BlackDiamond Financial

INVESTMENT INSIGHTS

FIRST QUARTER 2023

Market Update

- Banking Turmoil Creates Uncertainty for Investors
- Federal Rescue Reinforces Banking Stability
- Stock Valuations Remain Above Historical Averages

Banking Turmoil Creates Uncertainty for Investors

The Fed raised interest rates nine times this past year to combat inflation resulting in a cumulative increase of 4.75%. The Fed funds rate is now the highest it has been since 2007.

Financial conditions tightened meaningfully during the first quarter. The most notable impact of rapidly rising rates was the second and third largest bank failures in U.S. history. On March 10th, Silicon Valley Bank was closed by regulators after depositors lost confidence in the bank and rushed to withdraw their funds. Two days later, Signature Bank followed suit. Concern spread throughout regional banking stocks, which declined 29% in March.

Both the Treasury and the Fed moved swiftly to ensure stability in the banking system through deposit guarantees and added liquidity. Equity investors responded positively and pushed stock prices up this quarter as investors largely view the banking turmoil as contained. That said, the shock to banks will tighten availability of credit, particularly to small businesses, further dampening economic growth.

Today, the economy is stable. Job growth remains healthy, consumer spending is rising modestly, and home prices are only down marginally from their peak.

What comes next remains in question. The bond market suggests that the Federal Reserve will need to cut interest rates by one percent this year to respond to a looming recession. Equity analysts are more optimistic with projected corporate earnings growth of 1.5% in 2023 and 12% in 2024.

Financial markets face a number of obstacles over the remainder of the year. Despite the uncertainty, the stock market is priced modestly above long-term average valuation multiples, including a forward P/E of 18.4x. We continue to believe that stocks will thrive over the long-term. We also believe taking a cautious approach to public equities is prudent near-term and find the nearly 5% yields offered in short-term U.S. government backed treasury securities to be attractive.

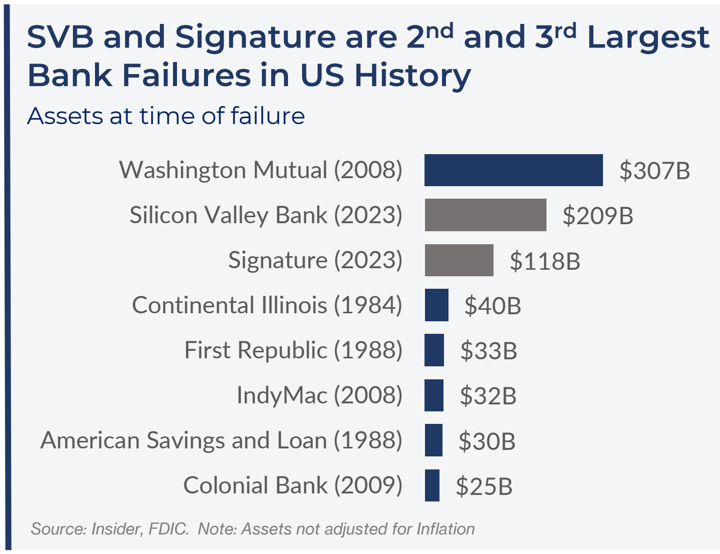
Comparative Returns

		Annualized Performance			
	Q1 2023	1 Year	3 Years	5 Years	10 Years
Large Cap U.S. Stocks[1]	7.5%	(7.7%)	18.6%	11.2%	12.2%
Small Cap U.S. Stocks[2]	2.7%	(11.6%)	17.5%	4.7%	8.0%
International Stocks[3]	6.9%	(5.1%)	11.8%	2.5%	4.2%
Real Estate[4]	2.4%	(20.2%)	10.8%	4.8%	4.7%
U.S. Bonds[5]	3.0%	(4.8%)	(2.8%)	0.9%	1.4%

1 S&P 500 index. 2 Russell 2000. 3 MSCI ACWI ex-U.S. index. 4 MSCI U.S. REIT index. 5 Bloomberg Barclays Aggregate Bond index.

Bank Failures May Dampen Economic Growth

The most notable impact of rapidly rising rates was the second and third largest bank failures in U.S. history. On March 10th, Silicon Valley Bank (SVB) was closed by regulators after depositors lost confidence and withdrew funds. Two days later, Signature Bank followed suit.



The key mistake bankers made was mismatching assets and liabilities. SVB invested over 50% of its customer deposits into treasury and agency securities with maturities exceeding five years. Bond values and interest rates have an inverse relationship, thus rapidly rising interest rates caused declines in the value of the bonds the bank held.

SVB's business model was highly differentiated among banks in that it primarily supported technology companies. Out of the $173 billion of customer deposits held at SVB at the end of 2022, $152 billion were reportedly uninsured (i.e., over the $250,000 FDIC insurance threshold).

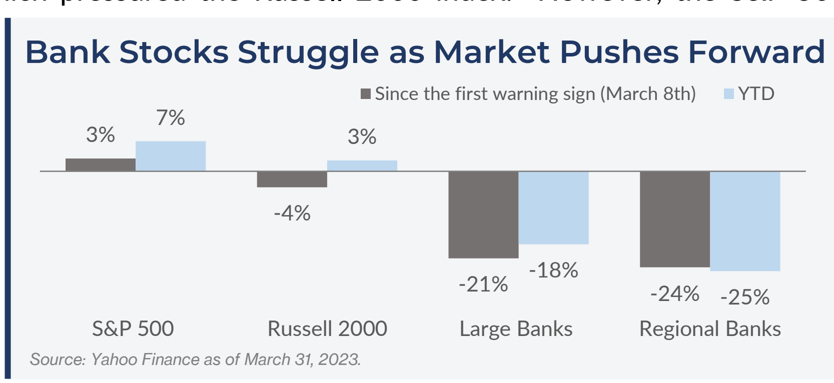
Stagnating business conditions for technology-oriented businesses caused many clients to withdraw deposits to fund operations. This forced the sale of some of the bonds SVB held at a loss to generate cash for customer withdrawals. As the losses grew, SVB tried unsuccessfully to raise capital, which subsequently led to a wave of clients asking for their money back and regulators taking over the company. The estimated cost to the Deposit Insurance Fund is $20 billion.

Across the Atlantic, another already weak bank, Credit Suisse, was forced into a sale to UBS. The deal was brokered by the Swiss National Bank to stabilize the global investment bank.

Banking Stocks Under Pressure

As investor concerns spread, bank stocks declined substantially in March. Regional banks were hit especially hard, which pressured the Russell 2000 index. However, the S&P 500 index of large companies was little impacted and produced positive returns.

Ultimately, the shock to banks will tighten lending standards, reduce the availability of credit to small business and further dampen economic growth.



Federal Rescue Reinforces Banking Stability

Following the collapse of Silicon Valley Bank (SVB) and Signature Bank, the Treasury and the Fed quickly introduced a new tool to provide liquidity and shore up confidence in the banking sector. The newly created Bank Term Funding Program offers one-year fixed rate loans to banks who pledge collateral such as U.S. Treasuries, agency debt and mortgage-backed securities. Banks can then use these borrowings to make new loans or to fund depositor withdrawals. This funding mechanism will allow banks to avoid selling the pledged collateral at a loss, which led to the demise of SVB.

Brokerage Firms Provide Substantial Investor Protections

The SEC's Customer Protection Rule provides a significant investor safeguard by requiring customer assets and broker assets to be segregated. In the event of a broker's insolvency, customer assets are completely separate from firm assets and protected against all creditor claims. Another investor safeguard, the Securities Investor Protection Corporation (SIPC), provides up to $500,000 of insurance per account type when a brokerage firm becomes insolvent and illegally removes assets from customer accounts.

Stock Valuations Remain Above Historical Averages

Recent bank failures will tighten the availability of credit and may further dampen economic growth. Wall street analysts project earnings growth for the S&P 500 to be 1% for 2023 and 12% for 2024. Earnings growth is the primary driver of stock returns and will significantly impact the trajectory of stock prices. The anticipated growth next year remains in question given that bond market prices indicate that a recession is likely.

Despite the uncertainty, the stock market is priced above long-term average valuation multiples. The current S&P 500 price-to-earnings (P/E) multiple of 18.4x indicates that markets are modestly overvalued by historical standards. The market is likely beginning to account for the estimated 12% earnings growth in 2024, which implies a 16.3x P/E multiple.

We continue to believe that stocks will thrive over the long-term. However, caution is prudent near-term as the economy remains unstable. We currently find the nearly 5% "risk free" yield offered in short-term U.S. government backed Treasury securities attractive.

Historical Valuation Multiples

S&P 500 NTM P/E Multiple

Source: J.P. Morgan, Refinitiv as of March 31, 2023.

ABOUT US

Black Diamond Financial, LLC is a fee-only registered investment adviser with a unique and holistic focus on preserving and enhancing wealth. Our mission is to help you achieve your financial goals through the use of low cost, tax-efficient investment strategies. We create individualized investment portfolios for each client that are risk-appropriate, returns optimized, and tax-efficient. Where appropriate, we incorporate institutional quality private investments to capture illiquidity premiums or yield opportunities. Furthermore, we believe cost is a critical factor in any successful investment strategy and therefore offer fully transparent pricing that is well-below industry standard. As an employee-owned firm focused on our fiduciary duty, we make our clients' interests our highest priority.

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