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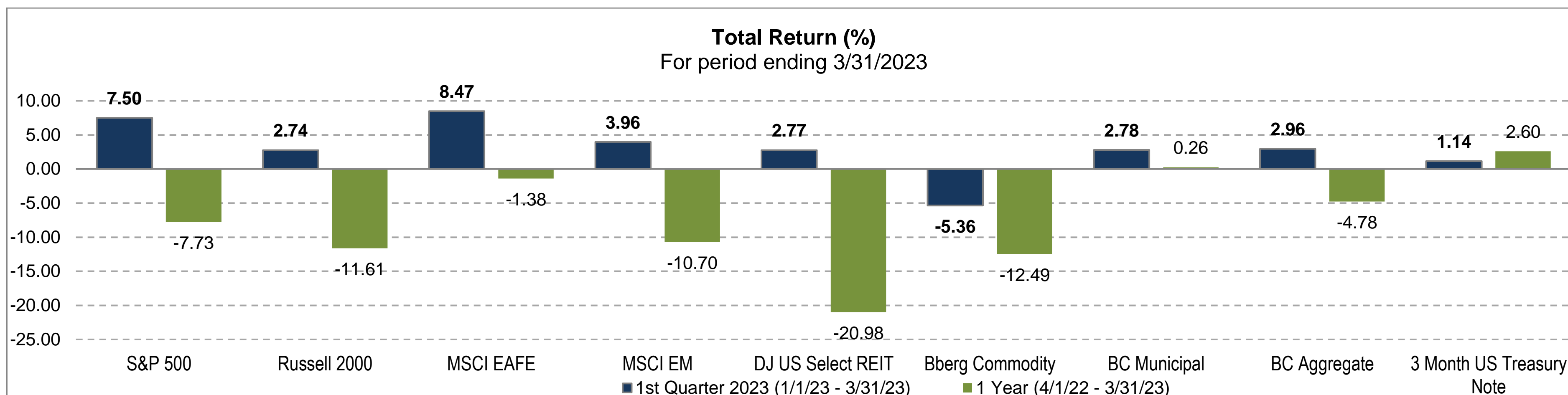
Wealth Management

No Peaks, No Valleys: Sage Advice From My Father

Schneider Downs Wealth Management Advisors, LP

Q1 2023 Market Commentary



My father told me that it would happen to me eventually; there would come a day in my life/career where I would feel "old." Like most things he said to me when he dropped me off in Chicago in 2005 to start my career, this statement all would eventually come true.[1] I bring this piece of sage advice because just like in 2005, cash is now a viable, reasonable returning, and dare I say it – attractive asset. Over the past 14 months, as the U.S. Federal Reserve has rapidly raised interest rates, yields on short-term U.S. Treasury bills, Bank Certificates of Deposits (CDs), purchased money market funds, and yes, even some (heavy emphasis on the some) regular checking and savings accounts have steadily risen. Yields on short-term instruments[2] are the highest they have been since 2005-2007, when you regularly saw your checking account yielding around 5%.

From an investment standpoint, the higher yields across the yield curve created significant volatility and pushed the prices of stocks and bonds alike downward for much of 2022. With base rates higher, investor expectations of what they should be compensated for moving out of cash equivalents and into stocks and bonds has changed. For stocks, that meant lower prices (paying less for $1 of earnings) and for bonds that meant higher yields (and by extension lower prices). From a portfolio construction and asset allocation perspective, for the first time in 15 years, something changed, and that something was cash being a viable alternative to risk assets. Whether you had your non-investable cash in a checking account, savings account, CD, Treasury Bill, or purchased money market fund, almost all of them were yielding the same rate, effectively nothing. Investors weren't punished for where they put their cash or how much money they left in cash (more on the banking issues later) for the past 15 years; that dynamic has changed in 2023. Where you put your money does matter; leaving money in a checking account yielding 0% while money market funds yield in excess of 4% is a considerable opportunity cost. With this change in dynamic in mind, I polled a few of my younger colleagues who join me every other week for our formal investment team meeting: how old were you in 2005? I got back 4, 7, 11, and 11. My father was right, it happened; I finally felt old.[3]

In my opinion, as the opening two graphs would indicate, the story of the first three months of the year is cash. Not just the yields an investor can receive on their cash, but the volatility throughout the banking industry. As a result of the failure of Silicon Valley Bank in California and Signature

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[1]Even though I still try and fight them off lest I give him the satisfaction of always being right. Even at 40, I still try and prove him wrong like I did when I was 8.
[2] Which SDWMA defines as purchased money market fund and any investment vehicle that matures inside of one year (e.g. CDs, Tbills, Agencies, etc.)
[3] My young colleagues are amazing, they keep me feeling young... but they still remind me sometimes... that I am old 😊

Bank in Manhattan, and the near failure of First Republic Bank in California, investors, for the first time in a long time, were forced to ask themselves – is my money safe? The FDIC insurance for bank deposits is $250,000 per account/entity (e.g. joint account, husband individual, wife individual, revocable trust), but there was a cohort of people with deposits over $250,000 that didn't really bother paying attention to how they held their money. In addition, businesses who for the first time in over 15 years were actually earning something on their deposits, had to ensure they had proper controls and protocols in place for their cash. The volatility caused the regional banking index to decline by almost 25%[4] and put pressure on larger banks as well (Bank of America declined by ~13% for the quarter and PNC declined by ~19%).

Many in the investment community felt that rising interest rates would be a net positive for banks of all sizes and their poor performance relative to other sectors was one of the surprises in the quarter. The poor performance of the financial sector weighed on "value" stocks broadly, while more growth-oriented stocks benefited from a flight to perceived quality. The perceived flight to quality in domestic stocks wasn't confined to just sector/style, it also occurred in market capitalization. Consider the table below that shows performance through the first two months of the quarter and then how the full quarter finished from a performance standpoint[5].

Market Index	**Market Capitalization**	**1/1/2023 through 2/28/2023**	**1/1/2023 through 3/31/2023**
S&P 500	US Large Cap	+3.68%	+7.48%
Russell Mid Cap	US Mid Cap	+5.68%	+4.06%
Russell 2000	US Small Cap	+7.89%	+2.74%

The first two months of the year largely played out how we thought they would, with large cap stocks underperforming small and medium-sized stocks. From a valuation perspective, small and medium-sized stocks had re-rated to lower valuations, while large cap stocks remained stubbornly higher. The move over the first two months made sense as U.S. large caps were no longer benefitting from a stronger dollar and the largest component of the index, information technology, was coming under pressure as dual headwinds of higher interest rates and questionable fixed costs (as a cohort, they over-hired during COVID). As the table above shows, the dynamic flipped in March as investors reacted to high profile failures of Silicon Valley Bank and Signature Bank. Regional banks are small and medium cap stocks; as selling pressure came on bank-specific names, it also indirectly impacted small and mid-cap stocks more broadly. Investors began to price in a Federal Reserve pause (stop raising rates) and pivot (begin cutting interest rates) to alleviate pressure on the banking system. Going back to the old playbook that was used from 2019-2021, a segment of investors piled into growth and technology stocks as they have historically benefited from low interest rates. While the market seems to believe the Federal Reserve is going to cut interest rates in 2023, the Federal Reserve has been adamant and steadfast in written and verbal testimony/interviews that it intends to keep the base rate higher for longer to reduce inflation to its 2% target.

Despite it being drowned out some by the higher yields offered in short-term cash equivalents and the volatility within the U.S. equity complex, international equities somewhat quietly outperformed U.S. large cap equities for the second straight quarter. With this outperformance, international equities are now outperforming U.S. equities on a one-year annualized basis.[6] The catalyst for this outperformance, as we noted in our last quarterly letter, began in June of 2022 when inflation peaked at 9% year-over-year in the United States. Three months later, the value of the U.S. Dollar Index peaked at 112.1, its highest level since 2001-2002. As the value of the dollar declined, it served as a headwind for U.S. equities (particularly U.S.

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[4] The SPDR Regional Banking ETF, symbol KRE, was down -24.74%

[5] Performance generated by Morningstar Direct and is on a total return basis

[6] JP Morgan Guide to The Markets, dated March 31, 2023. MSCI EAFE (International) MSCI USA (US)

large cap that generates ~50% of its revenue overseas) and a tailwind to international equities. In addition to the weakening U.S. dollar, lower valuations and higher equity dividend yields finally began to attract investors. With the prospect of China's economy opening more fully after the government dropped its "Zero COVID" policy and many emerging market countries in position to stimulate their economies via monetary (cut interest rates) and fiscal (government spending), we are optimistic about the prospects for international equities over the medium- to long-term.

While coaching my brother and I growing up, my father would constantly preach to us during games, "no peaks, no valleys," and then he would stick out his arm out parallel to the floor. What he was trying to instill in my brother and me (and our teammates) was to not overreact or underreact to any situation, but instead to be as even keeled as possible.[7] As I look back on the past three years (hard to believe the COVID pandemic shut everything down just three years ago), I keep coming back to the advice my father gave me over 30 years ago. There were peaks (hello 2021!) and valleys (COVID, 2022) that encouraged investors and market participants to react (bullish and bearish). I don't think we are through the volatility in capital markets; the policy response to COVID combined with the pace of monetary tightening by global central banks suggests a longer period of volatility is likely before any return to normalcy occurs. If volatility remains elevated as we expect, there are several levers that investors can pull on during this time: 1) diversification is your friend (own a mix of stocks, bonds and real assets), 2) invest your cash to ensure it is earning the highest possible return to take advantage of a 15+ year high in yields, and 3) an even keeled approach to the market; no peaks, no valleys. The market will continue to test our resolve as investors, challenging us and our long-term focus. We cannot succumb to the highs and lows that we know are coming our way. I started this letter off talking about feeling old, but I am ending it feeling like that twelve-year-old Lake County Bearcat basketball player, standing next to my brother Brandon and my teammates listening to my father from the sidelines. No peaks, no valleys, that is how we are going to get through this. Thanks Dad, for everything, but especially for that advice.

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[7] To those that grew up with us they all know, this lesson got through to my twin brother Brandon much better than it do me.