

QUARTERLY INSIGHT

MARKET UPDATE



STOCKS SHOW RESILIENCE AMID UNCERTAINTY

The S&P 500 gained 7% in the first quarter despite banking sector turmoil and economic anxiety. In typical fashion, early action reflected a reversal from themes that drove last years' markets. The tech sector showed significant strength after taking a massive hit in 2022. The tech-heavy Nasdaq Composite had its best quarter since 2020, gaining 17%. This was its largest outperformance against the Dow Jones Industrial Average since 2001.

On the other side, the energy sector led the way in 2022 but fell along with oil prices in the first quarter. In another reversal, interest rates declined during the quarter after spiking in 2022. The 10-year U.S. Treasury note yield declined to 3.49% from 3.83% at the end of 2022, its largest quarterly decline since 2020. The Barclays Aggregate Bond Index climbed 3.0% in the quarter, driven by bank failures and recession concerns.

BANK FAILURES SPOOK MARKETS

Multiple bank failures in March will be the most memorable aspect of early 2023. Early in the year the market had stabilized on the back of cooling inflation and decent economic data. Labor market and consumer spending trends were holding up well, and it seemed the Fed was reaching its goal of reducing inflation without breaking anything. That was all called into question as Silvergate, Silicon Valley Bank, and Signature Bank collapsed. All three failures were the result of classic bank runs with large amounts of deposits leaving all at once, which effectively breaks a fractional banking model where most deposits are not held as cash in a safe but lent out to borrowers.

DIFFERENCES FROM PAST BANKING CRISES

What is different from the 2008 financial crisis is there has not been a credit issue with the banks' collateral held against the deposits (the failures have not been from failed loans). Instead, these losses are largely the result of the inherent interest rate risks in the banks' investment portfolios. The U.S. Treasuries the banks hold on their balance sheet currently trade at a loss due to the rapid rise in interest rates since the bonds were purchased. When banks were forced to sell these positions to satisfy depositors' substantial demand for cash, they were forced to take losses, effectively wiping out equity value.

It's also important to note that U.S. Treasuries are much more stable and secure than questionable mortgage-backed securities held on the balance sheets of banks back in 2008 and 2009. In fact, the losses being incurred are effectively paper losses only, as these bonds will eventually mature at par value if held to maturity. In addition, the profile and concentration of the type of depositors were ripe for a run. An estimated 90% of depositors at Silicon Valley Bank, for example, held balances above the Federal Deposit Insurance Corporation (FDIC) \$250,000 insurance limit. The original government security blanket of \$250,000 provided little to no protection for most large customers.

2023:
FIRST
QUARTER

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TOTAL RETURNS

| | 1Q 2023 |
|----------------------------------|---------|
| S&P 500 | 7.5% |
| Dow Jones Industrial Average | 0.9% |
| NASDAQ | 17.1% |
| Russell 2000 | 2.7% |
| MSCI EAFE (International) | 8.5% |
| Barclays Aggregate Bond Index | 3.0% |

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MARKET UPDATE



The attention then turned to Credit Suisse Group and First Republic Bank as other banks, regulators and policymakers hurried to control the damage. The news drove massive outflows from traditional bank accounts into non-bank accounts and led to large inflows to other safe assets like money market funds.

WHAT WAS THE GOVERNMENT'S RESPONSE?

The U.S. government quickly realized that providing a back stop and a confidence boost for depositors was critical to quell the panic. The FDIC used the 'systemic risk exception' to protect uninsured depositors in Silicon Valley and Signature Bank. Deposits not covered by the banks' assets will be covered by the FDIC's deposit insurance fund. This means depositors in the banks will be made whole, although it does nothing for the equity value lost by shareholders.

In addition to this measure, the Federal Reserve and Treasury Department announced a lending facility (the Bank Term Funding Program – BTFP) to help prevent further issues. The program will provide advances against eligible collateral (Treasuries and Agency securities) for up to a year and, importantly, will value those bonds at par. This will help prevent other banks from having to realize losses on their securities portfolios to meet deposit redemptions, should they arise.

The banking situation seems to have been stabilized somewhat, at least for now. Apart from the banking news the economic data turned out to be less bad than feared, which explains the relative calm in the stock market. But questions about the stability of banks and the health of the broader economy are looming large over the market and will likely drive further volatility in the months ahead.

Q1 EARNINGS ARE NEXT UP

While investors watch and wait for the Fed's next move and developments in the banking sector, corporate earnings releases in coming weeks will provide evidence of how all this has affected profits. As of this writing the S&P 500 earnings are estimated to decline by 6.2% year over year in Q1. This follows a 3.4% contraction in Q4 of 2022. Materials, health care, tech, and communication services are the sectors expected to drive most of the decline, while consumer discretion and industrials are the sectors expected to drive the most growth. Macroeconomic softness and higher wage pressures are the largest headwinds to profits, but some easing in input costs, a resilient consumer, and a strong job market are expected to provide some support. With valuations still relatively elevated compared to historical averages, there isn't much margin for error for companies to disappoint.

MISMATCH BETWEEN MARKETS AND FED PROJECTIONS

As has occurred multiple times in recent years, markets are predicting a different path for interest rates this year than the

Fed. The Fed is projecting that it will hike rates one more time this year by a quarter of a percentage point to just above 5%. It then projects it will hold rates at that level for the remainder of the year. But derivatives markets are showing expectations that the Fed Funds rate will peak just below 5% in May, then drop to about 4.4% by the end of the year. This difference is likely due to the recent banking turmoil and market expectations for further economic slowdown in the months ahead.

Odds of recession have risen even though the economy has held up better than expected in recent quarters. Markets will be intensely focused on whether the Fed can engineer a "soft landing" that skirts recession. This has proven extremely difficult over the years. Recent headlines remind us that imbalances created in good times can manifest themselves quickly as tides turn. They also serve as further proof that our focus on quality and diversification must never waver. ●

INTEREST RATES & ASSET ALLOCATION



SHOULD HIGHER INTEREST RATES CHANGE OUR ASSET ALLOCATION?

Anyone who drives down a major highway these days can attest there is no shortage of billboards from banks advertising much more attractive yields on savings accounts and CDs. Obviously, the key driver for this major interest rate shift has been the Federal Reserve's aggressive rate tightening, which they used to battle the not-so-transitory inflation over the past 18 months. With a quick online search, it's pretty easy to find many banks offering one-year CDs paying between 4.5% and 5.0%+. In addition, money market funds at the largest custodians are currently paying between 4.5% and 5.0% depending on the amount of cash committed to the fund.

These rates seem like an attractive oasis of yield after our years of wandering in the desert with near 0% interest rates. So, at face value, it seems we're back to the good old days of lending banks some cash in return for healthy interest payments without having to endure the risk and volatility associated with equity and longer term fixed income investments.

WHAT'S THE REAL YIELD?

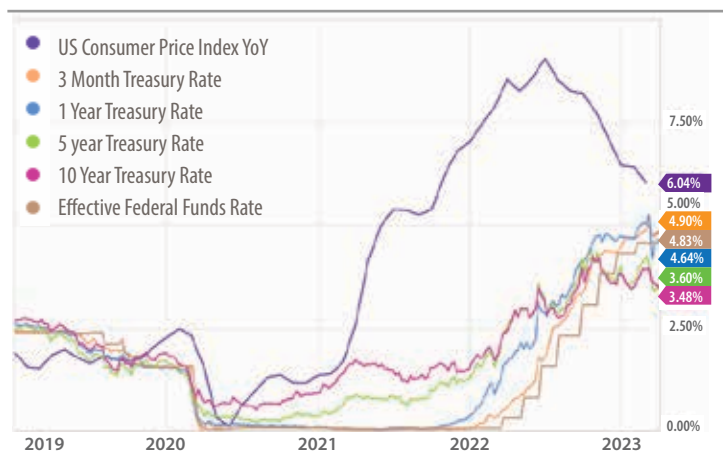
For many pre-retirees or current retirees, it can be tempting to consider these higher rates in the context of the "4% safe withdrawal rate" rule-of-thumb and think there's no longer a need to endure the roller coaster ride of volatility associated with equity and (more recently) fixed income investing. If an investor needs 4% from the portfolio, why not just invest in a combination of money market and CDs?

INTEREST RATES & ASSET ALLOCATION



The first problem is these rates are short term and variable. Money market rates are day to day and variable – tied to market interest rates for the shortest of fixed income securities. If the Fed were to lower rates for whatever reason, those juicy 4.5% yields would also be reduced in kind. Similarly, the short-term CD rates will expire when the CD matures, and if market interest rates are lower a year or two from now, those attractive rates will also no longer be available.

The bigger problem with this theory, of course, is that the interest rates we see on those billboards are “nominal” rates and do not factor in the deleterious effects of what are still elevated inflation rates. The chart below shows the 3-month, 1-year, 5-year, and 10-year treasury rates which are loose proxies for accompanying CD rates. (There are other differences like liquidity, FDIC insurance, etc. but we’ll keep it simple). For reference, the Fed Funds Rate is also shown. Obviously, the 6% inflation rate, even though it has retreated a bit, still dwarfs the rates being paid by US Treasuries and is still higher than the Fed Funds Rate. When we subtract the roughly 6% inflation, it’s clear the yield on a 1-year CD is not keeping pace with the loss in the value of those dollars if the CPI were to remain at the same level for the next 12 months. In reality, the “real rate” earned on that CD is -1% after backing out inflation.



INVESTMENT AND PLANNING IMPLICATIONS

An investment strategy can have many goals, but almost always the near-term top priority is to maintain purchasing power through growth exceeding inflation, which is also known as “real” growth. If the opposite occurs and inflation outpaces growth year after year, investors may have a false sense of security when, in reality, their lifestyle is actually being eroded. In real terms, price increases on investors’ spending are rising faster than the interest income is accruing.

This is where customized and personal situations must be factored into a the broader wealth plan as timeframe, growth

needs, risk appetite, and multi-generation goals are unique. Specifically, the CPI uses a “basket of goods” that are most commonly purchased by the broad population of US citizens. Obviously, people in different stages of life can have dramatically different spending needs.

For example, as of February 2023, “housing” comprised 34.4% of the weight of the CPI, but if a home is paid for or if the mortgage is locked in at a low fixed rate, the “inflation” on this component really wouldn’t apply. Similarly, the cost of education is another component, but the kids could be grown and education expense is no longer a consideration. Additionally, health care is about 7% of the CPI, which is obviously more impactful for retirees.

Clearly, the composition of spending before, during, and throughout retirement is very unique to each personal situation, and planning needs to factor in personal circumstances. In designing and maintaining an asset allocation, it’s critical to keep in mind:

1. The spending needs in the near term and the long term, to the extent that’s possible to know.
2. The asset allocation strategy must employ the core elements for balancing near-term liquidity (cash or money market reserves), growth (equities, historically the best inflation hedge), and stability (with fixed income, the ballast and buffer against inevitable stock market volatility).

Absent these foundational components of a portfolio, investors risk falling behind and losing purchasing power year after year, even at lower levels of inflation than today’s rates.

BOTTOM LINE

It’s tempting to think today’s higher rates are a free lunch to fund a retirement lifestyle. As the inflation chart shows, nothing could be further from the truth. While the decline in purchasing power certainly isn’t as explicitly noticeable as a decline in a portfolio’s value, inflation often acts as a silent thief, robbing one’s purchasing power. There are not many guarantees with investing, but one thing is certain: a portfolio that cannot keep pace or out-pace inflation is guaranteed to impact the ability to enjoy a multi-decade retirement. ●

Disclaimer: Any expectations presented should not be taken as a guarantee or other assurance as to future results. Our opinions are reflections of our best judgment at the time this presentation was created, and we disclaim any obligation to update or alter forward-looking statements as a result of new information, future events or otherwise. The material contained herein is based upon proprietary information and is provided purely for reference and as such is confidential and intended solely for those to whom it was provided by Johnson Investment Counsel.

PROMOTIONS

We are pleased to announce that these individuals have been promoted to new positions:

- > **Danielle Batchelder**
Sr. Trust Associate
- > **Gwen Burke, CFP®**
Associate Portfolio Manager
- > **Joe Carlo, CFP®**
Associate Portfolio Manager
- > **Zach Kaufman**
Senior Systems Analyst
- > **Lindsay Keith, CTFA**
Sr. Trust Officer
- > **Brandon Plumb, CFA, CFP®**
Associate Portfolio Manager
- > **Leah Quortrup, CTFA**
Trust Officer
- > **Diane Spitznagel, Esq., CTFA**
Sr. Trust Officer
- > **Christy Yost**
Equity Trading Manager



Batchelder



Burke



Carlo



Kaufman



Keith



Plumb



Quortrup



Spitznagel



Yost

NEW ADDITIONS TO THE TEAM

We are pleased to announce that these individuals have joined our team over the last several months:

- > **Andrea Ernst**
Portfolio Manager
- > **Christopher Gray**
Equity Research Associate
- > **Ashley Jenkins**
Digital Marketing Associate



Ernst



Gray



Jenkins



ABOUT US

Johnson Investment Counsel is one of the nation's largest independent wealth management firms, managing over \$16 billion in assets for clients in 49 states. Johnson Investment Counsel is an employee-owned firm, offering a full range of fee-only, integrated wealth management services, including: investment portfolios, education and retirement planning, cash management, estate planning, trust services, charitable giving, mutual funds, 401(k) plans, IRAs, and more. Johnson Investment Counsel has built strong, long-term relationships with individuals, families, charitable organizations, foundations, and corporations through four integrated divisions.

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LOCATIONS

CINCINNATI-KENWOOD
CINCINNATI-WEST
CLEVELAND-AKRON
COLUMBUS
DAYTON
METRO DETROIT

If you are a client of Johnson Investment Counsel, you should receive account statements on at least a quarterly basis directly from the qualified custodian that holds and maintains your assets. You are urged to carefully review all custodial statements for accuracy. If you are not receiving custodial statements, please contact our Chief Compliance Officer, Scott Bischoff at (513) 661-3100.

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