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1st Quarter Market and Economic Update

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"Spend each day trying to be a little wiser than you were when you woke up... those who keep learning keep rising." -- Charlie Munger

"Only when the tide goes out do you discover who's been swimming naked." -Warren Buffett

Happy spring to everyone. Well, that was some first quarter, wasn't it? As I mentioned in my special update of March 16, I will spend part of this update sharing a bit more detail about bank failures in general, and about Silicon Valley Bank (SIVB), in particular. As you can see, I've left the Warren Buffett quote I used in that special update in place for this one because it seems appropriate given where we are in the world.

We are in a new world as it relates to interest rates and inflation. For about 40 years (1981-2021), the U.S. experienced a period of stable to declining interest rates and inflation. That means many people and professional investors, including yours truly, haven't really had to deal with the opposite in their careers: rising inflation and rising interest rates for prolonged periods. In 2022, the Fed hiked rates at one of the fastest paces in history, taking short-term rates from zero to over 4%. They did so to combat the highest inflation we've experienced in 40 years.

Simply put, interest rates represent the cost of money. When the cost of money rises, it impacts everything in the financial realm. Higher borrowing costs can lead to lower corporate profits and a slowing down of economic activity. It costs more to buy a home or a car. These are things the Fed wants to see happen now to bring down inflation. On the other hand, keeping interest rates at zero poses problems, too. Cheap money leads to a misallocation of capital, which can cause bubbles to emerge. It also allows companies to survive who otherwise wouldn't. Cheap money can foster an environment of rampant speculation, in things like cryptocurrency and non-fungible tokens, which I've discussed before. Of course, it was the Fed who kept interest rates artificially low, for too long in my opinion, after the Great Financial Crisis (GFC) and after the Covid-induced recession in 2020. That and profligate government spending by both parties have put us where we are now. It is when this cheap money party ends that the hangover occurs. To paraphrase Warren Buffett above, the tide has gone out and now we see who may be in trouble.

I don't mean to pick on the Fed, though I've been known to do it from time-to-time. While I do think the current Fed Chair, Jerome Powell, is easily the best of the four we've had this century, that is a fairly low bar to clear. While the Fed's action in the immediate aftermath of both the GFC and the Covid-induced recession were appropriate, as is typically the case, they overstayed their welcome. Simply put, they didn't take the punch bowl away when they should have done so. Perhaps that's in part due to the lack of coherent fiscal policy in our country

for most of the last 15-20 years. Nevertheless, the Fed has put themselves into a box: they need to continue to be vigilant in the fight against inflation, but they also need to realize they've raised rates to the point that cracks are showing in the economy and in the regional banking system. Frankly, I think it would be appropriate for the Fed to stop raising rates and halt their quantitative tightening (QT) program now. We'll see what they decide at their next meeting on May 3. Will the Fed give me a birthday present that day and take my advice? We'll find out soon, but I'm not holding my breath.

It is in these times of volatility and distress that opportunities arise. For the rational investor, we can use times like this to gain a bit more wisdom and insight, and then apply that wisdom by using the tide heading out to our advantage. Plenty of wonderful opportunities have emerged over the last few months across several asset classes and sectors. While I could certainly be wrong, I do not believe the current banking stress is a systemic problem now. A recession would seem to be a certainty at some point later this year or early in 2024, but financial markets may have already discounted a mild recession. I am very excited about what the future may bring, as rational pricing of assets seems to be back in vogue. In your portfolio you may notice an allocation to an asset or two we haven't been in for quite a while, or may never have invested in before, but those now offer the potential for solid risk-adjusted returns.

In the 1st quarter, except for commodities, all asset classes were positive. That is encouraging because in the 11 previous cases, when the S&P 500 fell the previous year and rallied in the 1st quarter, over the last nine months of the year the index was up every time. Obviously, there are no guarantees, but that's a good track record. The ultimate answer for what could be ahead for the rest of the year lies in the fallout from the regional banking crisis, Fed policy, and inflation's trajectory, but history's message is a positive one.

Did you know that there have been over 500 bank failures since the beginning of 2009? While 140 of those were in 2009, one could argue that the worst of the GFC ended in that year. Thus, that leaves over 360 bank failures since 2010. Banks can fail for a number of reasons, but more often than not, a failure is caused when the value of a bank's assets fall below the value of their liabilities. When that happens, and it becomes well-known, a run on the bank can occur. Simply put, that is what happened to Silicon Valley Bank; more specifics on that in a bit. Most failures are of smaller banks, and it is only when a big failure occurs that it becomes front-page news. As one of the largest 20 banks in the U.S. at the time of its demise, SIVB's failure was sure to generate news, and it certainly did. Unfortunately, in this digital age, word of SIVB's troubles went viral and the run on the bank was swift and destructive. Hence, the bank failed quickly. Think about how the internet has changed banking. In the "old days" of the 20th century, in order to move money from a bank, more often than not, one had to go to the branch to withdraw funds. In today's digital world, we can all move money from one bank to another in an instant using our phone. The ease with which we all can move funds, along with social media, certainly played a role in the quick demise of SIVB.

So why did SIVB collapse? And will other banks follow in a repeat of the bank contagion of 2008? (As mentioned in the special update, the other two bank failures [Signature Bank and Silvergate] were uniquely tied to the cryptocurrency world, so their failures would seem idiosyncratic. Thus, I won't touch on them.)

SIVB was in one respect a very non-traditional bank. It was the banker for private equity companies and large Silicon Valley technology firms. As startup tech companies raised capital through venture capitalists (VCs), which could amount to hundreds of millions of dollars or more, the VCs strongly suggested their startups park their

cash at SIVB. These startups tend to burn cash at high rates and require short-term liquidity. SIVB did not appear to model that into their investment portfolio.

Well managed banks will match their liabilities (deposits) with assets: loans and investment portfolio. SIVB did not do so. What they did was to buy longer dated bonds and mortgage securities to generate greater net interest income, which is based on the difference between the rates on their assets and liabilities. The company apparently did not factor in the impact on their investment portfolio of rising interest rates. Furthermore, it did not hedge its interest rate risk. As a result, the value of their assets fell and could not meet the demands of their depositors to withdraw cash. Put simply, SIBV was a poorly managed institution.

Because of the make-up of SIVB's client base, most of its deposits were above the FDIC-insured amount of $250,000. Thus, once the bank's customers started withdrawing their cash, the bank didn't have enough money to cover those withdrawals, particularly because of the losses SIVB suffered on its investment portfolio, which was made up of mostly U.S. Treasury bonds. As I discussed in my year-end letter, 2022 was one of the worst years in history for Treasury bonds, as they dropped by over 20%.

In the recent special update, I touched briefly on politics, as there was so much hyperbolic nonsense being said by both sides. One suggestion was that deregulation played a part in the failure of all three banks, but especially SIVB. In 2018, some <u>bipartisan</u> changes to the Dodd-Frank law were put into place which raised the threshold to define "systematically important financial institutions" from $50 to $250 billion while also limiting stress testing to banks with over $100 billion in assets. These regulatory changes favored all but the 10 or so largest banks. In other words, the bipartisan changes favored over 4,000 banks. If only three of the 4,000 banks who benefitted from the rollback of some regulation have failed, then is it really a regulation problem? In my opinion, it is not.

The other thing I heard was that the focus on DEI (Diversity, Equity, and Inclusion) was to blame for the bank failures. With virtually every company having some sort of DEI goals stated as part of their mission and culture, this reason doesn't hold water. JP Morgan (JPM) has long been the best-run bank in the world. Its DEI mission and policies are a prominent part of their website and some public reports they file. So, the idea that DEI had something to do with these bank failures is nothing more than cable "news" hosts trying to get people riled up. For my money, the CEO of JP Morgan, Jamie Dimon, is the best bank CEO of the last 50 years, maybe longer. He steered the bank through the GFC with no issues, emerging from that period as the absolute strongest bank in the country, if not the world. I don't normally quote this much from someone in an update, but in his annual letter to JPM shareholders, Mr. Dimon touched on the banking issues in a very frank manner, saying, "*Regarding the current disruption in the U.S. banking system, most of the risks were **hiding in plain sight.*** (Emphasis is Mr. Dimon's throughout.) *Interest rate exposure, the fair value of held-to-maturity (HTM) portfolios and the amount of SIVB's uninsured deposits were always known – both to regulators and the marketplace. It is unlikely that any recent change in regulatory requirements would have made a difference in what followed. Ironically, banks were incented to own very safe government securities because they were considered highly liquid by regulators and carried very low capital requirements. Even worse, the stress testing based on the scenario devised by the Federal Reserve Board (the Fed) never incorporated interest rates at higher levels. This is not to absolve bank management – it's just to make clear that this wasn't the finest hour for many players."* He goes on to say: "*As I write this letter, the current crisis is not yet over, and even when it is behind us, there will be repercussions from it for years to come. But importantly, recent events are nothing like what occurred during the 2008 global financial crisis. This current banking crisis involves far*

fewer financial players and fewer issues that need to be resolved. Any crisis that damages Americans' trust in their banks damages ***all banks*** *– a fact that was known even before this crisis. While this crisis will pass, lessons will be learned, which will result in some changes to the regulatory system. However, it is extremely important that we avoid knee-jerk, whack-a-mole or politically motivated responses that often result in achieving the opposite of what people intended. Now is the time to deeply think through and coordinate complex regulations to accomplish the goals we want, eliminating costly inefficiencies and contradictory policies. Very often, rules are put in place in one part of the framework without appreciating their consequences in combination with other regulations. We do not want to throw the baby out with the bath water.*" I couldn't have said it better myself.

In response to your many queries over the years, I'm very pleased to announce that we have partnered with Pontera to manage corporate retirement plan portfolios (401k, 403b, 457 plans, etc.) in a compliant manner. We've already had clients volunteer and sign up for this new service. Our plan is for a full rollout to everyone within the next month or two. Please contact us with any questions.

Additionally, we also now have access to a suite of products designed to defer taxes on gains from the sale of either real estate or a business. Whether it is a 1031 DST or a Qualified Opportunity Zone, we are pleased to be able to offer this to you now. It has been a missing piece from our service offering for too long. Please contact us for any additional information or if you know of someone who may need tax deferral.

I hope you and yours are healthy and enjoying a wonderful start to spring. Please let us know if there is anything we can do for you. We're always here to help. From all of us at HFA, thank you for your trust, confidence, and loyalty. It is a joy and a privilege to work with you and your family.

Best wishes,

Harvey E. Hutchinson IV

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