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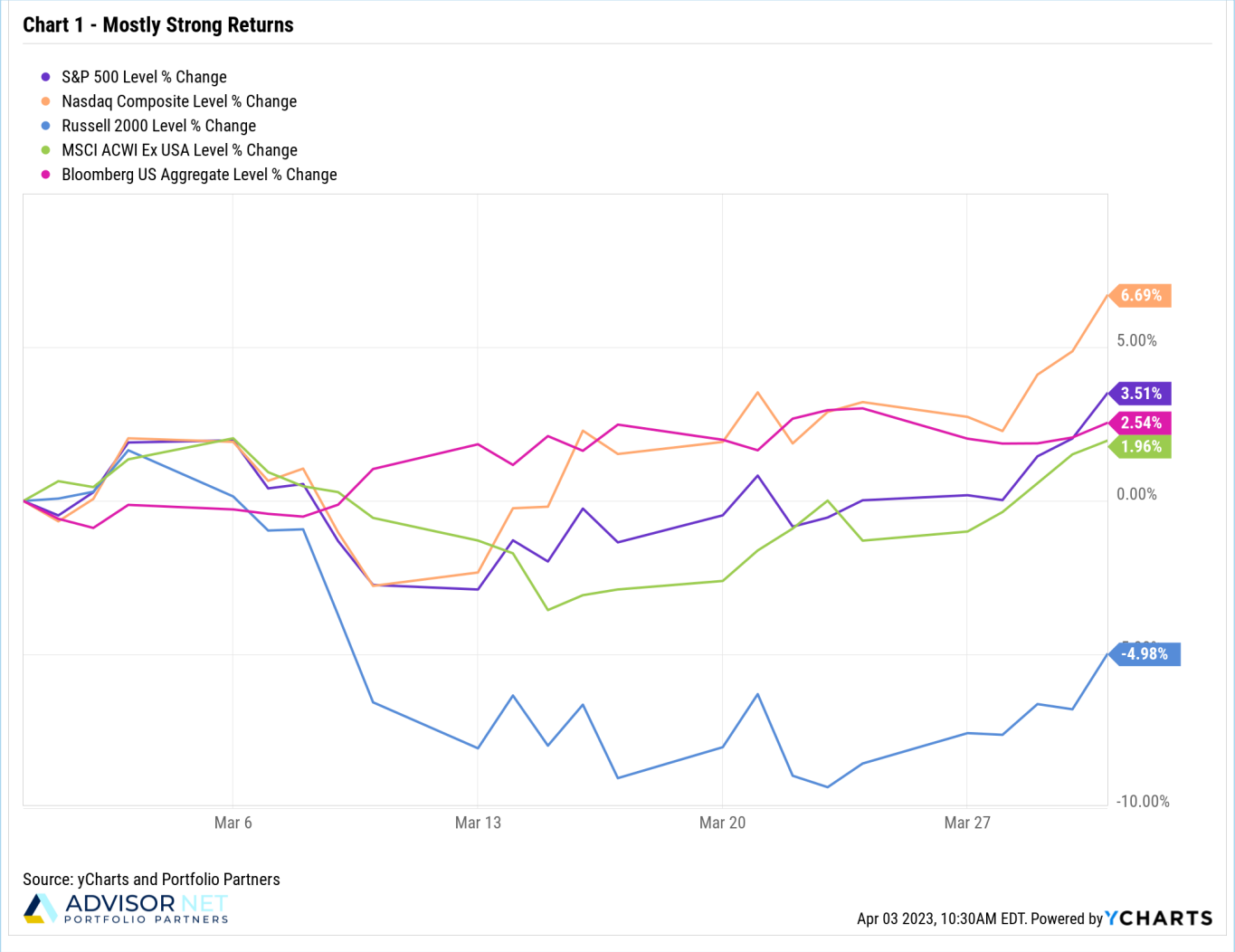
Newsletter

April 2023

March Surprise

One of the most important events heading into March was supposed to be Federal Reserve Board (Fed) Chair Jerome Powell's testimony to the Senate Banking Committee on March 7th. The market, however, received unexpected news on March 9th from a mid-sized regional bank disclosing significant losses on securities held which eventually led to a rapid failure of that bank. Astonishingly, that was not the biggest surprise. The real surprise to many investors was how well most of the major stock indices responded to the news.

The S&P 500 was up +3.51%, the NASDAQ Composite was up the most with a +6.69% gain, the Russell 2000 fell by -4.98% due to its large exposure to banking stocks and the MSCI ACWI held firm with a +1.96% gain during the month. The bond market benefited from a flight to safety mentality and pushed yields on the 10-year US Treasury rate lower from 3.92% last month to 3.49% at the end of March. This led to a gain of +2.54% for the Bloomberg US Aggregate index. (CHART 1)



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Banking 101

The current banking crisis started in early March 2023 with the collapse of a regional bank located in Silicon Valley, California, and another similar sized New York-based bank only days later. The genesis of these bank failures was a reported loss of almost $2 billion by the regional bank in Silicon Valley, California, related to its securities portfolio. It may be helpful to review the fundamentals of how banks operate to understand the implications of these failures.

At its core, banking is relatively simple: they take in deposits and give out loans. Customers bring deposits to the bank and the bank pays them interest to hold these deposits. The bank uses the money from the deposits to give loans to other customers. These customers then pay interest on the loans to the bank. The bank makes money by charging a higher interest on than loans than they are paying on the deposits.

Although this may seem straightforward, it gets complicated by the fact that the bank can loan out more money than they have in deposits. As a result, careful regulation is needed to ensure that banks will always have enough money to pay back its depositors. One requirement is for the banks to keep a certain amount of their cash in reserves that can be accessed to pay back depositors. Banks will often keep these reserves in low-risk US Treasuries so the money should be available when they need it.

A potential vulnerability of this system, however, is that failures could occur if customers demanded their deposits back all at once and a bank did not have enough in liquid reserves to cover the requests. This is typically known as a “run on the bank.” We think this is what happened with the regional banks in Silicon Valley, California, and New York. Depositors demanded their money and the banks did not have enough short-term cash to cover it. This caused the banks to sell longer-term US Treasuries from their securities portfolio, which were sold at loses due to rising interest rates. (Remember that higher rates mean lower bond prices.)

Many fear this “run on the bank” could happen at more of the thousands of other mid-sized banks that are less regulated than the so-called systemically important financial institutions (SIFI) that are “too big to fail.” Ironically, we think the uncertainty created by the bank failures may have influenced the Fed to raise rates by a smaller amount in March than the market previously expected.

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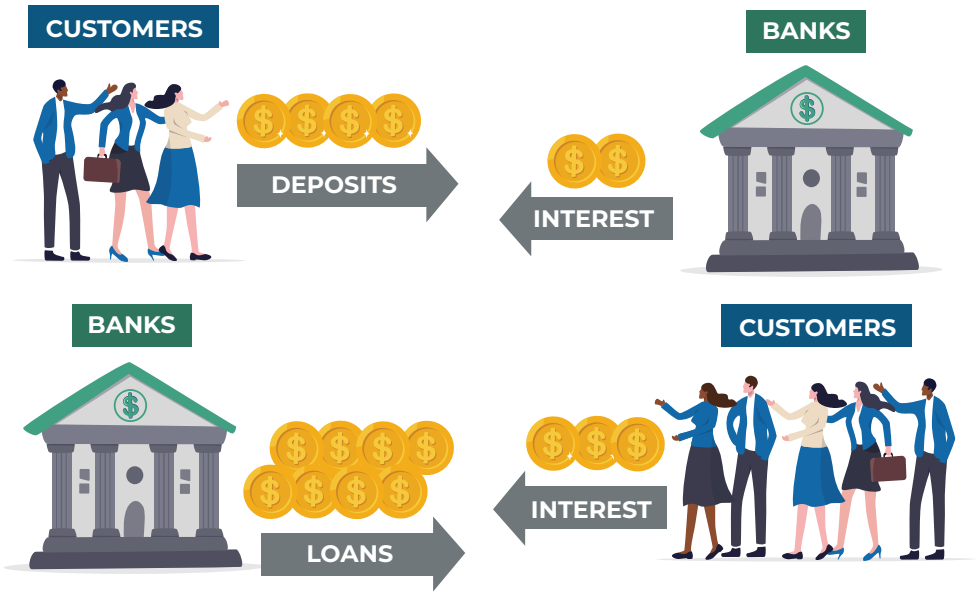
HOW A **BANK** WORKS



HOW A **RETURN OF DEPOSITS** WORKS

HOW A **BANK RUN** WORKS

Source: Portfolio Partners

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What We Think

The stock market reacted to the bank failures in early March 2023 by dumping bank stocks causing the KBW NASDAQ Bank Index to decline over -25% in just over two weeks. As stated above, we believe the primary fear was that regional banks will have a systemic problem with meeting demand for deposits, more banks will fail, and a recession will follow.

While we do not want to oversimplify the complexity of the situation, we think it is prudent to recognize that the biggest risk of failure tends to happen when customers panic and rush to demand return of their deposits all at once. In other words, if the Fed, US Treasury, and the Federal Deposit Insurance Corporation (FDIC) can work together to provide confidence that depositors will have access to their money, then the likelihood of future failures should significantly diminish.

We expect progress can be accomplished through supportive funding mechanisms to back uninsured deposits or cooperation with private enterprise to help support acquisition efforts. We think these efforts could give confidence to depositors that their money will be their when they need it thus preventing future bank runs.

We continue to like the market action of the rally that started on October 13, 2022. The market has broken out of the downtrend that plagued returns from 2022 and this is a positive step toward establishing a new uptrend. We will provide updates as the environment evolves, but much of the evidence is currently pointing toward brighter days ahead.

MARKET TRACKER – 3/31/2023

INDEX	3 mo	1 yr	3 yr	5 yr
S&P 500	7.50%	-7.73%	18.60%	11.19%
MSCI ACWI ex-USA	7.00%	-4.56%	12.32%	2.97%
BLOOMBERG US AGGREGATE	2.96%	-4.78%	-2.77%	0.91%

(Source: yCharts and Portfolio Partners)

MARKET TRACKER – 3/31/2023

S&P 500	4,109.31
DIJA	33,274.15
NASDAQ	12,221.91
WTI CRUDE OIL	$75.67 /BARREL
GOLD	$1,969.00 /OUNCE
10-YEAR TREASURY FIELD	3.49%
UNEMPLOYMENT	3.60%
GDP	2.60%
PPI	4.58% Year-Over-Year
CORE CPE (INFLATION)	4.60% Year-Over-Year

(Source: yCharts, Dorsey Wright and Portfolio Partners)

Thank you for your trust and support.
Stay focused on your long-term objectives.

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The KBW Bank Index is designed to track the performance of the leading banks and thrifts that are publicly-traded in the U.S. The Index includes 24 banking stocks representing the large U.S. national money centers, regional banks and thrift institutions.

The index, a member of the Dow Jones Total Stock Market Indices family, is designed to measure the performance of large-cap U.S. equity securities that are classified as "growth" based on a multi-factor analysis.

The index, a member of the Dow Jones Total Stock Market Indices family, is designed to measure the performance of small-cap U.S. equity securities.

The index, a member of the Dow Jones Total Stock Market Indices family, is designed to measure the performance of large-cap U.S. equity securities that are classified as "value" based on a multi-factor analysis.

The index, a member of the Dow Jones Total Stock Market Indices family, is designed to measure the performance of small-cap U.S. equity securities.

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The S&P 500® Consumer Discretionary comprises those companies included in the S&P 500 that are classified as members of the GICS® consumer discretionary sector.

The S&P 500® Utilities comprises those companies included in the S&P 500 that are classified as members of the GICS® utilities sector.

The S&P 500® Communication Services comprises those companies included in the S&P 500 that are classified as members of the GICS® communication services sector.

The S&P 500® Real Estate comprises stocks included in the S&P 500 that are classified as members of the GICS® real estate sector.

The S&P 500® is widely regarded as the best single gauge of large-cap U.S. equities. The index includes 500 leading companies and captures approximately 80% coverage of available market capitalization.

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The S&P 500® Financials comprises those companies included in the S&P 500 that are classified as members of the GICS® financials sector.

The S&P 500® Energy comprises those companies included in the S&P 500 that are classified as members of the GICS® energy sector.

This is not an offer to buy or sell any financial instruments and should not be relied upon as the sole factor in an investment-making decision.

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The Dow Jones Industrial Average (DJIA) is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange (NYSE) and the Nasdaq. The Nasdaq is a global electronic marketplace for buying and selling securities, as well as the benchmark index for U.S. technology stocks and is also used to refer to the Nasdaq Composite, an index of more than 3,000 stocks listed on the Nasdaq exchange. The NASDAQ Composite Index includes all domestic and international based common type stocks listed on The NASDAQ Stock Market. The NASDAQ Composite Index is a broad based index. The MSCI EAFE index is designed to measure the equity market performance of developed markets (Europe, Australasia, Far East) excluding the U.S. and Canada. The Index is market-capitalization weighted. The Bloomberg Barclays US Aggregate Bond Index, which was originally called the Lehman Aggregate

Bond Index, is a broad based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government–related and corporate debt securities, MBS (agency fixed-rate and hybrid ARM passthroughs), ABS and CMBS (agency and non-agency) debt securities that are rated at least Baa3 by Moody's and BBB- by S&P. Taxable municipals, including Build America bonds and a small amount of foreign bonds traded in U.S. markets are also included. Eligible bonds must have at least one year until final maturity, but in practice the index holdings has a fluctuating average life of around 8.25 years. This total return index, created in 1986 with history backfilled to January 1, 1976, is unhedged and rebalances monthly.

The Russell 2000 Index measures the performance of the small-cap segment of the U.S. equity universe and is a subset of the Russell 3000 Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership.

The MSCI All-Country World Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets. The MSCI ACWI consists of 46 country indexes comprising 23 developed and 23 emerging market country indexes. The developed country indexes include: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, the United Kingdom and the United States. The emerging market country indexes included are: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Peru, Philippines, Poland, Qatar, Russia, South Africa, Taiwan, Thailand, Turkey and United Arab Emirates.

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