



FROM THE DESK OF KEN SOUTH

March 29, 2023

Our team adheres to a set of principles designed to provide an exemplary client experience.

We believe the trust of our clients is earned over time and remains our most important asset.

We take great pride in the professional quality of our work. Exceptional client service that is proactive, thoughtful, and customized.

Competitive investment returns with a focus on risk management.

Sophisticated financial planning — an essential pillar in the development of your customized investment strategy.

We believe in continuous improvement. As our clients' needs change, we learn and adapt.

We stress teamwork in everything we do and remain accountable for our responsibilities.

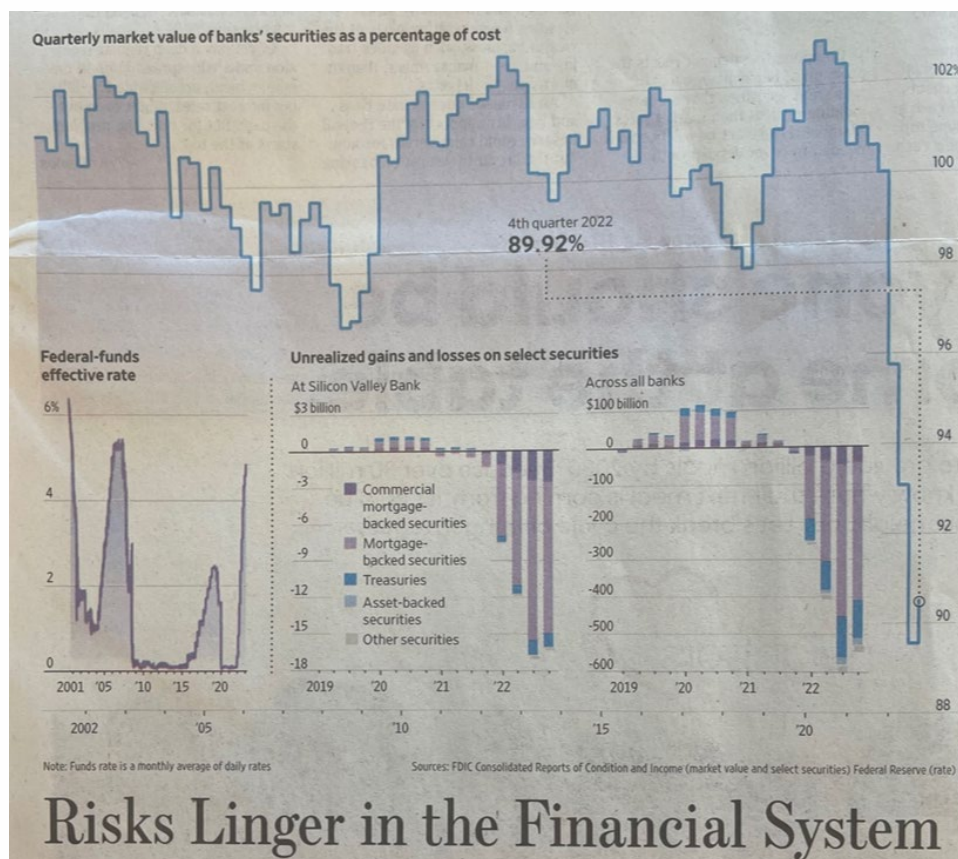
Integrity and honesty are at the heart of our business. Integrity: we do what we say we're going to do, full disclosure and no surprises.

Honesty means we give it to you straight, even if means having a difficult conversation

We regularly receive confidential information as part of our normal client relationship. It is our responsibility to protect against the unauthorized disclosure of this information.

In The Banking Crisis Of 2023, There's Plenty Of Blame To Be Shared

In only two weeks, the stresses to the markets have gone from inflation and the possibility of recession due to higher interest rates to an utter banking crisis. In my last two letters, I addressed the banking issues and attempted to explain what was "different this time." These were different than my normal missives due to the clear importance of the sovereignty of banks that all depend on. Since the issue was all about what banks had their money invested in rather than the 08-09 problem of lending mismanagement, I felt the illustration below from [The Wall Street Journal](#) is a necessary observation of how banks are currently structured as provided by the FDIC:

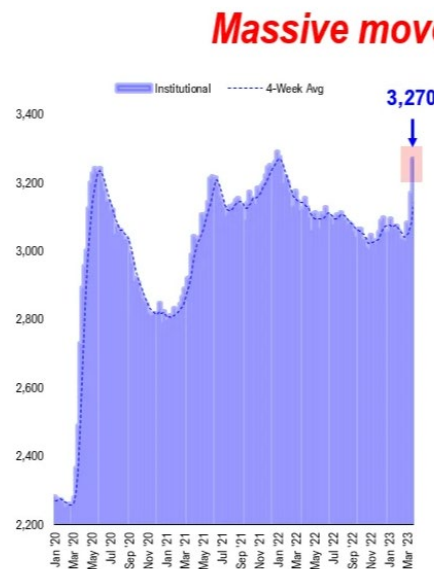


Over this past weekend, in multiple conversations with friends and acquaintances, many believe this is the Great Financial Crisis all over again. The public is rattled by the high-profile bank failures. Yet in looking at the overall stock market, the broad markets are showing tremendous resiliency. As of last Friday, March's month-to-date performance was +3.4%. This to me does not reflect an overriding fear that a financial collapse is in the offing.

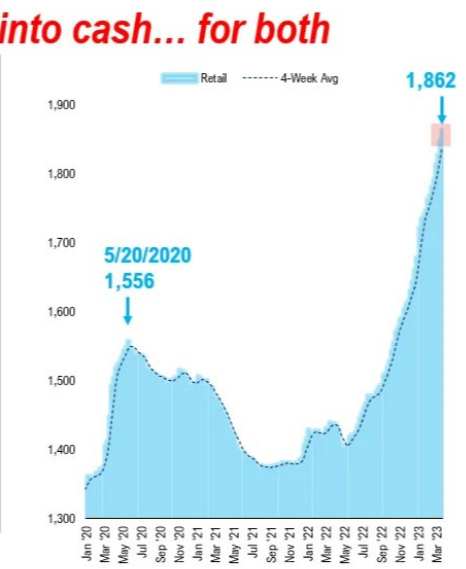
In looking at money market fund balances, there has been a tremendous amount leaving banks and equity markets and going into Money Market Funds. To put this in perspective, during COVID, Money Market balances topped out at \$3.1 trillion. But this number has now ballooned to \$5.1 trillion. For this much money to be put on the sidelines and for the equity markets to still be holding firm shows tremendous resiliency.

RETAIL: Sitting on more cash than pandemic high

Institutional Money Market Fund Assets
In \$ billions. As of 3/22/2023



Retail Money Market Fund Assets
In \$ billions. As of 3/22/2023



The eventual outcome from this banking crisis has two possibilities as I see it: either the crisis spreads and becomes a full-blown "hard landing," or the banking crisis is contained and the slower lending that ensues helps to tamp down inflation. To many, the banking crisis is in effect another interest rate hike since it is having a direct effect on lending and therefore economic growth. The lending that I am referring to should be divided into two different types of lending: commercial lending and residential lending. Also, the actions of Janet Yellen and the US Treasury need to be measured as this clearly shows that the financial bodies of the US Government aren't simply paying this crisis lip service but rather are showing action being taken. Before I show what is happening, I wanted to give some perspective on what has happened in our financial system since the second quarter of last year. The Fed has raised interest rates nine times in the last so many months.

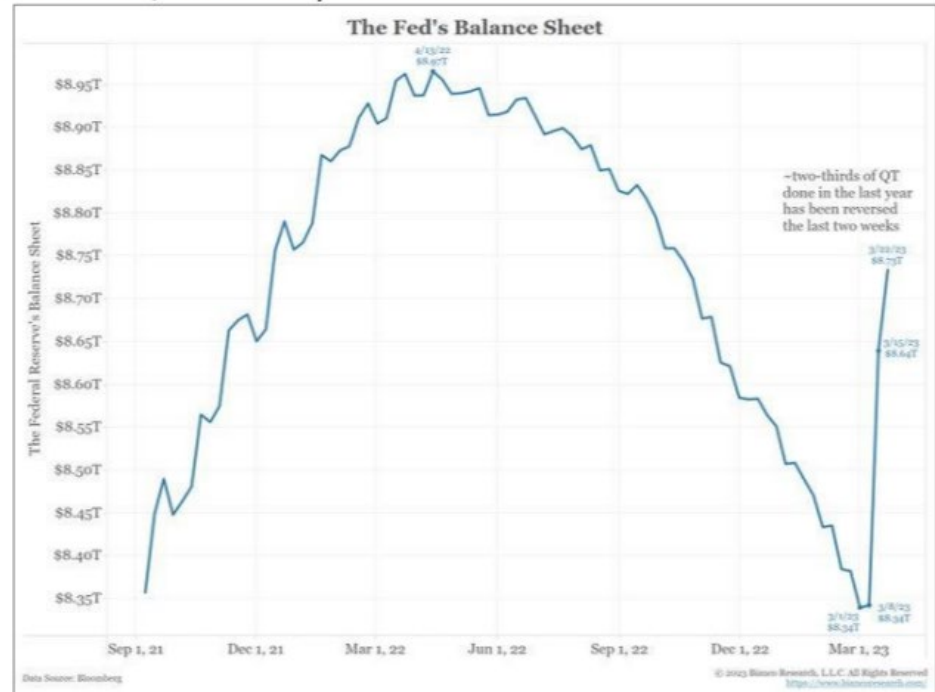
In the last week, investors were reminded that when it comes to Fed funds hiking cycles "the medicine" never goes down easy. More than a decade of easy money and a period of "free money," post COVID from the Federal Government, add angst and risk as well as the opportunity to the mix. The banking crisis is a direct result of this "medicine." I liken it to a cancer patient undergoing chemotherapy. Chemotherapy is a sort of poison being injected into the system. If given in small doses it is painful to the patient, yet cancer can be killed and eradicated. If the chemotherapy is delivered in too high a dose or in too many doses, it could kill the patient. This is what we are currently experiencing. This is the shoe that has dropped in the form of regional banks that have failed and caused the regulators to step in. In the case of commercial lending, vacancy problems were already showing because of COVID, and now the problem is hitting the pockets of the landlords. See below:

Vacancy in Office Commercial Properties was growing before Covid came on the scene.



As a result of the problems with commercial lending and the mismanagement of the investment portfolios of the banks due to the rapid spike in interest rates, the balance sheet of the Fed has spiked. This balance sheet is one of the primary mandates that the Fed has been trying to reign in since the beginning of 2022. As seen below, as the Fed has been forced to backstop the banks, the balance sheet has once again ballooned:

Two-Thirds of QT done in the last year has been reversed in two weeks.



A concern is that since the Fed will probably have to slow its tightening process due to the collateral damage being caused by spiking rates and the resultant lack of confidence in the banking system, the Fed may be forced to slow its hiking process or even take a pause too soon. This could end the battle against inflation too early- reigniting speculation and risking a resurgence of inflation could ensue. In my opinion, the Fed is unlikely to pause or pivot but rather it could remain adamant about remaining focused on its efforts to get inflation in check. This could mean only one more quarter-point hike, but the economic indicators will tell us the answer to this.

In my view, the crisis will track towards the bullish fork and the markets will continue this bottoming process (which began in October of last year) and begin rising into year-end. This will require policymakers and the Fed to react swiftly to restore confidence for bank customers and financial markets all at the same time. Two weeks after the failure here with Silicon Valley Bank followed by the Swiss giant Credit Suisse and then last week's Deutsche Bank this banking crisis is far from being completely contained. But there are signs that the crisis is not set to morph into a broader crisis:

- Deposit outflows appear to have slowed.
- Fed/Treasury is aware of the need to communicate protection for uninsured deposits.
- The First Republic is still in limbo by officials see it as stabilizing.
- A buyer from Silicon Valley has come forward.

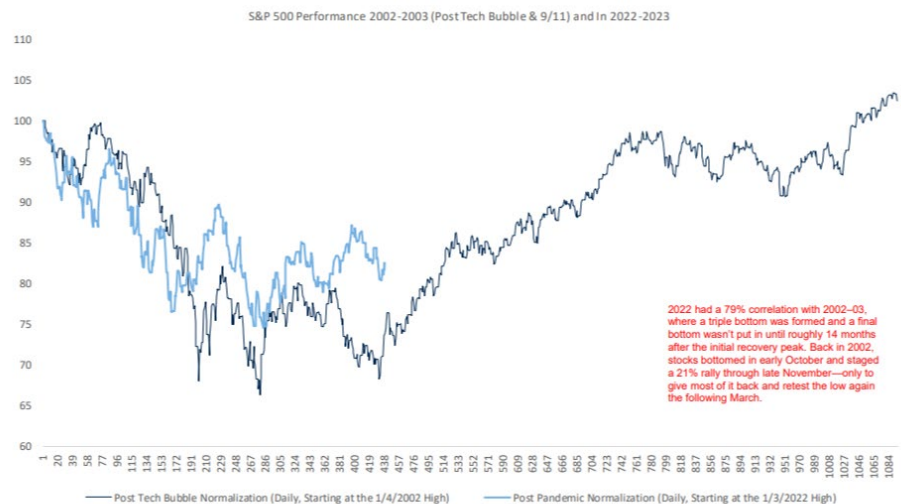
As for our investment stance, this remains overall positive. In past letters, I mentioned statistical consistencies in 2023 as compared to past years.



Technology, which tends to be one of our economy's major growth engines, has been strongly bucking the trend of the financials. So, we, therefore, believe that although the downside risks of these financial mismanagement issues are significant, they are not a killer to the overall thesis for 2023.

Bottom line: While it might feel like a Great Financial Crisis Redux is unfolding, the heavy cash positions mean many have adjusted to this situation already. It is ultimately important to recognize that the current financial problems are very different from those of 08-09. Back then, the main issue was credit risk (primarily regarding residential real estate loans and securities) and how markets were pricing that risk. Today the primary issue is an interest-rate risk on high-quality bonds (interest rates spiked and the market value of bank portfolios declined). But the Fed has already set up a new facility for banks that lets them, in effect, offload those securities to the Fed for a small fee, papering over balance sheet problems for banks able to take a small hit to earnings. Is this the best-case scenario? No, but it is better than the immense cost of an emotionally induced banking failure. I will close with a picture of where the market currently is based on what is the expected "rhyme" going forward:

S&P 500 Has Traded Similarly to 2002–03, Another Messy Post-Crisis Normalization



Source: RBC US Equity Strategy, Bloomberg. As of March 17, 2023.

As always, we will keep you informed about what we feel is important to pay attention to. Please let us know if you have any specific questions. We welcome your call.



Important Disclosures:

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial professional prior to investing. All performance referenced is historical and is no guarantee of future results. All indices are unmanaged and cannot be invested into directly.

All information is believed to be from reliable sources; however LPL Financial makes no representation as to its completeness or accuracy.

Investing involves risks including possible loss of principal.

The Standard & Poor's 500 Index is a capitalization weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The Dow Jones Industrial Average is comprised of 30 stocks that are major factors in their industries and widely held by individuals and institutional investors.

The Nasdaq-100 is a large-cap growth index. It includes 100 of the largest domestic and international non-financial companies listed on the Nasdaq Stock Market based on market capitalization.

The Russell 2000 Index is an unmanaged index generally representative of the 2,000 smallest companies in the Russell 3000 index, which represents approximately 10% of the total market capitalization of the Russell 3000 Index.

This information is not intended to be a substitute for specific individualized tax advice. We suggest that you discuss your specific tax issues with a qualified tax advisor.

