Wealth Enhancement®

Review of the Markets

First Quarter, 2023

Index	1st Qtr Return
S&P 500	11.69%
MSCI ACWI Ex USA IMI	9.81%
Bloomberg Bond Index	6.82%
Consumer Price Index	0.45%

On Banks

A key development during the first quarter was the failure of several large U.S. banks, including Silicon Valley Bank (SVB) and Signature Bank, and the subsequent scrutiny on the U.S. banking system. In addition to the bank failures in the U.S., UBS agreed to purchase Credit Suisse, furthering concerns over the banking system. Ultimately, the U.S. saw the second and third largest bank failures in the country's history.

One of the biggest issues with SVB was what is known as an "asset-liability mismatch". Bank deposits are an asset of the depositor and a liability of the bank. Banks will often take those deposits and invest them, either by making loans to customers or purchasing bonds that are generally considered to be safe from a credit risk perspective. The low interest rate environment of the last several years led some banks to "reach for yield" and buy longer dated bonds to earn higher (though still low at the time) yields. As interest rates increased over the past three years, the value of those bonds declined. If, as was the case with SVB, sufficient deposits are withdrawn from a bank (e.g., the loans to the bank are called), the bank may be forced to sell bonds in their portfolio at losses. If the magnitude of withdrawals and the portfolio losses together are large enough, this may cause a bank failure.

SVB was unique in that their depositors consisted of early-stage companies with high cash burn rates, rather than traditional (sticky) depositors, such as households. This uncommon structure created a situation in which over 80% of SVB's depositors had balances above the $250,000 FDIC insurance limit. The bank saw their deposits triple from early 2020 through the end of 2021 as their customer base thrived in the pandemic era. High growth tech companies saw valuations surge and IPO activity was robust. Over the last 15 months, the winners of the pandemic era lagged as interest rates surged and the market began to reward profitability rather than growth. Cash was withdrawn almost as quickly as it was accumulated as depositors burned through cash. By the time the bank failed on March 10, the trickle had turned into a flood, with clients withdrawing approximately 81% of the deposits held at the end of 2022.

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Over the past month, we have had many conversations with clients regarding asset safety. It is our view that, at this time, assets custodied with Schwab and Fidelity are not at risk for the type of failure seen at SVB.

It remains to be seen how pervasive problems caused by the decline in bond prices will be across banks, but generally we do not see this turning into a 2008-like crisis where even institutions with reasonable risk management were exposed to unforeseen risk through counterparty relationships with other troubled financial institutions. Further, in the case of the banks that failed recently, the government stepped in to protect depositors. Additionally, in response to SVB's collapse, the government has set up a Bank Term Funding Program (BTTP) facility to offer loans to banks in exchange for high quality collateral (such as U.S. treasury bonds) whereby that collateral is valued at par (face value) rather than market value for purposes of the loan. We believe these steps are reasonable and provide fortification to the banking system.

Clients may be asking what this means for them. First and foremost, we believe it is prudent for clients to confirm that their cash sitting in bank accounts is insured. As a reminder, banks typically offer FDIC insurance up to $250,000 per insured bank per account holder. If clients have uninsured deposits at banks, there are a number of potential alternatives with varying levels of risk. Banks have been slow to raise yields on deposits and U.S. treasury bonds and money market funds may offer compelling yields for cash. If you have questions about potential options, please reach out to us.

Additionally, we continue to carefully monitor developments within the banking system and the economy broadly. The Fed has aggressively raised rates over the last 12 months as they've tried to slow inflation and the economy. SVB was a bit of a perfect storm that we believe is an outlier within the U.S. banking system. However, we may see additional cracks in the economy as we navigate the latter stages of this Fed tightening cycle.

Market Commentary

Bank troubles aside, 2023 started off with a bit of a reprieve from the pain of 2022. Nearly every major asset class was positive for the quarter, with developed market international stocks leading the way, up 8.5%. In the U.S., the S&P 500 returned 7.5%. Smaller companies underperformed, with the Russell 2000 returning 2.7%.

While the quarter was volatile, the Bloomberg Aggregate Bond Index was up 3%. Despite the Fed continuing to increase the fed funds rate, interest rates declined

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modestly for most maturities, as markets quickly priced out additional rate hikes later this year and began to price in rate cuts later in 2023 and into 2024.

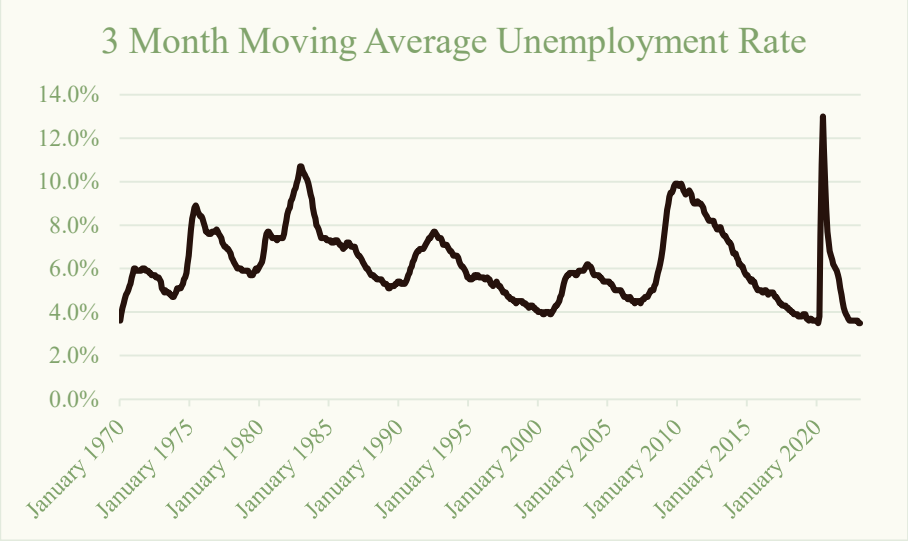
After being nearly the only place to hide in 2022, commodities gave up half of their 2022 gains in the first quarter, with the index dropping 5.4%.

Economic Outlook

All eyes continue to focus on the Fed. After the bank failures mentioned above, the market began debating the extent to which the Fed would forgo additional monetary tightening with the goal of alleviating financial strain caused by the banking system. Prior to the collapse of SVB, the market was pricing in some chance of a 0.5% increase in the fed funds target rate during the March meeting. That probability quickly diminished, leaving the market split between a 0.25% increase and no change. Possibly to avoid panic created by signaling that the banking system was no longer strong enough to hike interest rates, the Fed ultimately increased their target rate 0.25%. It seems likely that, at least in absolute terms (as opposed to time period), the Fed is closer to the end of their hiking cycle than the beginning.

Once the Fed believes they have finished hiking interest rates, it's unclear how long they will leave their target rate at the then-prevailing rate. However, the shape of the yield curve and futures markets indicate that the Fed may be finished hiking by May 2024. Presumably, future rate cuts will be attributable to inflation falling closer to the Fed's target (this is unlikely in the short term) or unemployment increasing. With the latter being most likely, this suggests the market is pricing in some sort of recession in the next year. That said, the three-month moving average unemployment rate (a measure we monitor closely for potential signs of recession) is at the lowest level since the Great Financial Crisis in 2008. However, we did see the unemployment rate tick up in February from 3.4% (the lowest level in over 50 years) to 3.6%. We would need to see a meaningful deterioration in the labor market to enter a significant recession. Most other recession indicators we watch are also in reasonably healthy territory, with the exception of industrial production, which may have peaked in September 2022. Until the banking failures, it would have been fair to characterize the economy as quite resilient despite the dramatic policy tightening. We remain in the camp that probability of recession remains elevated, but the likelihood of a severe recession is smaller than that of a relatively mild one.

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Source: U.S. Bureau of Labor Statistics, Unemployment Rate [UNRATE], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/UNRATE, April 4, 2023.

This remains a time to be disciplined in our view – not a time for panic or for excess risk taking. As always, please reach out to us if you would like to discuss your portfolio.

Please contact us at fingroup-info@wealthenhancement.com.

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