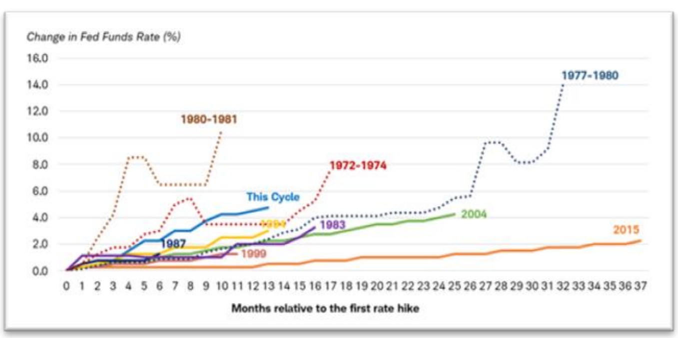
AMI INVESTMENT MANAGEMENT
Registered Investment Advisor

Quarterly Investment Commentary

FIRST QUARTER, MARCH 2023

It seems like a lifetime ago, but it's been just over twelve months since the Federal Reserve began its historic interest rate hiking campaign. At the time, it was the first rate increase in over three years, a quarter point (0.25%) nudge that got us off zero percent and on the path to higher borrowing costs. The Fed's projections and the consensus expectation was another six or seven quarter-point rate hikes should do the trick in cooling off demand and soaring prices. This would leave short-term interest rates at roughly 2.25% and presumably assist in bringing inflation back toward the target of 2%. Fast forward to today, and we recently registered the ninth consecutive rate increase. Short-term rates currently stand at 5% while inflation stubbornly hovers around 6%[1]. As the chart below illustrates, the pace and magnitude of this cycle can only be matched by the sporadic rate hiking campaign of 1980-81.



The actions taken by the Fed over the past year have been productive in wringing out some of the excesses that built up, and there's been slow progress in bringing down inflation, but it's hard to declare mission accomplished. More recently, the Wall Street chorus is growing louder for a pause on further rate hikes, which we think makes sense. Although inflation remains well above the targeted comfortable level, the full impact of higher interest rates on the economy has not totally worked itself through the system. A pause would allow the economy and markets time to fully digest the increases that have taken place while also offering some reprieve on what the Fed will do or say next.

As we noted in our fourth quarter 2022 investment commentary on the elevated risks: "…*the pace at which interest rates have risen over the past year increases the risk that something breaks down during the process and spooks markets. These problems are generally brought on by excessive leverage, exposure to exotic derivatives, or managers being too clever for their own good."* The collateral damage from rising rates generally occurs quickly and catches markets off guard. This time the ripple effects are being felt in the banking sector, in particular Silicon Valley Bank. The problems didn't arise from bad loans or toxic derivatives but from decisions made in managing the bank's bond portfolio in a rising rate environment.

Trouble in Banking Land

"I'm sorry my good fellow, but all my available funds are completely tied up in cash."
-W.C. Fields

[1] As measured by the Consumer Price Index (CPI)

This line from comedian W.C. Fields was in response to a request for a charitable handout, but it might also be used to describe some of the current challenges occurring in the banking sector. The recent string of regional bank failures, most notably the 16th largest bank in the country, Silicon Valley Bank (SVB), revealed the lurking consequences of a rapidly rising interest rate environment. In some ways SVB was a victim of its own success. A surge of deposits over the past several years from pandemic stimulus checks, tech start-ups, and venture capital firms left the bank with a cash windfall—a good problem to have. Banks can generally do three things with their deposits; leave it in cash, invest in high-quality securities, or make additional loans. Since idle cash generates no income and making loans produces income but also unwanted credit risk, SVB executives opted to tie up their cash in securities and cash equivalents. Investing excess deposits in U.S. Treasury notes and mortgage-backed securities was a safe way to generate some modest income relative to what they were paying out on savings, but it also introduced more interest rate risk to the books. The bank's problems started as interest rates rose throughout the course of last year, causing their safe bond portfolio to decline in value. This development wouldn't be a big deal if bonds were held to maturity, but the longer the maturity date the longer SVB had to wait to recoup these paper losses. At the same time, bank depositors woke up to the fact that money market instruments and U.S. Treasury bills were now yielding 4% or higher, much more than the paltry rates being paid at the bank. These so-called sticky bank deposits departed for higher-yielding alternatives, leaving SVB in a position where they needed to raise capital quickly. Selling bonds at steep losses while also announcing a common stock offering to raise liquidity was enough to rattle the confidence of markets and depositors. The mass exodus of deposits from the bank led to its failure and the ensuing ripple effect to other perceived weaker banking institutions. Even the 167-year-old Swiss bank, Credit Suisse, wasn't immune to the turmoil, which resulted in a forced sale to a competitor, thus wiping out some bondholders.

The failure of SVB and the few other regional banks has no direct impact on our client portfolios. It does, however, highlight the pressures building in the financial system. While bank failures are concerning, we don't foresee this recent episode as a repeat of the 2008-09 financial crisis. Each of the failed banks had its own set of unique issues, and assets being held on the books this time are largely "money-good" government bonds, not toxic debt. The Fed has also been quick to institute programs to assist banks in getting through any liquidity crunch, which many have already utilized. A concern moving forward is if this episode will ultimately lead to more banking regulation and tighter lending conditions. It's easy to imagine that the smaller regional banks will be saddled with higher costs and stricter lending standards that will hamper profitability. On the other end of the spectrum are the large money center banks, considered by many too big to fail. These large, diversified financial institutions have been attracting deposits from their smaller bank brethren while their size and scope will allow them to better employ resources to navigate a more rigid regulatory environment. For now, the instability in the banking sector has been contained, but the potential outcome is the big banks will get bigger.

Charles Schwab & Co. Safeguards

Last month Walt Bettinger, the CEO of our third-party custodian Charles Schwab & Co, gave an interview on CNBC[2] addressing the banking fallout caused by SVB. The link is footnoted if you are interested in watching. We felt Walt did a good job of clearly explaining how securities being custodied at Schwab differ from deposits being held at a bank. He referenced the SEC's (Security & Exchange Commission) Customer Protection Rule: a safeguard against co-mingling client assets with the assets of the

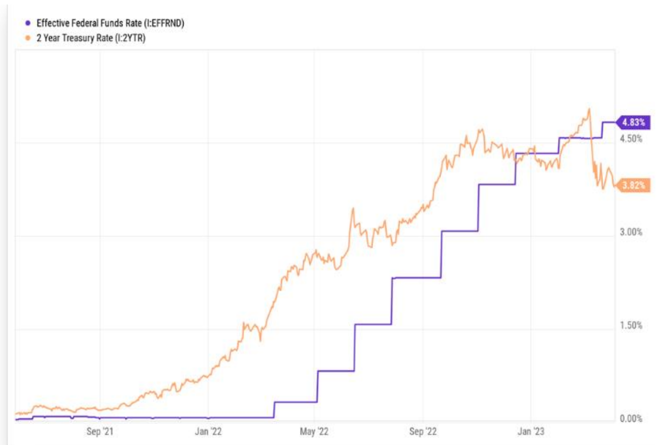
[2] https://www.cnbc.com/2023/03/14/charles-schwab-ceo-says-firm-is-seeing-significant-inflows-even-as-stock-gets-hit-during-banking-selloff.html

brokerage firm, thereby offering protection from creditors. In short, your assets custodied at Schwab are yours and not combined with other investors or depositors. This separation of assets provides added safety measures in the event a custody firm falls into financial difficulties.

In addition, uninvested cash balances being held at Schwab are also insured by the FDIC up to allowable limits (currently $250k). We remain comfortable with our long-standing partnership with Schwab and the safety and soundness of its business practices. Walt Bettinger also feels comfortable with the long-term business prospects, as he announced in the same CNBC interview that he recently added 50,000 shares of Schwab stock to his personal portfolio. We like a man that puts his money where his mouth is.

1st Quarter Recap

Despite the instability in the banking sector, asset classes were largely in positive territory to start the year. The S&P 500 and developed international stock indexes[3] both registered returns of just over 7% through the end of March. Stock prices in the banking sector were understandably hit the hardest, down 6% while investors chose to move to the perceived safety of large technology stocks, up over 20%. Volatility in stock prices was mild in comparison to bond markets during the quarter. Interest rates climbed in February after a strong employment and inflation report caused markets to expect further Fed rate hikes. The turmoil in the banking sector quickly altered this expectation as a flight to quality caused Treasury rates to plummet. The chart below shows the yield movement of the 2-year U.S. Treasury relative to the Fed Funds Rate (set by the Federal Reserve). As illustrated, the yield movement on the 2-year Treasury (orange) generally precedes moves in the Fed Funds Rate (purple). If the bond market is interpreting correctly, we could see the Fed cut rates over the course of the year, which is usually accompanied by weaker economic data, higher unemployment, and lower inflation. The decline in yields resulted in rising bond prices and total returns just over 2%[4] during the quarter.



We maintain a cautious outlook as the elevated risks in the financial system could result in further flare-ups along the way. We also continue to maintain some exposure to U.S. Treasury securities for portfolios with taxable fixed income. The yield on Treasuries remains attractive while also providing a hedge against volatility in the equity markets. Although it's been a bumpy road for investors in a rising rate environment, we have likely entered the late stages of the interest rate cycle. A pause in additional rate hikes or a future rate cut will eventually lead to a growth phase. Volatile markets can also be favorable for picking up great companies at reasonable prices, an undertaking we are constantly monitoring.

As always, we thank you for your continued confidence!

[3] As measured by the MSCI ACWI-Excluding US index
[4] As measured by the Bloomberg Intermediate Govt/Credit bond index