MH & ASSOCIATES • SECURITIES MANAGEMENT CORPORATION

INVESTMENT VIEWS

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BANKING CRISIS AND WHAT IS NEXT

In early March, the Federal Reserve was continuing it's aggressive fight to bring down inflation, with Chairman Powell threatening to raise rates much higher. Yet, the next day investors began to hear about problems at Silicon Valley Bank (SIVB), a bank that specialized in lending to technology companies. Days later SIVB was closed, and the status of depositor funds was in question, sparking bank runs across the country. Authorities eventually resolved the immediate crisis, and all deposits were guaranteed. However, the crisis then quickly claimed another victim, this time across the ocean in Europe as Credit Suisse collapsed and was purchased by UBS in a deal brokered by the Swiss National Bank.

While certainly some of the blame lies with the management teams at these banks, we also highlight the very aggressive rate rise actions taken by the Fed. As we have written before, the Fed moved far too quickly and aggressively in raising interest rates, willing to risk "breaking something" in order to bring inflation down. Well, the Fed has succeeded and now finds itself in a precarious situation as surely there are other institutions that are vulnerable, yet it continues to insist that inflation must be dealt with.

To be clear, there is nothing wrong with raising rates, it is more a matter of pace. After all, we have lived in a low interest rate environment for over a decade with the Fed increasing the benchmark interest rate from nearly 0% to 5% in the space of a little more than a year. This banking crisis did not come out of nowhere; it is squarely the result of the Fed's aggressive actions. We are now watching to see what measures are put in place to protect depositors from sudden problems at other banks down the road. While we do believe that another failure is unlikely, something needs to be done to stem the flow of deposits out of the banks to higher yielding vehicles. If this continues, lending (the life blood of the economy) will pull back considerably.

Tighter Spread Between Risk Free Rates and Deposits Needed

To shore up the current issues either the Federal Reserve needs cut rates or banks need to raise the amount of interest they pay on deposits. The former hurts the inflation fight, while the latter will weigh on bank profitability. The Fed has indicated a slowing of the pace of rate hikes, but is still voices a hawish tone. Inflation appears to be waning, so perhaps rates can be held in place or even lowered late in the year. In the long run, banking will never be the same as there has been a structural change due to technology and the hypermobility of deposits and it has made banks more vulnerable to runs.

STOCKS ARE NOT BANK DEPOSITS

Many investors became concerned about the safety of their investment holdings at various brokers as the banking crisis played out. We would like to remind our readers that stocks, bonds and other securities are not like bank deposits, which are lent out to borrowers to be repaid over time. Financial industry regulations require the strict segregation of broker and client assets, with custody of the assets being at a third part institution. In the unlikely event of a broker failure all customer assets would simply be moved to a successor firm.

PRECIOUS METALS WAKE UP

Gold and silver have had surprisingly strong runs this past month, with the shiny, yellow metal itself climbing nearly $200 per ounce in March alone. Investors sought the safety of these monetary metals as the banking crisis discussed above broke out and possibly also as a hedge against higher inflation. We note that the Federal Reserve under pressure to "pause" or "pivot" in their rate hike plans, which in either case will likely push gold and silver higher.

NOTHING MAGICAL ABOUT 2% INFLATION

The Federal Reserve System has a dual mandate, given by Congress, of pursuing maximum employment and price stability. The Fed determined that it wants to achieve "stable prices" using a 2% inflation target. This target is relatively new in the US and was officially made the standard in 2012 and is now used by central banks in most western countries. We note that prior to 2021, the low level of inflation was a real concern, with the Fed trying to get inflation above 2% for nearly 10 years.

Economists generally agree that some amount of inflation is helpful in our high debt society but why 2%---why not 3 or 4%. It turns out the 2% is arbitrary and is based on no economic evidence. Rather it is believed that it is a number that is easy for everyone to tolerate. Interestingly, it is thought to have been first discussed by a New Zealand finance minster in the 1980's during a TV interview.

Thus, we have the Federal Reserve embarking on aggressive tightening policy not knowing whether their arbitrary target is correct and along the way possibly causing unacceptable economic pain.

ENERGY STOCKS

Energy stocks had a stellar 2022 performance but have been largely sitting out the recent market rally as the price of oil declined. In fact, the current rally was sparked on the decline in oil prices with a view that inflation may be declining. In our view, the fall in oil prices was mostly artificial due to the release by the administration of additional oil from the SPR (Strategic Petroleum Reserve) in its quest to drive down the inflation numbers.

We are still very positive on the energy sector and have recently added an oil service company to our portfolio. We expect oil prices to rise in the coming months as seasonal demand increases in the spring, the SPR releases ends and China's reopening post Covid lockdowns is expected to fuel oil demand.

TECHNICALLY *Speaking*

Below is a chart of the S&P 500 going back to the Credit Crisis of 2008-2009. This period acted as a great reset for the chart and the beginning place for trendlines to be drawn. A couple things emerge right away. The middle of the trend tends to be touched every three years or so. It was established with the low in 2012 and touched it again in 2016, then 2019 and it is doing so again. While we have certainly been in a bear market for the past year, breaking below this line would be a bad sign and might propel the market back towards the lower trendline around 3200. A key item to watch is the bottom panel, which is the percent of stocks in the he S&P 500 that are trading above their 200-day moving average. When this is above 50 (as it is now) that is bullish. While this does move around quite a lot, you can see one it breaks back above 50 percent, it tends to stay there for a relatively long period. Breaks below tend to be more short lived.

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