Market Commentary

First Quarter 2023

Thomas J D'Auria, CFA	Fredric P. Lutcher, CFA	Caleb Lennon, CRC	Barbara Tweedy
Managing Partner	*Managing Partner*	*Director*	*Wealth Manager*

The first quarter of 2023 saw an increase in volatility across most asset classes, exacerbated by the bank panic that began in early March. While the full-quarter returns were positive, beneath the surface there was much happening. US stocks, as measured by the benchmark S&P 500 Index, increased by 7.5% on a total return basis during the quarter. These positive returns were achieved despite both continued interest rate increases by the Federal Reserve, as well as two bank failures during early March. Fixed income yields fluctuated wildly during the quarter, as investors were caught between parsing economic reports and a flight to quality assets during the immediate aftermath of the bank failures. The benchmark 10-year US Treasury note ended March yielding 3.49%, down from the 3.88% at year-end 2022. However, the real movement was seen in the shorter end of the Treasury yield curve. For example, the 1-year Treasury bill ended 2022 with a yield of 4.71%. It rose to 5.25% on March 8, and then tumbled to 4.64% by March 31. The 2-year Treasury note began the year with a yield of 4.43% and rose to 5.07% on March 8, before violently reversing direction to end the quarter with a yield of 4.06%. These types of swings are very uncommon in short-term Treasuries. In fact, we must go back to the market crash of 1987 to find similar moves over a few days. The declines in Treasury yields portend the ending of Federal Reserve interest rate hikes along with projections of slowing economic growth.

We should take an opportunity to briefly discuss what happened at the two failed banks to show why we believe these are isolated cases. Having been in this business through not only the 2007-2009 financial crisis, but also the 1984 failure of Continental Illinois Bank, we look for similarities and more importantly, differences. Moral hazard is defined as "a lack of incentive to guard against risk where one is protected from its consequences." Particularly at Silicon Valley Bank (SVB), this issue is concerning. The bank was a darling to the tech crowd and many technology companies kept prodigious amounts of cash at the bank, despite the standard SIPC insurance limit of $250,000 per depositor. As an example, Roku had $487 million on deposit at SVB. Roblox had close to $600 million at the bank. Obviously, that leads to the question of why management teams would keep so much uninsured money on deposit at a single institution. A good part of the reason is that SVB paid interest about 0.6% higher than its competitors. How was it able to do this? By putting a sizable portion of its assets in long-term treasury bonds, assuming interest rates would stay low for many more years. When interest rates rose sharply over the past 18 months, these bonds plummeted in value and - because SVB management had done little interest rate hedging - the bank was caught holding the bag. As whispers of problems spread, depositors scrambled to withdraw their funds causing a classic bank run.

To show how rapidly the bank failed, we provide some context. In 2008, Washington Mutual (the largest bank failure in US history) failed after a bank run in which $16 billion was withdrawn over a ten-day period. In mid-March, SVB failed after an astonishing $42 billion was withdrawn in a single day! That was more than 25% of their deposit base gone in 24 hours. No regulatory agency or stress test can model that type of customer behavior. It is possible in today's world due to both social media in which comments are broadcast worldwide in an instant, combined with the ability to move hundreds of millions of dollars with a single keystroke.

29 Emmons Drive, Suite A-5	2271 Porter Way	220 S Pleasant Street
Princeton, NJ 08540	Lancaster, PA 17601	Prescott, AZ 86303
Tel 609-452-2100	Tel 215-208-7994	Tel 928-521-5628

© 2023 Tandem Investment Partners LLC. www.tandeminvestment.com All rights reserved.

The hype about SVB and Signature Bank being the second and third largest banks in history to fail **ignores a good deal of context**. In 1984 when Continental Bank failed it was the seventh largest bank in the US with about one-third the assets of the largest bank at the time (Citibank). The largest bank today, JP Morgan has about $3.7 TRILLION in assets so it would take a bank with over a trillion dollars in assets to fail to be comparable. SVB's assets were just under $200 billion – *a number comparable to Elon Musk's net worth*.

Bloomberg has reported that in late 2020, SVB's asset-liability committee received an internal recommendation to buy more shorter-term bonds as prodigious amounts of deposits flowed in. This would serve to lower its duration risk (risk that changes in interest rates will decrease the market value of a fixed-income investment), but also would have reduced earnings, so management ignored the recommendation and continued to invest deposits into higher-yielding long-term assets. You can call this stubbornness, arrogance, or whatever you choose; but the bottom line is they took excessive risk, and it caused the bank to fail.

By guaranteeing all deposits, even those well above the $250,000 limit, Treasury and the Fed are encouraging more bank managements to stretch for extra yield knowing they will be bailed out if their bets go against them. As capitalists, we believe there should be penalties for incorrect bets. If management teams believe the government will rescue them, they will continue to take imprudent risks. We need only to go back to the failure of Lehman in 2008 to see this in action. Lehman management often stated that they always believed the government would rescue them if markets moved against them.

Economic and Market Outlook

The Federal Reserve has now added a third task to its juggling act. In addition to its dual mandate of price stability and maximum employment, our central bankers are now attempting to reassure depositors that the US banking system is strong and secure while making sure the problems at SVB and Signature Bank do not spread. At their most recent meeting that ended on March 22, the Fed raised the Fed Funds rate to a range of 4.75-5.00%. The hike came despite calls to halt rate increases following the bank failures. We took this as a sign the Fed believes these banking issues were isolated in nature and primarily due to a mismatch between assets and liabilities by those individual bank managements. Coincident with the most recent rate hike, the Federal Open Market Committee updated its economic forecasts. While reducing their GDP growth forecast for the current year to a paltry 0.4%, they now see Fed Funds rates peaking in 2023 at 5.125% (one more 25 basis point rate hike) with rates ending 2024 near 4.25%. Importantly, this means Fed participants see no rate cuts during 2023. We contrast that with Fed Funds futures that are currently pricing in 75-100 basis points of cuts later in 2023. One of these projections will be incorrect, and deciding which will help project the path of markets over the next several months. If rates stay where the Fed projects, we interpret that to mean there is limited damage to the economy and the labor market. Inflation will continue to gradually decline towards the Fed's target rate, and we will see a slow growth environment. If, however the Fed is incorrect and rates do decline by the amounts predicted by Fed Funds futures, that likely means the economy is slowing more rapidly than the Fed anticipates, unemployment is rising faster than projected, and there may be other dislocations throughout the economy. Of course, over the coming months, these two differing projections can move closer to each other, and markets will gradually adjust. This is the most likely scenario based on current economic information. We continue to believe the Fed waited far too long to begin raising rates, leading to the current challenges they face in subduing inflation.

© 2023 Tandem Investment Partners LLC. www.tandeminvestment.com All rights reserved.

Earnings estimates continue to drift lower at a slow pace. In our last commentary we wrote, "*As companies fine-tune their 2023 projections and reflect higher input costs, wage hikes, and higher borrowing costs, we believe earnings estimates for 2023 will come down, likely by 5-10% from the current $230.*" The current consensus estimate for S&P 500 earnings in 2023 has declined by about 4% over the past three months and is now up less than 2% from 2022 earnings. Last summer, analysts were projecting a 7-10% increase in earnings for the current year. We expect the combination of higher input costs (both goods and labor) along with higher interest expense - compounded by tighter lending conditions - to continue to keep a lid on earnings growth for the next few quarters. Supply chains are being restored and this will limit inflationary pressures, but the inertia of the past 18 months will keep costs higher than expected for many companies. If we assume flat earnings this year versus 2022, the S&P 500 is selling at about 18x forward estimates, slightly above the 10-year average of 17.2x. Thus, stocks are close to fair value in our opinion. This does not mean there are no undervalued areas in the market. Nor does it mean investors should be selling equities. Rather it means that we believe that in order to see a meaningful leg upwards in capital appreciation for the market, earnings growth will need to resume.

Turning to oil markets, the price for benchmark West Texas Intermediate (WTI) began 2023 at $80.26 and traded mostly lower during the three-month period as market participants reduced their estimates for oil demand due to slower global economic growth. During the month of March, WTI fell below $70 for the first time since late 2021, declining as low as $65 before recovering. Despite a sharp rebound in the latter part of March, WTI ended the quarter at $75.67, a decline of 6% in the three-month period. Oil has now retreated approximately 40% from the highs reached shortly after the Russian invasion of Ukraine as traders refocus on fundamental supply/demand issues rather than geopolitical turmoil. Our estimate for the fair value of oil remains in a range of $70-$90 per barrel with upside risks based on geopolitics and downside risks related to economic concerns.

We expect year over year inflation to continue trending lower to a range of 4-5% over the next few months with vehicle pricing and energy helping to reduce inflationary pressures. Shelter continues to be the stickiest part of inflation, currently accounting for more than one-third of total inflation. We believe getting inflation much below 4% will be a challenge as long as the labor market stays firm and housing prices remain resilient.

Portfolio Positioning

With our expectations that stocks are close to fair value, and the ability to earn more than 4% on very short-term Treasury securities, we believe income will be an important part of investor returns during 2023. Whether the income is from dividend paying stocks, fixed income securities, or higher-yielding money market funds, the ability to produce meaningful income will go a long way towards dampening portfolio risk as well as providing a decent portion of overall returns in the coming months. Tandem continues to focus on high quality investments with below market valuations, remaining in defensive mode. When markets become more volatile it is the time for prudent investors to protect capital rather than chase returns. As the Fed's interest rate hikes work through the economy, we will get a better sense of their cumulative effects on corporate earnings prospects., which will ultimately drive stock prices.

29 Emmons Drive, Suite A-5
Princeton, NJ 08540
Tel 609-452-2100

2271 Porter Way
Lancaster, PA 17601
Tel 215-208-7994

220 S Pleasant Street
Prescott, AZ 86303
Tel 928-521-5628

© 2023 Tandem Investment Partners LLC. www.tandeminvestment.com All rights reserved.

Conclusion
As longtime readers of our commentaries are aware, during trying times we counsel patience. The past 12-15 months have been volatile and challenging as the Fed tries to rein in inflation by moving interest rates higher after 15 years of extremely low rates. In fact, few people under the age of 40 know what a normal interest rate environment looks like. We have lived through a decade and a half of “free money”. We often remark that few things are more expensive than free money due to its ability to distort valuations and lead to imprudent risk taking. While unwinding a decade and a half of extremely low interest rates can be painful, the result should be one most investors will welcome. Stronger companies will perform better than weaker ones. Companies with excessive debt will be penalized by the marketplace, and bad business models will be recognized by investors more quickly. Free money covers a lot of mistakes and there are many companies that would not still be viable in a normal interest rate environment. In sum, the volatility of the past few quarters is the result of ultra-low interest rates ending combined with the after-effects of the global pandemic and its impacts on economies. As we get further removed from both phenomena, markets will reflect this in reduced volatility and again rewarding stable and growing companies.

In closing, we ask that you inform us of any significant changes in your financial situation or if you have any specific questions or concerns about your investments. We always like to hear from our clients and are happy to answer any questions you may have.

March 31, 2023

Tandem Investment Partners, LLC (“Tandem”) is a registered investment advisor. Tandem only transacts business in states where it is properly registered or is excluded or exempted from registration requirements.

All expressions of opinion reflect the judgment of the author as of the date of publication and are subject to change.

Information contained herein does not involve the rendering of personalized investment advice but is limited to the dissemination of general information. A professional adviser should be consulted before implementing any of the strategies or options presented.

Past performance may not be indicative of future results. Therefore, clients should not assume that the future performance of any specific investment, investment strategy (including the investments and/or investment strategies recommended by the adviser) will be profitable or equal to past performance levels.

All investment strategies have the potential for profit or loss. Different types of investments involve varying degrees of risk, and there can be no assurance that any specific investment will either be suitable or profitable for a client's investment portfolio.

29 Emmons Drive, Suite A-5
Princeton, NJ 08540
Tel 609-452-2100

2271 Porter Way
Lancaster, PA 17601
Tel 215-208-7994

220 S Pleasant Street
Prescott, AZ 86303
Tel 928-521-5628

© 2023 Tandem Investment Partners LLC. www.tandeminvestment.com All rights reserved.