Newsletter

MCS Family Wealth Advisors
Managing Risk to Increase Wealth®

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2023 First Quarter Newsletter and Outlook

BY MICHAEL C. STALKER, CFA

Investors are walking a tightrope. The Fed is increasing interest rates to slow economic activity and reduce inflation, while the side effects of higher interest rates are fueling a regional banking crisis. How both problems evolve is a source of significant risk.

For the first quarter of 2023 (if MCS clients' investments were treated as one large portfolio including their cash), on average clients gained 0.91%, after fees. For comparison purposes, the S&P 500 Total Return Stock Index (S&P 500) and the Bloomberg Barclays Aggregate Bond Index both rebounded from last year's double-digit losses, gaining 7.5% and 2.96%, respectively. The range of MCS individual client returns was from a gain of 4.47% to a loss of 0.92%.*

The clients with the lowest returns had overweighted inherited bank stock exposure that did poorly in the aftermath of the Silicon Valley Bank failure. Clients with the highest returns had higher stock exposure. Overall MCS client portfolios have much less volatility due to a very large allocation to state income tax-free, US Treasury Bills. Treasury bills currently yield 4.6% to 5.0%.

A Smoldering Banking Crisis

For now, the collapse of Silicon Valley Bank and a few other regional banks appears to be contained, from a depositor standpoint. Using special emergency powers, the Fed indicated it would insure all depositors at the troubled banks. This stopped a potential run on more banks.

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* MCS Family Wealth Advisors (MCS) consolidated client returns are dollar-weighted, net of investment management fees unless stated otherwise, include reinvestment of dividends and capital gains and represent all clients with fully discretionary accounts under management for at least one full month in 2023. These accounts represent 99% of MCS's discretionary assets under management as of 03/31/2023 and were invested primarily in US stocks and bonds (3% of client assets on 03/31/2023 were invested in tax-exempt municipal bonds). The Stock Index values are based on the S&P 500 Total Return Index, which measures the large-capitalization US equity market. The Bond Index values are based on the Bloomberg Barclays US Aggregate Bond Index, which measures the US investment-grade bond market. Index values are for comparison purposes only. The report is for information purposes only and does not consider the specific investment objective, financial situation, or needs of any recipient, nor is it to be construed as an offer to sell or solicit investment management or any other services. Past performance is not indicative of future results.

web › mcsfamilywealth.com
e-mail › info@mcsfamilywealth.com
toll free 800.525.8808
local 541.345.7023
750 NW Charbonneau St. / Suite 201
Bend, Oregon 97703
79 Centennial Loop
Eugene, Oregon 97401

A research paper titled *Limited Hedging and Gambling for Resurrection by U.S. Banks During the 2022 Monetary Tightening?*[1] dated April 3, 2023, paints a concerning if not damning picture of the banking industry. From the Abstract (my emphasis added):

> *"**Only 6%** of aggregate assets in the U.S. banking system **are hedged** by interest rate swaps […] The use of hedging and other interest rate derivatives was not large enough to offset a significant share of the **$2.2 trillion loss** in the value of U.S. banks' assets (Jiang et al. 2023)."*
>
> *"**The duration of bank assets increased during 2022, exposing banks to additional interest rate risk.** We find slightly less hedging for banks whose assets were most exposed to interest rate risk. Banks with the most **fragile funding** – i.e., those with highest uninsured leverage – sold or reduced their hedges during the monetary tightening. **This allowed them to record accounting profits but exposed them to further rate increases.**"*
>
> *"**These actions are reminiscent of classic gambling for resurrection**: if interest rates had decreased, equity would have reaped the profits, but if rates increased, then debtors and the FDIC would absorb the losses."*

The paper is saying:

- The banking sector is unprepared for a prolonged period of higher interest rates and the losses that higher rates impose their loans and investments.
- In fact, the riskier (fragile funding) banks are more exposed to losses from rising rates.
- 'Gambling for resurrection,' means taking bigger risks to get out of a financial hole dug by the bank's incorrect bet on interest rates.

Sticky inflation[2] means 'higher for longer' interest rates, making a continuation of the banking crisis more likely. And if that wasn't enough – there's banks' exposure to office building loans.

This pandemic related risk is catching up to regional banks. Regional banks hold 70% of commercial loans. The pandemic permanently lowered the demand for office space. Nearly 25% of the loans on office buildings will need to be refinanced this year according to Bloomberg. This will likely add to the loan losses of Regional Banks.

The Fed, using emergency powers, insured all depositors at troubled banks, thus stopping the panic, but bank stock and bond investors were not protected, experienced painful losses, and remain at risk.

There is also talk of a 'credit crunch', a situation whereby banks reduce their lending after being stung by their mistakes (bad loans). This, in turn, could contribute to a recession. I'm monitoring this potential risk. This situation is reminiscent of the early 1980s to early 1990s Savings and Loan Crisis[3].

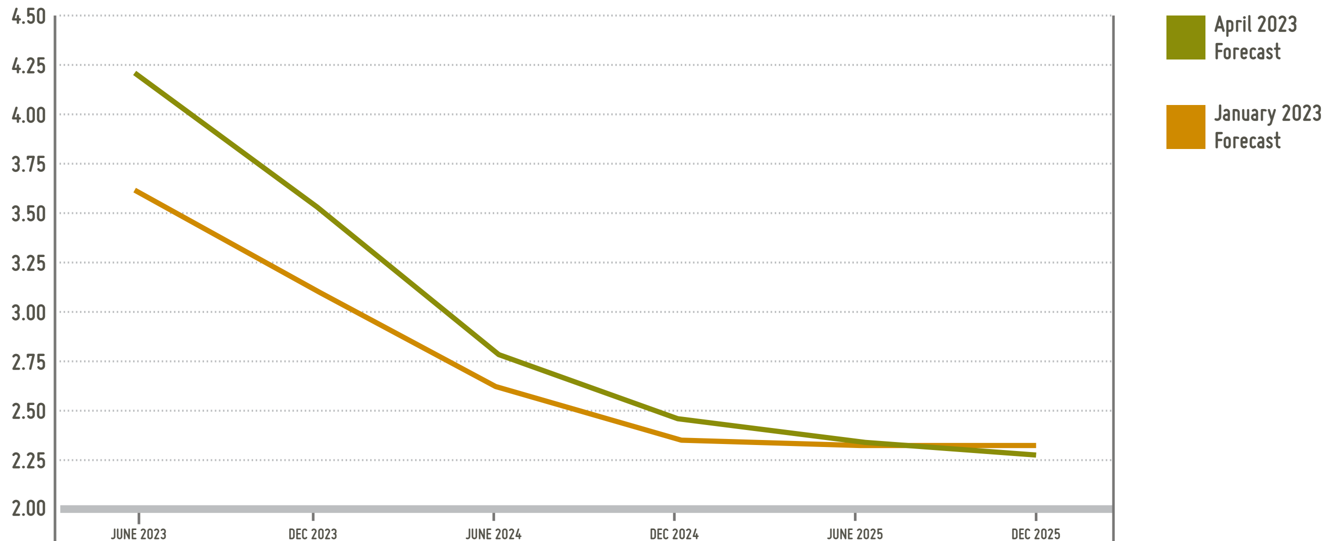
The Path of Inflation is Difficult to Forecast

As Figure 1 on the following page indicates, economists are less certain today of a rapid decline in inflation than they were at the beginning of the year.

Figure 1

Higher Expectations

Consumer-price index, forecast year-over-year percentage change



Source: Wall Street Journal April 15, 2023

Why is the Stock and Bond Market Up, Given These Problems?

The stock and bond markets are up on the *expectation* that inflation and interest rates will quickly decline this year and next. Some market analysts expect the banking crisis to reduce lending which slows economic activity or causes a *mild* recession that then reduces inflation.

The Fed and private sector economists are less sanguine and see the need to reduce sticky inflation with 'higher for longer' interest rates, because core inflation remains too strong (core inflation captures changes in the price of goods and services, excluding food and energy). As long as bank depositors are not panicking, the Fed's priority is to reduce inflation.

Fed officials say it's too early to tell whether the banking crisis will contribute to enough of a slowdown in the economy to move inflation lower. In other words, the Fed is uncertain of when the economic data will support lower interest rates. Therefore, it is committed to leaving rates high until it has more proof that inflation will decline and stay near its 2% target.

This Clash of Expectations leaves investors vulnerable to a future not working out as "expected." In our 2021 newsletter (https://mcsfa.com/2021-third-quarter-newsletter-outlook/) I expressed my skepticism about the Fed's 'inflation is transitory' expectation. In 2022, the Fed realized that inflation was not transitory, raised interest rates to drive down inflation, and stock and bond markets suffered double-digit losses.

Last quarter's newsletter mentioned the risk that Congress will not raise the debt ceiling on time, causing delayed payment of the US government's obligations. I wrote that I was looking for alternatives to US Treasury securities, suggesting municipal money market funds as a possible alternative. Municipalities must balance their budgets, so they don't get into debt ceiling drama. My research found that most municipalities invest their cash in US Treasuries, so they are exposed to the debt ceiling showdown as well. There are few safe alternatives when the benchmark for safety (US Treasury) is at risk.

A possible hedge is gold, but I am ambivalent about how well it would work. Please call me at 541-345-7023 or email me michael@mcsfwa.com if you'd like to discuss this further. Overall, the markets do not seem concerned about the debt ceiling showdown.

A Review of How I Invest on Your Behalf

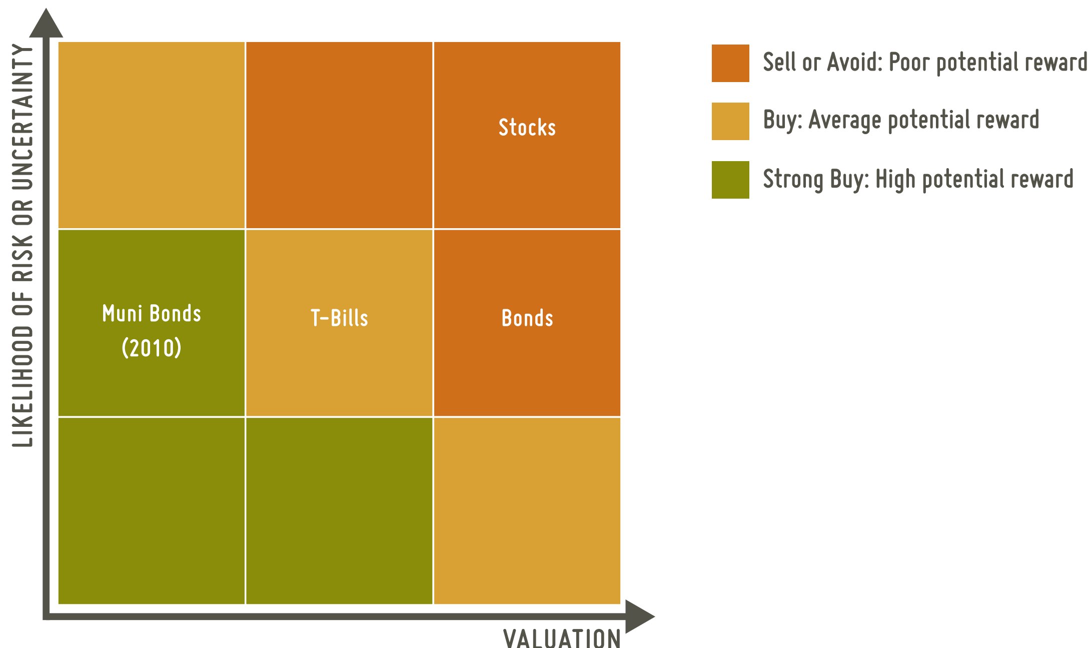
Before I risk your money, I consider the following:

1. Is the valuation of stock and bonds markets neutral to attractive from a historical perspective? (Buying historically over-valued markets results in poor long-term returns.)
2. Is the level of uncertainty not excessive? (Higher uncertainty equals more risk.)
3. Would a bad investment outcome significantly affect my clients' sense of security and well-being?

Risk vs Reward Assessment (Items 1-2)

Figure 2

Is There Enough Reward To Take The Risk?



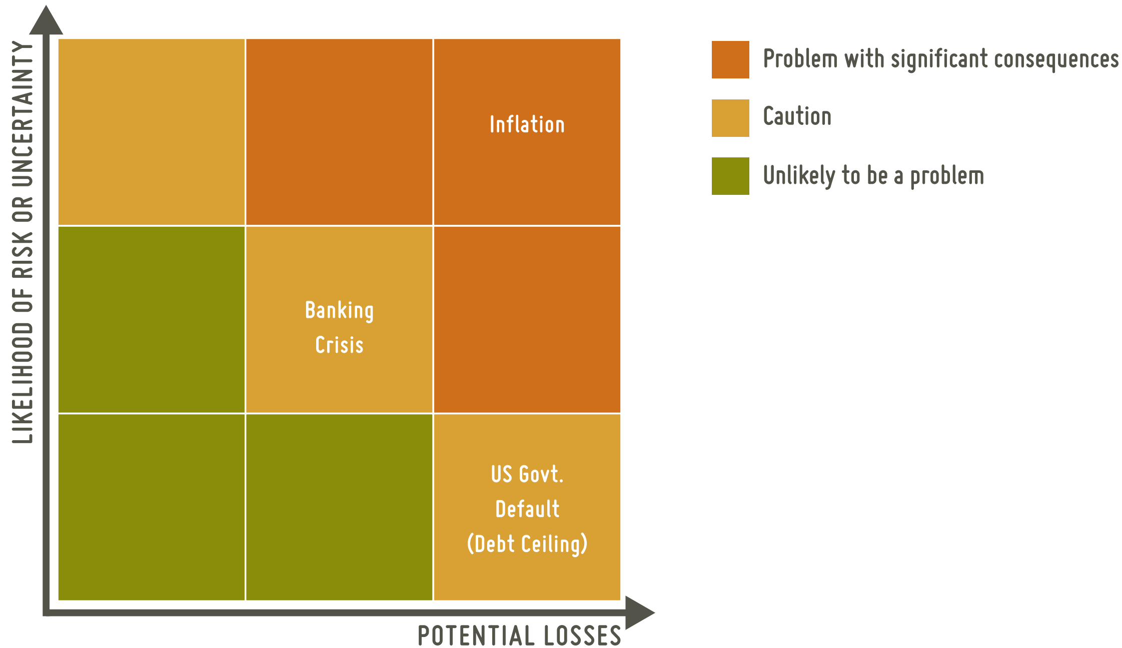
The table above is to give you a sense of how I see the world now relative to 2010, when we took advantage of a great investment opportunity: municipal bonds yielding 6-9%. There was bond crisis then, with some analysts forecasting massive defaults. It was an uncomfortable investment for some clients given the headlines. My analysis convinced me that the fears were overblown; bond valuation was at bargain prices; a combo of low inflation, high yields and excellent credit quality put the investment in the Green Zone. Not so today, not yet. Bonds and stocks are still expensive.

Note: Normally, Treasury Bills (T-bills) would be in the Green Zone, but debt ceiling politics has raised its Risk & Uncertainty ranking.

Figure 3

Risk, Uncertainty and Potential Losses

As related concepts, I have combined risk and uncertainty to simplify the graph.[4]



How will an adverse investment outcome impact my clients economically and /or psychologically? (Item 3)

Our mission is to "Transform Money from a Source of Worry to a Resource for Fulfillment." How much clients worry about their money really matters to us.

While money has many psychological implications, I'm going to focus on two:

- Is the client's identity partially linked to the amount of money they have?
  I have observed that men especially, me included, get a sense of satisfaction from knowing they are worth XXX amount. Thus, a loss of net worth, regardless of whether it has any real economic impact on one's economic security, does not feel good. Those feelings won't necessarily go away with 'You'll be fine in the long run' reassurances. Sometimes, the long run isn't long enough to be confident things will work out.

- Prospect theory describes how investors are more influenced by the possibility of loss than the prospect of an equivalent gain. And that's normal. https://www.simplypsychology.org/prospect-theory.html
  - A sudden loss of say 10-20% (or more) may feel very scary, yet those are common outcomes for stock investors. For example, if someone with $3 million loses a modest 10%, their wealth declines by $300,000. They may feel alarmed because $300,000 feels like a lot of money when their monthly expenses are $10,000.
  - How fast the market rebounds to make up the losses can vary from months to years. In some cases, losses can never be made up due to the client's post decline spending needs and an unlucky sequence of future returns. The anxiety of 'When will I recover what I had?' helps us understand why humans don't equally weight a possible gain and loss. Losing has more life changing consequences than winning for most people.

Bottom Line

Currently, we face investment risk and uncertainty from high inflation and a smoldering banking crisis. From a historical perspective, stock and bond valuations are high /expensive relative to inflation. This puts their reward / risk assessment in the Red Zone.

Within the next 3 months the US government will run out of money if the debt ceiling isn't raised. Usually, the debt ceiling is raised automatically. I think we'll muddle through the debt ceiling drama and the US government will pay its obligations.

Treasury Bills still offer the best return for the risk, but even their risk is elevated due to political polarization.

Please feel free to reach out to me at michael@mcsfwa.com if you have any questions or concerns.

Endnotes

[1] https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4410201

[2] https://www.reuters.com/markets/global-markets-inflation-pix-2023-03-10/

[3] https://www.investopedia.com/terms/s/sl-crisis.asp

[4] **The Difference between Risk and Uncertainty**
Source: ChatGPT

In economics, risk and uncertainty are related concepts. Both concepts refer to the unpredictability of outcomes or events, but they differ in the way information about these outcomes is available and how they can be managed.

Risk: Risk refers to situations where the probability distribution of possible outcomes is known or can be estimated. In other words, when dealing with risk, we have enough information to assign probabilities to different outcomes, even though we may not know which specific outcome will occur. This allows individuals and organizations to analyze, quantify, and manage risk using various statistical tools and techniques.

For example, when investing in stocks, the historical performance data can be used to estimate the potential returns and the variability of those returns. While we cannot predict the exact return, we can use this data to make informed decisions about the level of risk associated with the investment.

Uncertainty: Uncertainty, on the other hand, refers to situations where the probability distribution of outcomes is unknown or cannot be estimated. In cases of uncertainty, there is insufficient information available to assign probabilities to different outcomes, making it much more difficult to analyze and manage the situation.

An example of uncertainty is the impact of a new, unprecedented event or policy on the economy, such as a global pandemic or a radically different political regime or a war. In these situations, historical data may not be useful for predicting the consequences, and there may be no basis for assigning probabilities to different outcomes.

In summary, the key difference between risk and uncertainty lies in the availability of information and the ability to assign probabilities to different outcomes. Risk can be quantified and managed, while uncertainty involves a greater degree of unpredictability and a lack of information, making it more challenging to manage."

Risk and Uncertainty, a Haiku
Source: ChatGPT

Uncertainty looms,
Unknown probabilities,
Future's path unclear.

Economic risk,
Probabilities are known,
Managed with insight.

Disclaimer

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web › mcsfamilywealth.com
e-mail › info@mcsfamilywealth.com
toll free 800.525.8808
local 541.345.7023
750 NW Charbonneau St. / Suite 201
Bend, Oregon 97703
79 Centennial Loop
Eugene, Oregon 97401