MITCHELL SINKLER & STARR

Second Quarter 2023 — Economic and Capital Markets Commentary

Next Stop—Pottersville!

"You're thinking of this place all wrong. As if I had the money back in a safe. The money's not here. Your money's in Joe's house... right next to yours. And in the Kennedy house, and Mrs. Macklin's house, and a hundred others..."

– George Bailey, "It's a Wonderful Life"

Over a decade since the worst financial crisis in generations, financial institutions encountered a new banking crisis in the first quarter of 2023. This crisis was far more reminiscent of a classic bank run of the 1930s and was markedly dissimilar from the 2008 debacle. And as with the bank run in "It's a Wonderful Life," the Mr. Potters of the world (or in today's context, the largest banks) may be the ones to gain. For investors, a basic understanding of the two events and their differences will be helpful as we watch for any further developments and weigh possible impacts on markets and the wider economy.

The Crisis, Summarized

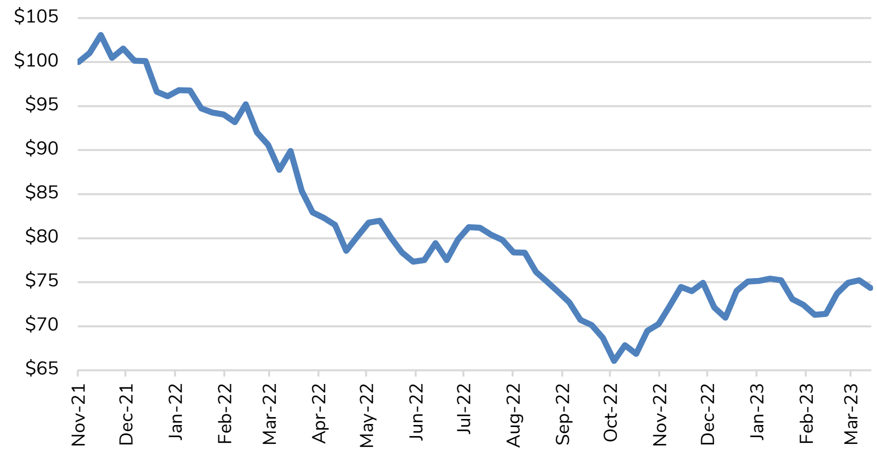
From 2020 to 2021, the massive fiscal and monetary stimulus injected into the economy in the wake of the COVID pandemic produced trillions of new dollars looking for a home. As a result, certain small regional banks grew rapidly, with some tripling their assets in just two years. A handful of these banks also had very concentrated, wealthy depositor bases—such as Silicon Valley Bank (SVB) with its venture capital funds, and Signature Bank (SBNY) with its wealthy real estate (and until recently, cryptocurrency) depositors.

With interest rates near zero percent, banks could make a nice "spread," or profit, by paying depositors almost nothing on their funds while investing the rest in safe Treasury bonds or other government securities yielding 1-2%. However, to capture this yield, these banks had to buy longer-dated securities with anywhere from 10-30 years until maturity.

This strategy works in a low-rate environment, but few predicted the swift interest rate hikes the Fed would deploy in 2022 to combat inflation. As the Fed Funds rate moved from near zero to over 4.5%, longer-dated Treasury bonds, *while safe from default*, saw their price decline considerably.

Normally, this is not an issue since bond prices eventually revert to par at maturity. But in March of 2023, as depositors continued moving funds out of banks and into higher yielding securities, some banks were forced to sell bonds at depressed prices. This caused depositors, in turn, to worry about the health of the banks and the safety of their deposits. Fears that certain banks might soon become insolvent began to prove self-fulfilling, and a feedback loop, fueled by social media and cell phone banking apps, caused large clients, en masse, to pull deposits from the banks in question.

Price of a 2% Coupon 20-Year Treasury Bond, Issued in November of 2021



A crisis—a bank run—was on.

Unlike the Last Go-Round

The financial crisis of 2008 was fundamentally a different phenomenon. That crisis exposed the high leverage and risky lending in mortgage-backed securities at large, systemically important banks. As investors and regulators questioned both the transparency and value of the assets on the books of these large banks, a credit freeze ensued, sending the economy into a deep recession.

In contrast, in 2023, smaller regional banks like SVB were not reckless with their investing, lending, or leverage. Rather it was their poor risk management and lack of foresight into potential depositor outflows in a higher interest rate environment that sunk their companies and caused this crisis. So far, while disruptive to local businesses that utilize these banks, the outflows have not had an impact on the larger economy.

The Fed's Solution

The Federal Reserve acted swiftly, and in a different manner than in 2008, to protect SVB and SBNY depositors. Rather than rescue banks by extending credit and buying their "bad" assets, the Fed used "good" bank assets and FDIC insurance to make depositors whole above the $250,000 FDIC insurance limit.

The net effect of this action was to reassure wealthy depositors and small businesses, preventing similar depositor outflows—bank runs—from occurring at other institutions around the country. At the same time, the Fed announced a new borrowing program—the “Bank Term Funding Program” or BTFP. This program allows any bank to borrow from the Fed using its Treasury (and other high-quality) bonds as collateral *at their initial par value—not current depressed prices*. Numerous banks were suddenly able to raise funds to cover withdrawals, without realizing temporary losses on their securities.

As of this writing, these actions may have at least stabilized the banking sector and calmed the market. Separately, the Fed has hinted at only one more rate hike through the end of this year, giving equity markets hope that this aggressive rate hiking cycle may be finally coming to an end as inflation continues to decline.

As events continue to unfold, our focus at Mitchell Sinkler & Starr will remain on investing in quality securities and finding new pockets of value. During times like these, when markets dislocate, this remains the soundest strategy for allocating our clients' capital.

- Mitchell Sinkler & Starr’s Portfolio Managers

Data Sources: U.S. Federal Reserve, Bloomberg Finance L.P.

Economic and Capital Markets Data

	March 31, 2023	(One Year) March 31, 2022	(Three Years) March 31, 2020	(Five Years) March 31, 2018
S&P 500 Index	4109	4530	2585	2641
Price / Earnings Ratio	19.7	23.3	17.0	21.3
Dividend Yield	1.68%	1.37%	2.34%	1.95%
Federal Funds Rate	4.75%	0.50%	0.25%	1.75%
10-Year U.S. Treasury Yield	3.47%	2.34%	0.67%	2.74%
Gold ($ per oz)	1,969	1949	1,577	1,325
Oil (Brent, $ per barrel)	80	100	23	70
Bitcoin ($)	28,395	45,850	6,624	7,543
GDP (Annualized)*	2.6%	6.9%	-4.8%	2.3%
Unemployment**	3.6%	3.6%	4.4%	4.1%
Inflation (Annualized)	5.0%	7.9%	1.5%	2.4%

S&P 500 Index earnings declined slightly in the first quarter of 2023, despite the fact that many companies continue to report fairly strong consumer demand.

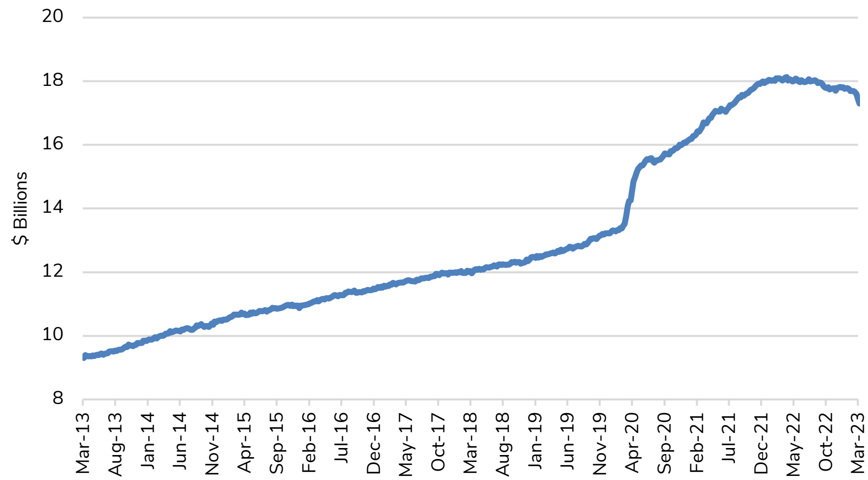
*GDP Data as of December 31, 2022

**Unemployment Data as of February 28, 2023

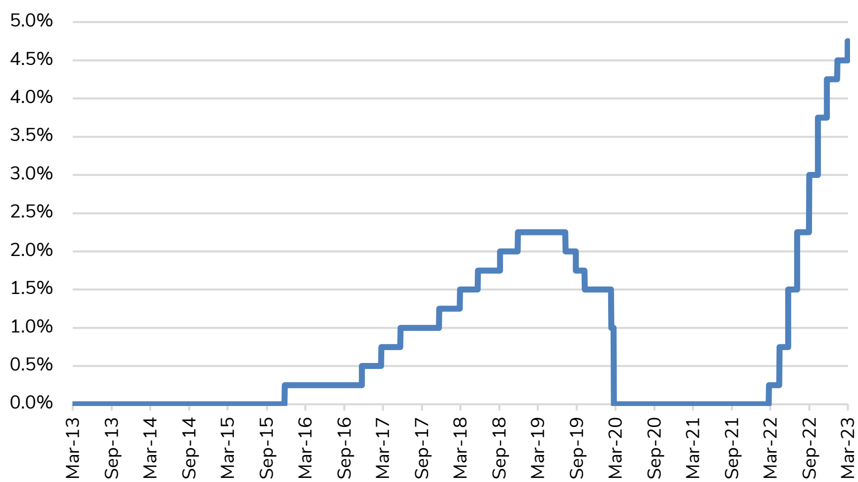
Quarterly Charts

Bank deposits increased dramatically due to government stimulus measures and Federal Reserve quantitative easing during the COVID crisis. While these deposits have declined as interest rates have risen and consumers have spent down their savings, they have yet to revert to the pre-COVID trend line they had been tracking.

Deposits, All U.S. Commercial Banks

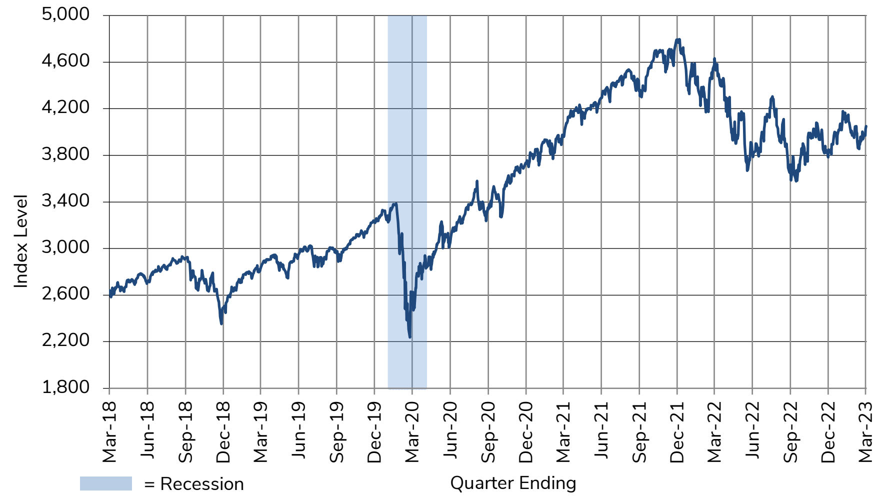


Federal Reserve Effective Rate (lower-bound)



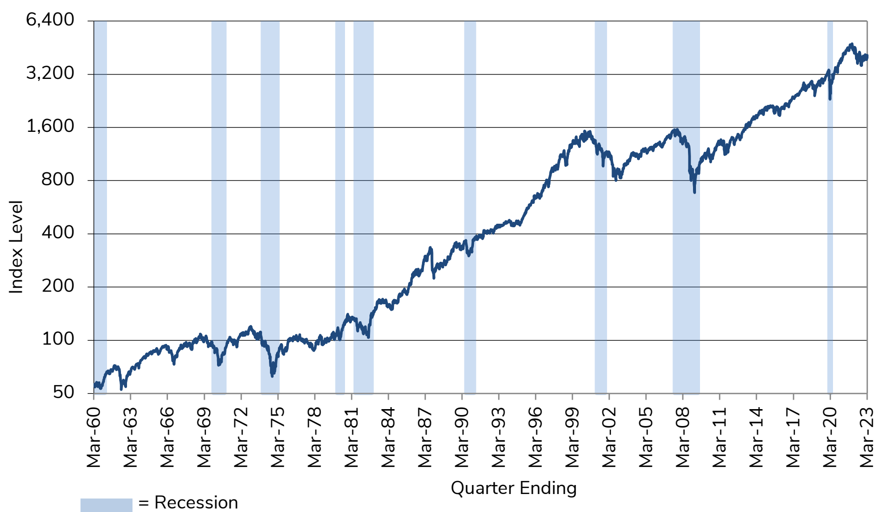
Part of the reason that deposits have been reduced across banks over the past year has been the rapid increase in interest rates by the Federal Reserve. Banks have been sluggish to increase deposit rates, leading customers to look for money-market funds or other short-term instruments yielding significantly more.

S&P 500 Index - 5 Years



During the first quarter, the winners and losers in the S&P 500 Index completely flipped, as growth stocks, specifically technology stocks, led the way over sectors that performed better in 2022, such as energy, healthcare, industrials, and utilities.

S&P 500 Index - Since 1960



As the market continues to look for direction, the Federal Reserve has hinted at the final rate hikes of this tightening cycle. If inflation continues to cool, there is the possibility of rate cuts later in 2023 or in 2024. Obviously, the rate of economic growth, influenced by the current bank crisis, will play a key part in their decision.

Know the Difference Between Assorted Federal Insurance Policies

The chaos that the banking sector experienced in March 2023 has led many individuals and small businesses to suddenly question the safety of their deposits and investments. In response, below is a quick summary of the different insurance policies available to depositors and investors.

Federal Deposit Insurance Corporation (FDIC)

This is the first program that typically comes to mind when considering deposit protection. Any federally or nationally chartered bank carries FDIC insurance, which protects each depositor up to $250,000 if the bank fails. Checking and savings accounts, and others such as money market accounts and CDs are covered by the FDIC at these banks. This insurance is backed by the full faith and credit of the United States government.

During the recent crisis, the Federal Reserve worked with the FDIC to insure all deposits for the two high-profile banks that failed, even over the $250,000 limit. This was a unique circumstance, designed to prevent a full-blown contagion, and one should not rely on a similar response in the future.

Separately, assets that are not covered by the FDIC include the contents of safe deposit boxes, life insurance policies, annuities, and investments.

Securities Investor Protection Corporation (SIPC)

This lesser-known program insures brokerage accounts up to $500,000 per account, including up to $250,000 in cash. It should be noted that this only protects the account in the event the broker fails or in the case of fraud. It does not protect against securities losing value. Many brokerages, like Charles Schwab, also hold "excess SIPC" coverage. At Charles Schwab, up to $150 million per customer (including up to $1.15 million in cash) is protected.

Importantly, brokerage firms are required to segregate client assets from firm assets, per the U.S. Securities and Exchange Commission's (SEC's) Customer Protection Rule. Segregated assets include stocks, bonds, mutual funds, and other investments such as money market funds. As a result, in the event of a brokerage failure, client assets are protected against creditors' claims. In most cases, investors would receive their securities in-kind rather than having to accept the equivalent cash value. Typically, accounts are fully transferred to another brokerage, without any change to the quantity of securities held.

In the current environment of higher interest rates, money market funds yield considerably more than most bank savings accounts. For this reason—and since money market funds are treated as securities—it may make fiscal sense for clients to invest excess cash in a money market fund (even a Treasury money market fund) in a brokerage account.

However, given the protections described above, cash in a checking account or brokerage account should still be considered a safer option than storing it under the mattress!

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