

Market and Strategy Overview- First Quarter 2023

April 25th, 2023

The stock market rally that began during the fourth quarter of last year continued through most of the first quarter of 2023. Our preferred benchmark, the Russell 3000, returned 7.18% for the three months ended March 31, 2023. The large-cap technology sector alone returned more than 21% for the period, without which the return on the Russell 3000 would have been less than half of the realized return. This disparity highlights both the significant weighting of technology within the index (almost 25% of the total index market cap) and investor confidence in, and focus on, the sector.

Excellent equity returns were generated despite the significant headwinds of higher interest rates, persistent inflation and the ongoing war in Ukraine, among other factors. We will discuss all of these factors in more detail below.

Further, despite two more interest rate hikes by the Federal Reserve during the period, the Bloomberg Barclays US Aggregate Bond Index (which has an average maturity of close to 9 years and contains most investment grade bonds issued in the US, including corporate, mortgage, and Treasury issues) returned a positive 2.96% during the first quarter. This disparity (rising short interest rates and declining longer-term interest rates) reflects a few themes.

Most obvious is the disconnect between the managed rate of Federal Funds, as dictated by the Federal Reserve Board, and the market derived rates embedded in the Aggregate Bond Index described above. The Fed is raising short interest rates in an attempt to reduce the current high level of inflation. Declining longer rates, meanwhile, infer the belief that the Fed will succeed in reducing inflation, and/or that higher short rates will result in a recession. This interest rate relationship, known as an inverted yield curve, has generally preceded periods of economic decline. We will discuss this in more detail below. But to recap, both equity and bond market returns were generally positive for the first quarter, despite numerous headwinds and persistent uncertainty regarding economic outcomes.

As we stated in our year end 2022 letter, lower inflation is not the same thing as low inflation, and the Fed is very intent in doing what they can to get to low inflation. Although the rate of inflation has come down from peak levels, it remains elevated. The Federal Reserve's preferred measure of inflation (Core Personal Consumption Expenditures, or Core PCE) is at 4.6% currently, down from 5.1% at the beginning of last year's 4th quarter.¹ Progress against high inflation is being made, but so far at a glacial pace. We therefore believe it likely that The Fed

¹ Source: U.S. Government Bureau of Economic Analysis (BEA)

will keep rates at or near the current level for the foreseeable future and will only move off current levels if there is a material reduction in realized inflation.

Lastly, with regard to interest rates, we think it is important to consider the current level of interest rates in the context of historical rates. Basically, despite the dramatic increase in interest rates over the last year, we are only now getting to levels that are “normal” or average over time. The average Federal Funds rate, dating back to 1954 has been 4.6%, basically where we are today.² Much of what we are dealing with economically, such as high inflation, elevated asset prices, and even the banking dislocations described below, are the end result of the protracted period low or zero interest rates extending back to the financial crisis of 2008-09.

The Recent Banking Fiasco

Given recent market turmoil, and concern for the health of the US banking sector, we want to add a few comments specific to that issue and express our views on likely outcomes going forward.

At the highest level, banking math is fairly simple. Banks take deposits and use that money to make loans and/or buy bonds (which are also fundamentally loans). Thinking about that from the balance sheet perspective, they have deposits on the liability side and cash, loans, and bonds on the asset side. The asset side of the balance sheet is always necessarily equal to the liability side plus the bank’s shareholder equity. If deposits decline to a large enough degree, the bank must eventually liquidate loans and/or bonds to meet that demand for cash. K so far? Let’s look at the two sides in more detail.

Deposits come in many shapes and sizes, from yours and my checking and savings deposits, to massive corporate deposits as corporations use the banking sector to process their revenues, facilitate operating cash flow, payroll, etc. An issue central to the recent banking crisis is how quickly deposits can move, given all the technology that exists today regarding electronic funds transfer. In the case of Silicon Valley Bank (SVB), billions of dollars of deposits were leaving the bank in a short period of time, triggering an equal level of need for liquidity on the asset side of the balance sheet.

Remember that bank assets are predominantly loans and bonds. Loans are typically difficult to liquidate on short notice, so in the case of SVB, they turned to selling off their bond portfolio to meet deposit outflow. The problem was that due to the dramatic increase in interest rates over the last year, their bonds were not worth what they originally paid for them! This was particularly true of longer maturity Treasuries and bonds backed by residential mortgages. Many of these bonds had very low coupons. Think of it this way with regard to mortgages: through the protracted period of very low interest rates, extending back to the financial crisis, the vast majority of homeowners refinanced their home loans to take advantage of 3% or lower 30 year mortgage rates. Now that mortgage rates are roughly 6% for the same loan, the old

² Source: FRED Economic Data (St Louis Federal Reserve Bank)

outstanding loan at 3% has to be discounted significantly to make it saleable relative to the new 6% loan. This is why bond prices move inversely with interest rates!

So in contrast to some earlier financial contractions, most notably the financial crisis of 2008-09, the issues that caused the SVB debacle were not credit related. Instead, their vulnerability extended from having borrowed short (deposits), and lent long (residential mortgages). Their deposit base proved to be vulnerable for a number of reasons, but especially as a result of a very high percentage of deposits over the insured level of \$250,000. Further, their lack of risk controls and/or hedges around their bond and loan book left them with material losses that had to be monetized during their heightened need for liquidity. In many ways, it was a perfect storm.

There have been a few other banks caught in a similar bind, and of course there could be a few more. However, we believe the banking sector at large is well capitalized and well-managed, and we do not expect a material breakdown of our banking system as a result of the dynamics discussed above. That said, a significant economic decline could induce an adverse credit cycle, and we will cover that potentiality in more detail below.

Lastly, a few clients have asked about Charles Schwab Bank specifically. First and foremost, the accounts we manage that are custodied at Charles Schwab are on neither side of the bank's balance sheet (i.e. Charles Schwab Bank has no claim on your account's securities). The cash balances, which we generally hold at less than 5% of your account value, are swept to Schwab Bank. In every case these balances are less than the insured level of \$250,000. Lastly, with regard to Schwab Bank's integrity going forward, we believe the nature of their deposits (other swept balances like yours) makes them less vulnerable to large-scale deposit flight. Only time will tell of course, but we continue to be very comfortable with our relationship with Charles Schwab as your custodian.

Outlook and Positioning

The key themes we shared at the end of 2022 remain in place, and we will recap the essence of them here.

As discussed earlier, the Federal Reserve is most focused on reducing current levels of inflation. We believe this will result in interest rates being higher for longer. The longer-term bond market is discounting that notion, with the 10-year Treasury trading at a yield of 3.39% this morning (04/12), or 161 basis points below the Federal Funds rate. As discussed above, an inversion of this magnitude generally portends a recession. Regardless of the ultimate economic outcome, we are keeping bond maturities/durations low relative to our benchmarks, taking advantage of the higher yields available.

Regardless of one's views to future outcomes, there is no question we are in the midst of a transitionary period. The Federal Funds rate has gone from 0 to 5% since the beginning of

2022, global economies are still working through the tailwinds of the COVID pandemic, and the geopolitical risks we have discussed previously seem only to become greater. All of these factors (and more) continue to contribute to heightened levels of economic uncertainty. Yet given those uncertainties, the 10-year Treasury yield is more than 100 basis points below the rate of inflation, and the stock market, by most valuation measures, is on the rich side of fair.

Based on the above, we continue to favor value and the less cyclical sectors of the equity market, such as health care and consumer staples. Along with these overweights come generally higher dividends than the market overall. Given the outlook, we believe higher dividends, compounded within a portfolio, will be a much higher portion of total return than has been the case the last several years.

On the fixed income side of our portfolios, we continue to favor considerably shorter maturities than the market overall, and maintain very high quality there as well, predominantly US Treasuries. Now that interest rates have increased as much as they have, we are generating yields of 4 to more than 5% on these very high quality, lower risk positions.

Lastly, we promised to talk about the banking sector relative to the potential for an adverse credit cycle. Everything else equal, higher interest rates equate to less credit availability. A commercial property, a company, or a piece of equipment that was fundable at 3% may not be at 6% (or higher). Further, given the banking turmoil discussed above, and the resulting impacts on bank profitability and capitalization, it is likely that the overall banking system will be tightening credit availability. Lastly, the commercial property sector in particular is facing decreased valuations as a result of higher interest rates, and in the case of commercial office space, the trend toward working from home as well. These factors will likely lead to difficulty in refinancing some of these properties as existing loans come due.

Curtailing credit availability is one of the main transmission mechanisms the Fed is relying on to curb inflation. Through this process, they believe they can reduce demand driven price increases, while doing as little damage as possible to the employment side of the economy. To-date, the plan appears to be working as inflation has come down considerably and employment has remained steady. As stated previously, we are in the midst of this transitional period, and only time will tell the ultimate outcomes. In the interim, we believe highly diversified and liquid portfolios are the best solution for long term investors.

As always, please reach out to us if you have questions or concerns. We think this is especially important as we work through this transitional period.

Happy spring to all,

Frank and Josh

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