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1st Quarter 2023 Investment Letter by Erik Ridgley, CFA April 10, 2023

We wish all our clients and friends a joyous spring! Below we provide a review of markets in the 1st quarter of 2023, which delivered positive and above average investment returns for equities and fixed income, plus our outlook for the balance of the year.

The Fed Signaled They Will Hike Rates for The Last Time on May 3rd, and Cut Rates at Year End

FOMC "dot plot" projections signaled the Fed will hike rates for the last time on May 3rd, and then pause and leave the Fed Funds Rate at 5.25% for an "extended period of time," and then begin cutting Fed Funds Rates in early 2024. The rule of thumb is that Fed Funds Rates should be 1% higher than inflation rates to force inflation down. The Fed is forecasting core personal consumption expenditures (PCE) inflation rate, its preferred measure of inflation, which excludes energy and food, to fall from 4.6% in Feb 2023 to 3.6% by December 2023 (and Fed Funds Rate of 5.1%), and to 2.6% by December 2024 (and Fed Funds Rate of 4.3%), and then to 2.1% by December 2025 (and Fed Funds Rate of 3.1%), and thereafter to the 2.0% target (and Fed Funds Rate of 2.5%) over the long run. However, bond markets think the Fed will be forced to cut rates sooner i.e., the futures markets are pricing in that the Fed will start cutting rates this summer, and cut to 4.3% by the end of 2023, per Bloomberg <WIRP>. Notably, the ends of Fed Funds Rate hiking cycles have historically been followed by 12-month periods of well above average equity returns, using data from the past 30 years, with the one exception being 5/15/2000.

Asset Class Benchmark Returns in 2023 – 1st Quarter and March

1st Qtr: +7.31%	March: +3.08%	Global Equities: MSCI All Country World Index (ACWI)
1st Qtr: +2.78%	March: +2.22%	Municipal Bonds: Bloomberg Barclays Muni Bond Index
1st Qtr: +5.05%	March: +2.65%	50/50 Allocation: 50% ACWI / 50% Muni Bond
1st Qtr: +7.50%	March: +3.67%	U.S. Large Cap Equities: S&P 500 Index
1st Qtr: +2.74%	March: -4.78%	U.S. Small Cap Equities: Russell 2000 Index
1st Qtr: +8.47%	March: +2.48%	Foreign Developed Equities: MSCI EAFE Index (EAFE)
1st Qtr: +3.96%	March: +3.03%	Emerging Markets Equities: MSCI Emerging Markets Index
1st Qtr: +2.72%	March: -2.48%	Real Estate: S&P U.S. REIT Index
1st Qtr: +3.57%	March: +1.07%	Junk Bonds: U.S. Aggregate Corporate High Yield Index
1st Qtr: +2.96%	March: +2.54%	U.S. Fixed Income: U.S. Aggregate Bond Index (AGG)

Fed Funds Rates Above 4% Are Driving Deposits from Banks into Investment Accounts

Since mid-2022, bank customers increased their "cash sorting" out of lower yielding bank accounts and into higher yielding investment accounts, not because of bank run concerns, but rather just to earn more interest. Because of continued cash sorting, banks of all sizes will need to moderate their lending to adjust for fewer deposits, which could reduce GDP by 0.7%-1.0%, according to credible estimates. These constraints on bank lending are consistent with the Fed's objective of slowing down the economy to reduce inflation. A "silver lining" to these storm clouds is that lower inflation will justify higher valuations for equities and fixed income, all else being equal. The important caveat here is that all else is not always equal, for example the negative cyclical effects on earnings from economic slowdowns.

<u>The Fed Keeps Raising Rates Until Something Breaks</u>

"Beware the ides of March," from *Julius Caesar*, written in 1599, was apropos in 2023 for bank CEOs. The Fed's monetary policy has often been described as "keep raising rates until something breaks," and something finally broke in early March. Silicon Valley Bank (SIVB) and Signature Bank (SBNY) were the second and third largest bank failures, respectively, in U.S. history, and Credit Suisse was one of 30 global systemically important banks (G-SIB), until it was forced into a shotgun marriage to UBS by the Swiss National Bank. FDIC receivership for SIVB and SBNY made all their depositors whole, and the Fed created a new lending facility to grant all banks the ability to exchange AAA-rated securities at par value for cash, without recognizing losses on assets classified as held-to-maturity. As a result of these actions the worst of this episode seems to be behind us. It appears that a panic by a small number of general partners of venture capital funds that directly or indirectly controlled an unusually large portion of SIVB's deposits triggered a bank run that so far hasn't spread to other banks with better management. From a policy perspective, the FDIC's goal is not to prevent all bank failures, but rather to ensure that individual bank failures do not cause the banking system to fail, without using taxpayer dollars, which was achieved.

<u>Review of 1st Qtr of 2023: Positive and Above Average Returns for Equities and Fixed Income</u>

The S&P 500 index of stocks rose +7.50% in the first quarter of 2023, including dividends, from 3,840 to 4,109, after rising to 4180 on Feb 2nd and then troughing at 3856 on March 13th. 10-year Treasury yields whipsawed from 3.87% to 3.47%, after falling to 3.37% on January 18th and then peaking at 4.06% on March 2nd. West Texas Intermediate (WTI) crude oil prices per barrel declined from $80 to $76, after dipping to $67 on March 17th. The US dollar currency index weakened from 103.52 to 102.51, after trading down to 101.22 on Feb 1st and trading up to 105.66 on March 8th. U.S. unemployment rates improved slightly from 3.6% to 3.5%. The Fed's 5-yr forward breakeven inflation rates rose from 2.18% to 2.26%, after first falling to 2.02% on January 18th and then rising to 2.47% on March 2nd.

U.S. economic activity decelerated late in the 1st quarter under the cumulative weight of 4.75% of Fed Funds Rate hikes over the past twelve months. The U.S. economy *real* GDP (QoQ% SAAR) was +1.3% in 1Q23 (est.), +2.6% in 4Q22, +3.2% in 3Q22, and -0.6% in 2Q22. But earnings, revenues, and expenses are all reported in nominal terms, not real terms. The U.S. economy *nominal* GDP (QoQ% SAAR) was +7.2% in 1Q23, +9.4% in 4Q22, +11.5% in 3Q22, and +8.1% in 2Q22 (Note: the relevant formula is "Nominal GDP = Real GDP + Inflation Rate").

The Fed's preferred measure of inflation, Core PCE (YoY%), was +4.6% in 1Q23 (est.), +4.8% in 4Q22, +5.0% in 3Q22, and +5.0% in 2Q22. U.S. headline CPI inflation (YoY%) was +5.9% in 1Q23 (est.), +7.1% in 4Q22, +8.3% in 3Q22, and +8.7% in 2Q22. The Fed's target rate of inflation is +2.0% for both measures.

<u>Outlook for the Rest of 2023: On Watch for Soft Landing vs. Hard Landing as Inflation Declines</u>

With the U.S. economy decelerating and inflation slowly receding, many investors seem to have given up hope that the Fed can successfully tamp down inflation without throwing the economy into a "hard landing" recession. This bearish view might still turn out to be too pessimistic, and it will likely be due to structurally tight labor markets and generous fiscal spending programs across the major economies. For a window into consensus expectations, Goldman Sachs forecasts a 35% chance of a recession in the next 12 months, which compares to 20% in average conditions.

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Consensus estimates for S&P 500 EPS growth are +0.3% in 2023 and +12.0% in 2024, after growing +7.4% in 2022, per I/B/E/S data by Refinitiv. Year-over-year quarterly EPS estimates are -7.5% in 1Q23, -6.4% in 2Q23, +1.7% in 3Q23, and +10.1% in 4Q23.

S&P 500 revenues per share are forecasted to grow +1.7% in 2023 and +4.8% in 2024, after rising +11.5% in 2022. Net profit margins are projected to decline to 12% in 2023 from 12.8% in 2022, and expand to 13% in 2024, per I/B/E/S data by Refinitiv.

The highly respected UCLA Anderson Economic Forecast predicted in March (based on an assumption that the Fed will stop hiking the Fed Funds Rate at 5.25%) that U.S. real GDP will grow by +1.3% in 2023 (up from +1.2% in Dec), and +1.8% in 2024 (down from +2.3% in Dec), and +2.2% in 2025. Wall Street's full year consensus forecast for U.S. real GDP is +2.1% in 2022 (actual), +1.0% in 2023, +1.0% in 2024, and +2.0% in 2025, and the quarterly forecasts are +1.3% in 1Q23, +0.2% in 2Q23, -0.5% in 3Q23, and +0.3% in 4Q23, per Bloomberg <ECFC>.

Both Europe and Japan are growing their economies at above trend rates. Europe's economy is forecasted (per ECB) to grow +3.6% in 2022 (actual), and +1.0% in 2023 (up from +0.5% in December), and +1.6% in 2024, and 1.6% in 2025, vs. its trend rate of +1% real GDP growth. Japan's economy is forecasted (per JCER) to grow +1.2% (down from +1.7% in Dec) in 2022 (actual), and +0.9% (up from +0.8% in Dec) in 2023, and +1.0% in 2024 (up from +0.6% in Dec) vs. its trend rate of +0.5% real GDP growth.

Price/earnings (P/E) multiples are 18.7, 13.6, 12.9, 13.4, and 12.3 for S&P 500 large cap, S&P 400 mid cap, S&P 600 small cap, foreign developed, and emerging markets, respectively, where E is EPS on next four quarters (NFQ), per Bloomberg consensus. The long-term average for U.S. NFQ P/E multiples is 15 ½. Thus, U.S. large cap equity valuations are 21% above average.

The Treasury yield curve is currently pricing in Fed Funds Rates to fall to 3.50% one year from now, and 10-year Treasury yields of 3.35% at year-end 2023, per Bloomberg <FWCM>. Importantly, the yield curve is priced for 10-year Treasury yields to remain below 3.75% for the next 5 years. The Treasury yield curve represents the "real money" pricing of many trillions of dollars of U.S. Treasury securities across maturities from 7 days to 30 years, based on bond investors' expectations for the future, which is why it commands the respect of equity investors and the Fed. Of course, the yield curve always reserves the right to change its mind, which it has been doing much more frequently in the past year.

The yield curve is inverted, with 10-year Treasury yields lower than 2-year Treasury yields by 59 basis points (bps), after a nadir of 108 bps inverted on March 8th. Yield curve inversion is a reliable leading indicator of a future economic downturn.

High yield bond spreads (over 10-year Treasuries) eased from 509 to 502 basis points, after troughing at 432 bps on Feb 3rd and peaking at 556 bps on Mar 20th, indicating that credit markets have priced in an economic slowdown (but are not yet pricing in a recession).

Long-Term Investing

To paraphrase Warren Buffett, successful investors need to invest for the long-term and avoid being swayed by the fear and greed of others that can cause irrational swings in the market. We do not let the daily noise and volatility of the markets deter us from our mission to be faithful stewards of our clients' capital. As long-term investors, we and our clients have committed ourselves to adhere to well-defined investment policy statements, which have been custom-built for each individual client, to achieve their long-term investment objectives, while accepting the inevitable price fluctuations of the public markets.

As fiduciaries, we relentlessly seek out the lowest costs and best terms for our clients. As trusted advisors, long-term relationships are of primary importance to helping our clients achieve successful outcomes through personalized financial planning and disciplined implementation.

Risk Management

Asset allocations should be based on well-designed investment policy statements to enable investors to get through bear markets without selling equities, by using fixed income or cash to draw upon until stock markets have recovered, which is common sense short-term risk management. However, comprehensive risk management should also account for the long-term shortfall risk of not achieving long-term portfolio growth objectives due to sub-optimal asset allocations and portfolio construction. Along the way, contingency risks (i.e., low probability and high impact) need to be efficiently managed with various tools including adequate liquidity, appropriate insurance protection (note: we do not sell insurance), coordination with clients' trusts & estate attorneys, and proactive tax planning with clients and their CPAs.

Proven and Repeatable Processes: Portfolio Rebalancing, Tax Loss Harvesting, and Tax Deferral

Portfolio rebalancing is a useful tool for long-term investors because it serves two important purposes. First and foremost, it keeps asset allocations in line with targets that have been codified in clients' investment policy statements (IPS). Second, it can be a mechanism to naturally "buy low, sell high", because it involves adding to an asset class that has decreased in price (e.g., >10%) relative to the overall portfolio, and cutting back an asset class that has increased in price relative to the overall portfolio. Good judgment, disciplined decision-making, and operational excellence are necessary to obtain the best results for every client from portfolio rebalancing.

Another proven methodology for long-term investors to take advantage of market volatility is tax loss harvesting. Unlike tax loss selling, tax loss harvesting precludes adverse impacts to investment returns, by simultaneously replacing the sold securities with very similar securities, while avoiding IRS wash sale rule violations. We actively implement tax loss harvesting throughout the year whenever material market declines create opportunities.

Tax losses provide economic value because investors can use them to offset capital gains tax, and unused tax losses can be carried forward into future years until they are fully used. The maximum federal tax rate on short-term capital gains is 40.8%, including the 3.8% net investment income tax, and for Californians the maximum combined state and federal tax rate is 54.1%. Although no one likes down markets, tax loss harvesting can effectively reduce negative returns by up to 54.1%, without sacrificing full participation in the inevitable market recovery for long-term investors.

Tax deferral strategies involve delay or even avoidance of realization of capital gains through judicious planning and portfolio management. Unrealized capital gains can be permanently eliminated over time with prudent trust & estate planning, via step up in cost basis when wealth transfers from one generation to the next.

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Conclusions

With the U.S. economy decelerating and inflation slowly receding, many investors seem to have given up hope that the Fed can successfully tamp down inflation without throwing the economy into a “hard landing” recession. This bearish view might still turn out to be too pessimistic, and if so it will likely be due to structurally tight labor markets and generous fiscal spending programs across the developed economies and China. U.S. large cap equity P/E multiples are higher than their long-term averages, but we would note that S&P 600 U.S. small cap and S&P 400 mid cap P/E multiples look compellingly low. Fixed income markets began this year with attractively higher yields, and investors are now anticipating the last rate hike of the Fed’s inflation fighting campaign on May 3rd. We believe that the Fed has been implementing a credible plan to bring inflation down on a multi-year glide path towards its 2% target. There are many examples of falling prices for key input factors across the economy, and indeed core PCE inflation rates have been decelerating quarter-over-quarter since mid-2022. This will allow the Fed to begin cutting Fed Funds Rates around the end of this year or sooner, following the rule of thumb that Fed Funds Rates should be 1% higher than inflation rates (i.e., core PCE) to keep forcing inflation down. Notably, the ends of Fed Funds Rate hiking cycles have historically been followed by 12-month periods of well above average equity returns, using data from the past 30 years, the exception being 5/15/2000.

We wish all our clients and friends a joyous spring. We will keep working hard to generate superior long-term after-tax returns for each of our clients with customized portfolios and personalized financial planning, and we are grateful for the trust and confidence our clients have placed in us.

Please let us know if you have any questions, we are happy to discuss these topics in further detail. Thanks!

Best Regards, Erik

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- Institutional investment management expertise combined with personalized financial planning and customized portfolios to drive superior long-term after-tax outcomes
- Assets under management custodied at Charles Schwab ($7.8 Trillion in client assets across 34 million customer accounts) in segregated accounts under clients’ names
- Welcoming new clients with over $10 million to invest with us

Selected to Los Angeles Business Journal’s List of Leaders of Influence: Wealth Managers in 2023, 2022, 2021, 2020, 2019

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- This analysis is not a guarantee, prediction, or projection of any particular result and your actual results may vary materially from those presented herein.
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- Equity (stocks), fixed income (bonds), and other investments do not always gain or lose value at the same time. Historically, volatility has been reduced over time by holding multiple non-correlated asset classes in a portfolio.
- Diversification within an asset class is important because it can eliminate idiosyncratic (i.e., individual security) risk within an asset class, but it cannot eliminate systemic (i.e., market) risk of an asset class. No investment strategy or allocation can eliminate risk or guarantee investment returns.
- Although single-asset class diversification is an important tool in the toolbox of investing, relying on it alone might cause an investor to forego the benefits of other non-correlated asset classes that may help them achieve their long-term goals. Asset allocation differs from single-asset class diversification because it involves being diversified across multiple diversifying asset classes.
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