

Dear Friend,

April 13, 2023

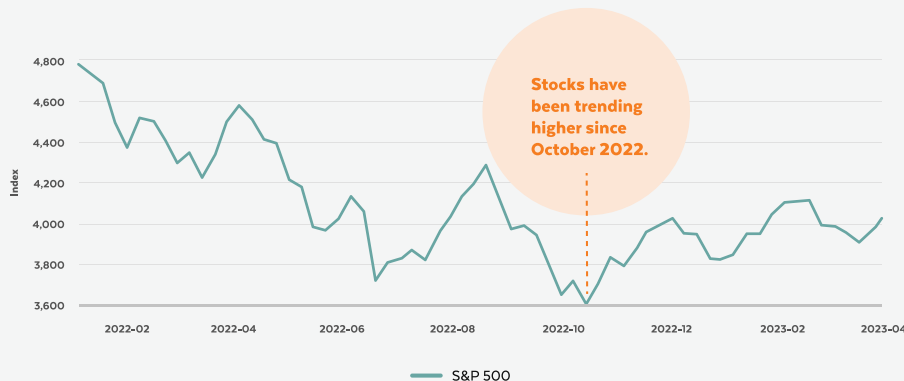
News in the first quarter was dominated by the high-profile failures of Silicon Valley Bank and Signature Bank New York on March 10, spanning through to March 19 when UBS announced the purchase of beleaguered Credit Suisse for \$3.2 billion in a deal brokered by Swiss authorities. While regional bank stocks endured sharp selling pressure during this period, the broad equity markets were largely resilient to rising uncertainty over the health of the banking system. Stocks posted three consecutive weeks of positive returns starting on March 13.

For the first quarter of 2023, the S&P 500 rose +7.5%, led mostly by the cyclical categories of Technology (+20%), Communication Services (+18%), and Consumer Discretionary (+13%). Significant outperformance of growth and technology stocks may have been a wager that the banking crisis would hinder economic growth later in the year, thereby raising the chances of easier monetary policy sooner than previously expected. The Federal Reserve also injected new liquidity (\$755 billion) into the economy in Q1 following five months of quantitative tightening, which likely acted as a tailwind for risk assets as it has in the past.

“The stock market is a wonderfully efficient mechanism for transferring wealth from the impatient to the patient.”

- WARREN BUFFET

S&P 500 OVER THE PAST YEAR



Source: Federal Reserve Bank of St. Louis

PRIVATE WEALTH
PARTNERS, LLC

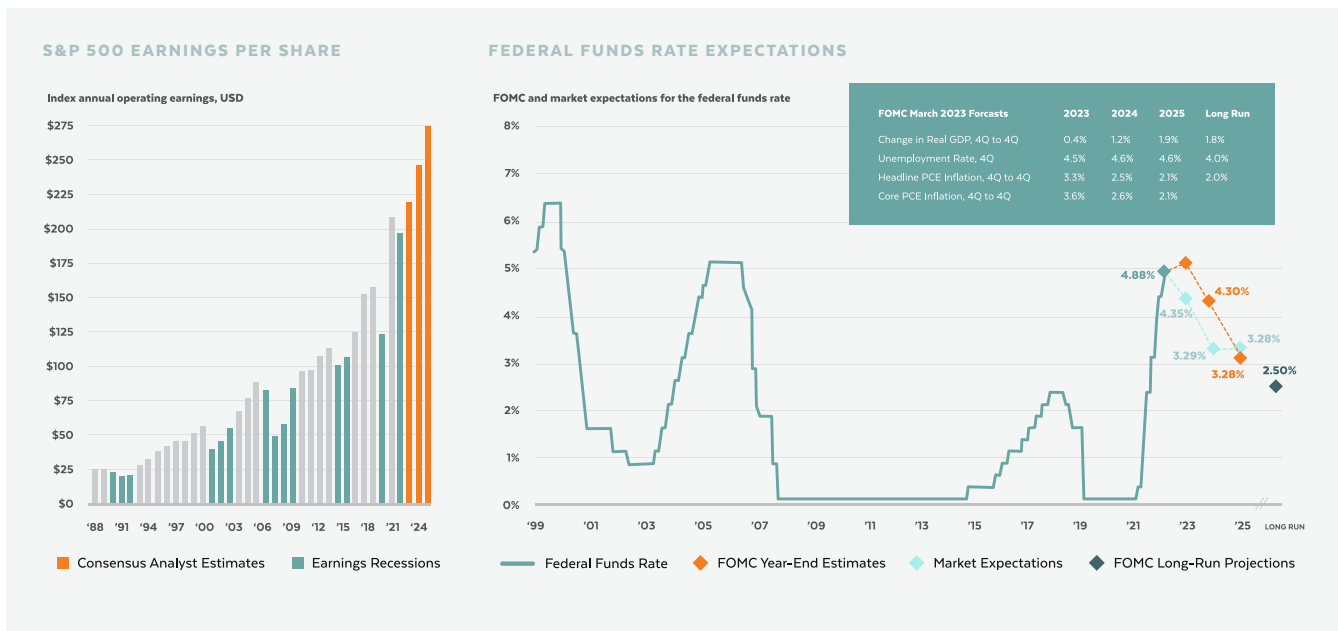
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In the fixed income markets, US Treasury bonds across nearly all durations rallied for the quarter, with the 10-year bond yield declining from 3.9% to 3.47%. The 2-year Treasury bond yield fell slightly more than the 10-year, which caused the yield curve inversion to reach its deepest level in 40 years. Combined with the likelihood of tighter credit conditions and lending standards resulting from bank failures, the case for a recession has risen since the beginning of the year.

Last quarter, we wrote that “the market may remain choppy in the short-term as bad news about the economy will likely accompany better news about inflation and interest rates.” The bank failures’ downstream impact on loans, credit, and economic activity—which could translate into headwinds on employment—could ultimately be the ‘bad news’ the Fed wants for its inflation fight. In this sense, bad news for the economy has been good news for the interest rate outlook, as the Federal Reserve is now forecasting only one more 25 basis point rate hike in this tightening cycle.

From an investment standpoint, if investors anticipate interest rates will be lower in future years than they are today—while corporate earnings are expected to stage a recovery a few quarters or even a year from now—that should be construed as a positive. We think both of these conditions are present today.



Source: JPMorgan

Within Private Wealth Partners (PWP) portfolios, it is worth noting that we had very minimal exposure to regional bank stocks, though we remain active investors in the Financials sector. At the end of the day, financial institutions play a central role in driving economic growth, with operations spanning lending, investment banking, trading,



payments, and so on. They exist to support and finance the rest of the economy, and this role is not going away.

PWP also continues to overweight technology companies with secular growth tailwinds, which took on new meaning at the turn of the year with the release of OpenAI's ChatGPT and GPT-4 tools.

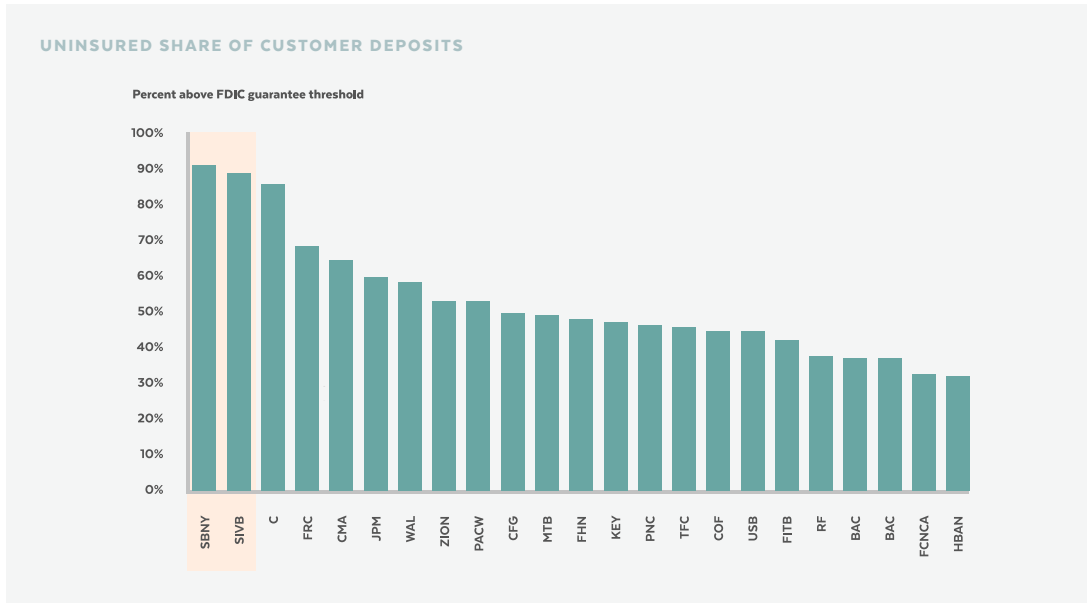
Generative artificial intelligence (AI) is broadly seen as a profound technology that could drive the next productivity boom. Goldman Sachs sees the possibility of a massive near-term disruption to the labor force with “two-thirds of current jobs exposed to some degree of AI automation.” The upshot is that historically, automation and other technological breakthroughs have greatly boosted productivity, allowing many in the workforce to do far more with far less technical knowledge of the underlying products. Assuming generative AI lowers labor costs and dramatically raises productivity—as we expect it will—the technology can also create massive amounts of new wealth.

We see significant opportunities for AI to drive earnings and profit growth across many market segments. One clear example is in drug discovery, a process that in recent times takes about 3 to 6 years. Generative AI has already demonstrated its capability to design drugs for various uses *within months*, which is of course a boon to patients but also to drug companies. Research firm Gartner expects more than 30%—up from 0% today—of drugs and materials to be discovered using AI.

Google's CEO Sundar Pichai referred to AI as a technology “as important or more than fire and electricity.” This may seem like hyperbole coming from a key stakeholder in AI's future, but when compared to other comments about AI from thought leaders across the economy, it is clear that AI may indeed be the next internet or iPhone moment. Goldman Sachs believes AI can eventually increase global GDP by 7%.

A BRIEF LOOK AT THE BANK FAILURES

Historically, bank failures tend to be driven by credit risk, but Silicon Valley Bank (SVB) and Signature Bank New York (SBNY) were unique cases where large bases of undiversified, uninsured deposit liabilities were mismatched with fixed rate securities that had fallen in value as interest rates rose – eroding the banks' capital.



Source: JP Morgan

SVB and SBNY ran into major problems in 2022 when the venture capital/startup world saw funding evaporate, and the cryptocurrency industry concurrently suffered major setbacks. This led many early-stage companies (clients of SVB) and crypto firms (clients of SBNY) to draw down cash reserves to continue funding operations, which eventually spiraled into a run on deposits once the banks’ balance sheet problems were exposed.

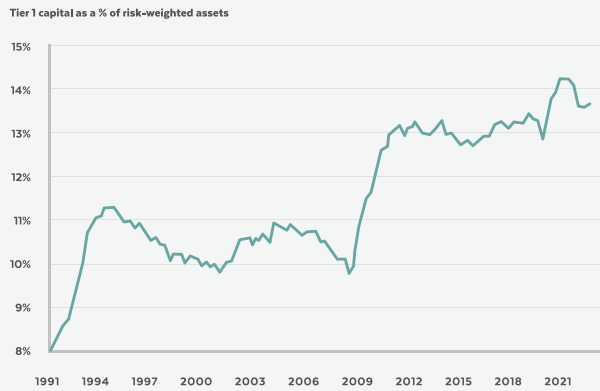
Credit Suisse’s forced sale a week later made it seem like a global bank contagion could be underway, but the Swiss lender had already been troubled for months—if not years. There is a good argument that Credit Suisse ultimately collapsed under the weight of unstable management, investment banking losses, and a string of bad bets—including its partnership with now-bankrupt Greensill Capital and a \$5 billion loss from the collapse of Arcegos Capital Management. Last October, rumors of Credit Suisse’s problems posted on social media led to a major outflow of wealthy clients. In 2022, deposits fell more than 40%, and assets plummeted by 30%.

All told, March’s bank failures may be better characterized as a crisis of mismanagement versus a symptom of systemic risk in the banking sector. A few days after the failures, we learned that supervisors at the Federal Reserve Bank of San Francisco had issued Silicon Valley Bank six citations in 2022 and placed it under full supervisory review, and that regulators met with the bank last fall to discuss their exposure to losses as interest rates rose. As Jamie Dimon wrote in his annual shareholder letter, “many of the risks were hiding in plain sight.”

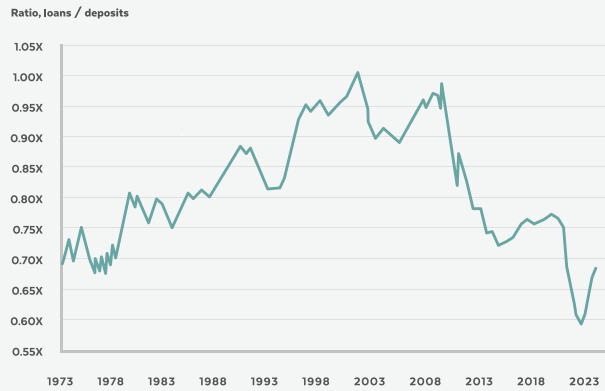
Worries about a possible banking crisis had largely faded by the end of March. Tier 1 capital ratios and loan-to-deposit ratios suggest the US banking is very well-capitalized, and we would note that nearly all large money center banks have the ability to meet withdrawal requests without selling illiquid assets or fixed income assets at losses.



US BANK TIER 1 CAPITAL RATIOS



US LOAN-TO-DEPOSIT RATIO, ALL COMMERCIAL BANKS



Source: JP Morgan

We think there are two risks to track from here. The first is the legislative impulse to respond to a crisis with more regulation, which can create uncertainty in the banking sector. The second is the degree to which credit and lending standards tighten as the year progresses. Banks may decide that a dollar in reserves is better than a dollar lent, which can have a meaningful impact on economic activity and perhaps employment.

A recession later this year would likely exacerbate the tightening of credit conditions, as has been the case historically. But JPMorgan notes that “the credit sensitivity of an economy is tempered when growth impulses are strong and there is less need for credit.” Corporations have spent years borrowing at ultra-low rates and building up cash reserves, which should limit external financing needs for strong companies. As JPMorgan put it, “the need for credit is more muted in periods of healthy balance sheets,” which we think keeps the argument for a mild recession intact.

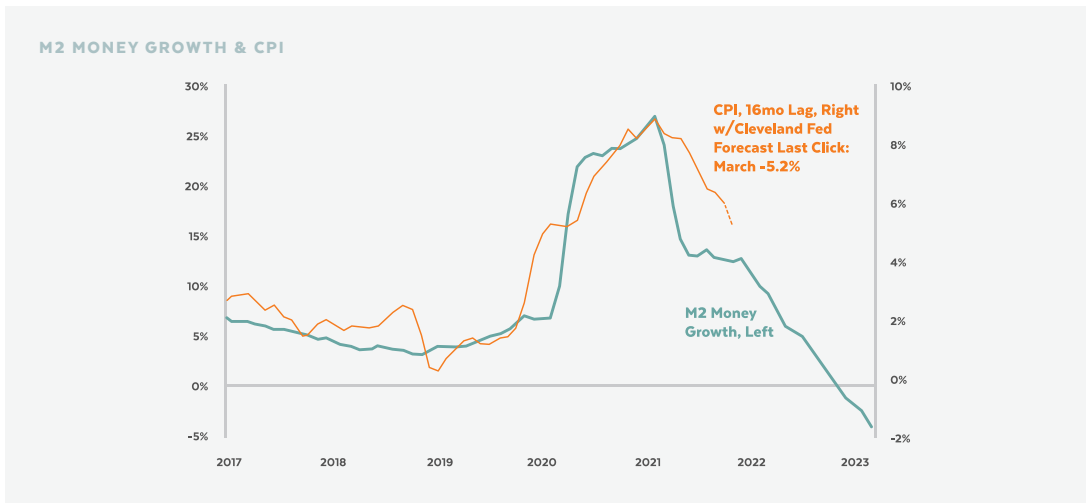
INFLATION, JOBS, AND THE FED

The Fed has made it clear they want to slow GDP growth down in an effort to fight inflation. As mentioned previously in this review, bank stress and the likely effect on loan activity and credit conditions will probably do some of the Fed’s work for them.

JPMorgan estimates that bank lending growth could slow from +12% in 2022 to +2% in 2023, which would certainly create a drag on economic growth (-0.8% by JPMorgan estimates) and perhaps employment. But as noted before, healthy balance sheets broadly across the nonfinancial corporate sector may limit external financing needs, and a strong jobs market with falling inflation should boost real incomes in the new year—supporting stable levels of consumer spending.



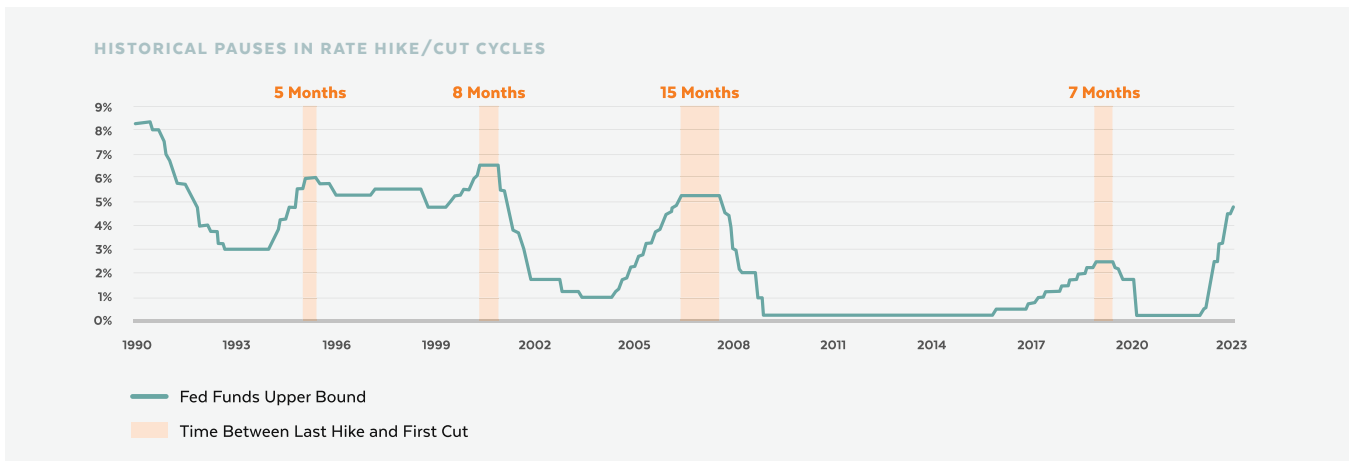
Two other key data points are bolstering the case for a Fed “pause” either at or after the next meeting. The first is M2 money supply declining by \$130 billion in February and -2.4% year-over-year, which marks the fastest rate of decline in M2 since the 1930s (chart below). Changes to the consumer price index tend to lag M2 money growth, which suggests we could see a significant anchoring effect on inflation in the coming quarters.



Source: Strategas Research

The second data point is the number of job openings in the US, which in February fell to 9.9 million from January’s 10.6 million. This figure is down considerably from the peak of 12 million job openings reached in March 2022, and signals that rate hikes are easing labor market pressures—particularly wage pressures—without triggering mass layoffs (at least not yet).

If the Fed does indeed decide to pause rate hikes, history suggests the length of the pause could be anywhere from 5 to 15 months before rate cuts commence. This timeline aligns pretty well with expectations for rate cuts in early 2024.



Source: Bloomberg



CONCLUSION

We think the table is set for a peak in the interest rate cycle, likely this summer. We've also made the case this quarter and in previous quarters that inflation should continue in a downtrend, barring another commodity market shock or some other extraneous factor—with geopolitics being the biggest risk.

The remaining question is how the US economy will respond, which seems near impossible to forecast given the ongoing resilience of US consumers and the labor market. There appear to be three possible outcomes:

- The US avoids recession altogether;
- The recession is 'mild' as just about everyone is predicting; or,
- A recession is worse than expected, perhaps because credit fundamentals deteriorate more sharply as lending standards tighten and borrower demand plummets.

Avoiding recession would likely register as a positive surprise for markets, and we think a mild recession is already baked into stock prices—meaning no surprise power. The final scenario might mean additional pain in the equity markets in the short-term, but a sharp recession would also imply lower inflation and falling interest rates—which would ultimately cause investors to look ahead to a subsequent recovery, albeit on a delayed timeline from what we currently expect.

In the coming months, we think it will be important to monitor bank lending activity to assess the spillover from recent failures, as well as to look for confirmation that weakening inflation keeps the door open for a Fed pause.

PRIVATE WEALTH PARTNERS UPDATE

We're pleased to announce two well-deserved promotions made in the first quarter. First, Katrina Sutherland has been promoted to Director of Client Services and Operations. Katrina has assumed this expanded role to lead Private Wealth Partners' efforts to continue to serve clients at the highest level. Second, Ashley Saia has been promoted to Client Services Officer and Controller. Ashley has assumed many of the firm's financial responsibilities while also working with clients, and we're excited to see Ashley's role continue to grow. She will be working closely with Michael Yongue, PWP's Chief Operating Officer and Chief Compliance Officer.

A valued PWP team member, Elyse Gottschalk, has taken the California Bar Examination and is now pursuing a legal career. We wish her all the best in her future endeavors.



If you have any questions about this review or your portfolio, please do not hesitate to reach out to us. We hope you have a wonderful spring season, and as always, we thank you for your support and for your continued confidence.

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