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FROM THE DESK OF
KEN SOUTH

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We believe the trust of our clients is earned over time and remains our most important asset.
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We take great pride in the professional quality of our work. Exceptional client service that is proactive, thoughtful, and customized.
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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.
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Honesty means we give it to you straight, even if means having a difficult conversation
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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.

March 17, 2023

A Banking Kerfuffle And The Fight To Thwart Inflation

Vacations are an interesting thing when managing assets in a dynamic market. I planned to go away for a few months before going to Spain, but clearly, there was no way to plan for bank failures and other financial shenanigans that took place.

Needless to say, there is plenty to discuss at the moment. If I attempted to cover every topic in my typically overlong fashion, this note would be 50 pages. Nobody has time for that time. Rather, this week I am going to try something a little different, using more of a stream-of-consciousness approach to touch on as many talking points as I can rather than try to tie everything together thematically.

No doubt you've seen dozens of headlines about Silicon Valley Bank (SVB) or Signature Bank that collapsed last week. We sent our clients some detail on this subject earlier this week, which you can grab a close approximation of here. The way I see it, there are three major issues at hand:

Banking on Long Duration

First, banks are currently sitting on a massive amount of US Treasury and other marketable securities that are worth a lot less than when they bought them. Naturally, as interest rates have risen over the past couple of years, bond prices have dropped since all those bonds yielding, say, 1% when issued back when rates were lower are no longer attractive compared to the higher-yielding bonds of today.

It's not a big deal as long as the banks can hold the assets to maturity, collect the paltry yield, and receive back their principal for reinvestment, but **if a lot of depositors want their money at once and the banks must sell those now-discounted bonds quickly for liquidity, they end up taking huge realized losses**. In that manner, a "liquidity issue" can immediately turn into a "solvency issue" if the losses are bad enough. Absent a bank run, it really shouldn't matter, especially from a systemic standpoint. As long as banks have enough liquid reserves on hand to service customers in the regular course of business, they don't need to sell down and take massive losses. It's when too many people come asking for their money at once that all hell can break loose.

Therefore, the Fed/Federal government has no choice other than to backstop the banking system and guarantee deposits, and probably well beyond the $250,000 per bank FDIC maximum. Otherwise, the public will lose confidence in the banks, everyone will try to pull their money out, and it becomes a self-fulfilling crisis.

The Fed has now set the precedent that they will provide that backstop, even if it's inflationary, and risks running the debt levels up even more.

Overplaying Their Hand

Second, so far the banks that have experienced problems are the ones tied to the more speculative areas of the economy. Silicon Valley Bank was a major lender to start-ups, and otherwise riskier businesses that have also seen their values collapse and their ability to raise additional capital become non-existent. So, the dilemma arose; who is likelier to need to pull large amounts of money from their banks – Profitable, cash-flow-producing companies or riskier pie-in-the-sky ventures that are no longer viable in a world without 0% interest rates?

The point is that at the moment at least, the issues have largely been reserved for the bottom echelon of companies, but if the economy worsens and more and more companies get in trouble, we could see the banking issues continue and the need for the government to bail out more depositors. The world has spent the last few days seeing how the Fed was going to handle the current test case and "so far" the financial markets have settled down a bit.

Sustaining the Federal Debt

And third is the question of if the government will potentially face a similar crisis in the years to come if rates remain higher for longer. The federal debt load has ballooned over the past several years, thanks in large part to the helicopter money COVID response. And while most of that was done when rates were low, the government also mainly used shorter-term debt to finance that spending.

According to the Brookings Institute, ***the weighted average maturity of the U.S.'s debt currently is around 75 months or a little over six years***. At the same time, though, the payments required to service the interest have gone parabolic over the last year or so and are expected to rise further. And now as the lower-rate debt issued these last several years mature, if the government wants to maintain the same level of spending, it will either have to issue new debt at higher interest rates or raise taxes, neither of which will likely be good for growth or US debt sovereignty. The alternative is to reduce spending, which is never politically popular and also not good for growth.

So, the U.S. in the years ahead will likely face some challenges that will need to be addressed — the rising cost to service its debt and having to choose between reducing its spending or funding it with more costly debt if rates don't plummet again (or by raising taxes). This is arguably the most significant concern. If the Fed keeps raising rates, things break. If the Fed doesn't raise rates inflation stays higher for longer. Which is worse? We won't know till we cross that bridge.

Additional Thoughts

Inflation took a back seat for the first time in a while over the past week but came back to the forefront Tuesday as CPI was released. I thought there was a good chance we would see a cooler-than-expected report considering last February was when prices went out of control as the Russia/Ukraine war ramped up, but inflation was in-line with consensus, and ex-Food and Energy were higher than expected. This was followed by Wednesday's numbers for Producer Prices

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and Retail Sales which DID show a slowing of economic growth and a slowing of inflationary progression. It should still leave it up in the air the thought that the Fed will or won't hike at the meeting next week, though it should now be 25-basis points rather than the 50 that some feared last week after Powell said rates would have to go higher than currently expected. The elephant in the room is the higher rates causing the breaking of the system as I explained at the beginning of this note.

I don't know why so many try to speculate on the exact future path of rate hikes and cuts. The past week should illustrate that conditions can change almost instantly so attempting to outline a clear path is a waste of time. However, **I do think the past week also shows that things can and will break if rates go higher and stay that way for a long**. I believe the Fed is likely stuck in a no-win situation and will at some point have to choose between bailing out the economy or getting inflation down to 2%. They will likely choose the economic bailout by first pausing hikes and then cutting rates even if inflation is still on the higher side. That probably means expecting inflation to come down quickly is a faulty assumption.

In Closing

In multiple ways, this is the most difficult time we have ever seen since the Great Financial Crisis. The good thing is that banks are well-capitalized and solvent. Also, we know what made the system break in 08-09 and today the standards that banks demand of borrowers are far more stringent. The issue was one of their internal portfolios dropping and at the same time an over-concentrated group of depositors demanding their deposits at this same instant- not good. The good thing is that the economy is slowing and at this rate should decline. The comparative rates on short-term paper compared to long-term paper telegraphs an almost unavoidable recession. This is termed an "inverted yield curve." Since people were flush with cash for so long inflation had to raise its ugly head. Now, the punch bowl of both money supply (M2) and dramatically higher interest rates have changed the financial dynamic of almost every industry. Hopefully, if the statistics hold as I have been showing for the last couple of months of what to expect from the markets in 2023, we should recover nicely, and this banking shockwave should subside. As seen below, the S&P 500 hit its low in October, a higher low in December, a nice start to the new year into February 2nd, and then Wham-O! Not fun, but as you can see, still holding a higher low- at least at this point.

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If labor in the form of wage growth is any leading indicator, then as seen below average hourly wages are moderating and this would limit the consumer's ability to afford higher prices. I believe this will be the case.

This has not been a fun month of February, but again, if history is a guide, February and the first couple of weeks of March set a backdrop for eight weeks of outsized positive returns. I will of course keep you informed of where we are and where it appears we are going.

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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.

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