Independence | Asset Advisors

MARKET MATTERS: FIRST QUARTER 2023

March 31, 2023

"There is no risk-free path for monetary policy" – Jerome Powell

TAKEAWAYS

- The Fed is approaching its terminal rate, but not without causing collateral damage.
- The Banking sector has shown cracks, but has not caved in.
- Real Estate's dismal returns show the impact of tremors that seismic rate hikes have sent through the economy.
- Volatility aside, fundamentals look bruised but not broken.

ONE YEAR OF RISING RATES

In March, we passed the one-year anniversary of the Fed's aggressive rate increases. Between 3/17/2022 and 3/2/2023 the Fed took its target interest rate from 0-0.25% to 4.75-5%, including four consecutive 0.75%/75 bps increases last year. As the Fed keeps adding friction to the tectonic plates of the economy, investors have been watching carefully to see which parts of the economy first show cracks in the surface which would, and which might, be at risk of collapse. Inflation (measured by the CPI) is slowly coming down, from a high of 9% to 6% over the last 12 months as of 2/28/2023, and continues to show signs of falling. However, slowing down rising prices has come at a cost. Companies are making headlines with layoffs, stock prices are seesawing, and price pressures are still an unwieldy burden for consumers and businesses. Despite this, the overall economy has been resilient. Consumer confidence is down from its high but relatively stable, employment and wages are holding up, and earnings have been roughly mixed instead of routed.

Economic forces are often underground. Even in times of precarity, it takes time for stress to build before we feel the shock waves. The Banking, Commercial Real Estate, and Housing sectors are positioned directly on fault lines, and we now see those pockets of the economy beginning to fracture. Amid alarming headlines, it's time to look at the way risk is materializing and how things look going forward.

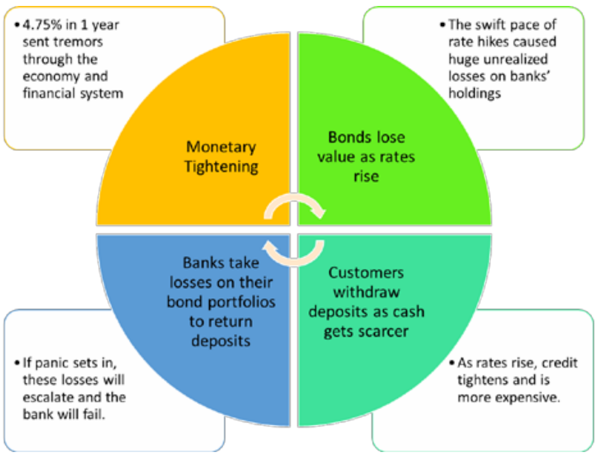
BANKS AND BONDS

Last year, analysts viewed the financial sector as being less sensitive to interest rates, having some potential to perform well in a rising rate environment. Yet bank failures were top-of-mind for investors this past quarter as Silicon Valley Bank failed, along with Signature Bank, and both entered into FDIC receivership. First Republic Bank was bailed out and Credit Suisse was taken over by UBS. Banking disruption brings many back to the 2008 Great Financial Crisis, when big bank failures required enormous government bailouts. The effects of the crisis cascaded and brought about a drawn-out recessionary period (A.K.A. the "Great Recession"). 2023 is categorically different in many ways. The balance sheets of large domestic banks are sound, and the U.S. banking system currently has the full support of the Federal Reserve and Treasury, who have steadfastly said they will not cease in their efforts to keep banks stable and depositors whole. These agencies quickly

Sources: BLS.gov, aei.org, Seeking Alpha, NBER, U.S. HUD, S&P Global, YCharts, George Booth

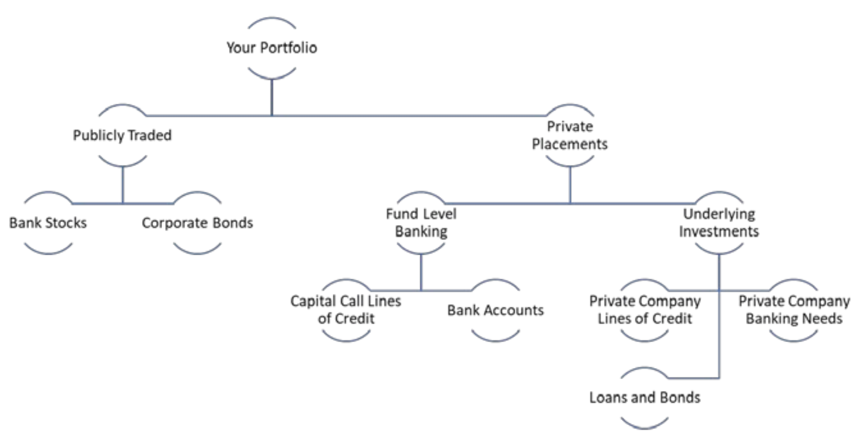
stabilized the industry as panic shook regional banks. Government agencies are taking a hands-on approach to shoring up the industry, which helped ease panic and slow deposit flight. The FDIC stepped in to assure the deposits at SVB and Signature Bank and made clear they would continue to prop up the banking system. These assurances helped the economy avoid financial catastrophe. The banking sector overall has a strong capital position, even though we are seeing significant points of weakness.

In theory, banks would do relatively better than many industries when interest rates rise because they can charge higher interest rates on loans and other credit. Banks are involved across the capital structure. They lend, borrow, broker, and issue their own bonds and equities. They also have a critical role to play at a high level - the complicated job of moving money forward in the economy. Rising interest rates are not only taking the heat out of the economy, but they are also cutting into the business model used by banks to do this job. When people put money in the bank (deposits), this would otherwise take money out of the economic system. Fractional reserve banking, employed across developed countries, lets banks take those deposits and lend a portion of them out to individuals and companies to spend on capital, operations, consumption, etc. Typically, banks take deposits from customers for safe keeping, then make loans or invest in debt assets that are higher-yielding than the yield the customer gets on their deposits, making a profit. Because banks only need to keep a portion of deposited capital available, they can make the rest available in the context of the broader economy, helping to fuel growth and keep things running smoothly. Banks are not required to keep much cash on hand, but this usually is not a problem because customers don't make large withdrawals *at the same time*. If the overall deposits of the bank start to decline, the bank will borrow or raise cash by selling the bonds that it invested in using deposits.



Monetary tightening has set off a cascade of economic effects that have caused a decrease in deposits and cut bond valuations. As credit conditions tighten in response to higher rates, depositors no longer have excess cash to leave on the sidelines, so they draw down their accounts. They may also choose to invest in money market securities to earn more than the (typically low) yield on deposits. On the other side of the coin, as interest rates rise, the bonds that banks invested in are worth less, as yields and prices move inversely. Over the last year, pressure has built under the surface of bank balance sheets as rates and unrealized losses climbed. When banks then sell bonds to give depositors back their cash, they realize losses. The more money withdrawn, the more losses realized, and this stress on the balance sheet can reach a breaking point and become an all-out fault when a bank runs too low on reserves. If depositors realize there is trouble, they will rush to withdraw deposits over the $250k FDIC insurance limit. Without cash on hand to pay all customers back, the bank will fail. Banks ended up in crisis this time not because of high-risk mortgage loans or exotic derivatives like credit default swaps (harkening back to 2008), but by not having enough stable-value reserves to pay back depositors. Bank executives at recently-failed institutions made bad decisions without detailed consideration of how current conditions would impact deposits and managed their interest rate risk poorly, but the fundamentals of the industry were stressed by the steep escalation of interest rates driven by monetary policy.

Investors shouldn't panic, but they should take a multi-pronged approach to banking risk as part of market risk and operational risk at various levels. Bank stocks are volatile, and bond valuations of worrisome institutions have tumbled. Investors should monitor exposure and manage as needed. For private investments, the same goes for each

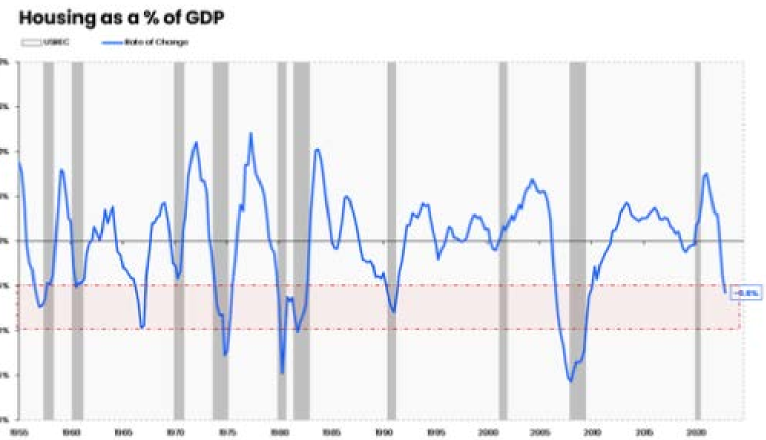


Sources: BLS.gov, aei.org, Seeking Alpha, NBER, U.S. HUD, S&P Global, YCharts, George Booth

manager, fund, and underlying holding. Analysis of financial institutions that one does business with directly will additionally give a clearer understanding of potential consequences and open the door to risk mitigation techniques.

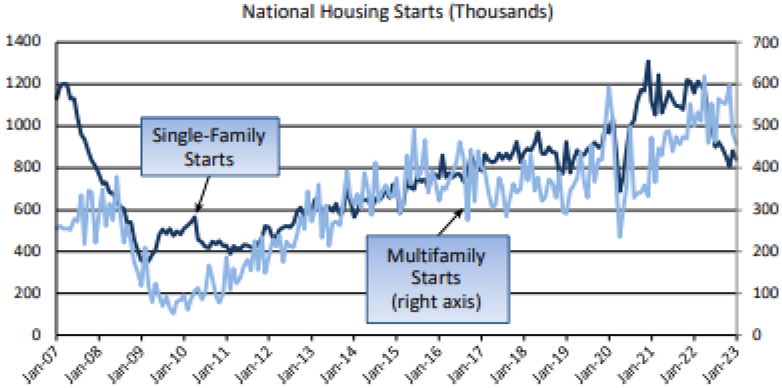
REAL ESTATE

The housing sector is the emblematic scapegoat for interest rate sensitivity, and is living up to that ideal. Over the course of the Fed's tightening cycle, downward momentum has rippled through the industry. Commercial real estate (primarily office and retail) remains underutilized. Single-family housing construction has dwindled, a detrimental force in the overall economy, and multi-family is coming under pressure.



New Construction Fell for Single-Family and Multifamily Housing

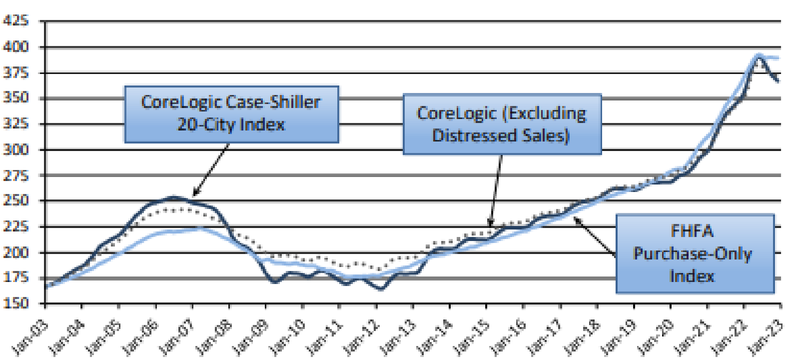
National Housing Starts (Thousands)



Seasonally Adjusted Annual Rate
Sources: Census Bureau and HUD.

Month-to-Month House Price Changes Through December

Monthly House Price Trends by Index ($ Thousands)



Sources: Standard & Poor's, Federal Housing Finance Agency, CoreLogic, and HUD.

The residential construction sector makes up 3-6% of the total economy, but is nonetheless extremely economically influential. Appliances, consumer electronics, furniture and more all rise and fall with home building and sales. Rising real estate values in and of themselves encourage consumer spending, while falling values hurt consumer confidence. Lower construction industry activity leads to lower economic growth as the effects trickle down through the economy. When housing falls as a percentage of GDP, this is usually followed by a recession (and typically a worse recession after a steep decline).

Single-family housing construction spending peaked in May 2022 and has been falling since. Multi-family building permits are also beginning to drop off. On the buy-side, new home sales numbers were almost 20% lower year-over-year at the end of January. Demand has cooled as mortgage rates have climbed, hovering between 6 and 7%. Inventory has fallen for existing homes, constraining supply and propping up prices, but price appreciation has dropped off and prices in some geographic areas are declining. As prices stagnate, builders have put new construction on hold.

Real Estate has performed dismally over the course of the last year. As of 3/31, the S&P 500 and Bloomberg Aggregate Bond indexes returned -7.7% and -1.5% (last 12 months). The Dow Jones REIT composite came in at -21.3%, and the DJ US Real Estate Index at -23.3%, 3x the negative performance of the S&P 500.

The rising rate environment is creating a scenario where it costs more to borrow than real estate investments are yielding (so-called "negative leverage"). This makes capital investment unappealing for developers and other early-stage stakeholders. Aftershocks of the banking sector panic will also have ripple effects through the housing sector, as banks may

Sources: BLS.gov, aei.org, Seeking Alpha, NBER, U.S. HUD, S&P Global, YCharts, George Booth

restrict lending by raising lending standards. However, the real estate cycle is long, and after taking advantage of opportunities to rebalance and re-allocate real estate exposure in the current slump, investors are setting themselves up for long term benefits. Careful asset selection is more important than ever. These disruptions will eventually work their way through the industry, and when the current slump ends the sector is positioned for future growth.

CASH MANAGEMENT

The shocks to the system lately have resulted in hairline fractures instead of chasms, but you wouldn't know it from watching the markets, where equities saw a three-month low in March. The uncertainty is palpable. Though inflation is slowing, it is still more than double the Fed's target, and at least one additional rate hike is likely to come.

Money market funds are currently yielding ~4.75%, an upside to keeping near-cash reserves instead of investing in volatile stocks and fixed income. While this is a bright side if an investor needs to keep money easily accessible for business purposes or to fund capital calls, it comes at a cost. The yield on money market funds, like fixed income securities, is fully taxable as ordinary income, yielding 3.32% after tax for an investor with a 30% average tax rate, and with no upside potential. Investing in other securities is risky, but the average return of a hypothetical 60/40 portfolio comes in at ~7.5% annually, with a lower tax burden and the highest returns coming after the drawdown conditions we have been experiencing, where stocks and bonds have both seen a period of negative returns. Dry powder can be valuable, but a money market fund is not a high-quality source of portfolio return for long-term investors. By keeping too much cash, investors who think they are sitting safely on the sidelines are really standing on the starting line well after the bull market race begins. There is no accurate method to time the market, and missing out on a few days of upside (the manifestation of "upside risk") will meaningfully shrink overall total return.

ASK QUESTIONS NOW, SELL LATER

The phenomenon of volatility clustering is well observed in the market. High activity begets higher activity, where large changes in prices tend to be followed by more large changes in prices. In times of high volatility, it's often hard to justify the observed level of variability with what is actually happening in terms of economic fundamentals. Investors take a "sell now and ask questions later" approach, acting out of fear instead of reason. The sell-off of financial sector assets during the banking disruption is an example of this. There were wild swings in the markets, but looking at the overall financial sector there weren't highly destabilizing or ameliorating events after the SVB collapse that both coincided with and merited, for example, a 5% decrease or increase in an overall financial sector ETF. Markets were primed for volatility after the sell-off. Due diligence is primary in times of elevated volatility because risk can be managed only when it is recognized. Vigilant investors can ride out disruption while staying informed and strategically re-allocate as needed instead of selling out of fear (ask questions now, sell later).

The coming months are likely to be shaky but we don't know the intensity we may experience. The Fed is projected to raise rates another 0.25% in May, and rates are expected to remain over 4% through 2024. This year will require investors to be patient and resist the temptation to play it "safe." Recessionary forces come in degrees and can impact parts of the economy with unequal force and at different times. Mindfully investing at current reasonable valuations will put investors on solid ground when the Great Inflation shakes out.

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