ARS INVESTMENT PARTNERS

THE OUTLOOK

April 5, 2023

IN THIS ISSUE...

The Accelerator/Brake Economy

Thoughts on the Troubles in the Banking System

Investing for a Non-Traditional Business Cycle

Driving With One Foot on the Accelerator and One Foot on the Brake

"Uncertainties are exceptionally high, including because of risks of geo-economic fragmentation which could mean a world split into rival economic blocs — a 'dangerous division' that would leave everyone poorer and less secure. At a time of higher debt levels, the rapid transition from a prolonged period of low interest rates to much higher rates — necessary to fight inflation — inevitably generates stresses and vulnerabilities, as evidenced by recent developments in the banking sector in some advanced economies."

-IMF Managing Director Kristalina Georgieva, March 25, 2023

The economic outlook has changed. As a result of the recent collapse of three regional banks, the Federal Reserve's policy of rapid interest rate increases and quantitative tightening have been importantly affected. The recent issues in the banking system have the effect of tightening credit, slowing the economy, and therefore reducing inflation – accomplishing what the Fed has been trying to do with its rapid increases in interest rates. The troubles in the banking system now have the Federal Reserve facing three issues – fulfilling its mandate to maximize employment, maintaining price stability, and now protecting the soundness of the financial system. This last point has added a new element to the Fed's decision-making process and future policy actions. On March 12th, the Fed created the Bank Term Funding Program (BTFP) to support American businesses and households by making additional funding available to eligible banks to ensure their ability to meet the needs of all their depositors. Additionally, the US and other nations set up currency swap lines to ensure that the global system had ample availability of dollars. Both these initiatives, while not well publicized, may prove to be key to providing ample liquidity and restoring confidence in the financial system.

Investors should now focus on recent legislation that is assuring rising demand and production now and for the rest of the decade.

The opportunities represented by the real economy rather than just the financial now stand out.

While the current market backdrop remains challenging, the investment opportunities presented by the real economy (goods and services) rather than just the financial side of economic activity now stand out. Given our expectations that banks will tighten lending standards, the US consumer will not likely be spending at the same level as in the past and thus will not be the same driver for growth in the near-term. Rather, investors should now focus on the areas where recent legislation is promoting rising spending by Federal,

state, and local governments, and corporations. This legislation is assuring rising demand and production now and for the rest of the decade. In our January 12th Outlook ARS introduced three critical, multi-year transitions – the cost-of-living increase, the realignment of the global geopolitical order, and the re-industrialization of the global economy – that are occurring today and have major implications for investment strategy. These and other factors help explain why there is no historical precedent for the current economic environment, and why so many investors struggle to make sense of the conflicting messages of economic strength and weakness in the economy.

We continue to favor those companies supporting the clean energy transition, improving productivity, lowering healthcare costs, and ensuring national security.

We continue to favor those companies supporting the clean energy transition, improving productivity, lowering healthcare costs, and ensuring national security. Our team has identified high-quality companies with strong balance sheets and solid dividend growth benefitting from the current economic outlook. We have been underweight in financial and consumer-oriented stocks, businesses with weak balance sheets (especially those with elevated levels of short-term debt), and those whose unsustainable demand has begun to have a negative impact on their outlooks for earnings and cash flow.

The Accelerator and Brake Economy

Market participants have struggled to make sense of the equity and bond markets this year as policymakers are driving the economy with one foot on the accelerator, stemming from Congress' accommodative fiscal policies (Inflation Reduction Act, Chips & Science Act, National Defense Authorization Act). The other foot is on the brake as the Fed had abruptly shifted from its ultra-easy monetary policy to significantly tighter conditions (higher interest rates) over a particularly short period of time. One of the biggest challenges for effective implementation of monetary and fiscal policy is the fact that the economic impact can take up to 18 months to be fully felt, and consequently the effectiveness of the Fed's policy and legislative acts will not be completely manifested until some future date. In response to the pandemic and war in Ukraine, the world has experienced the most aggressive monetary and fiscal policy initiatives in history. Policymakers felt the need to provide a forceful response to prevent the global economy from hurtling towards a depression.

The effectiveness of the Fed's policy and legislative acts will not be completely manifested until some future date.

The playbook from the Great Financial Crisis (GFC) led markets to first look toward central banks to provide immediate support to the global economy by lowering interest rates and enacting a new QE program (quantitative easing or the printing of money). Governments also implemented fiscal policy initiatives aimed at providing support to workers and businesses impacted by the crisis. As shown in Chart 1, the combination of monetary and fiscal stimulus from February 2020 to May 2021 totaled $30.95 trillion on a $100 trillion world economy. In the United States, policymakers' responses totaled $12.3 trillion or 57.4% of US GDP. The level of response was unprecedented,

and this was before Congress enacted the Inflation Reduction Act, the CHIPS and Science Act of 2022, and the National Defense Authorization Act in the past year.

Chart 1. Unprecedented Policy Response to Unprecedented Problems Globally

Global Monetary and Fiscal Stimulus to Counter COVID-19
February 2020 to May 2021

	Potential Central Bank Liquidity Injection		Potential Fiscal Stimulus		Central Bank Liquidity Injection and Fiscal Stimulus	
Country	($ in trillions)	(% GDP)	($ in trillions)	(% GDP)	($ in trillions)	% GDP
United States***	$6.21	29.0%	$6.09	28.4%	$12.30	57.4%
Eurozone	$2.38	17.9%	$4.51	33.9%	$6.90	51.8%
Japan**	$1.03	20.0%	$2.79	54.1%	$3.82	74.1%
United Kingdom	$0.57	20.7%	$0.69	25.1%	$1.26	45.9%
China****	$1.43	10.0%	$1.22	8.4%	$2.64	18.4%
Other*	$1.05		$2.99		$4.03	
World	**$12.66**	**14.6%**	**$18.29**	**21.1%**	**$30.95**	**35.7%**

Source: Cornerstone Macro
*incl RoW and ADB, IMF, WB ** Japan's ¥117.1 t supplementary budget includes: fiscal measures, an investment loan program, and private sector loans (i.e. guarantees). The total size of measures to fight the coronavirus crisis will reach ¥230 trillion [40% of GDP]" (Jiji, May 27). With BoJ's 20% potential liquidity injection, Japan's total stimulus may be 60% of GDP. ***U.S.: Fed's $6.2T injection incl the $2.5T announced on Apr 9, and the $3.7 facility. ****China CB stimulus incl liq injections and other activities, e.g., re-lending, RRR, direct small biz lending, etc

After a decade of central banks' attempts to lift inflation above 2%, it appears that a higher level of inflation now is imbedded in the world economy.

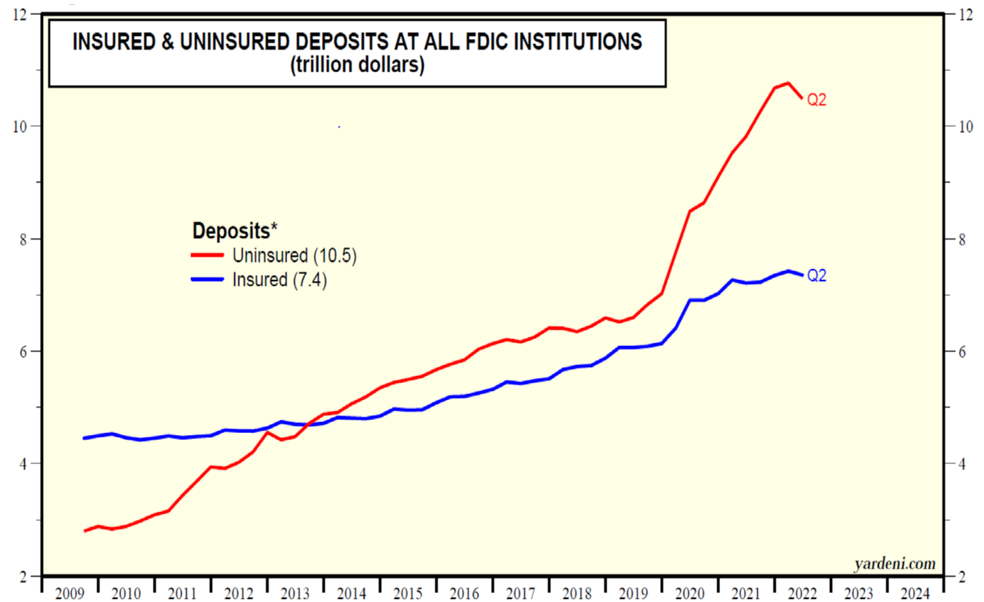
After a decade of central banks' attempts to lift inflation above 2%, it appears that a higher level of inflation now is embedded in the world economy. With the United States and global economies returning to more traditional interest rate structures, investors need to assess whether their current portfolios still have the same or better risk characteristics than they had a few months ago. The March inflation reading for Europe remained stubbornly high leading to the most recent 0.50% benchmark rate hike by the European Central Bank (ECB). The challenge for policymakers in the United States is further compounded by the need to address the debt ceiling and restore trust in the banking system, while battling inflation and a slowing economy with a critical election next year.

Thoughts on the Troubles in the Banking System

"Banking is a business that can be a very good business, when run right. There's no magic to it. You just have to stay away from doing something foolish. It's a little like investing. You don't have to do anything very smart. You just have to avoid doing things that are ungodly dumb."

\- Warren Buffett

Chart 2. A Crisis Waiting to Happen



During periods of ultra-low interest rates investors typically take on risk which does not appear to be excessive at the time but is obvious in hindsight.

The German economist Rudi Dornbusch once said, *"The crisis takes a much longer time coming than you think, and then it happens much faster than you would have thought."* The failure of Silicon Valley Bank (SVB) and others in the system was slow to develop and then happened with a speed that surprised even veteran investors. During periods of easy monetary conditions (ultra-low interest rates) such as we have experienced since 2009, investors typically take on risk which does not appear to be excessive at the time but is obvious in hindsight. This was the case when, after a decade of near zero interest rates, rates spiked up, access to capital slowed quickly, and importantly, confidence in the safety of the system was questioned.

The early assessment of the current banking crisis suggests that many factors contributed to the problem of Silicon Valley Bank with some being external and some being bank-specific errors. These include:

1. Uninsured Deposits - As shown in Chart 2, this vulnerability was building in the US banking system since 2013. Over 90% of the deposits at SVB and Signature Bank were uninsured at the time of the failures, and uninsured deposits are much more vulnerable to runs.

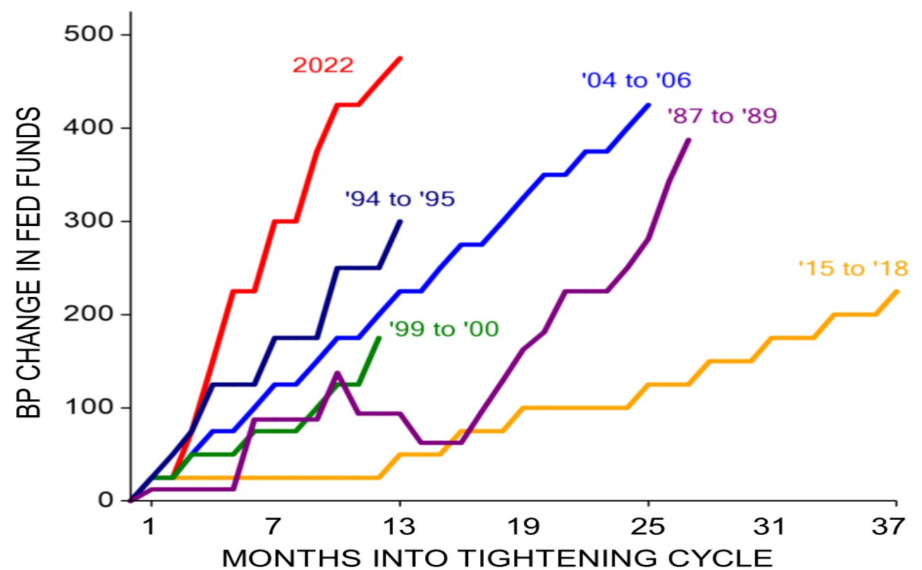
2. Lengthened Maturities – Many banks extended the bond maturities in their balance sheet holdings prior to the Fed starting its dramatic interest rate policy reversal to counter inflationary pressures which increased the banks' risk profiles. This shift occurred late in the economic cycle and made the banks more vulnerable to interest rate increases.

April 5, 2023

3. Monetary Policy Changes – The actual reversal of low interest rate policies (in reaction to inflation), was done so quickly that a problem was inevitable in hindsight. Since monetary conditions were easy for nearly a decade, it would have been ideal for the Fed to take longer to tighten conditions. However, the pandemic, the war in Ukraine, and supply chain problems created a spike in inflation that forced the Fed to raise rates much faster than ideal. Chart 3 illustrates the speed and magnitude of this tightening cycle compared to previous ones. It was totally unrealistic for a financial system that was a decade in the making to adjust in just 10 months.

It was totally unrealistic for a financial system that was a decade in the making to adjust in just 10 months.

Chart 3. Comparing Federal Funds Tightening Cycles



Source: Evercore ISI

4. Regulatory Changes – The Dodd-Frank Wall Street Reform and Consumer Protection Act (2010) was introduced to overhaul financial regulation following the Great Financial Crisis. According to the Senate brief on the law, the aim of the act was “to create a sound economic foundation to grow jobs, protect consumers, rein in Wall Street and big bonuses, end bailouts and too big to fail, prevent another financial crisis.” Dodd-Frank was followed by The Economic Growth, Regulatory Relief and Consumer Protection Act (2018) which rolled back some aspects of Dodd-Frank. One change was that it raised the threshold from $50 billion to $250 billion under which banks are deemed too big to fail. While reasonable people might disagree, this change was likely a factor in the SVB failure and was lobbied for by many mid-sized banks, including SVB CEO Doug Becker. It is notable that Mr. Becker also served as a Director of the Federal Reserve Bank of San Francisco up until March 10th, the day the bank was closed by regulators.

5. Mistakes by Management – In the process of reducing risk for the banks, the 2010 Act also changed the revenue opportunity for some, while the low interest rate environment hurt the ability to earn fees on deposits. While there is still much we do not know about what exactly occurred at SVB, the failure is likely the result of problems involving concentration risk of its business, weak risk management, and greed.

The failure at SVB is likely the result of problems involving concentration risk of its business, weak risk management, and greed.

A. **Concentration Risk** – First, the bank had tremendous success over the past decade as it became perhaps the most important banker to the startup community. It provided startup businesses with corporate loans and cash management services, personal loans for the founders of those businesses, investment and deposit services, and similar services to the employees of these startups. In short, its success in the hottest sector in the US lead to an unanticipated concentration risk in a highly volatile industry.

B. **Risk Management** – When interest rates rose at a much faster rate than its risk models might have projected, securities that were meant to be held to maturity, and therefore valued at full maturity value on SVB's books, were required to be revalued to the current lower values (marked-to-market) when too many deposits were withdrawn in a run. Additionally, it has been reported that SVB was without its Chief Risk Officer for 8 months at the time of its collapse.

When investors stretch for yield late in an expansion, the additional income is usually not worth the associated risk.

C. **Greed** – Finally, the bank increased the risk on its balance sheet by extending the maturity of its bond portfolio to increase its revenues (net interest margins). This in turn made it more susceptible to a rapid increase in interest rates and a run on its deposits. When investors stretch for yield late in an expansion, the additional income is usually not worth the associated risk. The Fed was clear in its communication regarding the path of interest rates, but SVB and others with large levels of uninsured deposits seem to have chosen to ignore the interest rate risk that each was accepting to boost earnings and its share price.

The economic slowdown resulting from now tighter lending standards will likely achieve what the Fed was embarking on to slow inflation in the first place.

Investing for a Non-Traditional Investment Cycle

Our investment process is focused on identifying the beneficiaries of the current economic environment and avoiding those areas of the market that are negatively impacted by the problems in the global economy. Based on our assessment of the United States economy, investors should focus on investing in areas where governments and corporations are spending and investing rather than relying on the consumer as the driver for growth as inflation is limiting consumer spending, and confidence is shaken by recent bank failures. The economic slowdown resulting from now tighter lending standards will likely achieve what the Fed was embarking on to slow inflation in the first place. Volatility and market declines are now yielding better investment opportunities among the beneficiaries of the Infrastructure Act, the Chips Act, and the Defense Authorization Bill.

Investment choices have narrowed resulting in capital flows and investment interest that is more focused toward companies that benefit from strong and rising demand, have strong balance sheets, are not difficult to analyze, and are in secular uptrends.

Recent interest rate declines are likely to stimulate home buying as mortgage rates have fallen and housing permits, a leading economic indicator, have risen. Currently, there is a housing deficit of three to six million homes while some 75 million millennials are entering their home buying years. Because investing in much of the financial sector has become more difficult, investment choices have narrowed resulting in capital flows and investment interest that is more focused toward companies that benefit from strong and rising demand, have strong balance sheets, are not difficult to analyze, and are in secular uptrends. In addition, national security remains one of the most critical areas that will continue to attract capital as tensions between democratic and autocratic nations remain elevated with no resolution expected in the near-term.

There is a continuing gap between US job openings and the smaller number of available workers due to a labor pool that is unlike the prior periods. In particular, there is a shortage of skilled workers that includes teachers, assembly line workers, electricians, health care professionals, construction workers, engineers, and workers for most economic activity. In January, there were more than 5 million more positions than people to fill them. Demographic trends play a leading role. The US working-age population shrank in 2018 – the first time since 1960. Baby boomer retirements picked up and fewer young people entered the labor force. From 2017 to 2022 the working-age population grew by 1.7 million people while between 2000 and 2005 working-age population growth was 11.9 million people. Challenges from this issue can be dealt with by raising the social security age (which also helps the funding problem), accelerating the use of advanced technology to substitute for labor, increasing productivity through medical breakthroughs, releasing infrastructure spending (which has begun), improving childcare policy (the Chips Act requires companies receiving $150 million or more to make childcare available to employees), and passing an effective immigration policy that the country needs.

Overall, the cost of labor has been rising and the Federal Reserve monetary policy of slowing economic activity and trying to create unemployment would only have the effect of slowing supply when increases in supply lowers inflation.

Overall, the cost of labor has been rising and the Federal Reserve monetary policy of slowing economic activity and trying to create unemployment would only have the effect of slowing supply when increases in supply lowers inflation. At the same time the infrastructure spending legislated along with the Chips Act serves as a stimulant to economic activity while the Fed is trying to slow activity. One foot is on the brake, the other on the accelerator.

While there are considerable stresses in the global economy, it is in times of economic stress and dislocation that some of the best investment opportunities are presented, and yet many investors are more concerned about risk avoidance than seeking opportunity. However, the two do not need to be mutually exclusive. The stresses in one part of the economy often create opportunities for other parts of the economy. ARS client portfolios are currently positioned to benefit from the clean energy transition by owning both fossil fuel and renewable energy companies, defense companies, industrial

As we are approaching the end of the rate-hiking cycle in the United States, we believe that equity valuations will begin to find firmer footing.

Innovation remains key to addressing many of the world's most pressing problems.

commodity and materials companies (steel, copper, and rare earths), and biotech, with characteristics that include strong balance sheets and quality dividends. Our financial sector exposure has been minimal and our fixed income portfolios have been invested to balance yield with preservation of capital, rather than stretching for income.

As we are approaching the end of the rate-hiking cycle in the United States, we believe that equity valuations will begin to find firmer footing. While there are several longer-term issues which may keep inflationary pressures elevated including labor shortages, the clean energy transition, and changes in terms of global trade, innovation remains key to addressing many of the world's most pressing problems. Critically, the reindustrialization of the global economy that is occurring is creating a generational opportunity for the manufacturing sector and the United States economy overall. In closing, we are reminded of another quote from Mr. Buffett that we feel is an appropriate reminder for investors as he once said, "Bad news is an investor's best friend. It lets you buy a slice of America's future at a marked-down price."

Published by the ARS Investment Policy Committee: Stephen Burke, Sean Lawless, Nitin Sacheti, Greg Kops, Andrew Schmeidler, Arnold Schmeidler, P. Ross Taylor, Tom Winnick.

The information and opinions in this report were prepared by ARS Investment Partners, LLC ("ARS"). Information, opinions and estimates contained in this report reflect a judgment at its original date and are subject to change. This report may contain forward-looking statements and projections that are based on our current beliefs and assumptions and on information currently available that we believe to be reasonable. However, such statements necessarily involve risks, uncertainties and assumptions, and prospective investors may not put undue reliance on any of these statements.

ARS and its employees shall have no obligation to update or amend any information contained herein. The contents of this report do not constitute an offer or solicitation of any transaction in any securities referred to herein or investment advice to any person and ARS will not treat recipients as its customers by virtue of their receiving this report. ARS or its employees have or may have a long or short position or holding in the securities, options on securities, or other related investments mentioned herein.

This publication is being furnished to you for informational purposes and only on condition that it will not form a primary basis for any investment decision. These materials are based upon information generally available to the public from sources believed to be reliable. No representation is given with respect to their accuracy or completeness, and they may change without notice. ARS on its own behalf disclaims any and all liability relating to these materials, including, without limitation, any express or implied recommendations or warranties for statements or errors contained in, or omission from, these materials. The information and analyses contained herein are not intended as tax, legal or investment advice and may not be suitable for your specific circumstances. This report may not be sold or redistributed in whole or part without the prior written consent of ARS Investment Partners, LLC.