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FINANCIAL MARKET OVERVIEW

The first quarter stock market performance was lopsided. Most of the gain occurred in last 3 weeks of March. By the end of the first quarter, all but one stock market index was up. The NASDAQ Index, dominated by tech stocks, had the best performance rising 16.77%. The S&P 500 Index was up 7.46% and the Dow Jones Industrial Average was up only 0.33%. Only the small-company value index was down about 0.67%.

In addition to tech stocks, both large-company ***growth*** and ***value*** stocks led the way with 14.3% and 18.26% gains during the first quarter – a significant reversal from the 30% decline in large growth stocks during 2022.

Both and mid-size and small company ***growth*** stocks were up 9% and 6% during the first quarter, however mid and small-company ***value*** stocks barely moved up at all. This complete reversal favoring growth stocks over value stocks during the first quarter was exactly opposite of their respective performance in 2022.

International stocks also advanced rising nearly 9% during the first quarter. Emerging markets (smaller-country international stock indexes) continued to under-perform rising only 4% during the first quarter, but certainly better than the negative 28% return in 2022.

Investment real estate returns during the first quarter were modest – rising only 1.69% compared to a 26% loss last year. Strangely, water utility stocks were down about 4% during the first quarter, however with significant rain and snow this year, the prospects look very attractive.

Energy stocks were flat during the first quarter after rising over 50% in 2022. Gold prices shot up after the bank crisis was announced in mid-March – rising 8% during the first quarter.

Fixed income or bond prices for short-term maturities rose just under 2% and intermediate maturity bonds were up nearly 4% during the first quarter.

The following chart displays sample returns of various asset categories during the first quarter of 2023:

Yr-To-Date 2023	1st Qtr. 2023	Index Return (*includes dividends reinvested*)
+ 0.38%	+ 0.38%	**Dow Jones Industrial Average (^DJI)**
+ 7.46%	+ 7.46%	**Standard & Poor's 500 Index (^GSPC)**
+ 7.18%	+ 7.18%	**DJ U.S. Total Stock Market (VTI)**
+ 14.30%	+ 14.30%	**Large-company stock-Growth (IWF)**
+ 18.26%	+ 18.26%	**Large-company stock-Value (IWD)**
+ 9.09%	+ 9.09%	**Mid-Size Stocks – Growth (IWP)**
+ 1.31%	+ 1.31%	**Mid-Size Stocks – Value (IWS)**
+ 5.96%	+ 5.96%	**Small-company stock- Growth (IWO)**
- 0.67%	- 0.67%	**Small-company stock- Value (IWN)**
+ 8.96%	+ 8.96%	**International (EFA)**
+ 4.12%	+ 4.12%	**Emerging Markets (EEM)**
+ 1.69%	+ 1.69%	**Real Estate Investment Trusts (VNQ)**
		Fixed Income (includes appreciation)
+ 1.61%	+ 1.61%	**Short-term U.S. Treasury (SHY)**
+ 3.92%	+ 3.92%	**Intermediate U.S. Treasury (IEF)**
		Alternative Investment Category
+ 8.01%	+ 8.01%	**Gold (GLD)**

**All returns calculated using adjusted historical quotes from finance.yahoo.com*

BANKING CRISIS, CHARLES SCHWAB STOCK, AND SCHWAB BANK

We have had many inquiries from clients regarding the safety of their bank deposits in general and specifically regarding

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Charles Schwab as their brokerage account custodian as well as Schwab Bank. Let us put this "crisis" in perspective right away.

Two banks started this "crisis" – both Silicon Valley Bank and Signature Bank collapsed. Shortly thereafter, First Republic Bank and Credit Suisse received an infusion of capital (money) from other banks. These banks in particular (and others to a lesser degree), suddenly experienced a double punch: First, **interest rates** have suddenly climbed (doubled) in the past year and second, depositors recently began **withdrawing their funds** rapidly.

Interest Rates: It all started when the COVID shutdown came about in 2020 and the Federal Reserve over-reacted by lowering interest rates to the lowest levels in our lifetime in a desperate attempt to keep businesses and the economy from collapsing. During this 18-month low-interest rate environment, banks invested depositors' funds (as they always do) into home mortgages, lines of credit and other loans to borrowers. Banks make a profit on the difference between the interest rates charged to borrowers and the interest income banks must pay to depositors.

In short, the loans were issued at a time when interest rates were at a historic low point (as a side note – this is the **primary** reason why home prices soared – low mortgage rates incentivized people to buy homes at low interest rates). During 2020-2021, banks were *paying* depositors less than 0.5% interest for funds deposited into their banks, and were charging borrowers and *receiving* 3% interest income on loans. A nice profit spread.

When interest rates suddenly started to rise in 2022 and then doubled by the end of the 2022 calendar year due to government over-stimulation, inflation, uncertainty, and massive federal spending. Suddenly, banks' balance sheets of low-interest rate loans began to fall in value. A simplified example will explain why bank loans lost value. If you owned/purchased a 3-year maturity fixed income instrument that was paying 3% and one year later, a new fixed income bond with 2 years remaining to maturity is paying 6.5%, your "old" bond is now worth less. Why would anyone buy your 3% bond with 2 years remaining before maturity when the investor could buy a brand new 2-year bond paying 6.5%. The selling price or value of the old bond (mortgages, lines of credit, etc.) paying 3% interest must drop in value by approximately 6.3% to make the two bonds "equal in value".

When banks do not have to sell any of the old lower-interest rate bonds, this problem is relatively "quiet". But, imagine what happens when bank depositors like you and me are suddenly fearful that banks may collapse and we start withdrawing our money from the banks. The banks then MUST start selling these old lower interest-paying bonds issued in 2020-2021 in order to generate cash for your requested withdrawal, and the banks must sell the bonds for less than the original value. Under this scenario, banks are losing money. The more loans a particular bank made during the low interest rate environment in 2020-2021, the bigger the problem. Result: some banks went under and others needed an infusion of money from other banks – essentially a partial sale of the bank's stock.

Will additional banks go under or more likely, will some banks receive infusion of capital from other banks? Perhaps some banks will. Should everyone withdraw their money from banks? No. First, each depositor's funds are insured up to $250,000 by FDIC (Federal Deposit Insurance Corporation). If you have more than $250,000 deposited at one single bank, a better first step to protect yourself is to move the excess (the amount over $250,000) to another bank.

<u>Next topic: Charles Schwab **brokerage** accounts.</u> Our clients' investment accounts are held at Charles Schwab BROKERAGE, not Schwab Bank. Schwab does not invest or have discretion over your investment account holdings – only you and your investment advisor decide how to invest the money. Charles Schwab brokerage accounts are not the same as bank accounts.

Charles Schwab DOES have a bank – Schwab Bank AND the small money market balances in our client managed accounts do hold Schwab Bank Deposit money market fund. These balances are very small and are certainly under the $250,000 insured limit. Further, IF any of our clients' managed accounts have over $50,000 in money market funds, we invest in Schwab Value Advantage – which is a money market mutual fund – not a bank account. In short, your Schwab brokerage accounts are not at risk.

<u>Schwab Stock value:</u> Banks and brokerage firms that own banks (like Schwab) have recently been in the press and their stock values have declined. In the case of Charles Schwab stock, over 50% of Schwab's 2022 revenue came from *net interest revenue* which simply means the difference between the interest *earned* on bonds /loans and the interest Schwab *pays* on cash/money market account balances. So, Schwab's revenue is going to fall because the "interest rate spread" is no longer as large as it used to be and consequently Schwab stock is worth less. It does not mean Schwab brokerage is at risk of going under.

Client securities held in a Schwab brokerage account are **segregated** from Schwab's corporate securities as required by the Consumer Protection Rule. Even if

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Schwab broker-dealer company went insolvent, your (our clients) assets are not available to Schwab's potential creditors.

FINANCIAL MARKET OUTLOOK

Expect more of the same volatility with short term monthly advances followed by downward price declines. At the start of this year, the press was full of forecasters suggesting that interest rate increases were over, yet the Federal Reserve continues to raise interest rates suggesting more interest rate increases were necessary to slow stubborn inflation. Then, without warning, the news of bank failures hit the news in March.

Now in an attempt to "calm" the markets, the expectation is the Fed will stop raising or might even lower interest rates by May. **Here we go again**. This speculation game that the Fed will start lowering its future interest rate policies continues to be untrue. While inflation has declined somewhat, it is still increasing at a 6% or higher rate – well above the Fed's target 2% inflation rate goal. The pundits' expectation of lower interest rates beginning in May 2023 is based on the current negatively sloped yield curve.

Long-term interest rates actually fell about 0.4% during the first quarter, inflation was up 6% and interest paid on Treasury Notes with 1- and 2-year maturities pay higher interest than 10-30-year bonds. On rare occasions, when short-term rates are higher than long-term rates, this is referred to as an Inverted Yield Curve and has been accurate recession indicator in the past. But, so far, a recession has not materialized… yet. Strange. Something isn't right. Either the Federal Reserve isn't worried about inflation and our government's' overspending or, pundits and traders are in for another false stock market advance that won't be sustainable.

In March, technology stocks jumped and pushed the technology stock index up 21.5% during the first quarter. The Nasdaq index, loaded with tech stocks, was up 16.7% during the first quarter. But most of the increase came from 10 stocks – Nvidia, Meta (Facebook), Microsoft, Amazon, Apple, Tesla and a few others – the very same stocks that led the steep decline during the 4th quarter, 2022. Even Bitcoin was up 71% during the first quarter.

Compared to the 21.5% advance in technology stocks, the Standard & Poor's 500 large-company stock index was up only 7.5% and the Dow Jones Industrial Stock average was up only 0.5%. The first quarter stock market advance is not broad-based.

While only a handful of stocks that traders love to hype are going up quickly, the broad stock market is only up one-third as much and the Dow Jones Industrial Average is nearly flat -something isn't right. One or the other group is out of sync.

Investors are still focused on whether the Federal Reserve will continue **raising interest rates** in 2023 to convincingly **slow the inflation rate** and restore price stability. Reducing the rate of inflation is critical and raising interest rates is the best tool to reverse this trend. The problem is, each additional interest rate increase also depresses economic growth. Each time interest rates are increased, the likelihood of pushing the economy into a recession increases – a difficult and delicate balancing act. Once the Federal Reserve pauses it's tightening and stops raising interest rates, the gloom hanging over the financial markets will lift, and thus set the stage for a sustainable stock market rally.

Inflation has pushed the Consumer Price Index up and inflation is currently up 6% since February of 2022. **Labor costs are likely to increase** in 2023 (more inflation pressure).

Gross Domestic Product (GDP) continues to decline. Last year, the Fed's projection of real GDP growth in 2023 was an anemic 0.5% - the updated forecast is a mere 0.1%. GDP has been steadily falling over the past two years and is very likely that 2023 GDP will be flat to 2% or about one-third of 2022 GDP.

Home Mortgage rates dipped 0.4% in March, but the average conventional loan rate is still twice as high as 2021 and ranges between 6% and 7% depending on what type of loan (variable interest rate, 30-year loan, 15-year loan). **Higher home mortgage expense** does imply home prices will continue falling in 2023. Prospective home buyers are discouraged by the high asking prices (up 30%-50% from 2000) and high home mortgage interest rates. In addition, existing homeowners are staying put with their locked-in low mortgage rates from 2020-2021. End result – short supply of homes for sale and discouraged buyers.

The number of personal residence sales have dropped 13 months in a row. The downward price adjustment of home values will likely continue into 2023.

Again, economic progress will likely be painfully slow and could easily continue into late 2023 or beyond. So, investors can bet one way or the other now, or stay in a neutral position and identify the investments now that would fit well into their portfolio and wait for less uncertainty.

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INVESTMENT OUTLOOK AND RECOMMENDATIONS

Current financial market conditions are not realistic unless an imminent improvement is coming. In the meantime, there is still plenty of time to identify what changes or additions should be made to managed accounts. Now is the time to identify and gradually/carefully re-allocate cash into selective stock holdings and simply accept the fact that no one will be able to correctly identify the exact date that stocks will begin a sustainable upward advance. We have already weathered the worst part of the storm and therefore the focus should be on the future.

Over the balance of this year, large cash-generating and profitable companies will likely be the best sector to start with. **Value stocks** and businesses that generate the most cash with higher shareholder returns is the safest selection for the near-term. Reliable, consistent, and dividend-paying stocks are likely to be the safest stock category to begin building positions. For a long-term time horizon, technology and small-company stocks are attractive. Tech stocks and smaller companies with faster growth prospects will shine again one day.

We are focusing on providing a mix of BUY recommendations: large-company value-oriented and income-paying stocks, technology, broad market stock indexes and small company stocks. Sometime in the next 10 to 18 months, the financial market environment will be better than today. A measured and slow approach to re-allocating cash into stocks is the path we are taking.

Contact Us

Brian D. Lowder, Inc.

Brian D. Lowder, CFA, CFP®
Michael Kinnear, CFA, CFP®
Rebecca Dodge, CFA, CFP®
Jennifer Finley
Pamela Priest

Address
12780 High Bluff Drive Suite 100
San Diego, CA 92130

Telephone
(858) 794-6800

Fax
(858) 794-6906

Website
www.bdlowder.com

Email
brian@bdlowder.com
mike@bdlowder.com
rebecca@bdlowder.com
jenn@bdlowder.com
pam@bdlowder.com

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Best Regards,

Brian Lowder

Michael Kinnear

Rebecca Dodge

Jennifer Finley

Pam Priest