QUARTERLY LETTER, APRIL 2023

Fellow Investors,

Inflation remained high in the United States in the first quarter with the February 2023 Consumer Price Index rising 6% year over year, down from the recent peak of 9.1% in June 2022. The February 2023 unemployment rate is 3.6%, little changed from February 2022 when it was 3.8%. The Federal Reserve continued its inflation-fighting efforts by raising the Federal Funds target rate to a range of 4.75% - 5.00% at their March meeting, an increase of .25%. The Federal Reserve also continues to shrink its balance sheet with the assets they hold falling to $8.6 trillion on 23 March 2023 from $8.9 trillion a year ago, a decline of 3.3%. Assets dropped as low as $8.3 trillion on 8 March 2023 before increasing by $340 billion over the next two weeks as the Fed initiated a new lending program to support stressed banks (more on that below). The Federal Reserve continues to raise rates and shrink their balance sheet in the belief that increasing the cost of borrowing and reducing the supply of money in the economy will reduce the demand for goods and labor and thereby bring inflation down. We view this as logical but note that in the 1970s we had both high unemployment and high inflation. Thus, we view it as quite possible that even if the Federal Reserve successfully increases unemployment, the inflation rate may not come down to their long-term target rate of 2%.

The U.S. stock market as represented by the S&P 500 Index has rallied modestly so far this year. The leaders of the rally were the laggards from 2022 and vice versa (which is to say that Tech and Crypto increased the most and energy has done poorly). The rally was marred by the rapid-fire failure of Silvergate Capital Corporation, Signature Bank, and Silicon Valley Bank. These bank failures triggered a selloff centered around regional banks in mid-March as investors became concerned that there may be more problems yet to come in the banking industry. In response to the bank failures the Federal Reserve created a new loan program that allows banks to borrow from the Fed using the par value of high-quality assets as collateral. Usually, such loans are made against the market value of the assets, so this is a meaningful change. It is under this program that the Fed made $340 billion worth of loans in two weeks.

The problem in the banks has two aspects: asset value and deposit retention. As interest rates have increased, the market value of bonds has fallen. Banks that hold large unhedged bond portfolios are thus sitting on significant unrealized losses. If the bank is forced to sell their bonds at market prices they will realize a loss—and the losses might be big enough to make them insolvent. (This is what happened to Silicon Valley Bank.) So far, this is not an asset quality problem, though if delinquencies and defaults increase significantly, it could become one. Car loans and commercial real estate loans seem particularly vulnerable to us. On the deposit side we note that even if depositors retain full confidence in the solvency of their bank, money market funds offer far higher yields (currently about 4.5%) than checking and savings accounts, and it is completely rational to move excess cash to a money market fund to achieve that return. Banks that only a year or two ago were turning away deposits may now find themselves raising interest rates paid on checking and savings accounts to retain them. We see no end in sight to either of these pressures on banks and conclude that banks will remain under stress for a while.

We stated in our June 2022 quarterly letter that we expected some sort of financial crisis to develop as the Federal Reserve raised rates, and we hypothesized that such a crisis would put the Fed on the horns of a dilemma—should it lower rates and increase the balance sheet (the standard Fed crisis moves) to fight the crisis, or continue raising rates and shrinking the balance sheet to continue to fight inflation? As explained above, the crisis we expected is now starting to unfold and the Fed is indeed on the horns of a dilemma. While they continue to raise interest rates and have stated that they intend to reduce their balance sheet, the new bank loan program has instead increased the assets on their balance sheet! It'll be interesting to see if the Fed is able to solve both the banking problems and the inflation problem at the same time—it's too early to tell.

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In our January newsletter, we listed three questions we thought were most important to focus on as we try to understand where markets are likely to go in the near term. Those questions, and our updated thoughts are below.

1. Will the U.S. enter a recession? In January we thought the odds were high that the U.S. was heading for a recession. We think problems in the banking industry make a recession more likely, not less. Let's say a recession is now "very likely," maybe even "almost certain." One data point that doesn't match the "Recession is coming" narrative is the strength we are seeing in home sales even with mortgage rates back near 7%. Still, most of the evidence points to recession, though we have no opinion about the duration or depth of the downturn.

2. What will inflation do? Banks going bust is very deflationary, pumping money into banks to keep them from going bust may or may not be inflationary, depending on some other factors that are hard to predict. Recessions tend to be deflationary over the short term. High and growing government spending tends to be inflationary. Increased regulations tend to be inflationary. Our estimate (and it's a low confidence estimate) is that we'll see inflation continue to come down to 4-5% over the next year or so and then rise from there. We stated before that the last time we had inflation this high it took strong monetary action and significant regulatory change over the course of a decade to get inflation back under control. We remain skeptical of the idea that it will be much easier this time.

3. Will we get a financial crisis? Yes, it's here, and will likely take some time to fully unfold.

In light of our negative near-term outlook, we remain unusually cash heavy, and very selective in our investments. We expect more lucrative asset prices in the future than we see today and want to be prepared to take advantage of them should they occur.

As always, if you have questions or comments, write, or give us a call. We'd love to hear from you.

With our best wishes for your continued success and good health,

Jeff Muhlenkamp, Portfolio Manager
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CPI *– The Consumer Price Index ("CPI") measures the average change in prices over time that consumers pay for a basket of goods and services, commonly known as inflation. One cannot invest directly in an index.*

Federal Funds Rate *- the interest rate at which depository institutions lend balances at the Federal Reserve to other depository institutions overnight. It is the interest rate banks charge each other for loans.*

S&P 500® Index *– The S&P 500® Index is a widely recognized, unmanaged index of common stock prices. The S&P 500® Index is weighted by market value and its performance is thought to be representative of the stock market as a whole. One cannot invest directly in an index.*

The comments made in this letter are opinions and are not intended to be investment advice or a forecast of future events.