LNWM Quarterly Commentary – Q2 2023

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A REALITY CHECK FOR THE FED

> "Economics is like gravity: Ignore it and you will be in for some rude surprises."
>
> — **Charles Wheelan**

IN SUM

Tighter credit as a result of recent bank failures will likely weigh on economic growth, on top of the slowdown inflicted by the steep rise in interest rates. Coupled with slowing job growth, this makes a US recession more likely, if we are not in one already. In early May, the Fed is generally expected to raise interest rates again, further increasing the risk of a policy mistake.

In the current environment, portfolio diversification is especially important, with the totality of ingredients in your portfolio offering the potential for mitigating risk and taking advantage of opportunities, as we explain in this Commentary.

The first quarter of 2023 will forever be marked by two of the largest US bank failures in history (Silicon Valley Bank and Signature Bank) and yet we finished the quarter just fine -- with most stock indexes up significantly and bond prices helped by falling rates. What gives?

Banking turmoil and slowing economic growth have reinforced the prevailing view that a much-anticipated recession may become a fait accompli. Given the strength in markets since the start of the year, investors seem to be pricing in an imminent Fed pause as well as rate cuts occurring earlier than the Fed has communicated, achieving ultimately the prized "soft" economic landing. Perhaps.

Instead of prognosticating a soft or hard landing, we would rather look at the facts and the implications of the recent banking turmoil in context of the new market regime we pointed to back in January 2022. That regime is defined by a steady state of higher interest rates and higher or just stickier inflation than what we have been used to (albeit not as high as in 2022), coupled with a shift in geopolitics.

Implications of the Banking Crisis

For years, we have been operating in a near-zero or below-zero interest rate environment. An analogy might be operating in zero gravity. Your behavior changes. You can do things you could not have done before without hurting yourself. But since March 2022, we have had relentless interest rate increases or a return to earth, if you will. During such major shifts, accidents happen as people and companies adjust to the higher cost of borrowing -- the pull of gravity.

Tighter profit margins for banks. The basic premise of banking is to pay less on deposits than you charge on loans. This was easy to do when banks could basically get deposits for free. Today, banks are once again competing for deposits, as money is going out the door into higher-yielding money market funds, other bank accounts or straight into Treasuries. Higher rates paid out mean lower bank profit margins, since banks cannot hike the rates they charge on existing fixed loans. Tighter margins coupled with the likelihood of stricter liquidity requirements after the recent bank failures mean less overall incentive to lend, thus reducing the fuel the economy needs to expand.

Consequently, we appear to be moving into a new phase of credit tightening with wide-ranging implications for financial markets and the economy. Recent estimates suggest the likely pullback in banking credit would be the equivalent of a 100-150 basis points hike in the Federal funds rate, implying a rate of 6.0% - 6.50% vs. the actual current rate of 5%.

Best to Tune Out the Noise

Less than 24 hours before the demise of Silicon Valley Bank (SVB), the consensus among Wall Street analysts was that SVB stock was a "Buy" with a $337 price target. There were zero "sell" ratings. Several analysts did downgrade SVB on March 10, the day the bank folded, yet none of these were "sells"!*

* *The Week in Charts* (3/14/23) by Charlie Bilello.

With cracks already showing from the highest US interest rates since 2007, it is hard to imagine additional credit tightening not pushing the economy into recession or creating a deeper and more protracted recession, if we aren't already in one. How long might that last? That is anyone's guess. History tells us the average duration of the typical recession is nearly one year (11 months). Keep in mind, though, that even if a recession lasts longer than that, the expansion phase of economic cycles has historically been over 5x as long as the contraction phase, on average.

What Bonds Are Telling Us

Tracking volatility in the Treasury bond market is usually like watching paint dry or grass grow. That's no longer the case. As inflation has accelerated since mid-2020, Treasury bond volatility has soared to a level not seen since the early 1980s. Why highlight this?

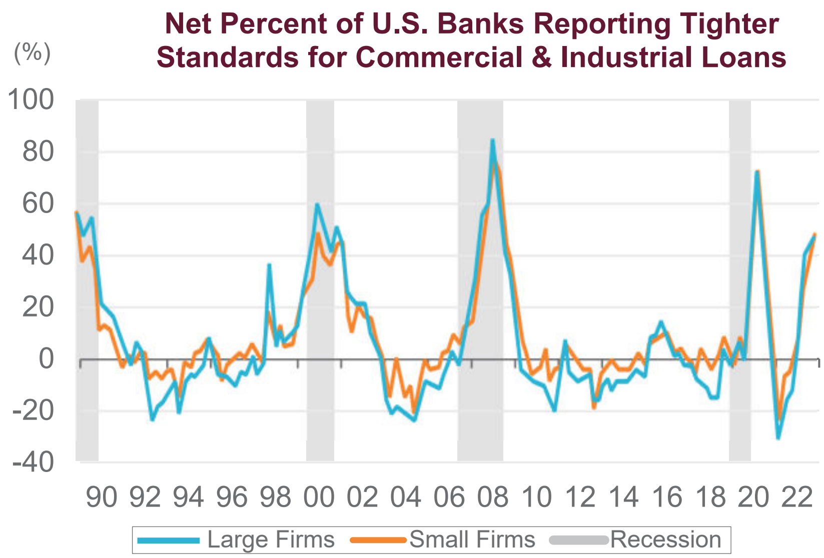
1981 was the last "intentional" recession brought on by a Fed bent on taming inflation. Fed Chair Paul Volcker back then pushed interest rates to more than 19%, despite high unemployment, tipping the US economy into two recessions over three years, lasting a combined 22 months, the worst downturn since the Great Depression. While current Fed Chair Jerome Powell cannot be explicit, the Fed seems to be following a similar playbook: combating inflation by causing recession.

As the 1980s unfolded, the aftershocks of extreme monetary tightening had consequences years later. Eventually, the stability of the Savings and Loan (S&Ls) industry was undermined: S&L depositors moved their money out to higher-yielding accounts while S&L loans (many of them in commercial real estate) lost value. This led to the US government bailout of the S&L industry and a mild, eight-month recession spanning 1990-1991.

There are major economic differences between today and the 1980s, including lower unemployment, greater reliance on services and technology vs. manufacturing, and stronger consumer finances overall, to name a few. The hope now is that these key differences coupled with a more responsive Fed will allow inflation to cool without a severe US recession.

Underlying Risks

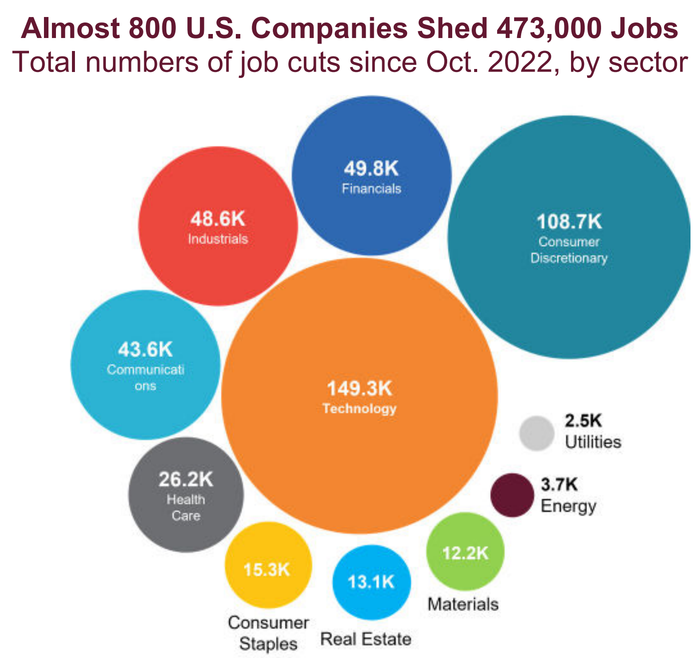
Does the current Fed have the dexterity to spot and address other risks lurking under the surface while combatting inflation, a dragon that seems to have been severely impaired, albeit not yet slayed? The answer to this question is critical. The onset of the recent banking crisis was the first concrete manifestation of something having broken in the system, and they missed it. You would think that an organization with 400 PhDs would be focused on assessing what other unintended consequences may be lurking across the financial system, before taking further action. But the Fed again raised interest rates on March 22nd. They seem to be ignoring the adage: "The Fed raises interest rates until something breaks."



Source: Federal Reserve, Haver Analytics, BofA Global Research.

Commercial Real Estate (CRE). In our ongoing evaluation of financial markets, we see the next potential inflammation point as commercial real estate loans. Consider that banks have a total of $3 trillion in CRE loans outstanding, the biggest allocation in their loan portfolios, and 85% of these are coming due in the next four years.

Of particular concern now is the office segment. CRE loans for office buildings were in many cases extended before remote/hybrid work became more common. With office vacancies continuing to rise, and defaults starting to emerge, the devaluation of CRE assets will likely, at a minimum, reinforce the banking sector's overall contraction. We bring this up as both a risk and a possible opportunity for a variety of strategies that may be able to take advantage of this dislocation (e.g., private real estate funds converting office space to multi-family units).



Note: Data comprises layoffs announced in terms of number of jobs or share of workforce from Oct. 1, 2022 through March 20, 2023.
Source: Bloomberg.

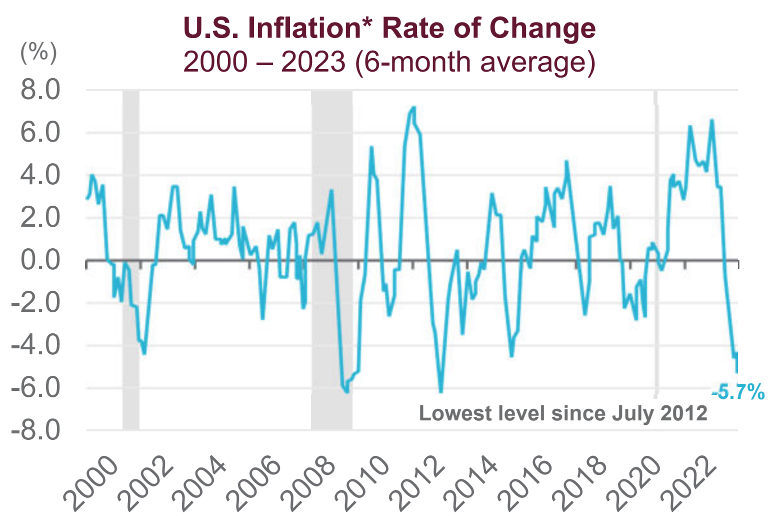
You may recall in past Commentaries we have pointed out that a typical business cycle starts with credit expansion, which then drives economic expansion. Given the likely tightening in credit conditions, fuel for economic expansion in the near term seems limited.

Implications for the Economy

Jobs. Many economists and investment strategists have been hanging their soft-landing hypothesis on the strong labor market. But that bright spot seems to be dimming. In February (latest data available), the number of US job openings decreased to less than 10 million for the first time since May 2021, while quits have generally stalled (workers are not as apt to leave their jobs in periods of uncertainty); and layoffs and discharges were 1.5 million (vs. 1.7 million in Jan.). While the tech industry has had the most high-profile layoffs, we could start seeing more of a rotational recession—one that rotates through different industries. You can see in the chart (bottom of previous page) that layoffs are starting to materialize in other industries.

Inflation. A positive aspect of a slowing economy is that it is giving the Fed what it wants to lower inflation. A mix of key inflation indicators (CPI, PPI, PCE -- both headline and core for each) provides a remarkable picture of the rapid decline in the rate of change (i.e. the speed of change) in inflation on a 6-month rolling basis. The steep decline shown in the chart at right hasn't occurred since 2012.

As we have said in the past, the Fed continues to cite year-over-year inflation data despite the fact that the rate of change in the most recent data is much more meaningful. Recent rate of change reveals that inflation is slowing.



*As measured by a mix of indicators: Consumer Price Index (CPI), Producer Price Index (PPI) and Personal Consumption Index (PCE), both nominal and core versions (excluding food and energy).
Source: *Economic Indicators*, Bespoke Premium, 3/31/2023.

The Financial Markets

In the 1st quarter of 2023, the S&P 500 advanced 7%, the Nasdaq surged nearly 17% while the Dow finished the quarter essentially flat (+0.4%). As mentioned earlier, the equity markets showed significant resilience in the face of many headwinds.

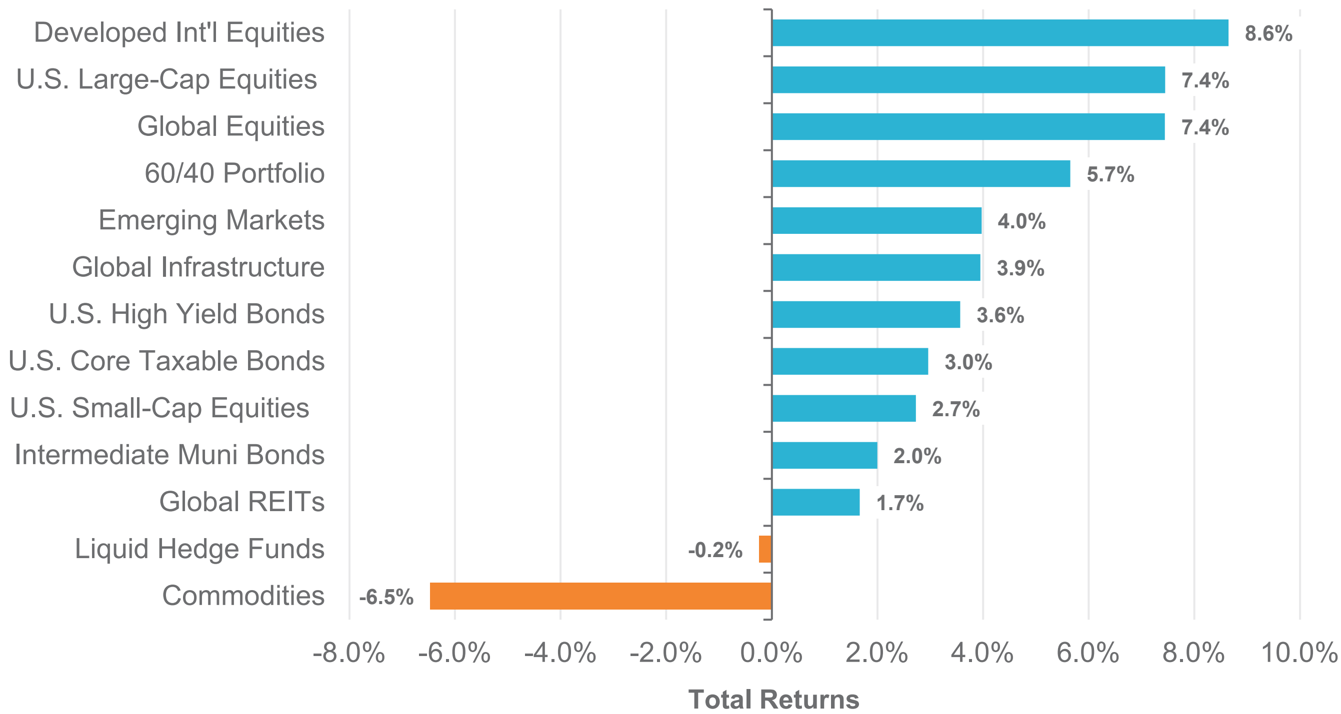
A closer look, however, reveals a bit of a different picture. Strong Q1 performance was dominated by 3 sectors: technology (+24.0%), communication services (+20.5%) and consumer discretionary (+16.8%). More specifically, the leaders were the pre-2022 mega-cap tech stocks: Alphabet (aka Google), Amazon, Apple, Meta (aka Facebook), Microsoft, Netflix, NVIDIA and Tesla. Take those names out, and the S&P 500 gained only 1.2% gain through March. Big Tech also drove Nasdaq's best quarter since 2020. Narrow leadership isn't necessarily a good thing. Aside from the broader macroeconomic and geopolitical factors that could impact markets, to get comfortable with the recent rally, we would need to see much broader participation. With that said, after a year like 2022, we'll take the gains!

Bonds and core fixed income also had a very good first quarter. With inflation by most measures continuing to cool and the likelihood of a recession rising, intermediate-term bonds were sought after by investors. The 10-year US Treasury yield was recently down to 3.3%, the lowest level since last

September, and corporate credit spreads tightened. Given this backdrop, longer-dated bonds outperformed in most taxable and tax-exempt sectors, whereas cash and equivalents lagged.

On the downside, real assets quietly struggled, lowlighted by commodities, which fell -5.4%. Infrastructure equities, which are benefiting from their defensive characteristics and secular trends, were a notable exception (+3.9%). Over the last 12 months, infrastructure has fallen only -3.5% while commodities overall are down -12.5% and REITs -19.4%, as concerns about a slowing economy and the real estate market overshadowed supply/demand disruption and inflation.

1st Quarter 2023 Returns by Asset Class
Through March 31



Source: LNWM, Morningstar, Bloomberg, Hedge Fund Research, ICE Data Services. Global Bonds return is calculated using total return.

Implications for Portfolios

There is more reason than ever today to maintain portfolio diversification, given the risk that the Fed may raise rates too far too fast. This is a risk we have highlighted in our risks-opportunities framework since early 2022.

Asset Class Diversification. The recent bank failures make a policy mistake by the Fed an even greater risk. Credit will likely not be as free flowing as before, which tends to drive lower corporate and consumer spending across most industries. A consequence of this could be stronger headwinds for risk assets and continued volatility.

In this type of environment, cash and core fixed income (2023) plus diversifiers (hedge funds, private market) have generally added to portfolios. Equities have benefited mainly from the resurgence in mega-cap tech stocks, which might seem less vulnerable to stresses in the financial system given their cash like balance sheets. But the tech sector is not immune to the business cycle.

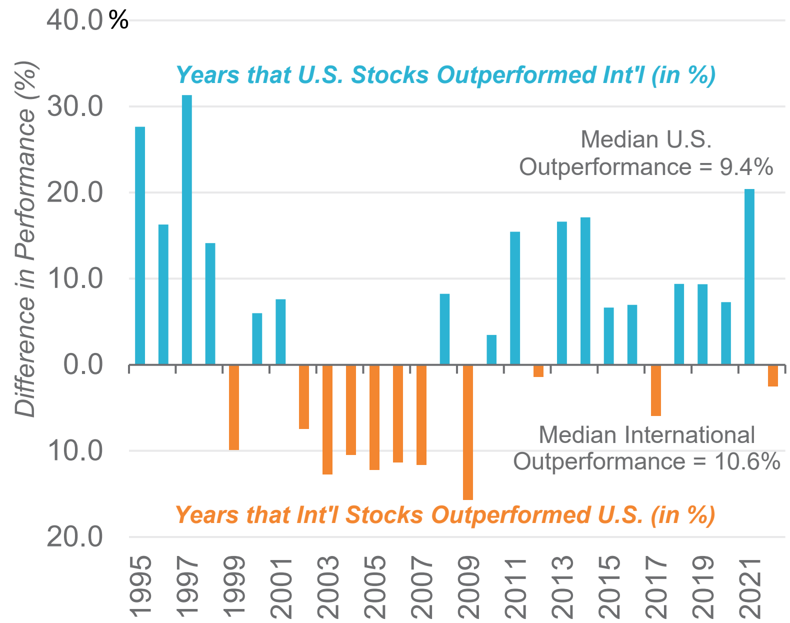
Non-US Equities. Investors tend to have a home country bias, favoring domestic over foreign stocks. It is easy to succumb to this bias, especially when your home team – US stocks – has been outperforming by a wide margin for the past decade. Don't! Historically US and international stock returns have experienced meaningful dispersion from year to year to the tune of a wide, 10 percentage spread! We feel it is important to be at least market-weight to non-US equities due to their compelling valuations vs. their history and vs. US counterparts.

One of the key drivers behind meaningful return differences between US and foreign equities is sector exposure. Most notably, international markets are 33% less exposed to tech stocks as well as other growth sectors. Easy money polices and globalization supported by the post-USSR peace dividend provided tailwinds for tech stocks but that is being challenged as part of the regime shift we mentioned previously. The trend toward de-globalization appears to have started with the trade barriers enacted against China during the Trump administration and has continued to gain momentum, resulting in diverging equity market returns.

The trade wars with China are also starting to manifest themselves in terms of investor preferences for countries closer or friendlier to the US. The chart on the next page shows investors are starting to prefer exposure to Mexico over China likely in anticipation of more industries moving to this US border country.

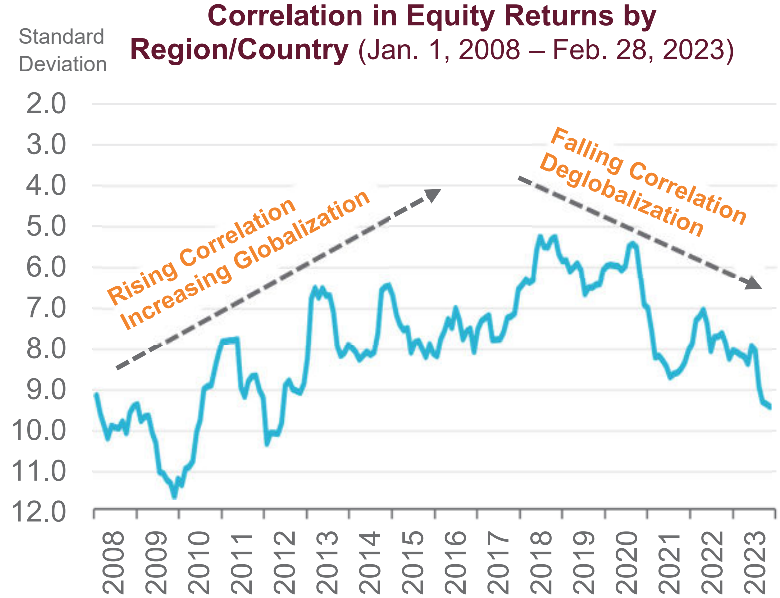
The issues with China are part of the broader shift in the geopolitical landscape—a driver of risks and

Relative Performance of U.S. vs. International Stocks by Year (1995 - 2022)



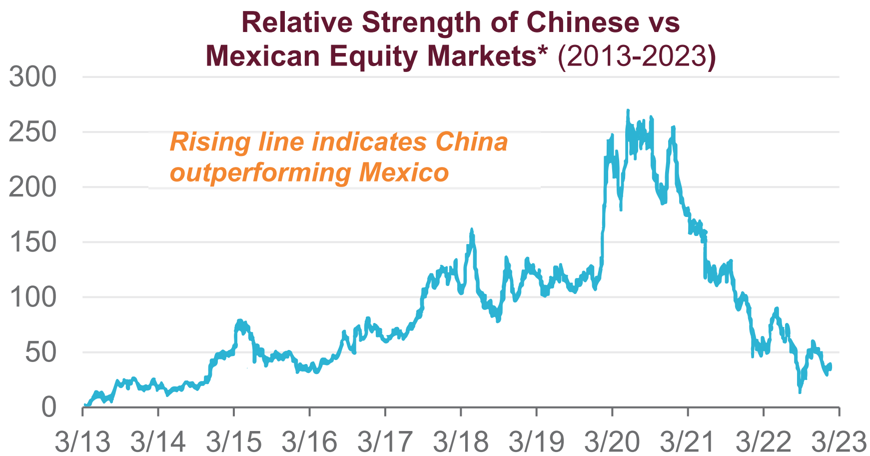
Relative returns of S&P 500 Index vs. MSCI ACWI ex USA Index. For index descriptors, see "Index Descriptions" at end of this document.
Source: Richard Bernstein Advisors LLC, Bloomberg Finance L.P.

Correlation in Equity Returns by Region/Country (Jan. 1, 2008 – Feb. 28, 2023)



Cross-country standard deviation of monthly excess returns for sectors in a country/region relative to MSCI ACWI Index (USD). If the sector returns in all countries were the same, this measure would be zero. The standard deviation is calculated over rolling 12-month periods for the following countries/regions: U.S., Europe, Japan, Pacific ex-Japan, Canada, and Emerging Markets. MSCI Indices in USD are used. For index descriptions, see end of this document.
Source: Richard Bernstein Advisors LLC, Bloomberg Finance L.P.

opportunities for years to come. In line with this, developments in Ukraine plus the unintended effects of the Fed going too far too fast remain the primary risks in 2023. On the Ukraine front, markets may have become complacent due to access to grain supplies (tenuous deal between Ukraine and Russia to allow shipments via the Black Sea), and lower energy prices, although OPEC's production cut starting in May could reverse that trend.



*iShares ETFs: MCHI for Mexico; EWW for China.
Source: Federal Reserve, Haver Analytics, BofA Global Research.

Credit Opportunities. Corporate credit spreads (the difference in yield between high-quality corporates and Treasuries) will likely remain volatile due to Fed rhetoric, mixed economic data and geopolitical developments. One of the upsides of this is the opportunity to establish strategic positions in the more esoteric corners of fixed income, which may be trading at a discount due to the evaporation of liquidity or vulnerability to rising rates. Allocations to niche areas such as credit hedge strategies, convertible bonds and Collateralized Loan Obligations (CLOs) may offer both upside and limited downside if a more severe recession takes hold.

Infrastructure Equities. While a buffer from inflation is one of the core benefits of the real assets category, it isn't the sole consideration. Even if inflation continues to cool, exposure to both traditional infrastructure assets (road, rail, utilities) and to renewable energy is attractive on a near-term and strategic basis. Many businesses in this segment tend to have near monopolistic pricing power, as they can pass operating price increases on to customers, often contractually. This makes them more defensive vs. broad equity markets. Just as important, global infrastructure spending appears to be on a secular long-term uptrend that continues to gain momentum.

In Closing

All of this adds up to a continued state of volatility across economies and markets. I can't tell you how many seasoned investment professionals are saying these are the most confusing times they have ever seen. Well, perhaps they haven't been around long enough. Pre-2022, markets levitating due to liquidity and other favorable conditions gave these folks the false impression that the market environment was easier to understand and simpler to navigate. The reality is that the future is always unknown and the many factors that can destabilize conditions have always been present in one form or another. The steady hand borne from experience is crucial for navigating these times.

Unlike the depositors who took down a couple of banks in a single day by reacting to fragments of information, we take in the daily data and facts but do not react to the digitally propagated noise of headlines and partial facts. While our goal with the Commentary is to parse recent developments, our overriding message tends to be consistent: We are focused on the steady execution of your investment plan via the levers we can control, helping to put the odds in our favor as we shepherd your portfolio(s) through turbulent times.

ABOUT THE AUTHOR

Ronald G. Albahary, CFA® is Chief Investment Officer at Laird Norton Wealth Management. As the head of LNWM's investment team (see below), Ron determines the firm's investment strategy, directs the investment selection process, and works in tandem with LNWM's client services teams to deliver investment solutions structured to attain each client's unique goals. Prior to joining LNWM, Ron served as CIO or CEO at regional investment firms focused on ultra-high-net-worth families and foundations. Earlier in his career, he held leadership positions in the private client business of major global financial institutions, including Merrill Lynch and Northern Trust Private Bank. Ron has a degree in economics from the Wharton School at the University of Pennsylvania and currently serves as advisor to the Center for High Impact Philanthropy at the University of Pennsylvania.

The investment team resulting from the combination of Laird Norton Wealth Management and Wetherby Asset Management is comprised of 11 analysts and strategists working together to design and implement investment solutions for client portfolios. Six analysts at the firm hold the Chartered Financial Analyst® designation, with expertise spanning macroeconomics, public and private asset classes across the global capital markets, and impact investing. Collaborating with each other and with client advisors, the investment team's overarching goal is to help clients and their families preserve and grow their wealth over many generations.

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DISCLOSURE

INDEX DEFINITIONS

CASH: Morningstar US 1-3M T-Bill - The index measures the performance of fixed-rate, investment-grade US Treasury Bills with 1-3 months remaining until maturity. It is market-capitalization weighted.

U.S. TAXABLE BONDS: Bloomberg US Aggregate Bond Index – Covers the US Dollar-denominated, investment-grade, fixed-rate, taxable bond market of SEC-registered securities. The index includes bonds from the Treasury, Government-Related, Corporate, MBS, ABS, and CMBS sectors.

U.S. INTERMEDIATE MUNI BONDS: Bloomberg Muni 1-10 Year Index – Tracks the performance of US dollar denominated investment grade tax-exempt debt publicly issued by U.S. states and territories, and their political subdivisions, in the US domestic market with maturities between 1 and 12 years.

U.S. HIGH YIELD BONDS: ICE BofA US High Yield Index - Tracks the performance of US dollar denominated below investment grade corporate debt publicly issued in the US domestic market.

GLOBAL BONDS: Bloomberg Global Agg Index - A measure of global investment grade debt from a multitude local currency markets. This multi-currency benchmark includes treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging markets issuers.

10-YEAR US TREASURY BONDS: BofAML US Treasury Current 10 Year Index – The market value weighted index of public obligations of the US Treasury with maturities of 10 years.

U.S. LARGE CAP EQUITIES: S&P 500 - The index includes 500 leading US companies and captures approximately 80% coverage of available market capitalization.

U.S. SMALL CAP EQUITIES: Russell 2000 Index - Measures the performance of the 2,000 smallest companies in the Russell 3000 Index, representative of the US small-capitalization securities market.

INT'L DEVELOPED EQUITIES: MSCI EAFE Index - A free float-adjusted market-capitalization index that is designed to measure developed market equity performance, excluding the US and Canada. Consists of the following 21 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland and the United Kingdom.

EMERGING MARKETS EQUITIES: MSCI Emerging Markets Index - A free float-adjusted market-capitalization index that is designed to measure equity market performance in the global emerging markets. Consists of the following 25 emerging market country indices: Argentina, Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Jordan, Korea, Malaysia, Mexico, Morocco, Pakistan, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, and Turkey.

GLOBAL EQUITIES: MSCI ACWI Index - A free-float weighted equity index. It was developed with a base value of 100 as of December 31, 1987. MXWD includes both emerging and developed world markets.

GLOBAL REITs: FTSE EPRA/NAREIT Global REITs Index - A measure that tracks the performance of listed real estate companies and REITs worldwide.

GLOBAL INFRASTRUCTURE: S&P Global Infrastructure Index - Provides liquid and tradable exposure to 75 companies from around the world that represent the listed infrastructure universe. To create diversified exposure across the global listed infrastructure market, the index has balanced weights a cross three distinct infrastructure clusters: Utilities, Transportation, and Energy.

COMMODITIES: Bloomberg Commodity Index - A broadly diversified index of futures contracts intended to be representative of the commodities market. It currently includes 19 commodity futures in seven sectors.

LIQUID HEDGE FUNDS: HFRX Global Hedge Fund Index – A daily-valued index designed to be representative of the overall liquid hedge fund universe. It is comprised of all eligible hedge fund strategies; including but not limited to convertible arbitrage, distressed securities, equity hedge, equity market neutral, event driven, macro, merger arbitrage, and relative value arbitrage. The strategies are asset weighted based on the distribution of assets in the hedge fund industry.

ILLIQUID HEDGE FUNDS: HFRI Fund Weighted Composite Index – A global, monthly-valued, equal-weighted index of over 2,000 single-manager funds that is designed to be representative of the overall composition of the hedge fund universe. It is comprised of all eligible hedge fund strategies. Constituent funds report monthly net of all fees performance in US dollar and have a minimum of $50 Million under management or a twelve (12) month track record of active performance. The HFRI Fund Weighted Composite Index does not include Funds of Hedge Funds.

DIVERSIFIED PORTFOLIO: 10% US Municipal Bonds; 10% US Core Bonds; 25% US Large Cap Equities; 5% US Small-Cap Equities; 22% Int'l Developed Equities; 9% Emerging Markets Equities;4% Global Infrastructure; 13% Illiquid Hedge Funds; 2% Commodities.

60/40 PORTFOLIO: 60% Global Equities, 40% U.S. Taxable Bonds

Diversification does not assure better performance and cannot eliminate the risk of investment losses. There are no guarantees that a diversified portfolio will outperform a non-diversified portfolio. International investments may involve risk of capital loss from unfavorable fluctuation in currency values, from differences in generally accepted accounting principles, or from economic or political instability in other nations.

An index is an unmanaged statistical combination of securities designed to be representative of the performance of an asset class, sector or investment style. Indices are shown for informational purposes only and it is not possible to invest directly in an index. Indices are not subject to management fees. Comparisons between a composite or a portfolio and an index or benchmark are unreliable as performance indicators and should not be considered indicative of the performance that may be experienced in a particular managed portfolio.

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