April 12, 2023

Hang on Tight

Dear Investor:

The earnings for the SP500 went up approximately $10 in 2022, from around $208 in 2021 to $218 in 2022. While an advance of 4.8% is not real exciting, it shows me that companies were able to withstand the high inflation and rising interest rates of 2022. It took a lot of work by executives as they wrestled with rising input costs, higher labor costs, shortages of materials, and higher interest costs, to name a few. Fortunately, consumers still had money to spend, so the economy stayed above water. In fact, it grew at a 2.6% rate and ended the year at $26.1 trillion. Although earnings actually advanced, the market, as measured by the SP500, came down over 18% for the year as sky high P/E ratios declined from over 21.0 at the beginning of the year to 16.7 by the end of the year.

While the market has come up nicely in the first quarter of this year, I wouldn't put too much stock in it yet. The move has been almost entirely in the growth stocks, which were down over 30% last year. Also, and more important in my opinion, we are seeing substantial expansion in the Forward P/E ratio once again. Factset, a major and respected provider of information to the industry, is estimating that earnings will decline -6.8% in the first quarter of this year. They are also expecting a decline in Q2, and then some growth in Q3 and Q4. Putting it all together, they look for earnings growth of only 1.2% this year. The Fed is currently predicting that the economy will have real GDP growth of 0.4% in 2023. It doesn't make a lot of sense to me that P/E ratios would be rising in that kind of scenario. Many people think the market is already looking past this year and focusing on substantial expected improvement in 2024. That could be the case.

The Fed has currently projected that they expect interest rate increases to end very soon in the range of 5.0% to 5.25%. Incoming data could always change that. Predictions wobbled when Silicon Valley Bank (SVB) was taken over by the FDIC in March. The Fed wrestled with the idea of a pause, but in the end pressed forward with another 0.25% increase. I read several detailed reports of what happened at SVB and was convinced it was bad management on their part, and it did not indicate our banking system was on the verge of collapse. SVB had been warned over a year ago that the risks in their portfolio were out of balance and they needed to make changes. Apparently, they did not take significant action. There are probably some other banks that need to make changes to get their house in order, but I don't think the US banking system as a whole is on the verge of failure.

While looking into the problems with the banks, I came across some interesting information to pass along. Most of us have at least some money in checking and savings accounts that are insured by the FDIC up to $250,000. Perhaps at some time or other, you may have wondered how much does the

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FDIC have in assets to make good on this insurance? As of December 31, 2022 the answer was $128.2 billion. A chart produced by Ed Yardeni shows that last year there was $7.4 trillion in Insured Deposits at FDIC institutions. Uninsured Deposits came in at over $10.5 trillion, for total deposits of around $18 trillion. You can easily see that runs on the banks have to be prevented at all cost. It's not that the banks are bad, it's the reality that if everyone wants their money at the same time, it's an impossible situation. A lot of that money has been loaned out, and the rest has been invested. There is no way they can get their hands on it all at once, it's impossible. The FDIC paid out $20 billion from their $128.2 billion fund to make ALL the depositors of SVB whole. They covered the Insured Deposits and the Uninsured Deposits. The FDIC is backed by the Treasury, and the Treasury is backed by the Federal Reserve and their ability to create money out of thin air. Thus, you can see just how badly a severe bank run could end. If the Fed had to bail out trillions of dollars in deposits, we could have the kind of hyperinflation you see in third world countries from time to time.

There will be a lot of discussion of moral hazard coming out of this incident. I think most sophisticated people realize that the game has already changed and Uninsured Depositors are likely to be made whole. We need to find some practical solutions to this problem as larger businesses need to have millions of dollars available at any moment in time. Raising FDIC coverage to $500,000 or $1 million would be fine for us average citizens, but it would do nothing to help business. In the case of SVB, I think it's important to clarify that SVB depositors were made whole, not the bank. The bank has been liquidated and is out of business.

Inflation is continuing to slowly decline. This morning's release showed CPI at 5.0% and core inflation at 5.6% for the last 12 months. The Fed is currently projecting inflation to be in the low 3% range by the end of the year. That seems possible with the downward trend we are on. The futures market is predicting a 65% probability that there will be another rate increase in May. The odds of rates going higher after that are low. We may be very near the end of rate increases. I believe that will set the stage for markets to begin to recover. I'm still confident that most of this current correction is behind us and we will be doing better soon. Please contact us anytime with questions or to review your portfolio.

Best Regards,

David E. Keim

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