Alex Thompson

Lance Hollingsworth

John Laughlin

Sarah Haizlip

Leslie Drummond

"Sentiment Contagion"

Dear Clients and Friends: April 14, 2023

On the surface, the first quarter presented a solid start to the year for investors. This was welcomed after a miserable 2022 when both stocks and bonds delivered negative double-digit returns. The total U.S. stock market finished the quarter up 7.1% with international equities continuing their slight outperformance, up about 8.5%. Even the bond market, helped by much higher starting yields, returned 3.0%.

Beneath the surface, the environment was quite a bit more precarious. Equity returns were more of a reversion to the mean with the stocks that fell the most last year becoming outperformers. Growth returned to beating value. Sectors that gave us the most trouble in 2022, like technology, exploded higher while favorites, like energy and healthcare, posted negative results. In fact, the headline return of the S&P 500 (+7.5%), which is overly concentrated in a few technology names, masks a more docile return of 2.7% for the "average" stock. Bond yields, across the maturity curve, vacillated more than at any time since March 2020 as that market seemed to overreact to every economic data release.

For much of the quarter, it looked like the financial woes of the COVID era (inflation and economic volatility) might be abating. In response, market participants cautiously began holding out hope for a soft landing in the economy, instead of the feared recession the Fed appeared determined to bring. But then, seemingly out of nowhere, news started to break of banks running into trouble.

A new banking crisis?

It started in early March with Silvergate Capital, a small bank catering to the cryptocurrency economy, being wound down. Headlines quickly shifted to the collapse of Silicon Valley Bank (SVB) and then to New York's Signature Bank. As a result, bank customers throughout the U.S. suddenly became concerned about the safety of their deposits. Small and regional banks experienced substantial withdrawals, raising questions about their solvency and creating renewed and unwelcome uncertainty about the nation's financial system.

What caused these events? The answers are both general and specific. Let's start by recognizing the business model of a simple bank. A bank's job is to gather deposits and to make loans. The difference in the interest they pay their depositors and the interest they collect on their loans minus expenses to run the bank is basically their earnings. In the recent and exceptionally low interest rate environment, banks have paid nothing to depositors but were also limited to what they could charge on loans. While bank earnings have been tepid, they have been reasonably consistent.

This was the situation heading into COVID. Banks found themselves with plenty of low-cost deposits, but a very low yielding book of loans, too. When COVID hit, individuals and businesses stopped spending and started receiving stimulus checks. Checking and savings account balances began to soar. On the other side of the ledger, banks struggled to put these fresh deposits to work as demand for loans dried up in the newly uncertain environment.

Summit Asset Management LLC ~ 5100 Wheelis, Suite 107, Memphis, Tennessee 38117
Phone 901.729-8100 ~ Fax 901.729-8101 ~ www.summitassetmanagement.com

Leading up to the 2008 Financial Crisis, banks had used excess deposits to make risky loans and purchase complicated derivatives, mostly tied to the housing market. We know how that ended. Having learned their lesson, this time, banks used the excess deposits to buy risk-free government bonds. To maximize the interest they received (and to boost earnings), banks often purchased treasuries with longer maturities, seeking the slightly higher yields. This worked just fine, until about a year ago when the Fed started their aggressive campaign of raising interest rates.

Remember last year's double-digit losses in the bond market? Banks experienced the same performance in their portfolios as well. Despite owning perfectly safe bonds, current prices are below what the banks paid. If they hold these bonds until maturity, all is well. However, a bank's job is also to give depositors their money back when they want it. As interest rates rose in 2022 and 2023, depositors began to search for higher interest than the banks wanted to provide. This led to withdrawals. If depositors request enough funds, banks will be required to sell bonds at losses, bringing their sustainability into question.

While this is the general problem some banks are facing today, we do not believe it is the beginning of a more widespread banking crisis. In the case of the three banks that failed in the U.S., they had very specific issues that complicated their situations. Silvergate and Signature were heavily levered to the extremely volatile cryptocurrency economy. They got caught on the wrong side of the current "crypto winter." SVB, conversely, was the go-to bank for startups and venture capital. COVID was a boon for these groups. They raised billions in capital that ended up as new deposits at SVB. 2022's stock market performance reversed that trend, turning deposits into withdrawals. As concerns started to grow, the bank's depositors took to Twitter. They also used SVB's mobile app to easily and quickly transfer funds out of the bank. This culminated in $40 billion leaving the bank in a single day. Ironically, the tech savviness of the bank's own customers sealed SVB's fate.

Most modern American banks are much more diversified in both their customer bases and income streams. While this does not make them immune to the current conditions, they are better situated to weather the storm. In response to this specific crisis, the Fed has introduced the Bank Term Funding Program. This facility allows banks to place their bonds as collateral with the Fed and borrow against their face value, alleviating the need to sell bonds at a loss and allowing them to be held to maturity. The recent banking episode was more of a "sentiment contagion" rather than the true systemic contagion we saw during the global Financial Crisis. The damage has largely been contained thanks to the quick action of federal agencies and other banks.

Your Investments at Charles Schwab

Naturally, we have had client questions about their assets at Schwab and what protections are in place. Schwab has been in the news because it runs a relatively unique business model as both a brokerage company servicing client investments and as a bank offering checking accounts and debit cards. Roughly 90% of Schwab's $7 trillion sits on the brokerage side of the business.

The first thing for clients to remember is that their investments at Schwab are theirs. The SEC's Customer Protection Rule prevents brokerage companies from using customer assets to finance their own business. At Schwab, all investments (stocks, bonds, mutual funds, ETFs, etc.) are held at a third-party depository institution, such as the Depository

Trust Company or Bank of New York. Stringent auditing requirements assure brokerages comply with this rule. Those segregated assets are protected from any Schwab creditors' claims. They remain the clients' assets in all circumstances.

Additionally, SIPC protection is activated in the rare event that a brokerage company fails and client assets are missing, meaning fraud existed or there was a failure in the auditing and third-party custody procedures mentioned above. SIPC provides up to $500,000 worth of protection against unrecovered assets, including $250,000 against cash. Schwab also maintains "excess SIPC" insurance for further coverage above these limits.

On a nightly basis, any cash in a client account is "swept" into a money market fund at Schwab Bank. Once there, the money market fund falls under FDIC insurance. This is the same $250,000 single owner and $500,000 joint owner government backed insurance that we rely on at our local banks. Bank sweep deposits may be automatically swept into more than one "program bank" to extend the total FDIC coverage available to you.

So, in summary, your investments at Schwab are custodied at an audited third-party depository institution to insure they are segregated from Schwab's corporate assets. These assets are further protected with SIPC insurance should the link between Schwab and that third-party become damaged. Lastly, on a nightly basis, all cash is swept into an FDIC insured bank. We are comfortable that the multitude of protections in place are adequate, and history has shown client assets are safe.

Outlook

Our outlook for the intermediate term has not changed much. The economy, while off the torrid pace of post-COVID, continues to make progress. The Atlanta Fed's real-time GDPNow forecast model is predicting first quarter GDP growth of about 2.2%. Inflation, while still too high, is consistently coming down. April's year-over-year inflation number was 5.0%, better than expectations and the smallest number since June 2021. The U.S. economy created another 236,000 jobs in March and saw the unemployment rate drop to an even lower 3.5%.

We have new concerns that the trouble in the banking sector could foster tighter credit as banks hold on to deposits and forgo lending, adding to the higher interest rates and acting as further braking for the economy. Valuations for some parts of the market appear stretched and we believe earnings expectations are still too high. However, the Fed looks to be nearing the end of its rate hiking cycle and is set to pause and observe. So, risks have increased a bit, but we still believe that most excesses in the economy needed for a painful recession just aren't there. The analogy used in our last letter, "We don't see the economy falling off a cliff, if anything, it will be like stepping into a swamp" still applies.

Thank you again for your continued confidence and trust as we work through these extraordinary times. We welcome your comments, questions, and referrals. Please don't hesitate to contact us. Please stay safe and well.

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