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First Quarter 2023 Commentary

Dear Clients,

Please find enclosed your First Quarter 2023 Investment Reports.

The U.S. Federal Reserve (the "Fed") completed its first short-term interest rate hike off 0% levels in March 2022. Nine hikes, +4.75%, and one year later, the first signs of a potential stopping point came abruptly into view as several bank failures captured national news headlines. Despite the anxiety created by the sharp drop in the value of regional bank indices, large cap U.S. stocks finished the quarter up a strong 8.6%. U.S. mid cap stocks were also up a respectable 3.9%, while U.S. small cap stocks were nearby at a positive 3.7% for the quarter. Developed International stocks were up 8.5%, while Emerging Market stocks were up 4.0% for the quarter.

U.S. Bonds and Global Bonds also produced a solid quarterly return of 3.0%.

Benchmark Returns

	Last Quarter	Last Twelve Months	Last Five Years
US Large Cap Stocks	8.6%	-8.3%	11.6%
US Mid Cap Stocks	3.9%	-9.8%	8.1%
US Small Cap Stocks	3.7%	-9.4%	6.7%
Developed International Stocks	8.5%	-1.4%	3.5%
Emerging Market Stocks	4.0%	-10.7%	-0.9%
US Bonds	3.0%	-4.8%	0.9%
Global Bonds	3.0%	-8.1%	-1.3%

Data source: YCharts. Past performance does not guarantee future results. It is not possible to invest directly in an index. Last five years data is annualized. Indexes in table are:
US Large Cap Stocks: CRSP US Mega Cap TR
US Mid Cap Stocks: CRSP US Mid Cap TR
US Small Cap Stocks: CRSP US Small Cap TR
Developed International Stocks: MSCI EAFE NTR
Emerging Market Stocks: MSCI Emerging Markets NTR
US Bonds: Bloomberg US Aggregate TR
Global Bonds: Bloomberg Global Aggregate TR

Underneath the surface however, the price changes in U.S. Bonds of different maturity lengths hint at a more complicated story of current financial conditions. The proximate cause of the aforementioned banking failures was mismanaged risk, but this era's risk was a different type of risk than what precipitated the bank failures of the 2008-09 Great Financial Crisis (the "GFC"). The troubles banks faced in the GFC primarily related to poor underwriting standards and overconfidence in risk pooling techniques in home mortgage lending. The more recent run on the banks has largely been a result of the capital market's "inverted yield curve" (as described in our last letter, this is when short-term investments pay higher rates of interest than similar credit quality long-term investments).

Banks as a business traditionally borrow at short-term interest rates (from depositors) and lend at long-term interest rates (to home buyers and businesses). The spread between these two interest rates is a large source of banks' profits. One can understand that if this were your business model, conditions would become problematic when the interest rates at which you borrow are higher than the interest rates at which you lend.

Enter the Fed, which in its fight to rein in inflation, has beaten its drum increasingly harder and louder with the message of "higher for longer" (referring to short-term interest rates). Meanwhile, banks have remained reluctant to give up their interest rate "spread" income and have not followed the Fed in raising short-term interest rates for their depositors (hoping that inertia and complacency would cause clients to leave their cash languishing in low yielding checking accounts). But eventually bank depositors heard the Fed's message: savers could make substantially more money lending to

the U.S. government directly (often through money market funds) than they could lending to the banks (through checking and savings accounts).

In the GFC, the risk that caught up with the banks was a solvency risk. The banks lent a dollar to someone who could not pay them back. The risk that has caught up with the banks today is a liquidity risk. The banks borrowed a dollar from someone who found a more attractive place to store that dollar.

Is the above an oversimplification of the problem? Yes and no. There has certainly been enough ink spilled on this topic in the press that we all feel a little bit like newly minted banking experts. What about the unrealized losses on banks balance sheets? What about the rising specter of bad loans in commercial real estate? What about the banks in Europe and the challenges they face? There is plenty more that could be unpacked here, but the central narrative would remain the same: we have a global economy that subsisted on extraordinarily low interest rates for an extended period, and it would be foolish to think that raising short-term interest rates (known as "taking away the punch bowl" at the investing party) would not eventually create changes in economic behavior that produce an inflection point. The bond market perceives that such an inflection point has been reached. Currently the bond market predicts that the Fed will need to cut interest rates by July. The Fed is still promising otherwise (no rate cuts in 2023), in an effort to maintain its fight against inflation.

We have reached that moment many anticipated would come when the Fed started raising rates a year ago; it is finally high noon at the O.K. Corral. It is the Sheriff (the Fed) versus the Market. The "fight against inflation" is likely to have a cost. And while the Fed continues to aim for a "soft landing", backing away from a gunfight is delicate work. We remain appropriately vigilant.

While the Fed and pundits are focused on this near-term showdown, it is worth turning our attention to a longer-term news story: artificial intelligence ("AI"). Like the recent bank failures, there has been no shortage of commentary on this topic in the past quarter. Should humans view AI as a positive or a (scary) negative? Our sense is that like all technologies, AI creates opportunities for human good and abuse, and we will see both in the years to come. We highlight the topic here, though, to add a touch of optimism to the ever-present short-term market uncertainties.

There are many fields where entrepreneurs and practitioners are tinkering with these new tools (yes, we tried to write this newsletter with AI, but it is safe to say we are not out of a job yet). We believe the benefits of adoption are not yet fully known and will manifest themselves in ways unexpected. There will be companies that earn immediate benefits (e.g. Microsoft), but there will also be surprise beneficiaries revealed only over longer horizons. You, as our clients, will benefit in two ways. First, as long-term investors, the economic benefits of increased productivity driven by this technology will accrue to you, whenever those benefits materialize; yes, some return comes in the "pop" we have seen in technology stocks from initial enthusiasm, but most of the return will accrue over the long-term as traditional industries are reimagined. And second, as diversified investors, you will enjoy a portion of the economic benefits created to whomever those benefits accrue; you do not have to presciently single out "the" only winner to enjoy success.

The strength of being a long-term, diversified investor is that you can watch the short-term silver screen gunfights with a little less anxiety than most. Your advantage over the anxious speculator is that you have already identified the long-term winner: human ingenuity.

Leavell Investment Management, Inc.

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