From: Aequitas Investment Advisors

Re: Full Faith and Credit

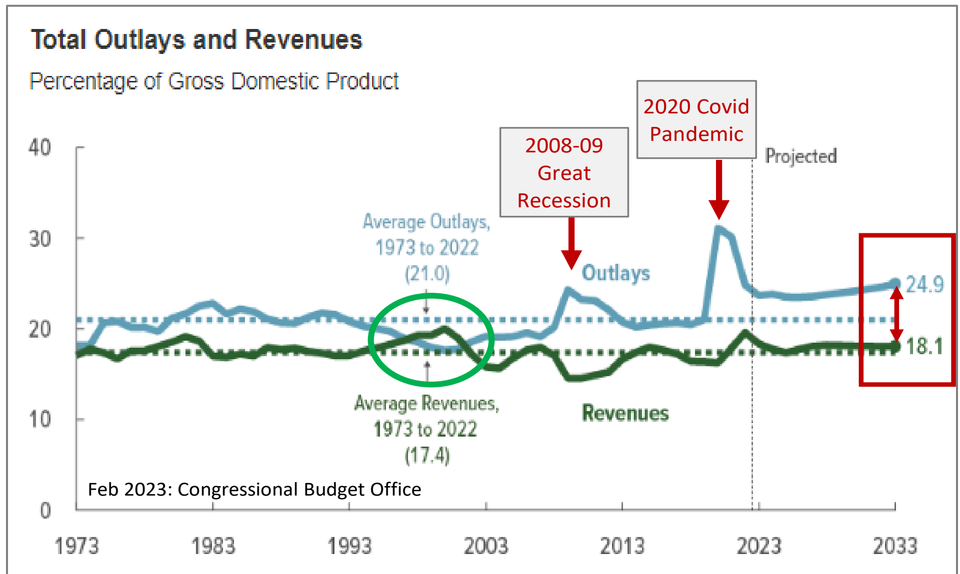
Warren & Your Team!

From the U.S. Department of Treasury website, "The authority to borrow on the full faith and credit of the United States is vested in Congress by the Constitution: Article I, Section 8, Clause 2. The Congress shall have power to borrow money on the credit of the United States."

The full faith and credit of the United States is the foundation upon which confidence in our financial system is built and the reason why the U.S. dollar is considered the world's primary reserve currency. Confidence in the financial system was tested in March when the Silicon Valley Bank (SVB) was taken over by the FDIC following a precipitous withdrawal of deposits. The SVB failure was the second largest in U.S. history and the largest bank failure since the 2008 financial crisis. While the balances of most of SVB's depositors exceeded the FDIC's $250,000 insured limit, within days of the failure the FDIC quickly stepped in to guarantee all depositors in an effort to forestall contagion into the broader banking system. Other confidence-restoring measures were quickly implemented by the U.S. Treasury and Federal Reserve, including a new Bank Term Funding Program available to any eligible depository institution which is designed to prevent such failures in the future. These efforts appear to have been highly successful given that the markets have settled down and fears of a broader financial crisis have been abated thus far. Remarking on the banking debacle, Warren Buffett aptly observed that there was "unnecessary fear and panic about depositors losing their money, when the system is set up to protect the entire nation's deposits." And lest we think that the FDIC's actions cost taxpayer's money, Buffett went on to say, "The costs of the FDIC are borne by the banks. Banks have never cost the Federal Government a dime. The public doesn't understand that," said Buffett. "Nobody is going to lose money on a deposit in a U.S. bank. It's not going to happen... you don't need to turn a dumb decision by managers [i.e., poor decisions by SVB's management] into panicking the whole citizenry of the United States about something they don't need to be panicked about."

While faith and confidence in the banking system appears to have been restored, another challenge to our financial system may be just a few months away when the government will need to raise the debt ceiling in order to honor our existing obligations. Unfortunately, this has become a political grandstanding issue which runs the risk of wreaking havoc on the financial markets and potentially costing us dearly should our creditworthiness be downgraded as it was for the first time in the summer of 2011 when we had a similar political standoff (more on this topic below).

Clearly, our budget deficit must be addressed, but this is not a new issue and both political parties share responsibility in getting us to this point by avoiding difficult decisions and kicking the can down the road. The chart below clearly indicates how our federal outlays (blue line) have vastly exceeded revenues (green line) since the last time our government had a surplus in the year 2000. Since then, federal outlays have risen steadily while revenue has remained relatively flat. The Great Recession of 2008-09 and the Covid Recession of 2020 created massive

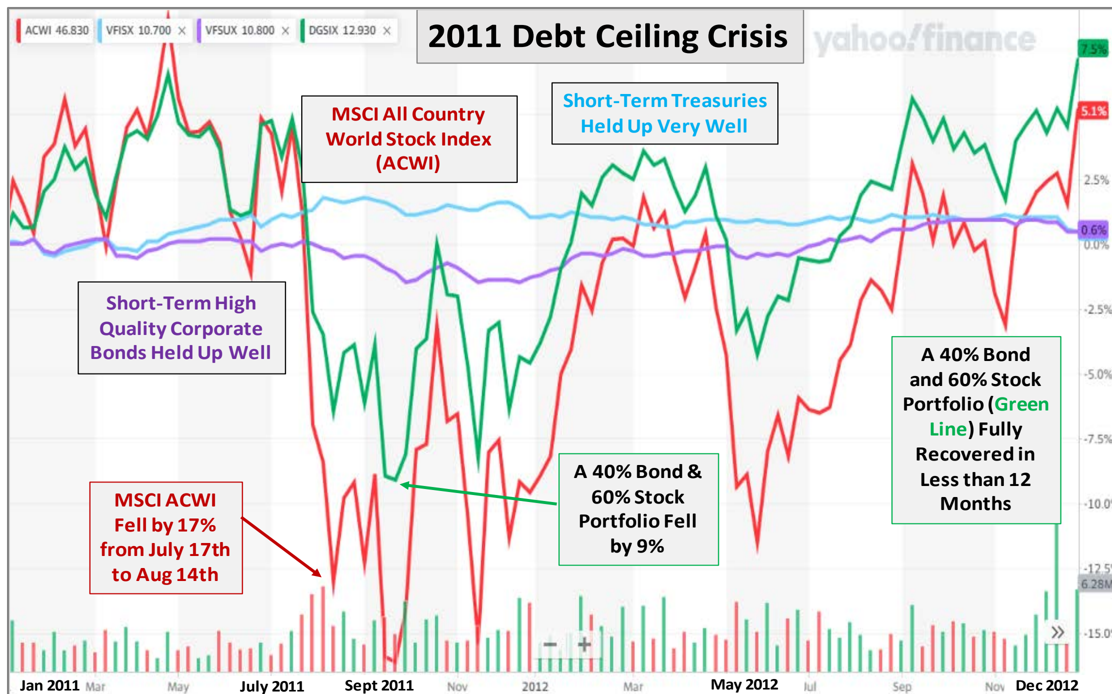


spikes in federal spending with no offsetting increases in revenue. To address the deficit, the Congressional Budget Office recently released a detailed publication outlining 17 major and 59 smaller options for getting the federal budget back on a sustainable trajectory (cbo.gov/publication/58164). Broadly speaking, the major options involve modest, but politically challenging, changes to Medicaid, Medicare, Social Security and defense spending. In conjunction with spending reductions, raising additional tax revenue is a necessary part of the solution. The CBO proposes several revenue options, including increasing income tax rates, limiting itemized deductions, imposing a new employee payroll tax of 2% on earnings, and a new tax based upon consumption, such as a value-added tax (VAT) which is utilized by more than 160 countries. The bottom line is that we need to reduce outlays and raise revenue to solve the deficit problem.

Rather than more political grandstanding and holding the full faith and credit status of our country hostage, we need the House of Representatives to authorize an increase in the debt ceiling which will buy time for both sides to come to the table to hammer out solutions which may be distasteful to either party's constituency, but are necessary if we're serious about tackling the deficit. Above all, we need to avoid the risk of making our economic conditions worse and possibly having our credit rating downgraded, once again, which would likely lead to higher borrowing costs and even larger future deficits. In the words of U.S. Treasury Secretary Janet Yellen, "The debt ceiling simply must be raised, and to put at risk the full faith and credit of the United States, and to threaten to cause an economic and financial catastrophe isn't an acceptable requirement."

2011 Debt Ceiling Crisis Redux?

Perhaps it's rather naïve to hold out hope that the two political parties will come to any sort of meaningful agreement well in advance of reaching the debt ceiling limit, so we may end up with an outcome comparable to 2011 when the circumstances were eerily similar. In January of 2011, the Republicans had taken control of the House of Representatives with Democrats still in control of the Senate and White House. Before agreeing to increase the debt ceiling, House Republicans demanded that President Obama negotiate over deficit reduction. The President's position was that we should not negotiate raising the debt ceiling which only ensured that the government could pay for past obligations and commitments. Neither side gave in until a compromise was reached on July 31st, just two days prior to the time the Treasury would have exhausted its options to avoid a default, but at that point the damage had been done. Standard and Poor's rating agency downgraded the credit rating of the U.S. government for the first time in history. Two weeks prior, the stock market began sinking and eventually fell by 17% by August 14th. Somewhat surprisingly, despite losing their Standard and Poor's AAA credit rating status, the prices of U.S. Treasury securities actually rose in value which significantly cushioned the blow to the stock market for balanced portfolios (e.g., a 40% bond and 60% stock portfolio fell by 9% compared to the 17% drop in stock prices). From August 14th onward, stocks began their recovery and the 40% bond and 60% stock balanced portfolio fully recovered in less than 12 months, keeping our clients' financial plans on track. An important lesson we learned was that a balanced portfolio not only limited the downside impact of the crisis, but the stable value of U.S. Treasuries and high-quality corporate bonds afforded investors the opportunity to buy stocks at discounted prices through the discipline of portfolio rebalancing as stock prices gradually recovered.

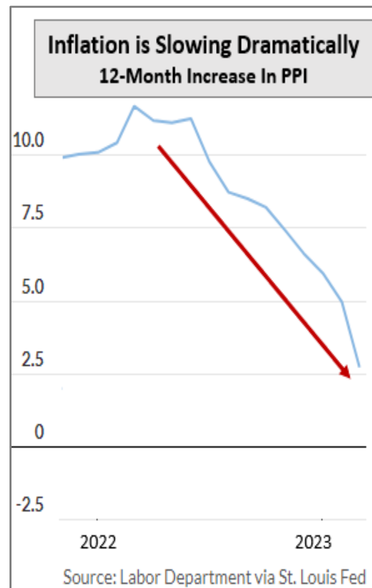


A *Not So Soft* Landing Appears More Likely Now

In our last quarterly letter, we wrote that a "soft landing" for the economy appeared more likely given the favorable direction of inflation (i.e., trending downward) and the underlying strength of the economy. Both of those factors remain intact; however, additional stresses on the economy have emerged following the collapse of

Silicon Valley Bank (SVB) which caused many depositors of regional banks to move their money to larger banks in search of greater perceived safety. Depositors have also been moving money out of low-yielding bank balances into higher yielding money market funds. This flight of deposits reduces the regional banks' ability to lend to households and businesses which is problematic for future economic growth given that regional banks account for 60% of all mortgages, 80% of commercial real estate loans and 45% of all consumer loans (according to Goldman Sachs). Such credit tightening will undoubtedly slow the economy further than the Fed had originally forecast before the SVB debacle. As a result, some pundits are now predicting the Fed may need to reduce interest rates sooner than previously assumed to prevent a more serious recession. As published in the minutes of its most recent meeting in late March, the Fed stated, "Given their assessment of the potential economic effects of the recent banking-sector developments, the staff's projection at the time of the March meeting included a mild recession starting later this year, with a recovery over the subsequent two years."

In addition to the Fed's less optimistic tone, the International Monetary Fund (IMF) recently published its World Economic Outlook, *A Rocky Recovery*, in which they forecast a sharper than expected slowdown for developed economies, including the U.S., Europe and Japan. "The cost-of-living crisis, tightening financial conditions in most regions, Russia's invasion of Ukraine, and the lingering COVID-19 pandemic all weigh heavily on the outlook." While they forecast that growth in the developed economies will slow significantly in 2023, they expect stronger growth in the emerging markets and developing economies. Their baseline forecast is that the growth in the global economy will slow from 3.4% in 2022 to 2.8% in 2023 with a modest acceleration in 2024, thus avoiding a recession. The greatest downside risk to their outlook is the potential for financial sector stresses to become amplified causing a sharp deterioration in lending conditions and a harder economic landing, perhaps in line with the Fed's mild recession forecast.

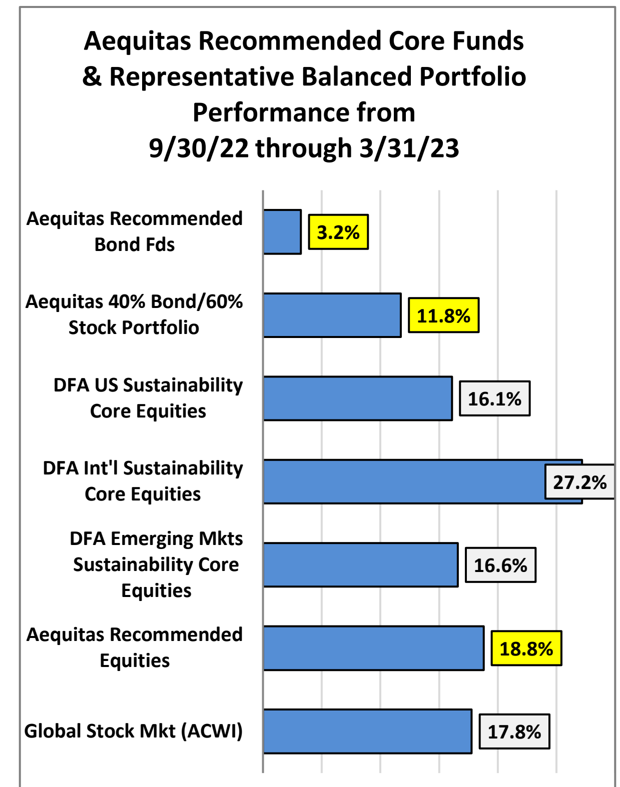


Inflation Update

We received some encouraging inflation news on April 13th when the Bureau of Labor Statistics reported that the Producer Price Index (PPI) fell more sharply than expected to 2.7% on a year-over-year basis, down from 4.9% the previous month. The PPI Index measures the prices paid to producers of goods and services, i.e., wholesale prices, which ultimately impacts prices paid by consumers. Should this downward trend continue, the Fed may feel less pressure to raise interest rates much further, or at all, and we may be even closer to a pivot toward lower rates.

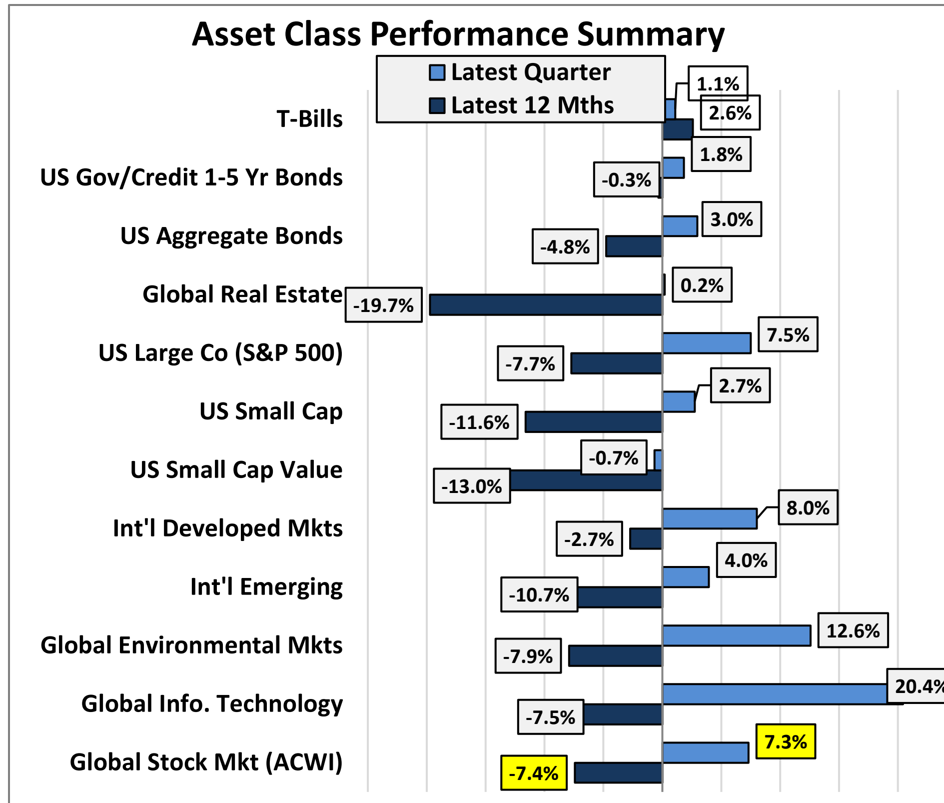
Representative Portfolio Performance Review
The Latest Six Months

Despite the media's stoking our fears and creating anxiety about a potential banking crisis and possible recession, the stock market has been chugging along as investors appear to be looking past these near-term risks and focusing on longer-term investment opportunities. In the chart below, we've listed performance over the past six months of our recommended three DFA Sustainability Core Equity fund strategies and a representative 40% bond and 60% stock balanced portfolio. We've also broken out the performance of the bond and stock components of the representative balanced portfolio which include the additional diversifying funds in our model portfolio strategy. At the bottom of the chart is the performance of the MSCI All Country World Index representing the Global Stock Market. The main message is that performance has been robust across the board. Equities are up by close to 19% led by international stocks. Bonds have rebounded nicely (+3.2%) and the representative balanced portfolio gained close to 12% for the six months ended March 31, 2023.



Asset Class Performance Review
Latest Quarter and 12 Months

For the latest calendar quarter, all major asset classes posted gains with the exception of U.S. Small Cap Value stocks. The Global Stock Market gained 7.3% while the U.S. Aggregate Bond Index advanced by 3%. The largest gains came from Global Information Technology (+20.4%) followed by Global Environmental Markets (+12.6%). Next in line were International Developed Markets stocks (+8.0%) followed by U.S. Large Companies (+7.5%). Performance of the other stock asset classes ranged from -0.7% to 4.0% for the quarter. T-Bills gained 1.1% and U.S. Gov/Credit 1-5 Year Bonds gained 1.8%.



Performance for the latest 12-month period was not as favorable with the Global Stock Market (MSCI ACWI) down by 7.4%. Bear in mind that the ACWI was down by more than 20% during the first six months of the trailing twelve months only to recover most of that loss during the last six months. The only asset class with a positive 12-month return in the performance summary was U.S T-Bills which reflected the surge in short-term interest rates due to the actions of the Federal Reserve. Short-term bonds, represented by the U.S. Gov/Credit 1-5 Year Index, were essentially flat (-0.3%). Notably, the U.S. Aggregate Bond Index fell by 4.8% reflecting the impact of rising interest rates during the early part of 2022. The range of negative returns among the stock asset classes was between -2.7% (International Developed Markets) to -19.7% (Global Real Estate).

Investing in (Particularly) Uncertain Times

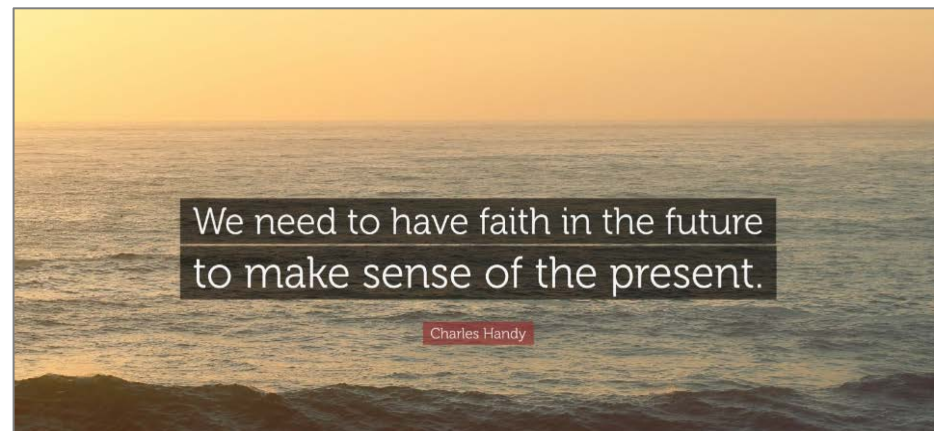
It's likely we'll experience choppy seas in the months ahead given the prospect of a debt ceiling standoff, the residual impact of the banking debacle and a slowdown in the economy (hopefully avoiding a hard landing). Developments in the war between Russia and Ukraine will continue to impact the markets as well as tensions between the U.S. and China. While it may be tempting to think about getting out of the stock market when the headlines appear so bleak, as long-term balanced portfolio investors, it's important to bear in mind that a significant portion of our portfolios are *already* out of the market (i.e., the portion invested in high-quality bonds). The stock portion, of course, will be subject to the inherent volatility of the markets, but history has taught us that stocks eventually recover from downturns and provide investors with substantial gains over the long term. After all, the headlines have been rather bleak over the past six months, yet the stock market has staged a remarkable rally despite it all. Rather than guessing about market timing and hoping to avoid the inherent volatility of the stock market, a proven strategy for managing short-term volatility has been to invest in a highly-diversified balanced portfolio aligned with one's risk tolerance and investment time horizon. Managing risk and being prepared for the inevitable economic downturns is front and center in the construction of our clients' portfolios. This is why our recommended portfolio allocations are aligned with the short, medium, and long-term financial goals and objectives of each of our clients. As a reminder, the following are some of the primary risk management strategies we utilize in the construction of our clients' portfolios.

- We recommend setting aside sufficient funds for short-term financial requirements. A typical guideline is at least six months' worth of cash flow needs. Given today's interest rates, one can earn 4%+ in higher yielding money market funds.
- We recommend an additional "safe haven" allocation in the portfolio invested in low-risk investments equivalent to 8 to 10 years of future cash flow needs. For example, if there is a need to withdraw $100,000 annually from a portfolio for living expenses, or organizational operating costs, then a minimum of $800,000 should be invested in short to intermediate-term bonds. By creating a safe haven allocation, the balance of the portfolio can be more confidently invested in riskier assets (e.g., globally

diversified stocks) designed for long-term capital appreciation. The safe haven allocation provides substantial liquidity and helps avoid the need to sell stocks when prices are depressed.

- We recommend diversifying the stock portion of the portfolio across a wide range of sub-asset classes designed to reduce volatility and capture favorable returns in various market cycles. Further, by integrating time-proven factors in stock selection, one can improve the odds of a successful outcome. Such factors include tilting the portfolio toward smaller cap stocks, toward stocks with lower prices, and stocks of the most profitable companies.
- We recommend regular portfolio rebalancing. History has taught us that attempts to time the market end up costing investors dearly given that a decision to sell stocks in advance of what one might think will be a downturn also requires a decision to get back into the market in advance of an upturn. Studies have found that such market timing can lead to missed opportunities. A better strategy is to apply the discipline of portfolio rebalancing by utilizing the bond portion of a balanced portfolio to buy stocks when their prices are depressed and trimming gains when stock prices are high.

A prudently constructed portfolio construction is built to weather a variety of economic storms while also increasing the likelihood of a successful outcome over the long term.



Closing Message

Confidence and faith underpin our entire financial system which is why the FDIC, the Federal Reserve and the Department of the U.S. Treasury are such important institutions supporting our individual and collective financial well-being. Having faith in the financial system enables us to more confidently plan for the future which was one of Alexander Hamilton's goals when he designed the Treasury Department at the time of our country's founding. From a financial perspective, faith in the future is strengthened when one establishes and monitors a prudent financial plan which considers the inherent risks in the investment markets and builds in safety measures designed to manage those risks.

We close with the insightful words of Charles Handy, an Irish author and philosopher, who said, "We need to have faith in the future to make sense of the present." We might add that investment lessons learned from the past can also better our understanding of the present and further strengthen our faith and confidence when planning for the future.