

Quarterly Market Commentary

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The Confidence Crisis



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“Confidence thrives on honesty, on honor, on the sacredness of obligation, on faithful protection and on unselfish performance. Without them, it cannot live.”

- Franklin Delano Roosevelt

Confidence serves as the very foundation of our economic, political, and social institutions. As human beings, we must be confident that we can address the ever-evolving issues in our education, healthcare, and social systems. Recently, as consumers, we must trust that the Federal Reserve has the tools, the experience, and the resolve to eradicate inflation. As American citizens, we must believe that our elected officials share a commitment to face and solve the country’s spending and debt liabilities – and to avert a catastrophic default. While our fragile confidence in these institutions has been under constant questioning since the formation of our union, the solvency of the banking system has reintroduced its own crisis in confidence.

The Failure of Silicon Valley Bank

As a bank depositor, you must have confidence that when you need to withdraw money, it will be there. Bank runs, while rare, inevitably occur when there are questions about the safety and accessibility of those deposits. These dynamics emerged in March with the failures of Silicon Valley Bank (SVB) and Signature Bank, as well as with the rescue of Credit Suisse, and continue to manifest in the U.S. regional banking sector. Remember, it has been nearly 15 years since the largest bank failure in the United States with the collapse of Washington Mutual (WAMU) in 2008.

For now, it appears that the FDIC has steadied the ship by guaranteeing deposits at SVB. Furthermore, the Federal Reserve, through the Bank Term Funding Program, is providing cash loans for banks willing to put up safe collateral. The question remains whether the issues that led SVB into bankruptcy are unique to the institution – specifically, poor management which exposed depositors to significant risk, coupled with a substantially uninsured depositor base that is highly levered to the volatile Venture Capital industry – or, if its

failure is indicative of further stress underneath the hood of the global economy.

While SVB may prove to be the most high-profile casualty of this interest rate hiking cycle, we do think its failure highlights the fragility of our highly complex financial system. In the Fed’s war on inflation, they bluntly targeted key cost centers – shelter, food, and energy – where the burden of upwardly spiraling prices crunched lower and middle-income families. By increasing borrowing costs for families and businesses, and by siphoning liquidity out of the economic system, the Fed has successfully put a lid on what was a 40-year high in inflation. Yet, as always, the unintended and unpredictable consequences of those policies continue to play out.

One outcome of the hiking cycle has been the decline in value of fixed income securities. Bonds, which serve as “safe capital” in investor portfolios and bank balance sheets alike, have been deeply impaired during this cycle. In SVB’s case, the bank invested \$21 billion in long-term treasuries and mortgages. While SVB’s bond book was largely free of credit risk, as it owned U.S. government and agency securities, it was acutely exposed to higher interest rates. As of the 4th quarter 2022, SVB’s bond portfolio had lost nearly -30%. As losses mounted and deposits drained, SVB’s flighty, interconnected, and uninsured depositor base was uniquely vulnerable to a classic financial panic.

Are other banks susceptible to what happened at SVB? Absolutely. But, given enough time, the paper losses on government bond portfolios will be recovered as those bonds mature at full value. This is not the credit crisis of 2008 where bad credit bets were left uncollectible and brought down hundred-year-old banking institutions. However, it will require both confidence and commitment from investors, depositors, and officials to

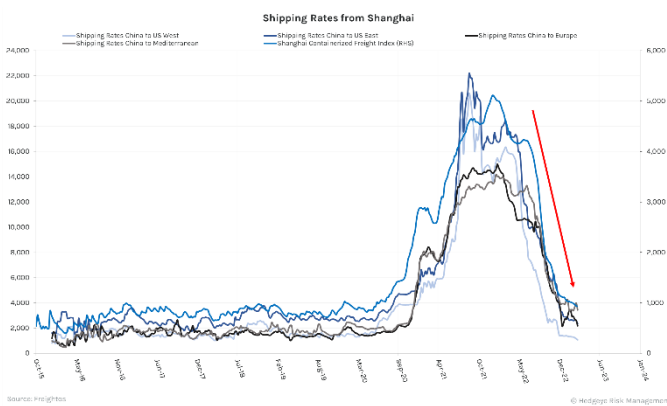
act rationally in an increasingly tenuous economic climate.

Threading the Needle at the Fed

Despite the banking sector’s challenges, the Federal Reserve raised interest rates two more times in the first quarter: 0.25% in February and another 0.25% in March, bringing the Fed Funds rate to 4.75-5.0%. The Federal Reserve is a convenient punching bag for members of Congress and investors alike, yet some recognition must be given to the Central Bank for its commitment and progress in bringing down the four-decade high in inflation that engulfed the economy in 2022.

Oil prices have been nearly cut in half from \$120 per barrel in June 2022 to \$67 per barrel today. Natural Gas, which is used to heat homes or run factories, peaked at \$9.65 in August last year and has fallen -77% to \$2.22 per mm/btu. The cost of shipping goods across the globe has also been slashed. Due to supply chain constraints caused by the pandemic, the Global Container Shipping Index peaked at \$10,360 per container while costs for the same shipment today have fallen 4-fold and have returned to pre-pandemic levels.

Shipping Rates from Shanghai¹



Shelter costs and service costs remain the lone standouts in the Bureau of Labor Statistics CPI report. Each has persisted as a frustratingly sticky component of the inflation basket. For the Federal Reserve to declare victory over inflation, it will be important to see rent,

¹ Hedgeye Risk Management

owners’ equivalent rent (OER), and service cost inflation decline in the coming months.

However, herein lies the problem for the Central Bank: Chairman Jerome Powell has communicated to the market and testified in front of Congress that the Fed will do what it takes (i.e. continue to raise rates) in order to reduce inflation to its 2.0% target. At the same time, the higher interest rates required to reach that inflation target have impaired bank balance sheets and threatened confidence in the financial system.

For now, the market appears to have confidence that the Fed can indeed thread the needle and hit their inflation target without causing further economic damage in the process. While off the February highs, risk assets held steady despite the events in the banking sector, with most indexes in positive territory for the first quarter:

Month To Date as of March 31, 2023 ²	
S&P 500 Total Return Index	7.5%
Dow Jones Industrial Average	0.9%
Nasdaq Composite Index	16.8%
Russell 2000 Index	2.3%
MSCI EAFE Index	8.6%
MSCI Emerging Markets Index	3.4%
Bloomberg Aggregate Bond Index	3.0%

Confidence Through Process

In his book published in 1996, *The Fourth Turning: An American Prophecy*, Neil Howe wrote: “Individually focused and collectively adrift, we wonder if we are heading toward a waterfall.” Nearly thirty years later, this is a sentiment that many of us feel as we navigate our way through a convulsing economic, political, and social environment.

The future is always uncertain, which is why we as asset allocators must rely on a repeatable, data driven process to make prudent investment decisions. If left to act rashly on daily news flow, emotional responses, or the

² Black Diamond

decisions of others, investment results will suffer. No investor can be right all the time (be wary of those who say they are), but only by following a consistent process can we make defensible allocation decisions.

It was the positive inflection in growth and inflation in May of 2020 that led us to move to a more aggressive allocation for clients. And it was the negative inflection of those factors that led us to move to a more defensive posture in August of 2021, and then the further deterioration that informed a shift to our most defensive position in August of last year. Having a repeatable investment process that relies on data is what gives our team the confidence to make active investment decisions that protect and grow assets over full market cycles.

As we look ahead, we continue to see a flattening of the risk curve, generating more return with less risk in the fixed income markets, and we see more risk than opportunity in the stock markets. The economic environment remains bifurcated and cloudy. Large retailers like Costco, Walmart, Home Depot, and others indicate that the consumer remains in a fragile position, while service businesses such as airlines continue to see strength. As banks tighten their lending standards and clamp down on credit growth in response to the recent stresses, consumption will be impaired further, and growth will slow. We continue to expect that the growth and quality of corporate earnings will also erode in the face of these challenges.

The current bear market is 16 months old – roughly half the length of the tech bubble at the start of the century. While we are unsure of the ultimate duration of this down-cycle, we do know it takes time for cycles to fully play out. From a positioning standpoint, we maintain our defensive posture, owning high quality fixed income and large, well-capitalized stocks with strong balance sheets. There will be a time to get more aggressive, and when it is, it will be our data driven process that provides us with the confidence to do so.

In the meantime, we appreciate your trust and partnership. We will continue to work every day to earn it. Wishing you good health and happiness as we step out of Winter and into Spring.

Respectfully,

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The impact of the outbreak of COVID-19 on the economy is highly uncertain. Valuations and economic data may change more rapidly and significantly than under standard market conditions. COVID-19 has and will continue based on economic forecasts to have a material impact on the US and global economy for an unknown period.