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KREITLER FINANCIAL INSIGHTS

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MARKET UPDATE Q1

Recent news has been dominated with challenges in the banking sector. Silicon Valley Bank, followed by Signature Bank, made headlines as the first major failures since the 2008 great financial crisis. Rumors about other banks swirled before the Federal Reserve stepped in to calm the markets. Stock markets remained relatively calm.

While the temptation is to dive into the detail of the news of the day, we think it's important to "zoom out" to review its context in the bigger picture.

CPI Inflation, which peaked in June 2022 at 9.1% (Source: YCHARTS) and as of March 31, 2023 had fallen to 5.0% (Source: YCHARTS), remains an issue. This was the result of the tremendous stimulus and supply issues associated with the Covid-19 pandemic relief response. High inflation pushed the Federal Reserve to begin raising interest rates. The Federal Funds rate, which had been at 0% as recently as January 2022, was increased by March 2023 to 5%. (Source: YCHARTS)

Higher interest rates have the effect of slowing economic activity.

Businesses become more careful about borrowing money to fund investment. Consumers may downsize or delay major purchases such as cars and homes. The effect spreads through the entire economy, one individual decision at a time. To the extent that it cools rising prices (i.e. inflation), this is positive. However, it may also slow or even stop economic growth, resulting in a recession. The Federal reserve may hope to achieve a

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MARKET UPDATE Q1

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Goldilocks outcome of cooling inflation without a recession, but this is difficult to accomplish.

Markets have responded to the rate increases with mixed reactions. Short-term interest rates climbed following the Fed's rate hikes. As of March 31, the yield on a 2-year Treasury stood at 4.1% (Source: YCHARTS). However, long-term interest rates, which generally reflect the market's overall opinion on long-term growth and inflation, have not increased as much and remained at a lower level. For example, a 10-year Treasury on March 31 yielded 3.5% (Source: YCHARTS). The result is what economists call an "inverted" yield curve.

This admittedly over-simplified summary brings us back to banking. Lenders can find themselves in trouble in a situation when this occurs. Over the last several years with mortgage rates at very low levels, money was lent over 15- and 30-year terms at interest rates as low as 2% to 3%. When banks borrow in the short-term markets in order to fund long-term loans, and short-term rates climbed to levels above 4%, this inversion means that any bank that owned these low-interest mortgages could be paying more to depositors than it collected in interest. This is a recipe for losses.

Warren Buffett famously said "It's only when the tide goes out that you learn who's been swimming naked." [Chairman's Letter - 1992 (berkshirehathaway.com)] No business can operate at a loss indefinitely. When depositors asked for their funds, Silicone Valley Bank found it could not sell its mortgage holdings quickly enough. The Federal Reserve had to step in to maintain order.

What other business models face pressure if borrowing costs increase? Real estate could be one if refinancing debt on buildings must be done at higher interest rates. Other businesses may be dependent on cheap rates in order to maintain profitability. When the interest rate increase cycle started, we observed that there may be some businesses that struggle. his has been the first evidence that we've seen that this in this cycle. In the context of the bigger picture, this is the pattern that has happened in other rate hikes cycles as well and should not be a surprise. This is the reason investors need to diversify portfolios to manage the risk of a single investment turning against them.

Markets often move lower in anticipation of a potential economic recession and may move higher before recessions end. Last year, the stock market declined in anticipation of a potential economic recession and decrease in company profits. This is because financial markets are forward looking. Despite two of the largest bank failures in history, stocks and bonds as measured by the S&P 500 and U.S. Bloomberg Aggregate Bond index posted positive performance year-to-date ending March 31st.

Asset Class	Index	Year to Date Total Returns
US Stocks	S&P 500 Total Return	7.5%
	Russell 2000	2.7%
Foreign Stocks	MSCI Emerging Markets	4.0%
	MSCI EAFE	8.6%
US Bonds	Bloomberg US Aggregate Bond	3.0%

*Source YCharts Returns as of March 31, 2023

Better days may be ahead for the financial markets, but investors should stay disciplined in their long-term plans and prepare for expected volatility and further declines in the market. Maintaining ones long term positioning means managing liquidity to deal with both planned and unplanned short-term expenses. We encourage you to read our piece on Liquidity and Cash Management for additional thoughts on this.

LIQUIDITY AND CASH MANAGEMENT BEST PRACTICES

When Silicon Valley Bank was taken over by federal regulators, cash instantly became a topic of conversation.

Thankfully, we have come a long way since the banking crisis of 1931 saw runs on banks, cash hoarding, and deflation that were hallmarks of the Great Depression. The Banking Act of 1933, also known as Glass-Steagall, separated investment banking from commercial banking and created the Federal Deposit Insurance Corporation, or FDIC. {Banking Panics of 1930-31 | Federal Reserve History} [Banking Act of 1933 (Glass-Steagall) | Federal Reserve History] Subsequent acts in the years since further regulated how banks could invest to limit risks to deposit holders.

In this piece, we're going to share a brief overview of how we view liquidity and cash management based on different time horizons, return objectives, and risks.
Investors need to consider two different questions when they're thinking about cash management:

1. How secure is my money?
2. When will I need access to my money?
3. What yield or return will I receive over the period that I hold it?

Question number one (security), is very important. How secure is the organization that holds my money? Are they dependent on others if I want my money and it needs to be repaid by a counterparty? Are the assets fixed or volatile in price? Thankfully, the FDIC now helps stabilize the banking system by insuring bank account deposits up to $250,000.

Question number two (time horizon) is also important. Do I need immediate access to my cash? If so, I may need to accept a lower interest rate than if I am willing to give up some liquidity and delay when I can access it.

Question number three (yield) can be a little confusing. In normal times, securities with longer terms tend to have higher interest rates than those with shorter terms or cash. Cash and fixed income assets that are considered safer will have lower interest rates than those that are riskier and therefore need to compensate their holder more.

In times of economic uncertainty, sometimes this relationship can switch resulting in what is known as an ‘inverted yield curve’ when short term bonds pay more than long term bonds. This occurred in 2022. To illustrate this, as of March 31, a 2-year Treasury note had a higher yield at 4.1% than a 10-year Treasury bond at 3.5% (Source: YCHARTS). More often this relationship is the reverse, with the long-term bond paying more than the short-term one.

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Conversely, a 10-year Treasury has a longer term or period with the stated yield. Held to maturity, a 4% treasury will return 4% (plus the potential return on interest reinvested at whatever future yields are) for the entire investment.

This is the investor's dilemma in an inverted yield curve. If yields drop, the 10-year bond will go up in price. This is the opposite of what occurred in 2022. On the other hand, if yields drop, the short-term securities will simply have a lower return, so how should an investor think about this?

At Kreitler Financial, our approach has been to think about the needs for cash and align the investments to those specific needs.

Bank Cash—Short term needs:
For short term needs, we generally use a bank account or brokerage account's bank cash option. The rates on these accounts are generally low, but the tradeoff is the cash cannot go down in value. Up to $250,000 can be protected by FDIC insurance. Some deposit programs use multiple banks to increase this amount. Your money is generally available immediately, although some banks may require several days to transfer money to other. We generally prefer to keep this simple and use a basic checking account to manage day to day or immediate cash needs.

Money Market Funds - Intermediate term needs
If you don't need immediate access to funds, you have more options. One option is to use money market funds. These are a type of security that owns very short term loans measured in days and issued by governments or corporations.

There are different types of money funds. Money market funds do not have FDIC insurance, so unless there is a big difference in yield, we generally prefer government money market funds. Government money market funds are required to keep the net asset value of each share at $1 (i.e. not fall in value). Their rates vary but are currently about 4.7% as of March (Source: Fidelity Investment Research).

There are also tax-free money markets that own municipal securities and prime money markets that may own corporate debt. While they are managed to avoid losing value, it is possible.

You must trade money market funds in order to buy or sell them. Liquidity is generally in a few days. Because we hold these for liquidity, we prefer money market funds to CDs that may lock you in. Rates are dependent on market conditions can change very quickly.

Bonds - Longer-term needs
We like to have liquid funds for future expenses, not just the short term. When the time horizon of those expenses grows longer, we often prefer fixed income or bonds. There are many types of bonds, and a description of them is beyond the scope of this summary. Generally speaking, bonds have a principal value (how much I buy), an interest rate (the income I will receive while I hold it), and a term (when the bond will be paid back to me).

Bonds may fluctuate in price while they are held, and longer-term bonds move more in price than shorter term bonds on the same interest rate change.

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They are held in a portfolio to try and capture a better long-term return than cash. Typically longer term bonds can be held for expected expenses that are farther away, and shorter-term bonds are held for nearer term expenses.

The inflation wrench in the works - real returns

All of these rates come with a big caveat, inflation.

If an investor received a hypothetical 4% yield, but inflation is 6%, their return after inflation or "real return" is approximately -2%.

This is the catch. The safety of cash comes at a price. While I avoid market volatility, if my real return after inflation is negative, I'm guaranteeing myself a loss in the value of my capital.

With CPI inflation at 5.0%. as of March 31, this is a real concern for savers today.

We believe greatest risk a person faces is not volatility but the risk they run out of money. Cash and other conservative assets should be held in proportion to your overall long-term strategy along with other assets such as stocks, bonds, or real estate.

We welcome any questions you have about your particular situation.

KREITLER FINANCIAL IN REAL TIME

Curling with Team Kreitler Financial

There's nothing quite like building team camraderie with a good curling match. Jake shared his love for curling with a successful and very cool, friendly out of office experience.

From left to right: Jake, Dwayne, Bernadette, Beau, Charlie, Alyse, Sandy, Bob, Michelle, Amy, Kersti

SPRING IS OUTDOORS!

Here are some suggestions on how to make the most of Spring from realsimple.com

- See the cherry blossoms
- Start some seeds
- Ride a bike
- Enjoy the Spring weather at an outdoor cafe
- Play a round of golf (or mini golf)
- Go horseback riding
- Hit the pickleball court

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203-867-4396
kreitlerfinancial.com

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