FORTHRIGHT PARTNERS, LLC

INVESTMENT LETTER, FIRST QUARTER 2023

EXECUTIVE SUMMARY

Doing the right thing is difficult, especially without the benefit of hindsight!

Financial markets will likely remain jittery in a slowing economy, contending with the looming debt ceiling deadline and an uncertain inflation path.

The investment landscape appears more benign for bonds than for stocks.

We prefer to stay with high-quality securities in both the bond and stock markets.

DOING THE RIGHT THING

In France, President Macron bypassed the Parliament to raise the retirement age from 62 to 64. From an economic standpoint, pension reforms are much needed as France already spends almost 15% of its GDP on pension benefits. With low birth rates and an aging population, the status quo is not sustainable.

This seemingly logical policy change, however, has been met with massive protests and the Macron government narrowly survived a vote of no confidence. Cutting benefits does not win votes. Kicking the can down the road is often a more popular and politically safer option than fixing the underlying problems; such is the dilemma of democracies.

"Between the polls and the short term, and the general interest of the country, I choose the general interest of the country."

Emmanuel Macron, President of France

HINDSIGHT IS 20/20

The Federal Reserve raised short-term interest rates <u>nine</u> times since last March, from 0% to 4.25% in the last three quarters of 2022 and another 0.5% thus far this year. The rapid rate hikes not only caused damage and volatility in the financial markets, they also led to unintended consequences such as the strong dollar and inflated commodity prices as discussed in our Third Quarter 2022 Investment Letter. Unfortunately, bank failures became yet another unintended consequence of rapidly rising interest rates.

We all had the displeasure of experiencing losses in our bond investments last year; the Bloomberg Aggregate Bond Index lost 13%. Banks also have large bond portfolios. When banks receive deposits, they keep some in cash for anticipated customer withdrawals, the rest is used to make loans and invest in bonds. Banks have considerable losses on the bonds they bought in the past three years. Who doesn't? 5-year government bonds now yield about 3.4% versus 1.7% in January 2020 and less than 0.5% during the pandemic. Was it imprudent to buy 5-year government bonds in 2020 when the world seemed to be falling apart?

Time Is Everything

Problems arise <u>if</u> banks are forced to sell investments at a loss to meet unexpected large withdrawals. Balance sheets and earnings take a hit and can quickly spiral into insolvency. If withdrawal patterns are more or less normal, it will give <u>time</u> for the previously-bought bonds to mature and for banks to reinvest the proceeds at today's higher yields. Silicon Valley Bank and Signature Bank did not have the luxury of time. As their start-up and crypto customers rushed to withdraw their uninsured deposits at the first signs of trouble, both banks failed withing 48 hours.

DID THE FEDERAL RESERVE DO THE RIGHT THING?

The swift collapse of Silicon Valley Bank and Signature Bank meant that overnight, the Federal Reserve's professed priority had shifted from slaying inflation to safeguarding the stability of the financial system. A week before the bank failures, Chairman Powell had signaled the possibility of a 0.5% hike in late-March due to stronger-than-expected job and inflation numbers. After the bank failures, the Federal Reserve took measures to increase liquidity in the banking system and proceeded to raise rates by only 0.25% on March 22nd. Even though the 0.25% increase was a consensus move, criticism abounded that the Federal Reserve's restrictive policy will overshoot to cause an unnecessarily steep recession.

Did the Federal Reserve do the right thing? Only time will tell, and it depends on who you ask.

The Federal Reserve and the Treasury certainly did the right thing by swiftly launching emergency liquidity programs and guaranteeing uninsured deposits to stop further bank runs, right? Yes, if the goal is to stabilize the financial system. Maybe not if you consider the potential consequences: rising deposit insurance costs, rewarding "bad" behavior…

Decision-making is not easy in a complex financial world where multiple moving and interconnected parts are to be considered. Doing the right thing, whatever that means, is easier said than done. Maybe generative artificial intelligence will come to the rescue in the not-too-distant future??

DAMNED IF YOU DO, DAMNED IF YOU DON'T

In our last investment letter, we wrote about the Federal Reserve's resolve to slay inflation versus the bond markets' expectation for the Central Bank to start lowering rates soon. The bond market "vigilantes" may prove right. The need to safeguard financial stability means that the Federal Reserve will unlikely raise interest rates much further. Tightening lending conditions resulting from the Silicon Valley/Signature Bank debacle may finally tip the economy into recession. However, given the Federal Reserve's inflation-fighting mandate, lowering rates before inflation goes back to the 2% target will likely imply some dire circumstances: A hard landing? financial contagion? Either case will be negative for the stock market.

If the bond market is wrong, i.e., the Federal Reserve will not lower interest rates soon, then interest rates will remain "higher for longer". This scenario probably portends a high inflation, low growth environment that is not as negative for stocks, but still challenging.

"It's not whether you're right or wrong that's important, but how much money you make when you're right and how much you lose when you're wrong."

George Soros

PORTFOLIO POSITIONING

We remain cautious as the macroeconomic environment has become even more uncertain in the aftermath of the banking crisis. The looming debt ceiling deadline will only add to market jitters. Even though our underweight position in stocks has not changed, we have been actively fine-tuning portfolios because of the recent market volatility.

We continue to favor dividend-paying companies with strong balance sheets. This strategy has hindered performance in the first quarter as the market was once again dominated by growth stocks (please see First Quarter Highlights for details). However, we are convinced this is a sound course of action in a low-growth, uncertain environment.

For bonds, we have been rewarded by not taking too much credit risks. High quality remains our mantra for both the bond and stock markets. 10-year interest rates moved meaningfully lower in March from 4% to 3.5%. We are still partial to shorter maturity bonds, preferring to wait for a clearer inflation (and therefore interest rate) outlook before buying longer-term issues.

As always, please do not hesitate to contact us if you have any questions.

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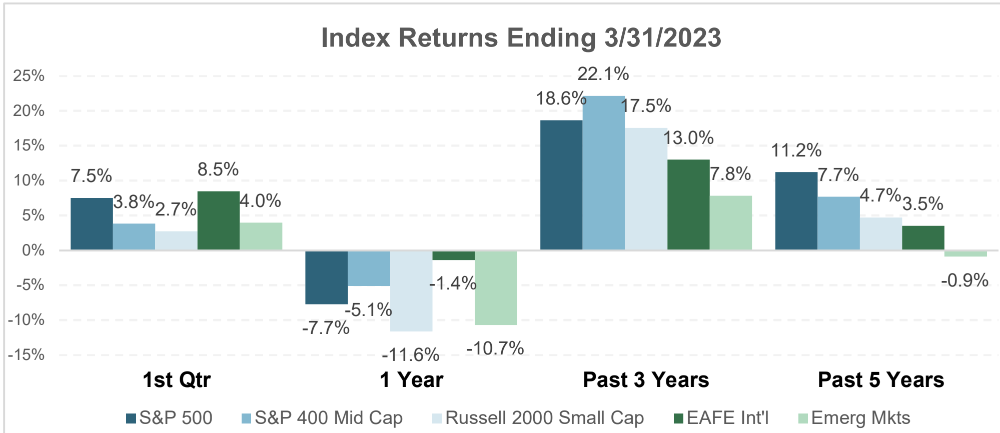
FIRST QUARTER 2023 MARKET HIGHLIGHTS

Stocks – Large Cap Growth Stocks are Beautiful (again)



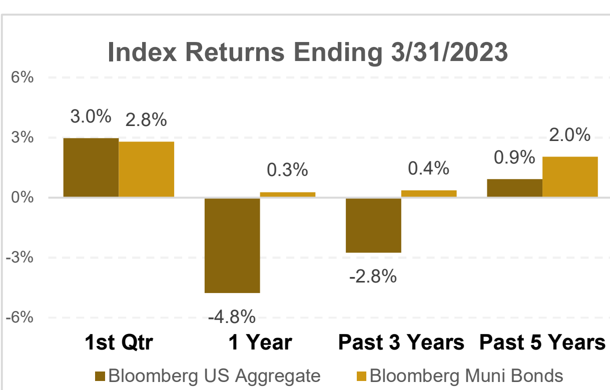
- Stocks remain volatile but have shown remarkable resilience as all commonly-followed benchmarks posted gains in spite of the banking crisis.
- Small and mid-cap stocks did not do as well due to fears of credit tightening.
- The S&P 500's first quarter gains of 7.5% were very narrow. Seven stocks, all 2020 darlings (Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia and Tesla) accounted for ~80% of the gains.
- Value stocks underperformed by a large margin primarily because of the weakness of financial stocks. The Russell 100 Value Index gained only 1% in the first quarter, versus over 14% for the Russell 1000 Growth Index.
- International stocks fared best in the last three months. Emerging markets did better than US mid-cap and small cap stocks. Valuation of overseas stocks remains attractive.

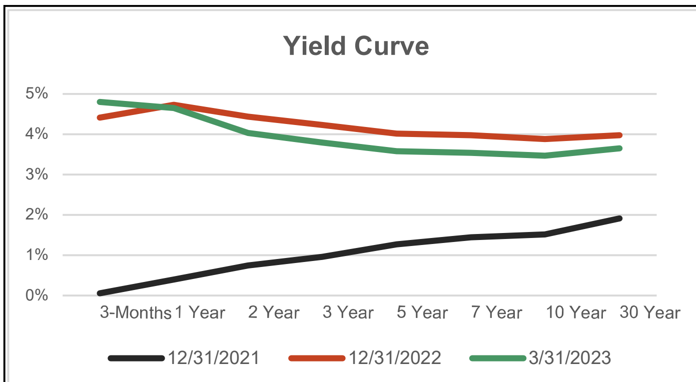
Bonds – Expect the Unexpected

- The bond market was just as volatile as the stock market. Bond prices jumped in January as investors expected interest rates to be lowered soon, only to see all the gains evaporate in February when economic and inflation data came in stronger-than-expected. March saw bond prices rising sharply again, as investors sought safety when the banking crisis unfolded. The 2-year Treasury yields dropped from 5% to 4% in 3 weeks.

	2 Year Bond Yield
12/30/2022	4.41%
2/1/2023	4.09%
3/8/2023	5.05%
3/31/2023	4.06%

- Taxable and municipal bonds posted a 3% gain in the first quarter, providing relief to bond investors who saw large losses in 2022. However, 1- and 3-year trailing returns remain uncharactiscally anemic.





- Remember the good old days when interest rates were near zero and mortgage rates were at 3%? That was only 15 months ago,
- Now, short-term rates are around 5% and no one wants to talk about mortgage rates. The bad news is the economy may finally tip into recession. The good news is, the worst days are likely behind for bond investors. Returns should be solid going forward, especially if one sticks to high-quality issues.