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WEALTH MANAGEMENT

3/22/2023 – Market Update and Outlook Letter

To the Man with a Hammer, Every Problem is a Nail… *-Maslow*

Greetings!

In light of last week's banking crisis and the failure of Silicon Valley Bank, and other banks, and the ongoing concerns over potential contagion throughout the banking system, we imagine investors are confused by this complex set of events and the causes of the crisis.

In today's letter, we will try to explain the events of late, in layman's terms, to clear up confusion, and give you a better understanding and a comfort level about your exposure, what you can do to immediately to protect yourself, and what to expect in the weeks and months ahead.

We will break the letter into two parts: Part 1 providing our market update and outlook, as well as what investors should be doing now, condensed into a few pages, with more information about what to do with you cash savings. Part 2 is optional reading, if you are interested, that explains in simple terms how the banking system works, and how today's banking crisis evloved.

Given these volatile developments, as always, if you have a friend or family member who you feel can benefit from this information, you have our permission to forward it to them.

Before we get started, we are pleased to announce the newest member of our team, **Liz Gialanella.** Liz joins us from The University of New Orleans, graduating with a degree in Business Administration and Marketing. Liz attended college as a division 1 scholarship student-athlete, competing on the volleyball team. She will be working directly with me as an Executive Assistant. In addition, she will be focusing on several important projects that will continue to broaden our platform. Liz will also be spearheading enhancements to our website and the build out of our social media presence to enhance client communication and market insights. Welcome Liz!

Market Update:

To long time readers of this letter, no one should be surprised about the events in the banking system, as we have repeatedly expressed concerns that the current Federal Reserve Board, specifically Chairman Jerome Powell, have moved too far, too fast in raising rates, and now cracks in the financial system are beginning to show up. We have felt the Fed had been pumping the brakes of the economy too hard, and if they were not careful, ***they were going to send us through the windshield!***

Let us be clear at the outset, the current situation is not even remotely as severe as it was during the 2008-'09 Great Recession! Its is serious, but in our view containable. If the Fed continues what we feel is

an unrealistic goal… returning to 2% inflation rate, “no matter what it takes,” there is a chance the Fed could provoke a more severe recession than in necessary. 3 or 4% inflation would be fine.

In our view, the current Chairman has made repeated consistent errors in setting policy, and more importantly, continues to send unclear messages to the market, as well as setting strong expectations to the global financial community that back the Fed into a corner. This leaves little room for adjustment as changes to the circumstances develop, as is happening now. Regional banks are at the highest risk of needing government support since the 2008-09 Great Financial Crisis.

This Federal Reserve Chairman has developed a credibility issue due to several compounding errors that always has the Fed playing catch up to reverse earlier statements and interest rate changes.

To recap…

In late 2018, after 9 consecutive rate hikes over 2 years, the stock market crashed -24% in a matter of a few weeks, forcing the Fed to admit fault and reverse course, having to cut rates in 2019.

In early 2021, with the Covid induced financial crisis over, the Fed left rates at zero far too long. Powell defiantly claimed inflation was “transitory,” stating, “we’re not even thinking about thinking about raising rates!” Inflation spiked to 10%, the highest level in 40 years.

In March of 2022, the Fed finally began raising rates to calm inflation. After raising rates 50-basis points at their second meeting, the media asked Powell, (paraphrasing) ‘now that you admit inflation is *not* transitory, was a 75-basis point hike ever on the table?’ Powell adamantly stated, “Never.” The Fed then went on to raise rates by 75 bps at the next four meetings…

So now, after a year of the fastest and most aggressive rate hikes in forty years, despite warnings from numerous sophisticated market experts, serious cracks are occurring in the foundation of the financial system, and banks are failing.

Today, just a week after the bank failures and intense government interaction to stave off another banking contagion, the Fed raised rates again for the 9th consecutive time. Also declaring they will continue to sell bonds held on the Fed’s balance sheet (quantitative tightening). More concerning to us is that they hardly addressed last week’s banking crisis at all. We do not agree with this decision to raise rates today, as serious stresses on the financial system are beginning to reveal themselves. We believed a tactical pause was in order, to give the financial system time to adjust to the highest rates in 15 years. We’ll see how it shakes out in the weeks ahead, however we are in the camp that this remains more of the same confusing messages to the market and consumers. And markets do not like uncertainty.

Inflation is still elevated; however, it is well off its peak and continues falling. It would be our preference to allow the rate hikes made over the past year a chance to gain traction, as it takes up to a year for interest rate hikes to hit the economy.

The Fed has several tools in its arsenal to slow the economy and drain risk from the financial system, however, Powell has simply chosen repeated rate hikes. Powell admits, rate hikes are a blunt tool. Yet, he remains adamant that this is the only solution. As A. Maslow stated, ***“To the man with a hammer….every problem is a nail!”***

Market Outlook:

As we headed into 2023, we felt that the stock market had a good chance to finish the year higher, with a gain of 10 to 15%. This was based on the assumption that the Fed was to orchestrate a soft landing, and pause in hiking rates further. However, we believed this would be a second half of the year event, with the first half delivering the same cycle of volatility we experienced in 2022. As such, we remain cautious on the market in the short term. Be prepared for volatility ahead.

Today, at 3,950 on the S&P 500, we feel the market is fairly valued if S&P 500 earnings finish the year at $220 per share. If a more severe recession develops, then fair value is closer to 3,500, the October 2022 lows. We will be buyers down there if that scenario develops. For now, we remain content to be conservative and live to fight another day, sitting on plenty of cash and risk free treasury bonds earning over 4.50%.

If the Fed pivots on from further rate hikes in the weeks ahead, as we think they should, the market will most likely explode higher and we can alter positions then.

What to do now:

For the past year, we have been underweight equities in most of our portfolios. We continue to recommend this posture. For the past year, we have adjusted our portfolios, fading risk, and buying short-maturity Treasury bonds now that rates had risen above 4.5%, and up to 5.20%. In fact, of the $500 million we have undermanagement, we are currently sitting on approximately $143 million of cash and short-term bonds mostly in risk free Treasury bills and bonds, and high-quality municipal bonds. That is some 28% of our clients' assets out of harm's way.

Since most of our clients are deep into retirement, our job as fiduciaries is to ensure our clients are in a position to survive market chaos and make it through the valley of corrections and recessions. Together, we have been through many difficult markets…and we haven't lost a patient yet!

If you want to press risk, no problem…. Call a hedge fund, they will gladly take your money! Our goal is to help clients build a stalwart balance sheet, creating generational wealth over their lifetime, and preservation of capital during uncertain times is paramount to that end.

We have been slowly nibbling on stocks on weakness but are in no rush to get back to a fully weighted stock allocation. We remain in more defensive holdings such as pharmaceuticals, consumer staples and large cap value stocks. To get back on the bullish wagon, we will need to see what we outlined in our 11/11/22 letter: The Fed must stop raising interest rates, the yield curve must un-invert, and the composite of Leading Indicators, which have been declining for several months now, begins to improve. Likewise, we will gain more confidence in the market if the geopolitical situations, primarily Russia's war on Ukraine, resolve themselves.

Now, if you are under 50, or at least ten years from retirement, you should simply stay the course, maintaining a decent exposure to stocks, and continue investing regularly in you 401k, 403b or investment account with each paycheck. Time is on your side, and environments like this allow you to

add regularly to stocks at lower prices, ensuring an average market price over time. We are doing this for many clients now who have sent us cash earmarked for long term investments.

What to do with your cash:

We have consistently recommended that clients keep as little cash in your bank savings and checking accounts as needed (six months of expected living expenses will suffice), and move the rest of your savings into very short term treasury bills and bonds held in your brokerage account. The FDIC insures bank deposits up to $250,000 per person, per banking institution ($500k for a joint account). The FDIC is funded by all banks paying regular premiums to the FDIC insurance fund. However, with over $19 Trillion of deposits in US banks, there is no possible way the banking system can insure them all. In fact, Treasury Sec. Yellen stated the Treasury is not considering "blanket insurance" to guarantee all bank deposits over FDIC limits, sending treasury rates lower, prices higher, and crushing stocks. ***To a man with a hammer….***

Treasury bonds, unlike bank deposits, are backed by the full faith and credit of the U.S. Government, with the ability to raise money through taxes, issuing government bonds, and of course, the ability to run the printing press they keep in the basement to unlimited amounts. Unlike FDIC insured bank deposits up to $250k, there is no limit to the amount of treasury bonds you can hold, risk free.

Not only are the Treasury bonds safer than bank deposits, but they are also yielding significantly more than deposits in a bank! Bank deposits now average around 2.5%, with some smaller institutions (riskier) paying up to 3.95%. Meanwhile, 6 month to 1 year Treasury bonds are yielding between 4.5% and 4.7%. We don't expect these to stay this high for long, as the current crisis has assets flowing into Treasuries, pushing rates down.

We do expect some noise in Congress around the raising of the debt ceiling later this summer, and this could cause treasury bond rates to move temporarily higher, however, this debate and threats are political theater, and we remain confident the debt ceiling will be raised….*though probably at the last minute*.

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The rest of today's letter is optional reading if you are interested in better understanding the present situation with banks.

Part 2: The Current Banking Crisis. Explaining what happened.

To clear up any confusion of current events, its best to briefly review why this crisis in banks is occurring. To do so requires a 60,000-foot view of how the financial system works, which we will make overly simplistic. ***The global financial system works on two primary consistencies: leverage, and confidence.***

LEVERAGE:

The financial system operates under the concept of borrowing money in the short term and lending it out for the long term. Borrowing money is a debt, and this is where leverage works itself into the entire financial system. **In fact, leverage is the backbone of the financial system**.

In its most basic form, a bank takes in deposits from every day individuals and businesses, which are short term loans made to the bank, as on any given day a depositor can withdraw their money. In return for these deposits, the bank offers an interest rate competitive in the marketplace so the deposits remain with the bank.

The bank then takes those deposits and does two things; first, they lend money out long term in the form of 30 years mortgages and other longer-term loans at a higher rate than they borrow it from depositors. Second, they invest some of the capital in bonds that they hold on their balance sheet to meet reserve requirements set by the Fed, as well as to meet short term withdrawals from depositors.

Given that the level of interest rates set by the Fed since the 2008 financial crisis, reinforced by pandemic, have, until recently, been at zero these past 15 years, depositors have come to expect very little interest paid on their deposits. With so much cheap money for the banks for so long, both banks and investors became lackadaisical in managing risk, and stretched for higher yielding bonds.

This is how banks make their profit. They borrow overnight from depositors or the Fed at an interest rate which for many years has been around 0% to .25%, and lend out in the form of 30 year mortgages and other loans at 4.5% or higher. Or they buy longer dated bonds that pay the bank a higher interest rate.

CONFIDENCE:

So, the entire financial system works on the concept of leveraging its balance sheet (according to reserve requirements set by the Fed), and invests or lends out the rest. This means our deposits in our bank accounts are not all available at once. Our money is tied up in loans the bank makes, holding only a fraction of our money to meet daily withdrawals. After all, not everyone comes to the bank at once and withdraws all their money. Its very similar to how insurance companies operate; taking in daily premiums, waiting for claims to be filed in the future. While the money sits around waiting on future claims, this "loan" from the policy holder is known as FLOAT, and it can be invested in stocks, bonds or real estate.

Side note, this is how Warren Buffett made his fortune: borrowing from future insured claims today to invest until some future date when the customer files an insurance claim. So the Berkshire fortune was basically made with an expert investor using massive leverage, borrowed against future claims.

Now, and here is the rub, all of this only works when there is CONFIDENCE in the entire financial system. When times are calm and interest rates are steady, everyone goes about their day trusting the system. However, when cracks in the system develop, such as now, panic sets in and nothing brings markets down like a loss of confidence!

Why this Crisis Occurred:

So as our readers now know, the "borrow short-lend out long" concept only works when the yield curve is "steep". That is when short rates are low and can be lent out at higher long-term rates. This is how banks make their profit. When the Fed raises short term rates aggressively, as they have been doing for a year now, the curve inverts. This means short term rates are higher than long term rates, and the banks can't borrow cheaper than they can lend out, and they pull back lending. This choke off in available credit causes the economy to contract, because the profitability of the loan evaporates.

Remember, its not just banks and our 30-year mortgage example that we are talking about. It is the ENTIRE financial system operating under this same concept. All commercial loans to businesses. Life insurance companies, Hedge Funds, Private Equity Firms, and Investment Banks that trade securities…the entire global financial system all operates on borrowed money. Even our largest corporations, such as Caterpillar, borrow from the weekly commercial paper market to meet payroll while they wait for their tractors to be sold and generate revenues. The entire global economy works this way!

When I traded bonds professionally, if I owned $100 million of a bond position on my book, my firm only had a fraction (maybe 10%) of that capital on its books backing up the position. The rest was financed. So long as the cost of carry was lower than the bond yield on bonds I owned, everything worked. When the cost to carry rises, and the cost to hold the bonds goes negative, you lose money holding bonds, so bond and stock traders, …and hedge funds, etc. etc. etc., around the world, quickly unload securities so as not lose money.

In years like 2008, when the underlying assets are incredibly illiquid (like the massive sub-prime housing bonds held by banks worth only cents on the dollar), financial institutions of all sizes began to fail! A loss of confidence is what financial regulators fear. When this happens, the Fed works diligently to guarantee various bonds to instill confidence back to the system. In fact, don't be surprised if other confident instilling entities and investors, come out of the woodwork to help recapitalize banks. Warren Buffett will surely be involved if it gets that far out of control.

The Silicon Valley Bank Collapse

In addition to mortgages and loans made to customers of the bank, Silicon Valley bank actually held very safe Treasury bonds on their balance sheet in the form of very long-term treasury bonds with maturities of 15 to 20 years. The portfolio managers of the bank felt they had to buy longer dated bonds to earn a higher yield than the short-term borrowing rates. Despite the long-term nature of the treasury bonds held, the bank executives failed to hedge them adequately in case rates rose, and the bond prices fell. Over the past few weeks, with the yield curve continuing to invert dramatically, things began to unravel.

People in the Venture Capital industry, who were the customers of SVB, began to get word that the bank was losing significant amounts of capital on those long-dated treasury bonds, as the Fed moved aggressively to raise rates. Word spread and depositors began to exit the bank, withdrawing $42 billion in a single day. As we described above, the bank did not have that cash available, and it went in to sell their bonds to meet withdrawals. The problem was, as rates rose, those bond prices fell, and there was not enough capital to meet redemptions and have some left to keep the bank solvent. Hence the Fed had to step in and secure the deposits so the customers of the bank would not be wiped out.

It was a replay of the scene from 'It's A Wonderful Life.' A classic run on a bank, which did not have adequate capital on hand to meet the withdrawal demands. Once confidence erodes in one bank, there is a run on all smaller financial institutions and then panic sets in, and the Fed needs to re-instill confidence to the system. This is what you are seeing in real time.

As we close, every investor should keep their savings and investment assets in what is known as a Systematically Important Financial Institutions (SIFI). We can write another letter going into the safety of your assets. For now, please remember, having gone through the '08 Financial Crisis, when we decided

to leave the bank owned brokerage firms, we had our choice of where to custody our client assets. Wanting to never go through that experience and fear again, knowing eventually another financial crisis would occur, we chose to place our client assets in the safest institution we could find: Bank of NY Mellon, the oldest and largest bank in the country. They hold over $45 Trillion of custodied assets for wealth management firms like ours, but also the largest foundations, trust company deposits, corporate deposits, hedge funds and governments around the world. BNY Mellon is not a retail bank with branches and tellers. It is an institutional custodial bank, supporting firms like ours around the world. This is the most systematically important bank in the country, and governments from around the globe will move heaven and earth to protect this entity.

If you have any questions on anything in this letter or would like to discuss the safety of your assets in more detail, or any other concerns, please reach out to me or David directly at 973-358-4921.

Our best to you and your families!

John

John F. Parisi -Managing Partner and Chief Investment Officer

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