. dollar denominated investment grade bond market, which includes investment grade government bonds, investment grade corporate bonds, mortgage pass through securities, commercial mortgage backed securities and asset backed securities that are publicly for sale in the United States.

The price-to-earnings ratio (P/E) is the ratio for valuing a company that measures its current share price relative to its earnings per share. The price-to-earnings ratio is also sometimes known as the price multiple or the earnings multiple. P/E ratios are used by investors and analysts to determine the relative value of a company's shares. A company's P/E can be benchmarked against other stocks in the same industry or against the broader market, such as the S&P 500 Index It can also be used to compare a company against its own historical record or to compare aggregate markets against one another or over time.

Earnings per share (EPS) is calculated as a company's profit divided by the outstanding shares of its common stock. The resulting number serves as an indicator of a company's profitability. The higher a company's EPS, the more profitable it is considered to be.

Please contact us at 781-400-2800 for more information on how we can assist you with your financial needs.