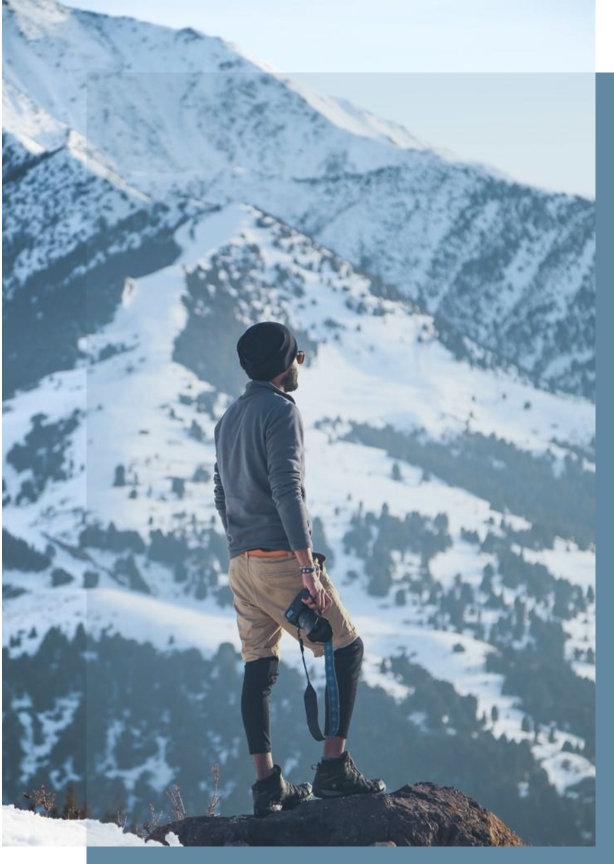
PERSPECTIVES

Benefit Financial Services Groups Newsletter

Quarter Ending March 31, 2023



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Market Recap

Patrick Powers, CFA®, CPA/PFP, CFP® (Managing Principal)

We were off to a good start. After falling 8% during the last two weeks of 2022, largely as the result of tax-loss selling, the U.S. stock market started the new year strong, rallying 11% through the month of January and recovering all of what was lost the last half of December, and then some.[1] However, the market gave it all back in February and early March. The February retrenchment was perhaps the result of increasing expectations of the Federal Reserve (the "Fed") having to lift the federal funds rate higher to fight sticky inflation. However, the March losses were directly attributable to the sudden collapse of Silicon Valley Bank and concern that other banks would follow suit, and a few did.

Banks take in deposits (liabilities) that are typically held for long periods of time. That allows banks to use that money to lend to individuals and businesses (assets). The difference between loan rates (what the bank earns) and deposit rates (what the bank pays) is the primary way banks generate earnings. Because it takes time to convert deposits to loans, banks may also invest deposits in other generally "safe" investments such as bonds from the U.S. Treasury to earn interest income until that money is needed to serve borrowers. For banks with bonds held on their balance sheet, the current value of those bonds has dropped as rates have risen (bond prices fall as rates rise). If deposits are stable, these bonds can be held to maturity, where banks would hypothetically receive face value. However, if many depositors are trying to get their money out at the same time (as was the case for Silicon Valley Bank), then the bank may be forced to sell bonds to raise cash resulting in the realization of losses and depleted capital. Therefore, with stable deposits, the bank may remain viable, but when faced with a bank run, the issue compounds. Serious mismanagement at Silicon Valley Bank did not help either!

Fortunately, the Fed, the U.S. Treasury, and the Federal Deposit Insurance Corp. (FDIC) acted swiftly to try to quell fears of depositors and help banks maintain adequate capital. First, the government moved to fully protect insured and uninsured deposits at the failed regional banks. Further, the government provided banks with a special lending program that allows banks to source liquidity by posting assets (i.e., bonds) as collateral at face value (100 cents on the dollar). These combined efforts have helped to stem the tide on any immediate bank runs and is likely welcome news for depositors and banks alike. Even more, other banks have stepped in to buy the assets of the failed

banks. The hole in the dike was largely plugged and this fast action seems to have done the trick. As a result, we've enjoyed a nearly 10% rise in the stock market during the last 2½ weeks of March. Further stimulating investors' appetite for stocks, is the fact that it appears that inflation is coming down slowly but surely, that consumer spending is holding up relatively well, that economic growth is slowing but not collapsing, and that the Federal Reserve may raise interest rates just one more time and by only a quarter of a point. The S&P 500 Index rose 7.03% during the first quarter.

Non-U.S. developed markets stocks faced similar challenges and followed a similar performance pattern as U.S. stocks. Emerging markets stocks rallied in March and advanced for the quarter but not as strongly as developed markets stocks. The MSCI World ex USA Index rallied 7.22% in the first quarter.[2]

The financial system uncertainty led to market expectations for no additional rate hikes and rate cuts later this year. The decline in yields led to broad bond market gains for March and the first quarter. The Bloomberg U.S. Aggregate Index advanced 2.96% in the first quarter.[3]

Forecast

Steven Yamshon, Ph.D. (Managing Principal)

While it is partially true that supply chain issues have influenced inflation this time around, it is also true that monetary policies undertaken by the Fed have had their part to play in it.[4] We soon will be entering a third year with inflation above 3% (currently at 4.6% based on the Fed's preferred inflation measure).[5] This doesn't seem transitory to me. To get inflation down to the 2% level, which is the Fed's longer-run inflation goal, we believe the Fed would have to crush demand, send unemployment above 6% (current unemployment rate is 3.6%[6]), and raise the federal funds rate to around 6% (current target range 4.75% – 5.00%). We don't think the Fed has the political stomach for such an operation, especially when Congress is questioning its independence.

Several other factors are coming into play that should keep inflation relatively high for the next decade. The Clinton Administration sparked a trend towards globalization which enabled the U.S. to import cheap goods from Asia which helped keep inflation low. With trade wars breaking out, and supply chains moving inward, goods will likely cost more. Second, war is inflationary not only in terms of paying for it, but for increases in defense spending for new weapons. Recently, Defense Secretary Lloyd Austin has stated that the defense budget will need to increase even further driven by the strategic competition with China, let alone a possible war with Russia.[7] Lastly, higher oil prices are inflationary since almost everything we do or make is dependent on oil. Since the Biden Administration has discouraged domestic oil production and OPEC+ is reducing output, any conflict that blocks Middle Eastern oil from reaching our shores will send the price of oil higher. Supply chain movements, defense spending, and higher oil prices are all inflationary.

More worrisome is the recently announced currency bloc that Russia, Iran, South Africa, Brazil, China, and Saudi Arabia are cooking up.[8] These countries want to replace the U.S. dollar as the mainstay for international payments with the Chinese yuan. Almost 44 countries are now wanting to sign up to this new currency block. While the dollar's share of the world's central banks' $12 trillion foreign exchange reserves has declined since 1999, it is still nearly twice that of the euro, yen, pound, and yuan combined – the same as it was a decade ago. Its nearest competitor for global currency status, the euro, accounts for barely 20% of central bank reserves compared to the dollar's 58%, followed by the Japanese yen at 5%. The much-touted Chinese yuan lags far behind at under 3% of foreign exchange reserves.[9] Without a viable challenger, it's very unlikely that the dollar will lose its special role as the world reserve currency anytime soon, however, we have to be prepared.

As your advisor, we have a plan of action. A level head is the first order of business and we work hard to keep emotions out of any decision making. Second, a diversified portfolio of stocks, bonds and hard assets should cushion against higher inflation and protect portfolios from other risks that exist.[10] In the chaos of crises, it is tempting to retrench into the safest assets but you have to accept some risks to earn long-run returns. Simple steps like proper diversifcation and managing your emotions while others panic is a sure way to protect your portfolio and benefit from market surprises over the long-run.

Portfolio Management

Michael Allbee, CFP® (Partner/Senior Portfolio Manager)

Market history tells us how often the unexpected occurs. Surprises are the norm. I mentioned in last quarter's newsletter that we expected more speculative investments would fail as interest rates normalize and the abundant liquidity that led to a massive bull market in most financial assets drains from the system. This was exemplified by the failure of Silicon Valley

Bank and Signature Bank during the first quarter. One of Warren Buffett's most famous quotes is: *"Only when the tide goes out do you learn who has been swimming naked."* Well, the tide is receding and we are just starting to see those investors and companies that were dependent upon the liberal use of cheap debt financing. So don't be surprised as bare bodies start to appear. Private equity buyout strategies, nonbank financial intermediaries (NBFI) including pension funds, insurers, and hedge funds (which account for nearly 50% of global financial assets[11]), and some areas of commercial real estate certainly come to mind.

NBFI's play a key role in the global financial system by providing credit and thus supporting economic growth. If additional stress emerges, this could perpuate a negative feedback loop for the economy. For these reasons, we are defensively positioned within portfolios by largely avoiding companies that rely on cheap debt financing, favoring large market-capitalization companies over small-to-medium size companies, preferring dividend-paying stocks (as the old proverb goes, "A bird in the hand is worth two in the bush"), finding comfort in owning high-quality bonds, and above all, avoiding levered strategies (i.e., direct lending, direct real estate, purchasing securities on margin,etc.).

In our view, while cash is no longer trash, it is still an asset class for short-term spending needs. The level of income for cash will go away quickly once rates go down and then you have reinvestment risk. Too much of it brought into longer-term portfolios can result in lower income potential and provide a lack of diversification benefits. Assuming we are closer to the end of the Fed's rate hiking cycle than the beginning, then the fixed income asset class should be well positioned to return to its place within an overall asset allocation as the ballast that provides an offset to the historic volatility of the overall markets.

Talk With Us!

Arash Navi, CPA, CFP®, AWMA® (Controller/Wealth Manager)

Losing a loved one can be difficult no matter what stage of life you are in. If you are fortunate to have a network of close friends and family, they could provide support through the grieving process and help you cope with the initial stages of this inevitable part of life. However, eventually you'll have to move forward with the day-to-day activities. This could be particularly challenging for individuals who had relied on their loved ones to make certain decisions for them.

As financial advisors, we witness the difficulties faced by many widows/widowers from traditional households that relied on their spouse to make financial decisions. In a short period of time, while coping with the loss of a loved one, they are now faced with having to make decisions regarding Social Security, taxes, life insurance, investments, and other financial decisions with which they may not feel comfortable with.[12] In addition to all of this, they also face the "widow's penalty" which is well known in the financial industry but may not be anticipated by many individuals.[13] In summary, the "widow's penalty" refers to the fact that after losing a spouse, you'll eventually have to file your tax return as a single individual and possibly fall into a higher tax bracket and if you were both collecting social security, you will only receive the larger of the two social security benefits. Moreover, if your spouse was still working or receiving a pension you may lose that income stream as well. Therefore, a widows/widowers income source could be meaningfully reduced while many of their expenses such as mortgage, insurance and property taxes may stay the same.

Here at BFSG, we like to see ourselves as our clients' partner during the challenging stages of their lives. We have checklists and guides to help our clients gather important documents they need when they lose a loved one. We'll be able to help you navigate this transition by working with our network of attorneys and tax professionals, and creating a financial plan to help you feel confident with your finances. Our goal is to educate and support you so you'll be able to comfortably and confidently make your desired financial decisions and achieve your financial goals.

We encourage you to Talk With Us if you or a family member have experienced a loss and would like to learn more about the ways we can assist you during these difficult times.

In the News

- NAPA names BFSG Institutional Services to Top DC Advisor Team (2022). Read the press release here.

The Score Board

	03/31/2023	YTD Change
Dow Jones Industrial Average	33,274.15	0.38%
S&P 500*	4,109.31	7.03%
NASDAQ Composite*	12,221.91	16.77%
MSCI EAFE (USD)*	2,092.59	7.65%
Bloomberg Commodity Index	105.51	-6.46%
U.S. Aggregate Bond Index	2,109.41	2.96%
10 Yr U.S. Treasury Bond Yield	3.48%	- 40 bps
30 Yr Fixed Mortgage Rate	6.93%	27 bps
Prime Rate	8.00%	50 bps
Crude Oil ($ / Barrel)	$75.67	-5.72%
Gold ($ / Oz.)	$1,969.00	8.20%
U.S. $ / Euro €	$0.92	-1.08%
Core Inflation (excluding food / energy)		5.50%
Inflation (including food / energy)		6.00%

**Without Dividends; **Unadjusted 12-Months ended November 2022; bps (1 Basis Point = 1/100%); UNCH (Unchanged)*
Sources for Score Board and quoted statistics: WSJ, US Dept. of Labor, Federal Reserve

Sources:

1. The S&P 500 Index is designed to be a leading indicator of U.S. equities and is commonly used as a proxy for the U.S. stock market. Price return only.
2. The MSCI World ex USA Index captures large and mid cap representation across 22 of 23 Developed Markets countries (excluding the U.S.) and 24 Emerging Markets countries. Price return only.
3. The Bloomberg U.S. Aggregate Bond Index is a broad-based index used as a proxy for the U.S. bond market. The index was created on July 7, 1973.
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