NOTTINGHAM ADVISORS
ASSET MANAGEMENT

Stocks and Bonds Rejoice

The financial market returns experienced last year were very unusual, with stocks and bonds facing meaningful drawdowns in the same calendar year.

The first three months of 2023 provided a wonderful respite from the inhospitable landscape of 2022. January saw equity markets move higher, with many approaching 10% YTD returns by early February, 2023.

DOMESTIC EQUITY RETURNS

NAME	MTD	QTD
S&P 500 Index	3.67	7.48
S&P 400 Mid Cap Index	-3.21	3.79
S&P 600 Small Cap Index	-5.16	2.54
S&P 500/Citi Growth Index	5.85	9.63
S&P 500/Citi Value Index	1.31	5.15

INTERNATIONAL EQUITY RETURNS

NAME	MTD	QTD
MSCI ACWI Index (USD)	3.15	7.44
MSCI EAFE Index (USD)	2.61	8.65
MSCI EM Index (USD)	3.04	3.97
FTSE 100 Index (GBP)	-2.48	3.55
Nikkei 225 Index (JPY)	3.04	8.45

Source: Bloomberg, Nottingham Advisors, as of March 31, 2023

This risk-on bounce coincided with improving market sentiment and rising expectations for a no-landing (no recession) outcome for the economy. Inflation readings moving steadily lower buoyed hopes that the Federal Reserve rate hiking cycle would not have to be as aggressive as expected, increasing the likelihood of it ending without suffocating economic growth.

Risk markets swooned in early March as Silicon Valley Bank was seized by regulators after a historic run on its deposits. Their customers attempted to withdraw $42 billion in a single day. For context, the largest bank run in U.S. history had been Washington Mutual bank in 2008, totaling just $16.7 billion (over 10 days).

The suddenness of Silicon Valley Bank's demise shook the equity markets, which quickly gave up most of the January rally, before moving up again to close out the first quarter with positive single-digit returns.

Interest rates were not immune from similar sentiment swings. Rates had moved higher as the Federal Reserve continued to raise the Federal Funds Rate and the economy seemed to be defying expectations of a slowdown.

FIXED INCOME RETURNS

NAME	MTD	QTD
Bloomberg Barclays US Government Index	2.87	2.98
Bloomberg Barclays US Agg Index	2.54	2.96
Bloomberg Barclays US Corporate Index	2.78	3.50
Bloomberg Barclays US Corporate High Yield Index	1.07	3.57
Bloomberg Barclays EM USD Agg Index	1.24	2.15
Bloomberg Barclays Global Agg Treasuries USD Index	2.47	3.12
Bloomberg Barclays Municipal Index	2.22	2.78

Source: Bloomberg, Nottingham Advisors, as of March 31, 2023

From the start of the year through early March, Treasury yields inside of 10 years pushed higher while longer dated Treasury yields remained roughly flat. This changed quickly. Treasury yields reversed course and declined 20 to 40 basis points across the yield curve within days of the seizure of Silicon Valley Bank. Yields on shorter maturity Treasury bonds continued to decline through the end of the first quarter.

This reversal in the direction of interest rates pushed bond returns higher, taking them from slightly negative results in early March, to broadly positive returns at the close of the quarter.

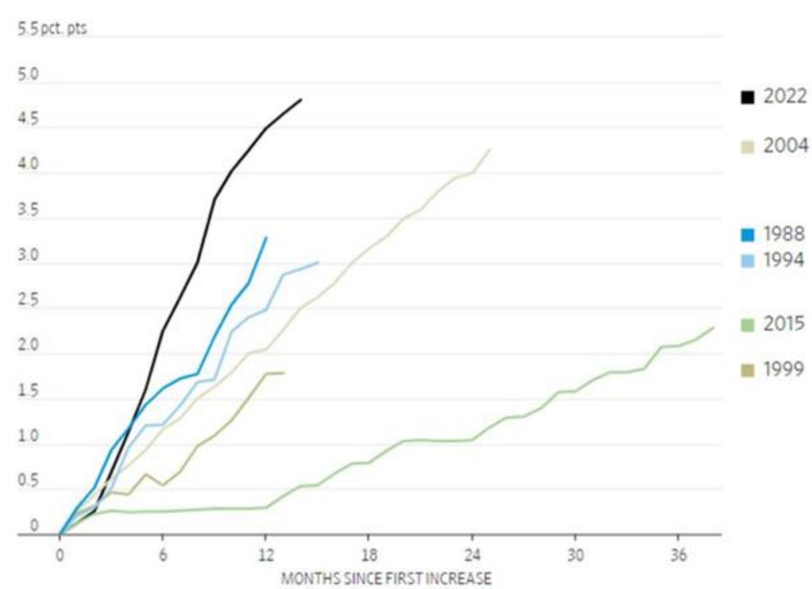
Europe experienced its own bank uncertainty in March. Credit Suisse was caught up in a crisis of confidence and facing liquidity concerns. Switzerland's central bank offered Credit Suisse access to a $50 billion CHF liquidity facility. It was not sufficient to calm jittery investors' nerves. Roughly a week after Silicon Valley Bank was seized in the U.S., Swiss authorities strongly encouraged UBS to acquire Credit Suisse in an attempt to avoid a national banking crisis, which has thus far seen success.

Lagged Effects

In retrospect, neither of these issues should have come as a complete surprise. Fed rate hike cycles always break something. Traditionally, the Fed tightens monetary policy until cracks begin to show, and then they tighten a bit more. We are currently in the midst of the most aggressive tightening cycle in generations. It is not difficult to believe that some companies/managers will be wrongfooted during a period of time unlike any they have previously experienced.

As the issues created become clearer, the Fed is forced to backpedal and lower interest

Cumulative Change in Federal-Funds Rate since Start of Initial Rate Increase

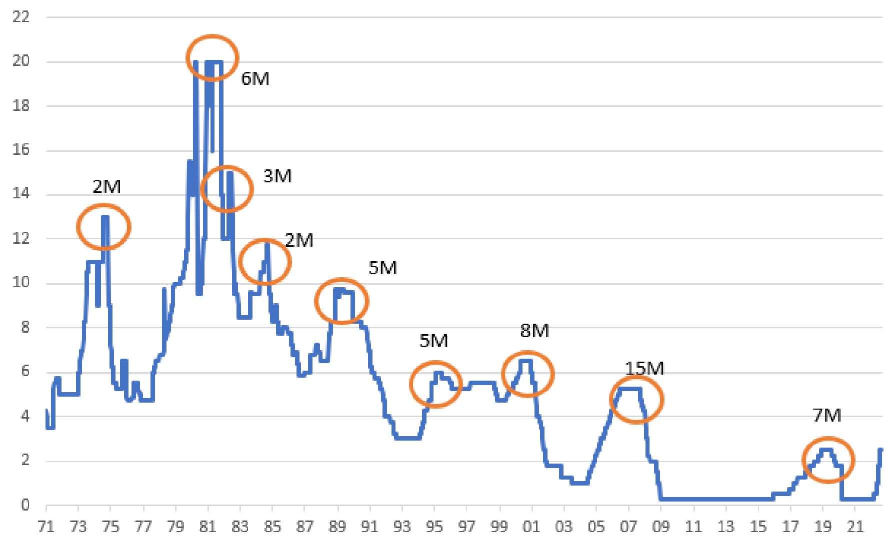


Source: Federal Reserve

rates to soften the economic impact of the troubles that their monetary tightening forced to the surface. Typically, this reversal comes within a quarter or two of their final rate increase.

Why does this happen so often? What leads the Fed to continue tightening policy into a slowdown or crisis? The typical explanation is that the effects of monetary policy reveal themselves only after a significant time lag.

Duration between Last Fed Rate Hike and First Rate Cut (months)

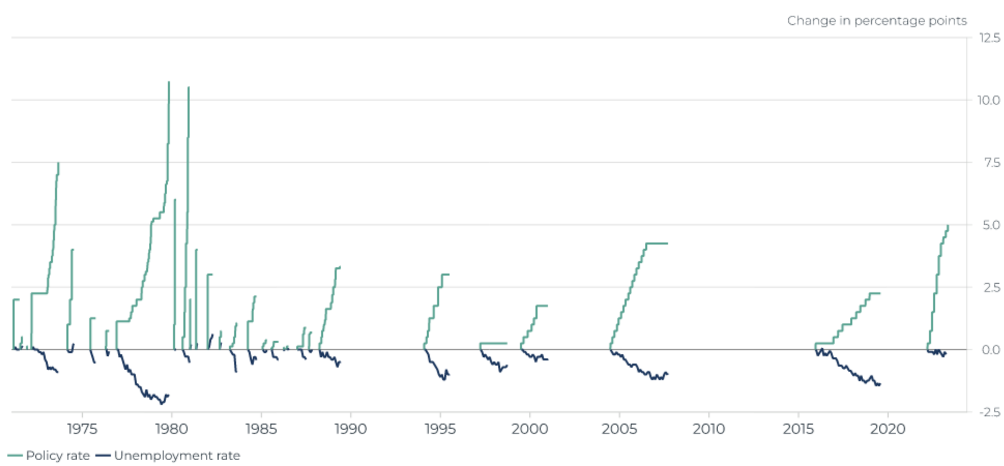


Source: Macrobond, ING

In the current cycle, the Federal Reserve has continued to raise rates because they are not seeing (in real time) the results they are looking for – a slowing economy and weakening unemployment, necessary to achieve their goal of bringing inflation down into the two percent range. It is not unusual to see unemployment continue to move lower through much of a Fed tightening cycle, due to the lagged effect of Monetary Policy changes.

This cycle is more complex than any faced by the Fed in the past 40 years due to multiple issues. The level of inflation is beyond what most Federal Reserve board members have had to deal with during their careers. Sadly, the legendary Fed Chairman, Paul Volcker, who battled inflation during the late 1970s and early 1980s, passed away in 2019.

United States: Unemployment Rate during Hiking Cycles



Source: Macrobond; Federal Reserve

The Fed magnified the difficulty of the situation they are in through their delayed recognition of inflation as valid concern.

Global trade, which has historically acted as an inflation dampener, is beginning to reverse/reorder itself due to supply chain dependability and national security concerns. The sectors where this shift is most easily seen are technology (China) and energy (Russia). The effects will not be obvious for some time, but are unlikely to be helpful in accomplishing the Fed's goal of reducing inflation.

Liquidity

Companies, Municipalities, and Individuals were flush with "cash" for much of the past few years. This was driven by the government's efforts to dampen the negative effects of the Covid pandemic. They pushed cash into people's hands, and offered grants and loans broadly, to keep the economy from locking up. The cash made its way into bank accounts. Short-term interest rates were near zero back then, so to make money, bankers bought longer maturity bonds with the deposits, apparently assuming that the deposits were not going to be withdrawn anytime soon. As inflation moved higher and the Fed raised interest rates, the value of the bonds purchased declined significantly, but the deposits owed to account holders remained the same. Some banks saw the value of their unrecognized investment losses grow so significantly (Silicon Valley Bank) that their customers lost faith in the organization as a going concern, spurring the run on deposits that put the bank into receivership. Silicon Valley Bank actually sold a large chunk of its investment portfolio due to liquidity needs. The recognition of these losses opened a hole in the bank's capital and required it to raise additional equity. When Silicon Valley Bank announced this was the case, instead of investors injecting capital and saving the bank, they saw an even greater amount of deposits withdrawn, and regulators stepped in.

Unrealized Gains (Losses) on Investment Securities

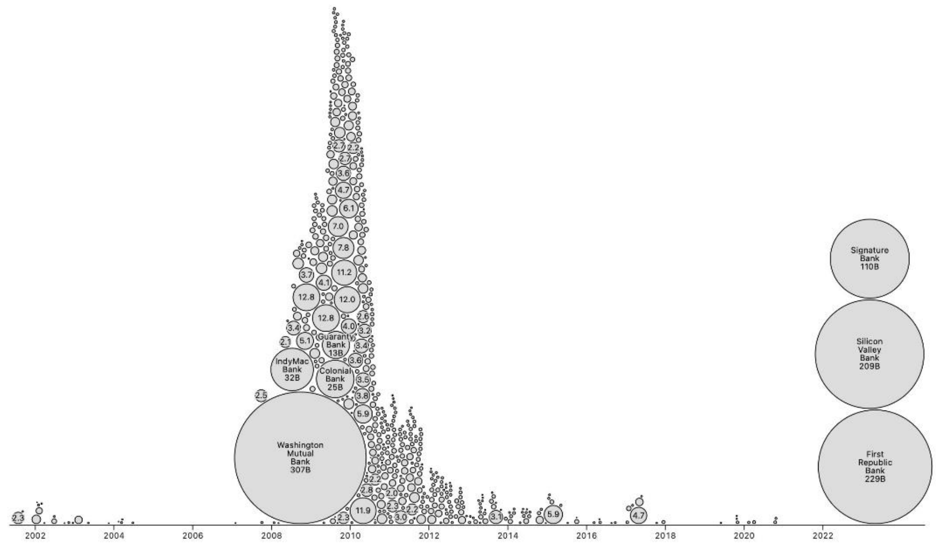
Source: FDIC.
Note: Insured Call Report filers only.

While selling investments and recognizing the loss may have made sense to executives at the time, it is likely to be viewed as a very negative market-signal going forward due to its association with Silicon Valley Bank's demise.

Silicon Valley Bank was not a traditional bank. It had seen massive inflows from its niche, start-up/venture companies and related parties. These flows were treated as a stable source of funding, and invested in long duration bonds, when no sensible risk management executive (Silicon Valley Bank did not have one) would have approved.

First Republic is another bank that pursued a niche strategy – making interest-only mortgages at extremely low interest rates to applicants with exceptionally high incomes and top-notch credit scores. The value of these mortgages on their books had plummeted almost $20 Billion, impairing their capital position. There were no outside banks willing to acquire them prior to being taken into receivership, and auctioned along with additional guarantees/risk-sharing from the regulators. Again, this was not a traditional bank.

In the bank failures experienced in 2023, no depositors have lost money. No Depositors Have Lost Money! The regulators have made all depositors whole. The precedence has been established. Investors are at risk – Bondholders, Preferred Stock holders, and Equity holders go to zero. Depositors are indemnified from loss.



Source: Mike Bostock

Risk of loss was one of the two issues driving deposit outflows. Protecting all depositors puts out half of the fire.

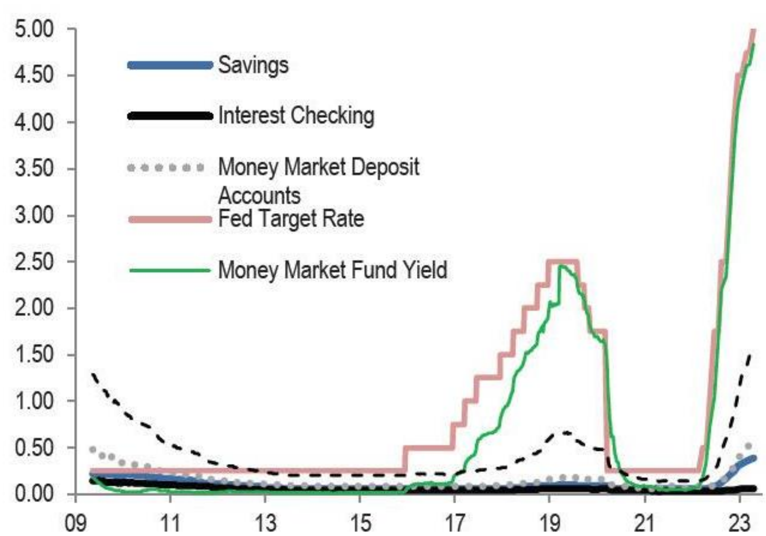
Yield Maximization

Higher interest rates have made it appealing to withdraw deposits from bank accounts offering no or low yields and invest those funds in a higher yielding asset such as a money market fund. This disintermediation is the second troubling source of deposit outflows for banks. As it becomes more widely known that earning more than 4% on the money currently sitting in your savings/checking account is relatively easy, banks will have to begin offering similar yields to their depositors in order to stem deposit outflows. This will crimp bank profit margins.

Banks could continue to pay almost nothing on deposits and let them leave, accessing the Fed borrowing facilities for needed liquidity to fund the outflows. Unfortunately, those facilities also have relatively high costs (relative to the deminimus yield paid on deposits) and will also weigh on profit margins.

Accessing liquidity by selling investment portfolio holdings and recognizing losses has already been discussed. It is currently a strongly negative market signal and management preference will be to avoid.

U.S. Money Market Fund Yields vs U.S. Bank Deposit Rates



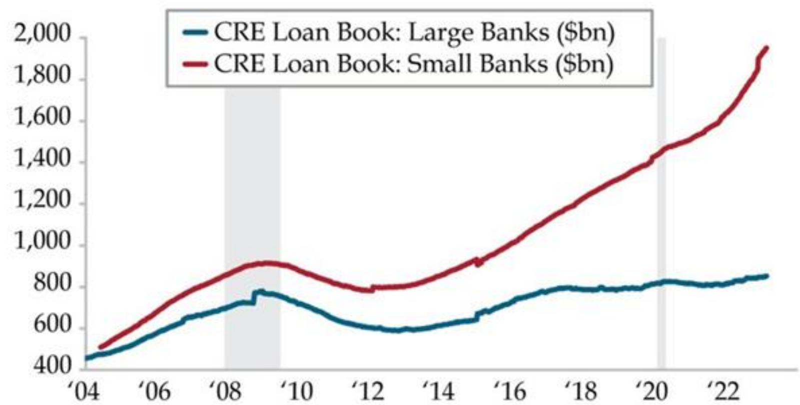
Source: FIDIC, J.P. Morgan.

To bolster liquidity, banks could reduce or suspend their dividends (as PacWest did last week). This has long been a negative market signal. Since PacWest's stock has already declined roughly 75% in 2023, they are presumably not concerned about spooking the market. Most banks will want to avoid altering their dividend policy.

The remaining option is to reduce or eliminate new lending, allow loans to pay off, avoiding refinancing or extensions.

Uncertainty

The world has moved quickly from interest rates near zero (or even negative) to a significantly higher level. This jeopardizes investments or acquisitions that were meant to be long-term, but were purchased with short-term financing. When refinanced at current market rates, the original investment case may no longer hold, or may require a significant adjustment of the asset's valuation. Commercial Real Estate (CRE) is the poster child for this category.



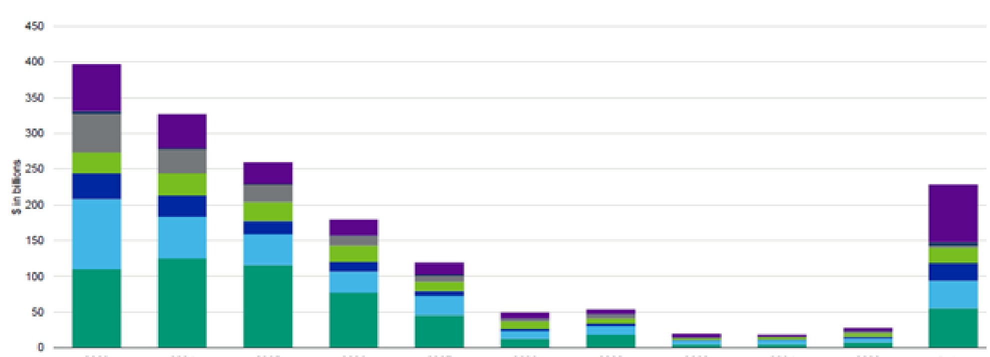
Source: Quill Intelligence, Federal Reserve. Recessions shaded.

Banks that will be looking for liquidity from a reduction in lending have a large exposure to the CRE market. These loans often have relatively short maturities, at which point they are refinanced at current market rates for another relatively short period of time. In 2023, roughly $400 Billion of CRE loans will mature and need to be refinanced. With fewer banks interested in making loans, and even less interested in the growing risks within the CRE market, many of these loans will have to find alternative financing or face foreclosure, and be sold into an already distressed market.

The contraction in credit availability will not be limited to CRE loans. Banks are tightening lending standards for all types of credit. Historically, this has led to negative outcomes such as rising unemployment, higher defaults in the High Yield corporate bond/loan markets, and recession.

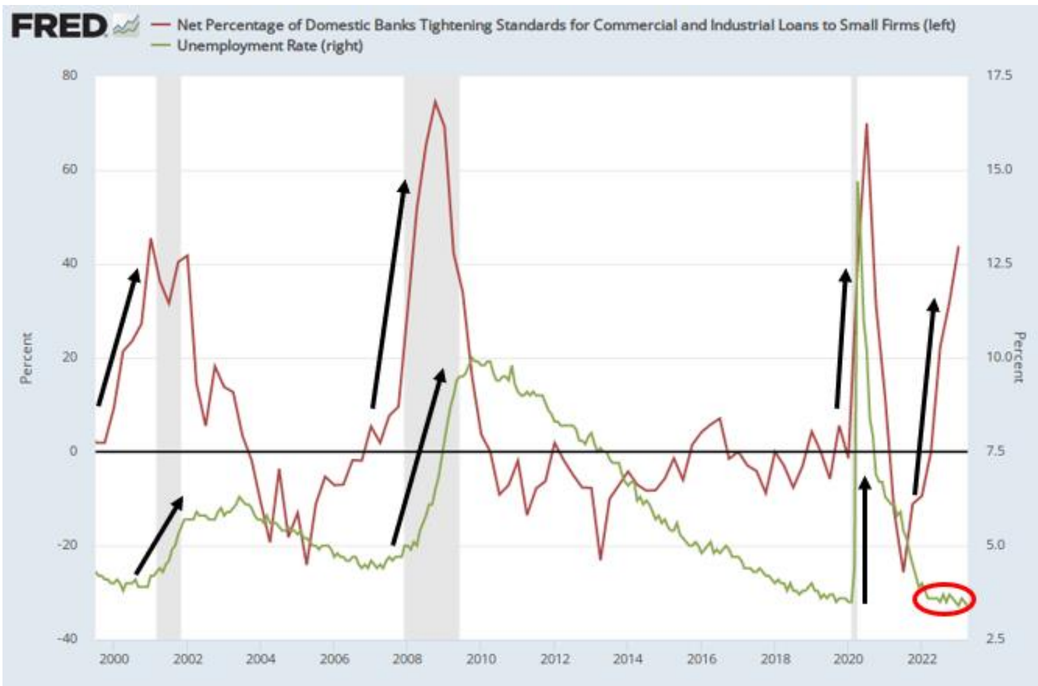
Almost ¼ of U.S. Banks' CRE Loans are due for Refi in 2023

Maturity profile of U.S. banks' CRE loans by property type (excl. construction,) 31 December 2022



Source: Mortgage Bankers Association, Moody's Analytics, Moody's Investors Services

When a significant percentage of banks (>40%) are tightening standards for Commercial and Industrial (C&I) Loans to small firms, unemployment tends to rise with a time lag, and the economy contracts. With the banking sector adjusting to the brave new world of higher interest rates, it seems likely that we will have an experience that rhymes with historical precedence. The outcome of this credit tightening adds to the work of the Fed, in its pursuit of dampening growth and raising unemployment. Unfortunately, its effects are also felt with a lag, and make it even more likely that overtightening will occur.



Source: Board of Governors; BLS

Continued Vigilance

Given the potential deleveraging discussed, we have found it helpful to tilt towards higher quality and income producing exposures in portfolios. We have unwound exposures that we feel could be negatively impacted in this environment. The composition of our equity holdings are as defensive as they have ever been. The bond market offers attractive yields on high credit quality investments that can provide ballast during periods of market volatility. We continue to evaluate the market risk within our portfolios on an ongoing basis, and adjust accordingly.

We encourage you to reach out with any questions.

Timothy D. Calkins, CFA
Co-Chief Investment Officer
May 2023

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