

Some Sand in the Gears

“Aw, c’ mon guys, it’s so simple...It’s all ball bearings nowadays!”

– Fletch (1985)

It’s been said that “there are decades where nothing happens; and there are weeks where decades happen”. We think the last several weeks have characterized the latter in light of seeing two sizeable bank failures – Silicon Valley Bank (SVB) and Signature Bank (SBNY).

As can be seen in the chart below, the number of bank failures has remained benign over the last decade – nothing like the Great Financial Crisis (GFC). To that point, over the last 20 years, 80% of bank failures occurred between 2008-2012. Still, the significant size of these two recent bank failures has raised plenty of critical questions for the management teams and regulators of these banks.

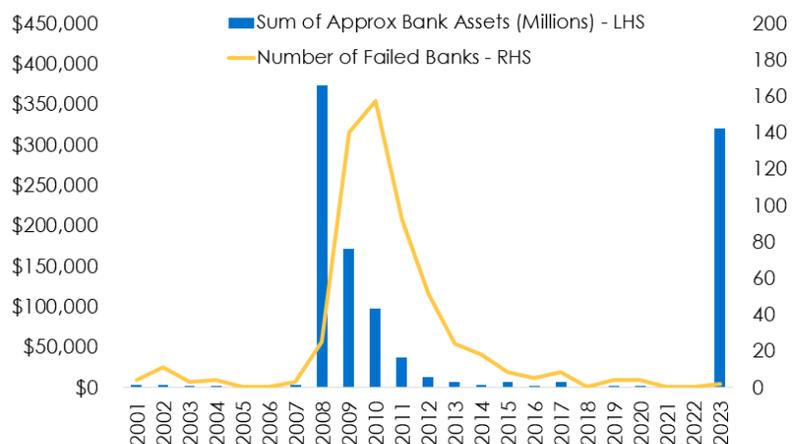
In our view, the primary issue comes down to a combination of concentration risk and duration or interest rate risk. Both SVB and SBNY were heavily exposed to large and concentrated deposit bases in high growth

industries (venture capital in the former and cryptocurrency in the latter) – customers particularly sensitive to the higher rate regime. In the case of SVB, having an investment securities portfolio that was longer duration made them doubly exposed to the negative impact of higher interest rates. As deposits left, the bank became more reliant on its outsized securities book for liquidity, which forced unrealized losses (impacted from higher rates) to become realized – permanently impairing dwindling capital.

While there are plenty of other details yet to unpack, here are the initial lessons learned from these events:

- Companies under financial duress are often related to the interlinkages between concerns over capital (ability to absorb losses) AND liquidity (ability to fund daily activities).

US Bank Failures
2001-Current



Source: FDIC



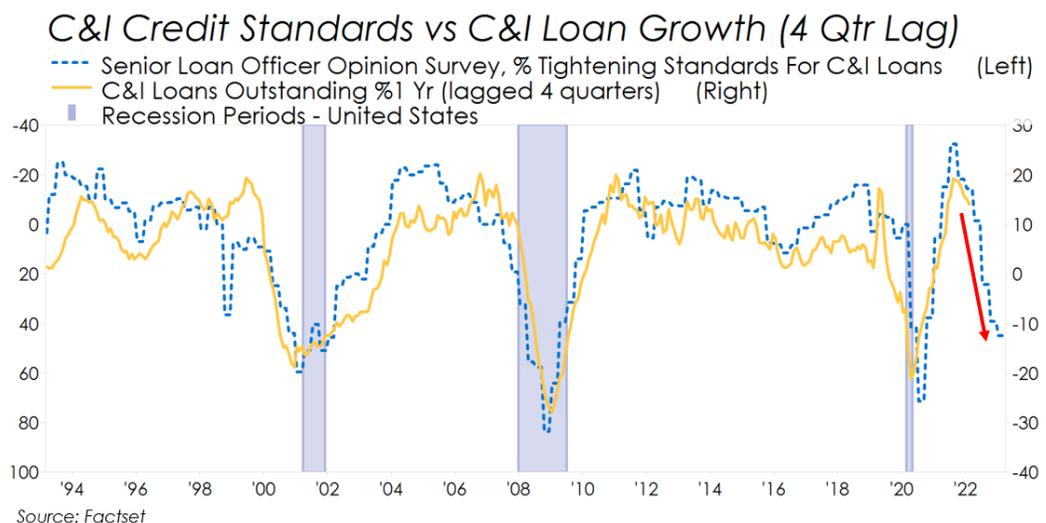
- A diversified deposit base is paramount for lending institutions. The more an institution's deposit customers are diversified (by size, type and industry), the better. Ideally, deposit customers should also be diversified, in part, from lending customers so that any funding impact doesn't also become a credit one (vice versa).
- A bank's securities portfolio is often the second line of defense for liquidity needs and, therefore, should be prioritized as such over profitability. Picking up those proverbial nickels in front of a steamroller by reaching for yield (and extending duration and rate sensitivity) exposes one to the negative impact of rising rates and can impair the liquidity objective.
- Sufficient capital is important so as to never put undue pressure on the desposit base or the securities book. Lack of capital to absorb losses can kick off liquidity pressures creating a negative feedback loop.
- Of course, this also highlights the importance of good overall risk management. We'd also make the obervation that a policy of zero interest rates for over a decade has led to consequential impacts when said policy is no longer sustainable.

The good news is that most banks look unlike SVB and SBNY and the industry as a whole remains much better capitalized than prior to the GFC. In our opinion, both the extreme concentration risk and duration risk seen in the circumstances of these banks suggest to us that these were outlier cases. That's not to say that it's clear

skies from here but rather that we think the bigger worries might be of the earnings variety as opposed to the going concern type.

Given the Fed's less than surgical tools to slow inflation – it's unfortunate, though perhaps not

completely surprising – that marginal lenders might suffer the most. In aggregate, monetary policy is effective in slowing the economic machinations by throwing sand in the gears. In other words, higher short-term interest rates eventually slows down lending – the lifeblood of growth. Fed policy appears to be doing just that. As can be seen in the chart above, bank lending standards tend to be a very good leading indicator for bank loan growth. As of January, lending standards were already the tightest that we've seen since 1Q09 (ex COVID). We think the events in March further exacerbate these lending standards and thus banks' willingness to lend. As such, this is yet another example of liquidity draining out of the system which acts with a lag on economic growth.

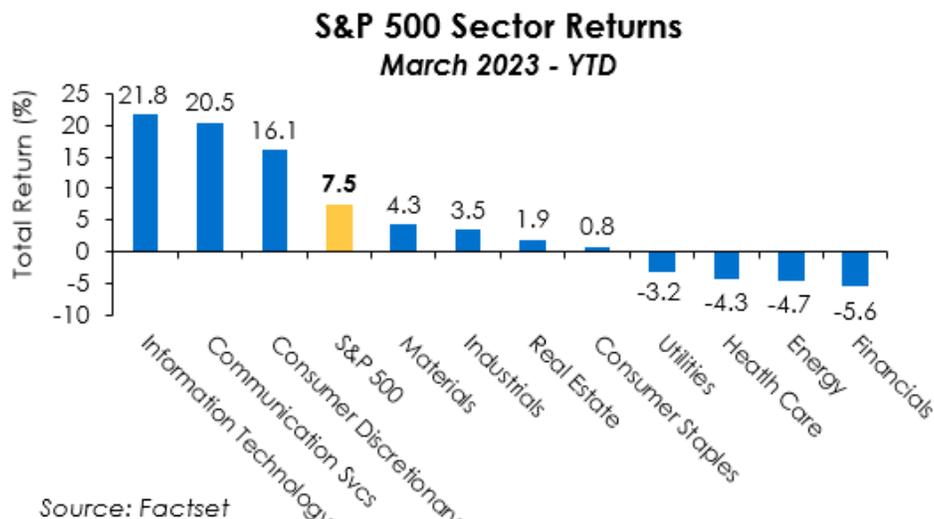
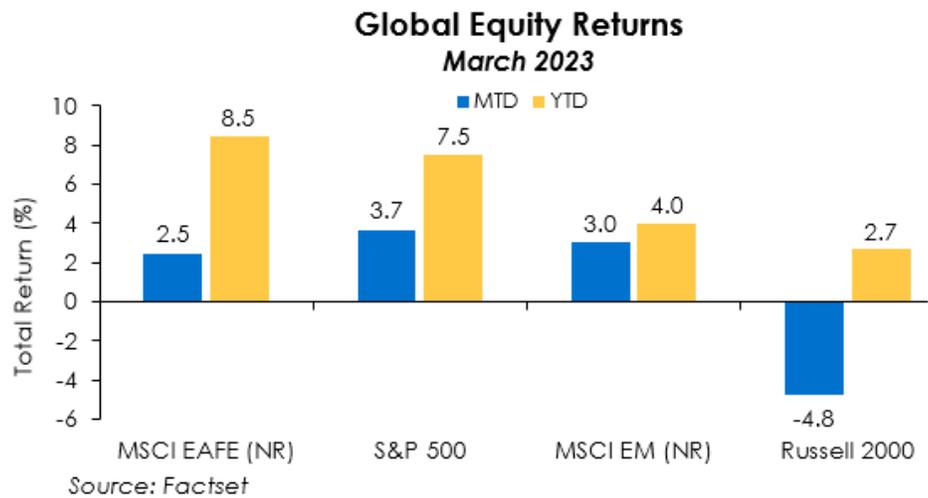


Risk markets rallied in March, resulting in the best first quarter performance for the S&P 500 since 2019. Despite the headline strength, broader capital markets weren't a monolith as small caps finished significantly lower on the month while US large cap performance was concentrated in cyclical growth sectors. Fixed Income and Commodity markets also had more defensive undertones as duration outperformed credit and precious metals outperformed industrial metals.

Stocks

Equity markets were up strongly to close out the first quarter, however, March had more defensive undertones than in previous months. US Small Caps (Russell 2000) underperformed US Large

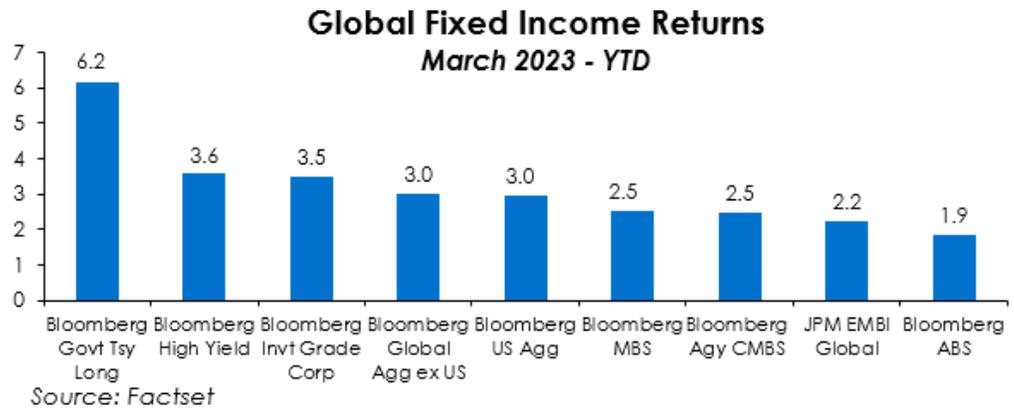
Caps (S&P 500) and sector outperformance included some defensive areas like Utilities and Consumer Staples – a reversal from January and February. Meanwhile, year-to-date performance continued to favor higher priced, cyclical growth sectors (Technology, Discretionary and Communication Services) while cyclical value sectors like Financials and Energy gave way to rising uncertainty. Overseas, international markets were aided by the US dollar rolling back over in March as rates began to fall. This created a tailwind for Emerging Market equities (MSCI EM) in the month. International Developed Markets (MSCI EAFE) delivered among the best returns year-to-date as financial firms have benefited from a return to positive interest rates and industrials have been helped by warmer weather and the avoidance of an energy crisis.



Bonds

Following aggressive moves by the Fed – having now hiked short-term rates by 475 basis points (to 4.75-5.0%) amid ongoing balance sheet reduction – policymakers continue to “hold the line” on rate policy. Longer term rates have been volatile but biased lower year-to-date – decreasing in early January as inflation data came off the boil only to bounce back in February amid tight labor markets and concern that inflation might prove to be stickier. In March, long-term rates fell again as liquidity concerns gripped the global banking sector. Meanwhile, the yield curve remained inverted – an indication of macro stress as monetary policy restricts to the point of deteriorating growth prospects with the entire Treasury curve having moved below the Fed Funds rate. Lower rates benefited the bond market, in total, with positive broad-based returns year-to-date. As such, duration outperformed with Long-Term Treasuries (Govt Tsy Long) leading all other fixed income market segments.

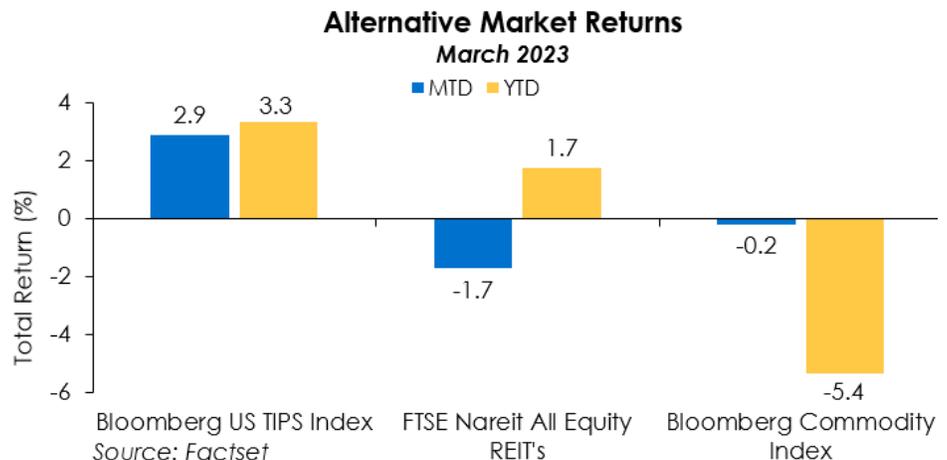
Corporate bonds (High Yield, Investment Grade) remained resilient despite seeing some stress in March. International bonds (Global Agg ex US) performed in line relative to the US



Aggregate (US Agg) due to the benefit of a weaker US dollar. Conversely, securitized credit (MBS, CMBS, ABS) and dollar based Emerging Market debt (EMBI) underperformed.

Alternatives

Commodities posted their third consecutive month of negative returns in March as weakness in Energy more than offset strength in Precious Metals. Meanwhile, Publicly Traded Real Estate (REIT's) continued to give back some of their January outperformance.



Finally, Treasury inflation protected securities (TIPs) benefited from the rate move in bonds.



Market Outlook

“Woods are not like other spaces...Stand in a desert or prairie and you know you are in a big space. Stand in the woods and you only sense it.”

– Bill Bryson, *A Walk in the Woods* (1998)

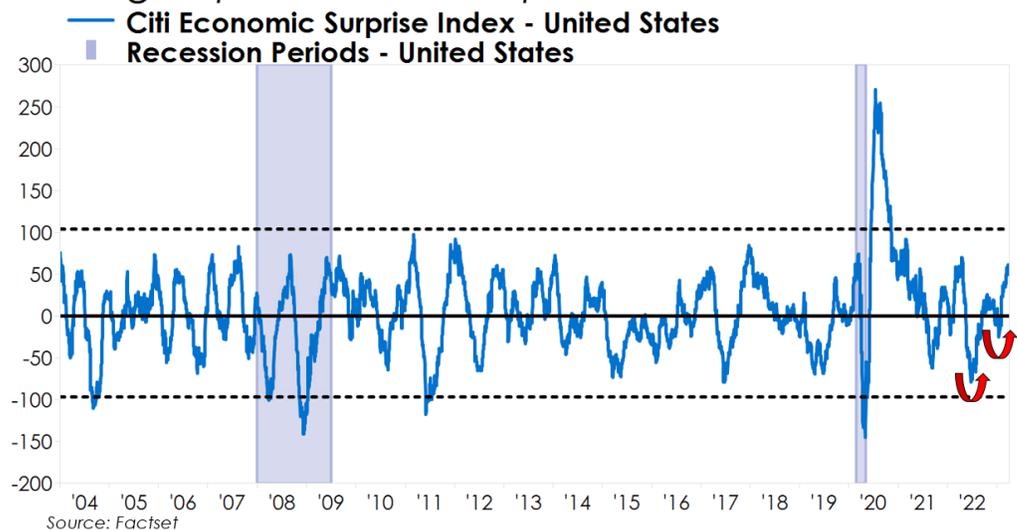
We’re dubbing our main theme for 2023 as “Seeing both the Forest AND the Trees”. As such, we think it’s especially important to have two frameworks for managing portfolios – the cyclical (shorter-term) and the secular (longer-term). The cyclical perspective is an attempt to assess where we are in this particular business cycle while the secular perspective evaluates where the structural tendencies might be over multiple business cycles.

From a secular lens, we remain sympathetic to the notion that the economic paradigm is changing to one that ushers in the potential for more persistent inflation which is likely to result in a higher cost of capital world. We find historical parallels today to the higher inflation regime that existed back in the ‘60’s-80’s and we think the Fed is re-learning the painful lesson of falling behind inflation – one that it hopes not to repeat any time soon. Additionally, we believe there are structural considerations that exist today that might also support this changing paradigm including changes to both aggregate demand (money supply) and supply (de-globalization, labor markets, energy complex).

At the other end of the spectrum is the cyclical perspective, which we think currently carries more weight given its

more immediacy and potential divergence from the secular view – at least for a time. As can be seen in the chart above, US economic data has continued to positively surprise relative to expectations keeping the soft landing narrative in tact. Positive economic surprises are now notably above the long term average and headed toward historically positive extremes (as denoted by the dashed line which represents two standard

Citigroup Economic Surprise Index



deviations above the historical mean). The last several months have seen a falling dollar along with lower (albeit volatile) long-term interest rates – conditions that have historically led to positive economic surprises. Seasonally warmer weather, excess liquidity (from '20-21) and continued strength in the labor markets have helped as well. Still, we remain laser focused on our balance of leading indicators which suggest the following more cautious set of conditions:

- We remain in the latter stages of the business cycle. What inning we're in remains up for debate, but a combination of liquidity, labor market, capacity and confidence measures all support the conclusion of being late cycle.
- Liquidity is being drained from the economy. Lots of data support this notion including a deeply inverted yield curve, negative year on year money supply growth (\$650b off the peak), a dramatic decline in the savings rate and credit standards that are the tightest since 1Q09 (ex Covid) with additional tightening likely.
- Growth is slowing. The combination of the above points to slowing growth conditions. We expect nominal GDP growth to be impacted by last year's weakening money supply growth with about a 12 month lag. Meanwhile, the leading economic indicator composite is suggesting deteriorating real GDP growth. Finally, our leading profit cycle indicators are still pointing to earnings growth slowing six months out.

One of the more well known investor mantras has been "don't fight the Fed". This phrase has almost always been used with a positive connotation, in part, due to the last decade of free money. Whenever the economy ran into trouble, the Fed not only came in to provide support but remained supportive for long periods of time thereafter (zero interest rate policy). This led to investors being pre-conditioned to take risk given that the downside was seemingly limited by what's been referred to as the "Fed put". But with a markedly different inflation backdrop is that mantra changing?

FOMC Projections	1Q23e	4Q23e	Difference
Real GDP \$ (Billions)	20,357	20,263	(94)
Real GDP % YoY	2.2%	0.4%	
Real GDP % QoQ	0.87%	-0.46%	
Real GDP % SAAR	3.5%	-1.8%	
Unemployment Rate	3.6%	4.5%	0.9%

Source: Factset, FOMC. Estimates for 4Q23 Real GDP and the Unemployment Rate are based on Fed projections as of their March 22, 2023 meeting. Estimate for 1Q23 Real GDP is based on the Atlanta Fed GDP Nowcasting measure as of March 22, 2023. 1Q23 Unemployment Rate current as of February, 2023.

In March, the Fed decided to take the Fed Funds rate to 4.75-5.0% (by hiking 25 bps or 0.25%) while also suggesting that it was likely nearing an end to materially more rate hikes. The major takeaway was that policymakers were now trying to balance between the negative effects of financial instability and policy lag juxtaposed against still elevated inflation conditions. As such, forecasts implied that rate hikes were largely complete but rate cuts were still not anticipated until next



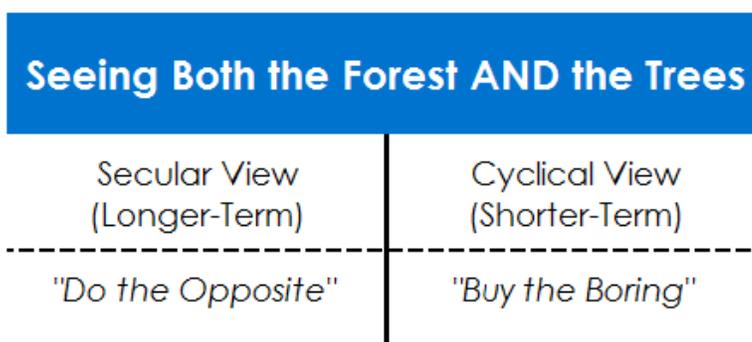
year at the earliest. What got less press were Fed forecasts around economic growth conditions. It would seem that policymakers are now suggesting an economic recession is their base case for 2023. In order to get there one has to reverse engineer estimates for Real GDP figures for 1Q23 and 4Q23. As can be seen in the table on the prior page, we started with the Fed’s forecasted assumption for Real GDP growth of 0.4% at year end (dashed box). We also used the Atlanta Fed’s NowCasting measure (real time estimate for GDP growth in the current quarter) to estimate 1Q23 real GDP growth – taken on the date of the FOMC meeting. Backing into the math suggests the Fed is now forecasting real GDP growth to decline from 1Q23 to 4Q23. This is consistent with the Fed’s forecast for the unemployment rate to rise by almost 100 bps (dashed box). While the numbers suggest a shallow recession, we think the broader point is that the Fed is recognizing – a bit more overtly – that it will likely have to force a recession to fulfill its price stability mandate. The bottom line is that the phrase “don’t fight the Fed” may now have a very different meaning.

With this phrase in mind along with rates moving higher and liquidity draining more quickly, we can’t help but wonder if markets are just trading one cyclical risk (Inflation) for another (Recession). The S&P 500 is still trading (~18X) well above levels where multiples have typically bottomed during major valuation corrections over the last thirty years (10-15X) at a time when earnings are biased downward and inflation is still elevated. And with bond yields notably higher, there’s now a real alternative to stocks (i.e. skinny equity risk premium). To us, this still doesn’t appear to be a great set up for risk assets from a cyclical point of view.

So what are the implications and key takeaways for portfolios?

With an eye on both the Secular and Cyclical views, we think it might make sense to keep two simple phrases in mind – “Do the Opposite” and “Buy the Boring”:

- From a longer-term point of view, if the economic paradigm is changing, then it may pay to “do the opposite”. In other words, the relative winners over the past 10-15 years may not be the same winners over the next decade. Businesses that took advantage of free money to leverage up their balance sheets in the hopes of high growth payoffs far out in the future might now offer greater risk in a higher cost of capital world. Conversely, the losers over the past 10-15 years might now become the new areas of opportunity. These might include companies built to be a bit more insulated from inflation with more balanced business models, more immediate cash flows and a focus on the bottom line.
- From a shorter-term point of view, late cycle conditions that might suggest we’re trading one cyclical risk (Inflation) for another (Recession) argue to “buy the boring”. Should growth continue to slow



leading to a profit and/or economic downturn, it might be more beneficial to buy the things that people need over the things that people want.

From a portfolio positioning perspective, we continue to believe that it's important to "See both the Forest AND the Trees". To us, that means managing the overall exposure and mix of risk assets consistent with a maturing cycle (i.e. Cyclical) while also being cognizant of the potential changing paradigm (i.e. Secular). Over the last several months, we've given an increased weight to the cyclical over the secular as we've reduced portfolio risk. In December we recalibrated portfolios in order to maintain an underweight to risk assets. That adjustment was facilitated by trimming equities and adding to bonds. Additionally, we further lowered our equity beta by remixing more defensively within our US Large Caps as the risk of a profits recession continues to increase. This involved increasing the overweight to the more defensive areas relative to cyclical value sectors while remaining underweight cyclical growth stocks. In essence, we continue to downshift risk in portfolios given the late cycle setup.

Within equities, our positioning is modestly UW and continues to favor a value sector tilt while also leaning toward the more traditionally defensive sectors (Staples, Health Care, Utilities) within our US LC exposure. We continue to be decidedly UW the most expensive, cyclical growth areas (Tech, Discretionary, Communication Services).

Within fixed income, we remain UW the most cyclical parts of the bond market (High Yield and Emerging Market Debt) while our US Core Fixed Income exposure remains among our biggest OW in portfolios. Our US Core Bond managers are slightly OW corporate bonds, though we've previously moved up in credit quality by adding some Treasuries and lengthening duration consistent with a downshifting of risk in portfolios.

Within alternatives, we're OW in aggregate with a bit more defensive skew. We remain the most OW to Diversified Alternatives which provides some hedge against market volatility (especially in an environment where there's lower correlations between stocks and bonds). We're more modestly OW to Commodities as a way to bolster inflationary hedges. Meanwhile, we're UW Real Estate as a way to further reduce overall portfolio risk.



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