Insight Newsletter

SPRING 2023

Investment Commentary: April 2023

Market Recap

Despite the stress in the banking system, including the failure of Silicon Valley Bank, global equity markets held up remarkably well in March and posted solid returns for the quarter. The S&P 500 index was up 3.7% in March and gained 7.5% in the first quarter. Developed international stocks (MSCI EAFE Index) returned 2.5% in March and climbed 8.5% for the quarter. Emerging markets stocks (MSCI EM Index) gained 3% in March and 4% for the quarter.

Underneath the calm market surface there was wide dispersion in returns across sectors, market caps and styles. Large-cap growth stocks (Russell 1000 Growth Index) gained 14.4% in the quarter, while the large-cap (Russell 1000 Value index returned 1%. The tech-heavy Nasdaq Composite surged 17%, while the Russell 2000 Small Cap Value Index dropped 0.7%.

Fixed-income markets had a strong quarter as longer-term bond yields fell, generating price gains. Core investment-grade bonds (Bloomberg U.S. Aggregate Bond Index) returned 3%, as the 10-year Treasury yield fell to 3.5% from 3.9% at year-end. Riskier high-yield bonds (ICE BofA U.S. High Yield Index) outperformed core bonds gaining 3.7%. Municipal bonds gained 2.3% (Morningstar National Muni Bond Category). Flexible/nontraditional bond funds we use gained around 3%.

Alternative strategies and nontraditional asset classes generally underperformed traditional stock and bond indexes for the quarter. Trend-following managed futures strategies had a particularly tough period, losing anywhere from 6% to 10%, as some of the major trends from 2022 sharply reversed – particularly interest rates.

Thoughts on the Silicon Valley Bank Failure and Contagion Risk

Silicon Valley Bank (SVB) was a victim of a classic "bank run," where the bank doesn't have the "liquidity" (the cash on hand) to meet depositors demand for withdrawals. But importantly, SVB had unique characteristics that made it particularly susceptible to such a run. This is one reason we and most economists/analysts do not see this as the beginning of a replay of the Great Financial Crisis (GFC) of 2008. But there clearly will be broader economic and financial market impacts.

SVB was particularly exposed to interest-rate risk as it held an unusually large share of its assets in long-duration bonds. As such, SVB faced extremely large unrealized losses on their bond portfolio when rates rose sharply last year as the Fed sought to choke off inflation. In addition to SVB's huge exposure to unrealized losses in its bond holdings, it also had a highly concentrated depositor base comprised of start-up tech,

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venture capital firms and the like; and almost its entire depositor base was above the FDIC insurance limit of $250,000 per account.

Combined, these characteristics of SVB caused some of their concentrated, large, uninsured depositors to start pulling their money from the bank. This in turn forced SVB to raise capital (liquidity) to meet the withdrawals by selling bonds at losses (and/or raise equity capital), turning the unrealized losses on their balance sheet into realized losses, raising the question of not only liquidity risk for the bank but solvency/bankruptcy risk, leading to even more depositor flight, etc., until the FDIC and Fed stepped in over the weekend of March 11 to take over the bank, guarantee all SVB deposits above $250,000, and set up a broad banking system liquidity backstop (the Bank Term Funding Program (BTFP)). While the banking system is not out of the woods and there may be more smaller-bank takeovers, it seems these steps and subsequent actions from authorities have stemmed the risk of a widespread bank-run contagion.

Investment Outlook and Portfolio Positioning

With above-normal inflation and the Fed sharply tightening, the short-term outlook for economic growth was already poor coming into the year. Add to that the impact from tighter credit conditions due to the recent banking stress, and the growth outlook has gotten worse. A U.S. recession this year is not a certainty, but weighing the evidence as we see it, we believe recession is still the most likely outcome, and has become more likely with the banking system stress.

In an economic recession, it is almost certain corporate earnings will decline. S&P 500 index earnings typically decline around 15% to 20% (peak-to-trough) during economic recessions as both sales growth and profit margins compress. In a mild recession, the earnings decline might be closer to 10% to 15%. Yet, the current consensus earnings expectations for 2023 do not reflect nearly that magnitude of decline; nor do current stock market valuations.

As such, our assessment of the U.S. equity market (S&P 500 index) has not materially changed from the end of last year. If our base case earnings recession scenario plays out, there is a strong likelihood that the S&P 500 index will materially decline from current levels. As a reminder, last Fall we reduced our equity exposure and added to core bonds in our balanced portfolios.

Longer term, our current base case five-year expected return estimates for equities is for mid-single digit annualized returns over the period, which assumes a recessionary bear market happens. This is a decent but not great expected return for U.S. stocks given their risks. It is also well below our five-year return expectations for developed international and emerging markets (EM) equities of high single to low double-digit annual average returns.

Among the three regions, we tactically favor EM stocks right now based on their higher expected returns, which are a function of what we expect will be faster sales growth and improving profit margins over the next several years. This comes after more than 10 years of stagnant EM earnings growth. We also expect some narrowing of the historically large valuation discount between EM and US indexes.

Additionally, we expect the U.S. dollar to decline versus most other currencies over the medium-term, which would further add to EM and international equity returns for dollar-based (unhedged) investors. When the U.S. stock market declines to levels that offer more compelling medium-term returns and adequately discount shorter-term risks, we will look to add back exposure by selling more-defensive assets such as fixed-income, where we are currently slightly overweight.

In addition to our core bond exposure, we continue to have a meaningful allocation to higher-yielding, actively managed, flexible bond funds run by experienced teams with broad investment opportunity sets. There are many fixed-income sectors outside of traditional core bonds that offer attractive risk-return potential, and we want to access them via our active managers.

Finally, we maintain core positions in marketable (liquid) alternatives, including alternative strategies and trend-following managed futures. We believe they offer powerful long-term portfolio benefits in providing non-correlated returns relative to traditional stock and bond holdings. They can perform well whether the macro backdrop is deflationary, inflationary, stagflationary, or growth-oriented. Our conviction in owning these strategies remains high.

Closing Thoughts

Even with a recession as our base case near-term economic scenario, we currently see attractive medium-term expected returns from developed international and emerging markets stocks – better than what we expect from the U.S. market. As such, among our equity allocation we have a relative overweighting to equities outside the U.S.

Fixed-income assets and high-quality bonds are also now attractively priced with mid-single digit or better expected returns, depending on duration and credit quality. Core bonds will also provide valuable portfolio ballast in the event of a recessionary bear market. For this reason, we have a slight overweight to fixed-income. Our investments in alternative strategies and trend-following managed futures should provide further resilience to our portfolios.

We thank you, as always, for your continued trust.

—Litman Gregory Wealth Management

The Current State of the Banking Industry

The story of the Silicon Valley Bank is by now well known, and the failure of First Republic Bank has become recent news. While the immediate contagion risk has been addressed by aggressive regulatory intervention, the implications for the broader banking industry remain a source of concern for many and we wanted to address the subject and offer our research perspective.

To provide some context and explanation, what follows is more information about the events surrounding First Republic Bank and a review of the downfall of Silicon Valley Bank (SVB).

Update on the Failure of First Republic Bank

Although this is no longer breaking news, very recent to the writing of this piece First Republic Bank (FRB) was taken over by regulators and sold to JP Morgan Chase.

While FRB did not share all of the unique characteristics that led SVB to fail (such as aggressive and ill-advised bets on long maturity, highly interest-rate-sensitive bonds), they did see deposits gradually and problematically erode as depositors left for higher rates elsewhere.

Once SVB and Signature Bank failed in March, it sparked broader fears of a banking crisis that can become self-fulfilling and contributed to what happened to FRB: the fleeing of depositors accelerated and aggressive moves to assuage fears, including an influx of $30 billion in deposits from major banks and generous liquidity provided by the Federal Reserve Bank, proved an insufficient match against basic human fear and departing assets.

Fortunately for depositors the many assurances they have been provided in recent months will be upheld. FRB opened this morning as a part of JP Morgan Chase and announced that business will continue uninterrupted. All of FRB's deposits and its loan portfolio are reported to be part of the deal struck by regulators and JP Morgan Chase, and they communicated there will be no losses for depositors. Losses on the loan portfolio are being shared by JP Morgan Chase and the Federal Reserve Bank (the Fed). (Customers of FRB may have seen this notice from the bank: **https://www.firstrepublic.com/resource/message-to-our-clients-chase**.)

What's next? We can expect the Fed and banking regulators to continue to stamp out any new fears that arise through aggressive provision of liquidity and expanded deposit guarantees as deemed necessary. We will continue to assess the situation and will follow up on further developments, but for now wanted to communicate quickly with the basic facts and context.

Please feel free to reach out to your Litman Gregory Advisor with any questions about your banking arrangements and situation.

The Leadup & Aftermath of the Silicon Valley Bank Failure

This post is adapted and updated from our latest quarterly investment commentary.

In a nutshell, SVB was a victim of a classic "bank run," where depositors en masse seek to withdraw their money but the bank doesn't have the "liquidity" (the cash on hand) to meet their demands.

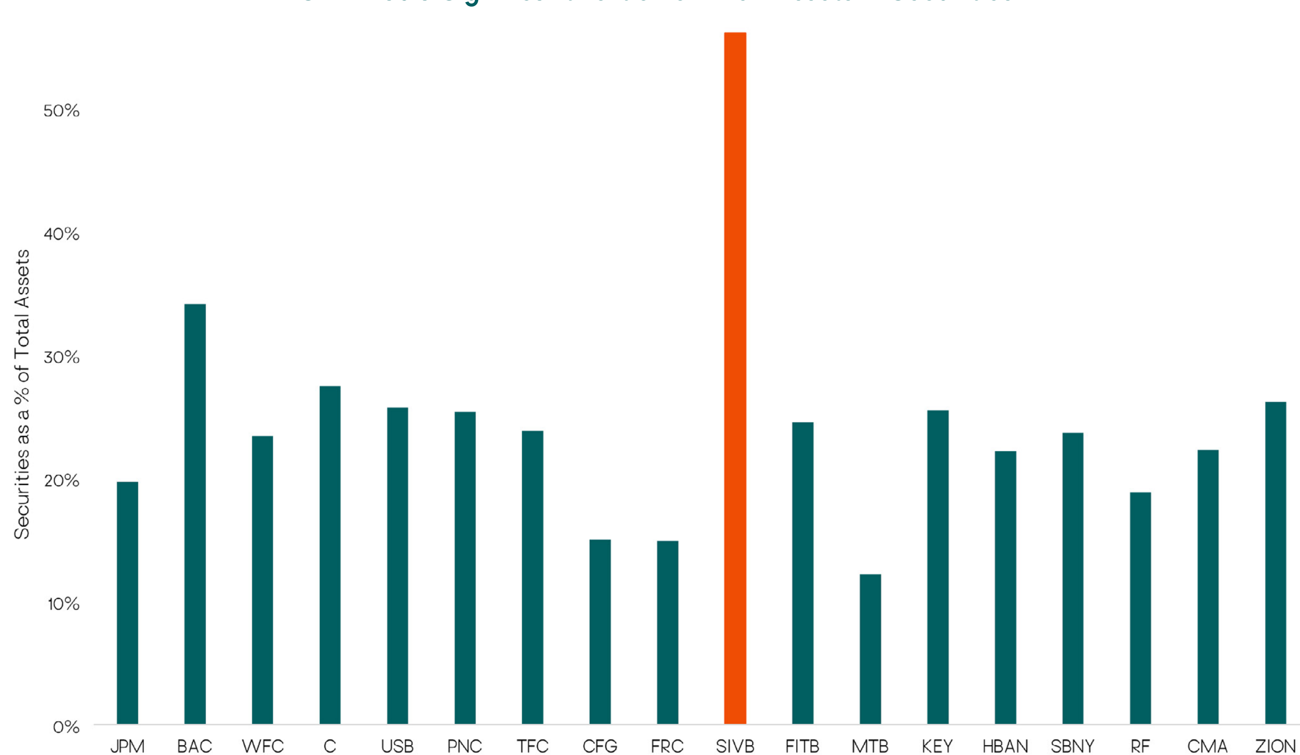
Importantly, SVB had unique characteristics that made it particularly susceptible to such a run. This is one reason why we and most economists/analysts do not see this as the beginning of a replay of the Great Financial Crisis (GFC) of 2008. But there clearly will be broader economic and financial market impacts, which we will discuss.

While SVB's situation was unique, the seeds of the bank run, and the broader banking system stress now playing out, were planted with the Federal Reserve's unprecedented monetary policy stimulus (quantitative easing and zero interest rates) in the years following the GFC and then turbocharged by the pandemic

stimulus. The damage has come from the Fed embarking on its most aggressive monetary policy tightening in 50 years — hiking interest rates from 0% to 4.75% over the past 12 months.

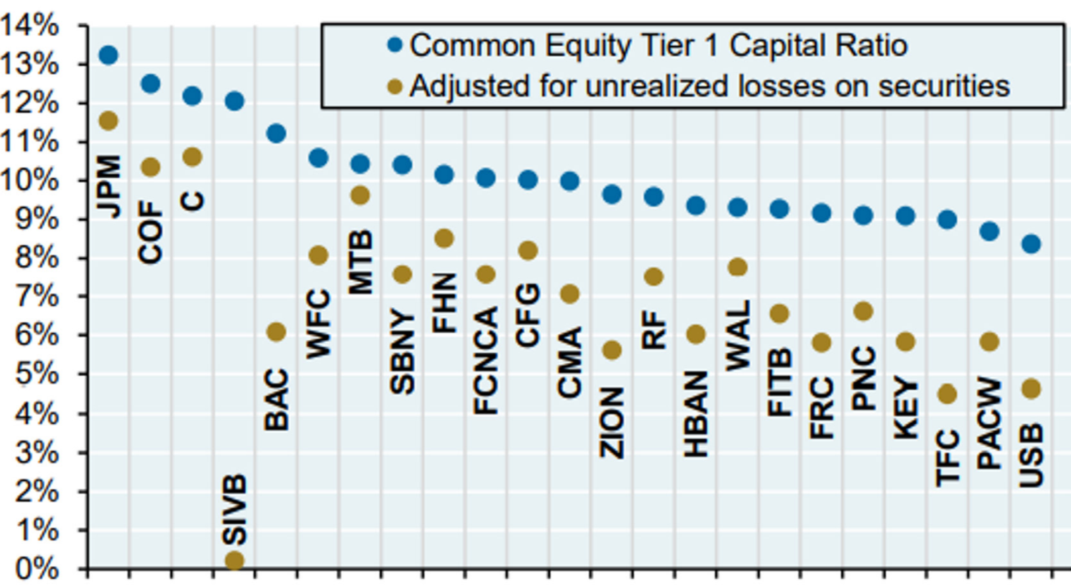
As all bond investors painfully experienced last year, sharply rising interest rates caused sharp declines in core bond prices (the worst price declines in U.S. bond market history). This included Treasury bonds and government agency mortgage-backed securities (MBS) – where many banks invested some of their customers' deposits.

All banks' bond-holdings have been hurt by the sharp rise in rates/falling bond prices, but SVB was particularly exposed to this interest-rate risk (or bond "duration risk") as the charts below show. SVB held an unusually large share of its assets in bonds, and those bonds had particularly long duration (a measure that implies the sensitivity of a bond's price to changes in interest rates) i.e., they had a lot of duration risk, meaning their prices (values) were highly sensitive to changes in interest rates. As such, SVB faced extremely large unrealized losses on their bond portfolio, which the bank had purchased when interest rates were much lower/prices were much higher.



Source: FDIC. Data as of 12/31/2022.

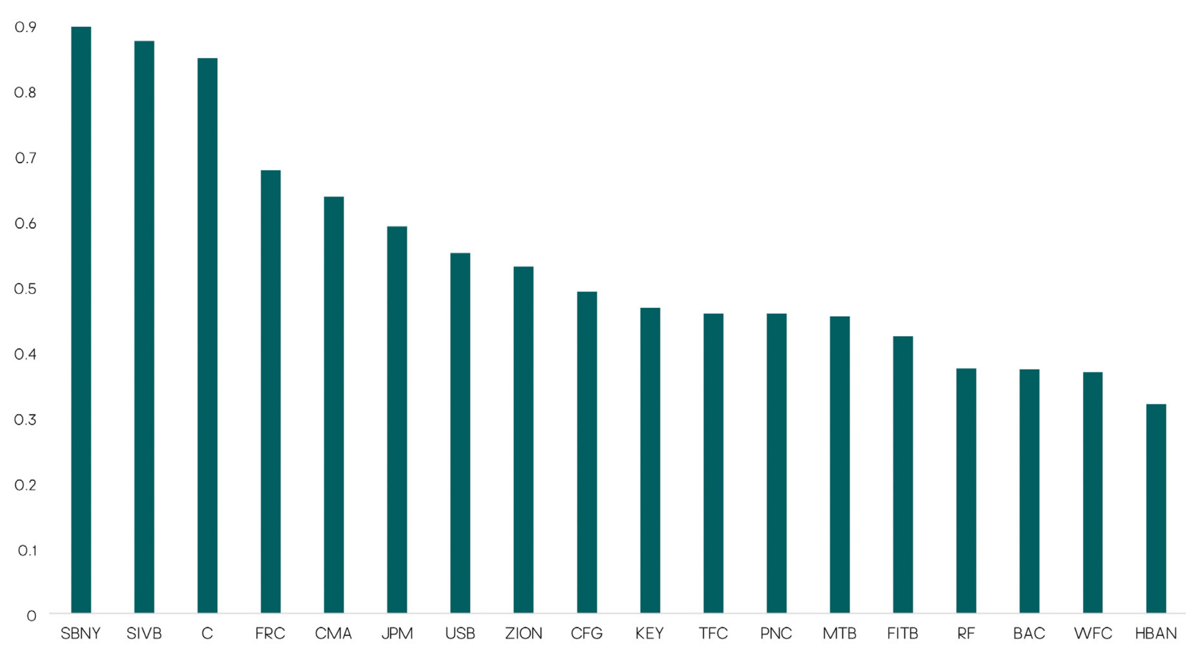
Impact of Unrealized Securities Losses on Capital Ratios Percent



Source: JPMAM, Q4 2022.

But that's not all. In addition to SVB's huge exposure to unrealized losses in its bond holdings, it also had two other unique susceptibilities to a bank run: (1) a highly concentrated depositor base comprised of start-up tech, venture capital firms and the like; and (2) almost its entire depositor base was above the FDIC insurance coverage limit of $250,000 per account. As shown in the chart below a whopping 90% of SVB's total deposit base was FDIC uninsured at year-end 2022. (Note that Signature Bank of NY (SBNY), the other regional bank taken over by the FDIC, also had roughly 90% of uninsured deposits.)

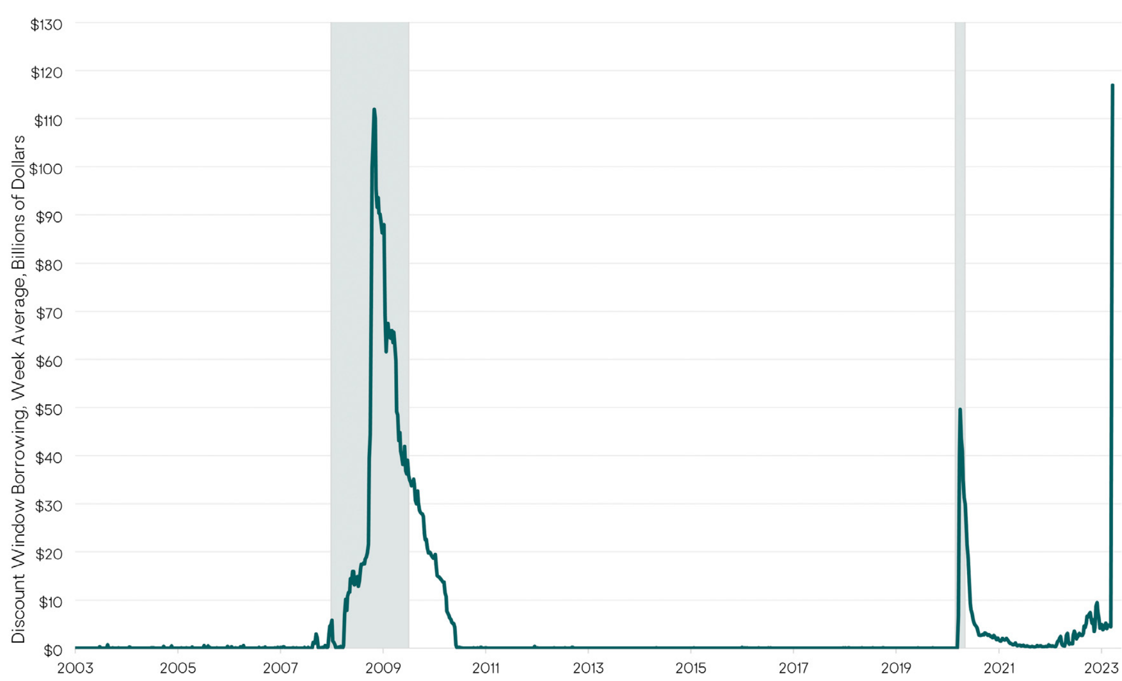
Uninsured Deposits: Total Deposits that Exceed FDIC Insurance



Source: Company 10-K Annual Reports. Data as of 2022.

Combined, these characteristics of SVB caused some of their concentrated, large, uninsured depositors to start pulling their money from the bank, which in turn forced SVB to raise capital (liquidity) to meet the withdrawals, which meant SVB had to sell bonds at losses (and/or raise equity capital), turning the unrealized losses on their balance sheet into realized losses, raising the question of not only liquidity risk for the bank but solvency/bankruptcy risk, leading to even more depositor flight, etc., until the FDIC and Fed stepped in over the weekend of March 11 to take over the bank, guarantee all SVB deposits above $250,000, and set up a broad banking system liquidity backstop (the Bank Term Funding Program (BTFP)).

The BTFP allows banks to borrow from the Fed for up to a year, based on the issued face value (par value) of their Treasury bonds and agency MBS, rather than the current (lower) market value. This new facility, as well as the Fed's decision to ease the lending terms on its existing "discount window" short-term (90-day) lending facility, enables banks to meet deposit withdrawals and other liquidity needs without having to sell currently underwater bonds at a loss. As the chart below shows, banks have taken the Fed up on its offer, and then some.

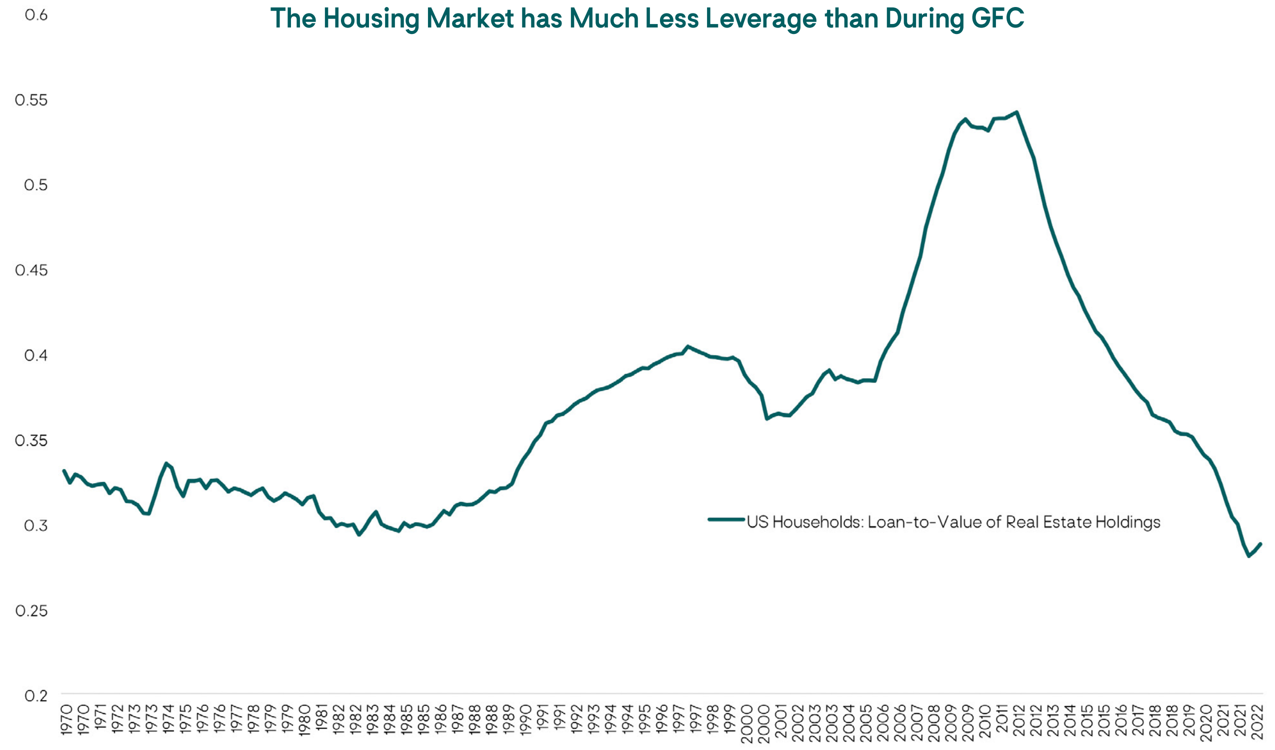


Source: Federal Reserve. Shaded areas indicate NBER-defined recessions. Data as of 3/22/2023.

While the banking system is not out of the woods and there may be more smaller-bank takeovers, it seems these steps and subsequent actions from authorities have stemmed the risk of a widespread bank-run contagion.

More broadly, as to why we don't see this as likely the beginning of "GFC 2.0," we'd highlight the following key differences between now and then:

1. The GFC was the result of a self-reinforcing negative spiral involving credit risk and counterparty risk. Banks and other financial institutions lent hugely to unqualified borrowers (e.g., NINJA mortgages to home-owners with no income/no job/no assets) and the systemic risk was multiplied by the pervasive creation of financial derivatives based on such shoddy loans (and even derivatives on the derivatives). As housing prices fell, the value of these loans collapsed and banks had insufficient capital to handle the declines. This led to a credit crunch, which further fed the housing price decline and economic downturn, leading to further losses on loan values, further bank insolvency, etc. etc.



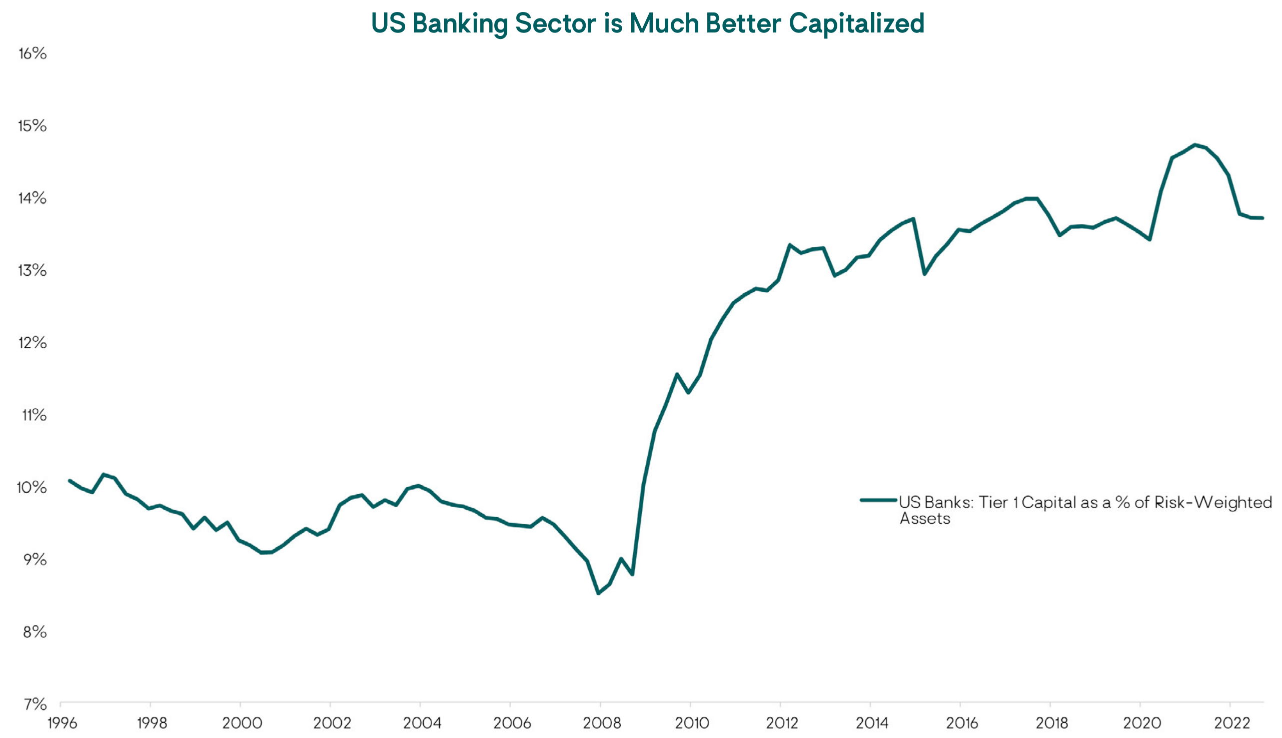
Source: Board of Governers of the Federal Reserve, Z.1 Financial Accounts of the United States. Data as of 12/31/2022.

This time, the problem is not caused by poor lending standards (credit risk), exploding derivatives and weak bank balance sheets (although poor management of the failed banks is a common theme), but instead interest rate duration risk from the banks' Treasury and agency bond holdings, whose values plunged as interest rates soared. There is no risk of default — no credit risk — in Treasuries and government agency MBS.

Further, in the current situation, as core bond yields have subsequently fallen in response to risk aversion and macro fears caused by the SVB crisis, the value of banks' high-quality bond holdings have increased (unrealized losses have lessened). So, this seems more of a self-limiting feedback loop, very different from the self-perpetuating adverse feedback loop of the GFC.

2. U.S. consumers in aggregate are now less leveraged and lending standards were tightened, especially in the housing market where regulations since the GFC have reduced loan-to-deposit ratios and raised loan qualification standards.

3. Banks are better capitalized now, particularly the very largest "systemically important" banks, due to tighter regulations since the GFC.



Source: Federal Reserve Bank of New York. Data as of 9/30/2022.

4. Having lived through 2008, the authorities (Fed, FDIC, Treasury) have acted relatively quickly and forcefully to stem the systemic contagion risk.

While the likelihood of a repeat of the 2008 financial crisis is unlikely for all these reasons, there will likely be ongoing impact from the sharp rise in rates that led to the Silicon Valley Bank takeover. The decline in many bank stocks may have been triggered by the short-term contagion fear, but through a more analytic lens the repricing reflects the market's appreciation that higher rates will hurt many banks' earnings even if their solvency is not in question.

In our portfolio management, we don't make tactical bets on sectors, such as through over or underweighting financial services or banking, but we do analyze broadly the impact of higher rates on the risk and return potential for our investment portfolios. Our broader investment commentary shares the analysis that underlies our portfolio positioning, but in terms of the aftermath of Silicon Valley Bank we have no specific concerns that warrant portfolio changes, for the reasons outlined above. As always we remain highly engaged and open minded as events unfold, and if anything changes in our analysis we will of course share it with our clients.

Wealth Management Team Updates

We are committed to providing a quality team of experienced professionals to support our clients' financial success in the decades and generations to come. Below, we share news of the recent advancements within the Litman Gregory Wealth Management team.

Recent Promotions

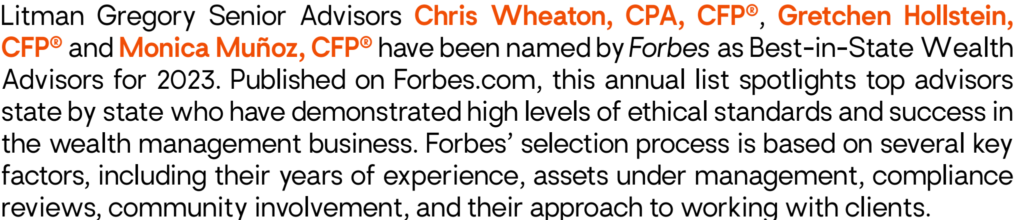
Laura White was recently promoted to VP – Operations.

Laura joined Litman Gregory in 2006 and she is responsible for valuation and transaction maintenance, reporting and client paperwork preparation related to private funds.

Kiko Vallarta was recently promoted to SVP – Portfolio Management, iMGP Fund Management – Asset Management.

Kiko joined the team in 2012 and is responsible for manager selection and oversight, asset class research and other analytical support.

Chris Wheaton, Gretchen Hollstein, and Monica Muñoz Named as 2023 Forbes Best-in-State Wealth Advisors



Litman Gregory Senior Advisors **Chris Wheaton, CPA, CFP®**, **Gretchen Hollstein, CFP®** and **Monica Muñoz, CFP®** have been named by *Forbes* as Best-in-State Wealth Advisors for 2023. Published on Forbes.com, this annual list spotlights top advisors state by state who have demonstrated high levels of ethical standards and success in the wealth management business. Forbes' selection process is based on several key factors, including their years of experience, assets under management, compliance reviews, community involvement, and their approach to working with clients.

"We are very excited to see Gretchen, Chris and Monica receive this recognition for the fourth year in a row." said LGWM/iMGP CEO Jeff Seely. "This further validates the trust and skill they and our entire Litman Gregory Wealth Management team bring to our clients."

Chris joined Litman Gregory in 1997, Gretchen in 2005, and Monica in 2007. Between them, they have over 60 years' experience in the investment industry serving individuals, family groups, endowments, foundations, and retirement plans. Their collective specialties include income tax planning, retirement and financial independence planning, personal financial analysis, asset allocation, next gen accumulation phase planning, and multi-generation family gift and legacy planning.

The full list of *Forbes* Best-In-State Wealth Advisors can be viewed **here**.

The 2023 ranking of the Forbes' Best-in-State Wealth Advisors list was developed by SHOOK Research and is based on in-person and telephone due-diligence meetings to evaluate each advisor qualitatively and on a ranking algorithm that includes client retention, industry experience, review of compliance records, firm nominations, and quantitative criteria (including assets

under management and revenue generated for their firms). Overall, 39,000 advisors from across the U.S. were nominated, and over 17,000 were interviewed by SHOOK Research analysts. This year's list covered 7,321 financial advisors in the U.S. Neither Forbes nor SHOOK receive a fee in exchange for rankings.

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Past performance is no guarantee of future results, and there is no guarantee that the views and opinions expressed in this newsletter will come to pass. Individual client needs, asset allocations, and investment strategies differ based on a variety of factors.

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The Standard & Poor's 500 Composite Stock Price Index is a capitalization-weighted index of 500 stocks intended to be a representative sample of leading companies in leading industries within the U.S. economy. Stocks in the Index are chosen for market size, liquidity, and industry group representation.

The MSCI ACWI Index represents the performance of large- and mid-cap stocks across 23 developed and 24 emerging markets. The index covers 2,900 constituents across 11 sectors and approximately 85% of the free float-adjusted market capitalization in each market.

The MSCI EAFE Index is an equity index which captures large and mid-cap representation across 21 Developed Markets countries around the world, excluding the US and Canada. With 799 constituents, the index covers approximately 85% of the free float- adjusted market capitalization in each country.*

The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. The MSCI Emerging Markets Index consists of the following 23 emerging market country indexes: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Peru, Philippines, Poland, Qatar, Russia, South Africa, Taiwan, Thailand, Turkey and the United Arab Emirates.

The Bloomberg U.S. Aggregate Bond Index is a broad-based benchmark that measures the investment grade, U.S. dollar- denominated, fixed-rate taxable bond market.

The US High-Yield Market Index is a US Dollar-denominated index which measures the performance of high-yield debt issued by corporations domiciled in the US or Canada.

The ICE BofA US High Yield Index is market capitalization weighted and is designed to measure the performance of U.S. dollar denominated below investment grade (commonly referred to as "junk") corporate debt publicly issued in the U.S. domestic market.

The ICE U.S. Dollar Index is a geometrically-averaged calculation of six currencies weighted against the U.S. dollar.

The S&P/LSTA Leveraged Loan 100 Index (LL100) dates back to 2002 and is a daily tradable index for the U.S. market that seeks to mirror the market-weighted performance of the largest institutional leveraged loans, as determined by criteria. Its ticker on Bloomberg is SPBDLLB.

The MSCI Hedged Indexes include all of the securities and weights of each corresponding unhedged MSCI Parent Index, enabling investors to measure the impact of hedging currency, for all the constituents of the Parent Index.

Contact

Contact our team for more information on our services

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