ADKINS SEALE CAPITAL MANAGEMENT, LLC
Investment Commentary
April 6, 2023

Dear Clients:
According to the mainstream media, the demise of Silicon Valley Bank and Signature Bank was an unforeseen crisis in the making for the US banking system. From our perspective, these failures represent a long overdue awakening of investor demand for an economically rational return on cash assets. This re-awakening will likely have profound effects on the commercial banking system both here and abroad. Interest rates paid on checking deposit accounts have been very low traditionally to compensate banks for transaction processing services and account servicing activities. This structure was actually reinforced dramatically by the “zero interest rate policy” (ZIRP) of central banks following the financial crisis of 2008. A further unintended consequence of ZIRP was to diminish the focus of depositors on the risk of holding uninsured deposits in commercial banks.

Fast forward to 2022 when the US Federal Reserve Bank “woke” up to the risk of rising price inflation and began raising short term interest rates to a level necessary to preserve the purchasing power of US dollar denominated yield instruments. Bank customers accustomed to receiving annual yields of 0.01% on their checking deposits began the process of limiting checking account balances to the bare minimum to conduct daily transactions and moving the excess to higher yielding alternatives such as direct purchase of US Treasury Bills and money market funds. Little wonder since the average yield on the bellwether three month US T-Bill averaged 2.6% for all of 2022 and finished 2022 at close to 5%. The impact of this transfer “stampede” on bank finances will be significant since earnings for most commercial banks have benefitted from the practice of paying virtually nothing for checking account balances. A high level view of the typical regional and local banks suggests the net revenue from low rate deposit accounts contributes between 30% and 40% of total net revenues and between 70% and over 100% of pre-tax profit. Bank managements will no doubt have to consider raising prices for loan and deposit services to offset the decline in net revenue from low yielding deposit accounts.

The focus on holding uninsured deposits is a necessary market discipline in pursuit of efficient capital allocation decisions. We believe the FDIC insurance limit should remain at the current $250,000 per account per bank. Individual depositors making the decision to accept a higher yield on an uninsured deposit amount would be individually responsible for any loss of capital should the bank fail. Putting tax payers on the hook for such individual decisions erodes the benefits that accrue from taking personal responsibility and the freedom to choose.

This most recent financial “crisis” will be described by some as a “Black Swan” event; a situation that has no historical precedent and can only be explained in hindsight. The foremost living authority on the nature of Black Swans, Nassim Nicholas Taleb, would more likely describe it as a perfect storm of several errant policy actions. Our past investment commentaries have addressed the adverse consequences of prolonged use of ZIRP, Quantitative Easing (QE), and extraordinarily large federal budget deficit spending. Each of these policy actions were well intended and may have actually been needed for an immediate but very short lived economic therapy to treat the 2008 financial crisis and the 2020 COVID-19 scare. Taleb’s more recent writings address potential policy actions to create a societal structure capable of absorbing unexpected events that lead to disruptions of expected ways of doing things. Perhaps the greatest challenge in achieving effective societal mitigation of major disrupting events is setting the proper balance between top down governmental and bottom up individualized solutions. We think Taleb’s concept of “convex tinkering” has much appeal; to wit: “decentralized experimentation outperforms directed research.” In other words, Adam Smith’s invisible hand of the masses probably works better in the long run but does not deliver short run gratification.

As each of you are well aware, your investment assets managed by our firm are held in brokerage accounts at Charles Schwab & Company (Schwab). Schwab has gotten some attention in the financial press due to its large amount of low-yielding deposits in Schwab Bank derived primarily from brokerage accounts. We have reviewed Schwab’s financial position as of 12/31/2022 and believe Schwab maintains sufficient liquidity on its balance sheet to meet the withdrawal of virtually its entire deposit base; we do not believe such an event is likely. Schwab Bank is unique in that it has a very small loan book with virtually no credit losses. Although we have no concerns about Schwab's capacity to provide quality custody services for your investment assets, you can be assured that we will endeavor to minimize your exposure to below-market interest returns on cash equivalent assets and to keep deposit levels well below FDIC limits.

Market Returns as of March 31, 2023

Market returns exhibited continuing levels of high volatility in the first quarter of 2023. The total return including dividends for the broad US stock market index was 7.2%, while the total return for the broad US bond market index was 3.0%. Similarly, the total returns for the broad indices for non-US stocks and bonds were 6.9% and 3.1%, respectively. The results are even more dramatic when viewed from the recent cycle bottom of 10/15/2022. For this short period, US and non-US stock returns were 14.2% and 21.5%, respectively, while the returns for US and non-US bonds were 6.4% and 13.6%, respectively. All of these returns, if sustained, suggest an expectation for lower future inflation and stable earnings levels and future earnings growth.

In contrast, annualized returns on these same indices since the all-time high for the S&P 500 Index was reached in January 2022 were -11.7% and -9.6%, respectively, for stocks and -8.5% and -15.9%, respectively, for bonds. The divergence in outcomes for these periods is significant and suggests future returns remain subject to wide swings.

Our View Going Forward

Stock and bond price levels remain somewhat elevated in relation to current inflation observations and potentially recessionary economic conditions. The rapid recovery in asset prices since 10/15/2022 strikes us as having characteristics of a bear market rally, so we advise continued patience in extending asset duration for both stocks and bonds. Of particular importance will be where the forward inflation rate settles, since it is a foundation building block for future asset return expectations. We view the current bond market pricing as suggesting forward inflation at about 3% per year. If this expectation becomes imbedded in asset prices, intermediate term bond yields would move toward 5% from around 4%, and US stock price/earnings ratios would move toward 16x from around 20x. Time will tell how all this shakes out, but put us in the camp of hoping for higher bond yields and historically average price/earnings ratios.

In Closing

We look forward to visiting with each of you about your investment results and expectations for the future and to make sure your portfolios are aligned with your specific circumstances. We greatly appreciate the opportunity to serve as your investment adviser and pledge our best efforts to meet your expectations.

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