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# Investment Committee Perspective

*First Quarter 2023*

*Our Investment Committee meets quarterly to evaluate asset class performance, analyze macroeconomic data and trends, and review asset class valuations and risks to refine our market outlook and tactical portfolio positioning. This quarterly investment committee perspective summarizes the topics discussed during those investment committee meetings and provides guidance on our outlook and corresponding tactical investment strategy.*

## Our Perspective on Recent Events

The recent turbulence in the banking system has raised concerns about the potential for bank runs – or deposit flights – to cause otherwise healthy financial institutions to become insolvent. The concerns are idiosyncratic to a handful of poorly managed banks and not indicative of the underlying solvency of the U.S. banking system – where herd-like behavior, emotions, and media coverage are playing a more significant role than the fundamental soundness of the overall banking system. In the case of Silicon Valley Bank (SVB), a combination of factors allowed a bank run to take form – the concentration of business deposits outside of FDIC insurance limits, an overlapping customer base of technologists coordinating withdrawals through social media, and unhedged interest rate exposure/balance sheet risk – which ultimately led to its swift downfall and the immediate takeover by the FDIC and the implementation of emergency lending facilities by the Federal Reserve.

The fallout from the collapse of SVB has caused fears of contagion across the financial system to other depository institutions. However, in response, the Federal Reserve enacted emergency measures, namely the Bank Term Funding Program (BTFP). The BFTP allows eligible institutions to access liquidity from the Fed for up to one year by pledging high-quality securities as collateral. Specifically, the BTFP, albeit temporarily, helps to eliminate interest rate risk on long duration securities that have plagued the balance sheets of financial institutions - as the collateral posted is valued at par and not the temporarily depressed market prices that have materialized due to rapidly rising interest rates.

Although the support provided by the Federal Reserve has helped pause the panic, lingering concerns remain as the pain experienced during the 2008 financial crisis fills the air once more. The parent company – The Charles Schwab Corporation – of our primary securities custodian – Charles Schwab **Brokerage**[(1)] – has been in the news because their separate subsidiary institution – Charles Schwab **Bank**[(2)] – is a topic of discussion of being at risk for deposit flights. To provide clarity, our clients' assets are custodied with Charles Schwab **Brokerage –** not Charles Schwab **Bank.** Unlike banks which use customer deposits to make loans, investment assets held at brokerage firms, like Charles Schwab **Brokerage**, are safeguarded and segregated to comply with the SEC's Customer Protection Rule. Customer assets are not commingled with other investments made by Charles Schwab **Brokerage** or with bank deposits held at Charles Schwab **Bank**. Despite the spotlight placed on the banking system at large, we have no concerns for the safety of our clients' assets at Charles Schwab **Brokerage**.

Focusing on the broader economic impact – a spillover effect of the banking turmoil will likely be a tightening of credit lending standards and credit extension may slow as banks prioritize liquidity and capital building. However, the actual banking impact appears, for now, to be a story of a few small banks exposed to flighty deposits with high depositor concentration/overlap and a high percentage of uninsured depositors that suffered a loss of confidence. By taking proactive steps to address the underlying risks and vulnerabilities in the banking system, policymakers have helped to mitigate potential contagion. In fact, since the involvement of the FDIC, Treasury, and Federal Reserve, deposit flows have stabilized – lending credence to the notion that the acute phase of banking turmoil is under control and may be behind us. Nevertheless, despite the recent stabilization of deposit flows, there have been increasing concerns of a pending recession, even prior to the banking episode. As a result, it becomes an even more appropriate time to monitor the economic situation closely. In light of this, the remainder of this letter outlines the key macroeconomic drivers, our views on the possibility of an economic recession, and what that means for our overall market outlook.

(1) The legal name for Charles Schwab **Brokerage** referenced in this letter is Charles Schwab & Co., Inc., which is an operating subsidiary of The Charles Schwab Corporation
(2) The legal name for Charles Schwab **Bank** referenced in this letter is Charles Schwab Bank, SSB, which is an operating subsidiary of The Charles Schwab Corporation

## Economic Outlook

As we look at 2023, and into 2024, we maintain a measured optimism regarding a recovery across most asset classes, despite the potential challenges of a looming recession. It's no secret that many are concerned about the possibility of an economic downturn as the topic continues to dominate media coverage and everyday conversations. While we acknowledge the likelihood of a recession, we remain steadfast in our belief that there are opportunities for growth and progress across global financial markets. As far as economic outlook, we believe there are three key macro factors influencing that economy and impact our expectation for continued volatility in the financial markets: **Inflation**, the **Fed**, and **Economic Growth**.

**Inflation**

In recent months there has been a steady improvement in U.S. inflation data and as of June 2022, assuming no further shocks, inflation appears to have peaked. While this is encouraging, it is important to note that inflation continues to remain well above the Federal Reserve's 2.0% target. Furthermore, the Fed's message is clear: it intends to maintain tight monetary policy throughout 2023. Although measures of core, excluding food and energy, inflation have started to decline on a year-over-year basis, they still hover around 5% to 6%, which is significantly higher than the Fed's target.

Furthermore, the largest input cost for businesses is wages, and this cost is closely linked to inflation expectations. When the two combine, they can trigger a self-reinforcing "wage-price" spiral, which poses a significant risk. The data on wage inflation and inflation expectations is mixed. As of December 2022, year-over-year wage inflation was at 6%, well above the Fed's 2.0% inflation target. For the Fed to feel more confident in containing this risk, wage inflation will need to fall into the 3% - 4% range. Such a decline has historically only occurred during economic recessions - accompanied by increases in unemployment. In the current labor market, the supply and demand for labor remains imbalanced with job openings still far outnumbering unemployed workers and the unemployment (%) rate remains near an all-time low. Although we may have already seen the peak in wage inflation, it may take some time to align labor supply and demand to drive wage inflation lower.

One bright spot, in the inflation outlook, has been the stability of medium and long-term inflation expectations. Inflation expectations play a crucial role in determining inflation outcomes, as elevated expectations can trigger the wage-price spiral that the Fed aims to avoid. In the early 1980s, double-digit inflation expectations fueled a decade-long hyperinflation regime. Today, inflation expectations have remained in the 2 - 3% range, which is a positive sign that persistently higher long-term inflationary expectations have not taken hold as they did in the 1980's.

**The Fed**

Tighter monetary policy is an effective tool to reduce inflationary pressures by slowing demand through increased interest rates, barring any external shocks to the supply side such as wars or pandemics. The Federal Open Market Committee (FOMC) raised the fed funds rate by 25-basis points (0.25%) at its 2/1/2023 meeting and followed up with a 25-basis point (0.25%) hike at its 3/22/2023 meeting, setting the target range at 4.75% to 5.00%. The Fed elected to hike interest rates at its March meeting despite the widespread concerns over the fallout from the collapse of SVB, which demonstrates their confidence in the resiliency of the banking system.

In an effort to manage market expectations, the FOMC delivered a revised tone, acknowledging that the recent developments in the banking system were "likely to result in tighter credit conditions for households and businesses and to weigh on economic activity, hiring, and inflation". The Fed stressed that while the effect of these conditions is uncertain, they remain "highly attentive" to lingering inflation risks.

In addition to the recent rate hikes, the FOMC revised its unemployment rate forecast for the end of 2023 to 4.5%, up from the historically low unemployment rate of 3.4% measured in January 2023. Based on historical data since 1950, every increase in the U.S. unemployment rate by more than half a percentage point from its low has coincided with an economic recession. Hence, if the revised unemployment Fed forecast materializes, it is largely indicative of a pending recession.

**Economic Growth**

Despite the recent improvements in U.S. inflation, the growth outlook for both the U.S. and most developed countries remains bleak for 2023. In fact, the fourth quarter saw further declines in key macroeconomic leading indicators, which combined with tight monetary policies, strongly suggests a high likelihood of a recession in the coming year. Additionally, another reliable indicator of an impending recession, the inverted Treasury yield curve, with short-term bond yields above long-term bond yields, also reinforces the likelihood of an economic contraction within the next 12 months.

## Market and Tactical Outlook

Putting all the pieces together, a recession is the most likely scenario over the next 12 months. To the extent the economy does not dip into a recession, and inflationary pressures remain elevated, the Fed may have to tighten more than anticipated, which would prolong market and banking volatility, trigger another short-term market sell-off, and lengthen the duration and possibly the severity of an eventual recession (i.e., a “hard landing”).

While we recognize the above outlook is not reassuring, successful long-term investing requires an understanding that financial markets are *forward-looking* discounting mechanisms and markets largely "price in" the most probable economic outcomes well in advance, especially during cyclical inflection points. In fact, on average, financial markets move six-to-nine months *in advance* of actual economic data/outcomes. As we begin 2023, it's important to consider what markets have already discounted, such as the likelihood of a recession. Historical data shows that the average stock market decline during economic recessions is around -31%, and the U.S. stock market's decline of -25% from the end of 2021 through October 2022 suggests the market has largely priced in the potential for a 2023 recession. While this doesn't mean the markets won't continue to fluctuate or decline once again from recent, partially recovered levels, it does reflect that the 2022 market declines reflected an anticipated difficult 2023 macroeconomic environment, including a mild economic recession.

The world of finance is full of "experts" who love to speculate and predict short-term economic outcomes. However, the reality is the economy is a complex and constantly adaptive system that cannot be predicted with certainty. Attempting to “time” the market is not only futile but detrimental to long-term investment success. The most successful long-term investment strategy is to prioritize staying invested and adhering to the tried-and-true adage of "time in the market, not timing the market." Because of this, we construct our client portfolios based on extensive research and modelling of long-term asset class risk and return while also incorporating each client’s unique risk profile and financial goals and objectives.

In addition to this foundational basis that drives our long-term strategic portfolio construction, our Investment Committee analyzes expected risks and returns over a tactical, medium-term horizon of *five to seven years*. This enables us to make informed, data-driven decisions about portfolio changes and adjust our strategies accordingly, without getting caught up in short-term market fluctuations. Our focus remains firmly on helping our clients achieve their long-term financial objectives rather than chasing short-term noise or trying to make short-term predictions about the unpredictable.

Moreover, as we weather the expected 2023 volatility, we grow more optimistic about expected returns over our five-to-seven-year tactical investment horizon. In fact, expected returns over that horizon are now the highest they've been in over a decade, largely driven by the abysmal returns across almost all asset classes in 2022 (i.e., markets got “cheaper”). By maintaining our focus on risk management, global diversification, and multi-asset strategies, we're confident in our ability to navigate the near-term volatility and deliver on our clients' return targets over the long term.

Even while the market fluctuates and the economic tides sway back and forth, there are still opportunities to add value across client portfolios. For example, during the market correction in 2022, which served as an opportunistic reset of financial valuations, we implemented meaningful tax loss harvesting across our clients’ taxable accounts. We do not sell investments at permanent losses. Instead, we swap them into like-equivalent investments so that the assets remain invested to participate in their ultimate recovery. This is simply a tax strategy that has no impact on your investment plan or portfolio. By recognizing temporary declines, to take advantage of the tax benefit of the loss, we enhance the after-tax returns of your portfolio.

Lastly, we hold an increasingly optimistic outlook that the strategic changes that we made to client portfolios in 2022 will further mitigate risk, enhance income, and returns over the coming years.

We appreciate the trust our clients place in us and encourage you to reach out with any questions or concerns. Regular communication with our clients is essential to ensure we're meeting your investment and financial planning objectives.

Cordially,

Causey Demgen & Moore Investment Committee
Robb Stone, Nathanael Koch, Stephen Warren, Paul Demgen, John Connell