INFLATION'S PERSISTENCE: MONETARY POLICY AGAINST THE BACKDROP OF A LOOMING RECESSION

April 2023

BDO WEALTH ADVISORS, LLC

With You Today

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EXPERIENCE

Mark Biegel is a Partner at BDO and the National Leader of BDO Wealth Advisors. He is an experienced Investment Manager with a proven track record of advising high-net-worth families and family offices on complex financial planning and investment needs. Mark is responsible for the overall strategic management and operations of BDO Wealth Advisors and embraces a team-oriented, collaborative approach to running the business. Mark is a member of BDO's Investment Committee and leads the firm's private investment efforts.

Mark has three decades of experience in the wealth management industry. Prior to joining BDO, he co-founded Biegel Waller Investment Advisory Services, where he served as Partner, Senior Portfolio Manager, and Chair of the Investment Committee.
Before shifting his career to investment management, Mark was a Senior Manager at Deloitte and served as tax attorney in their DC office. Mark is a member of the Maryland Bar and a Certified Public Accountant (CPA) and leverages his tax and legal expertise to advise clients on complex wealth management issues.

EDUCATION

J.D., University of Baltimore School of Law
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MATTHEW GOTLIN, CFA

Chief Investment Officer
Managing Director, Wealth Advisory

EXPERIENCE

Matt is Chief Investment Officer and a Managing Director with BDO Wealth Advisors in the BDO Maryland office. He is responsible for managing client portfolios to meet the customized goals and objectives of high-net-worth client and institutions. Matt is focused on optimizing the investment process through his analytical background. He has more than 26 years of experience in the investment area.

Prior to joining BDO, Matt was a Partner and Director of Research at Biegel &Waller, LLC. He focused on identifying investment opportunities with attractive risk-adjusted return characteristics. Matt possesses a depth of knowledge, experience, and dedication to the investment research process.

Matt's extensive research background includes founding March Capital, a private equity firm; conducting equity and fixed income research as a Senior Analyst at Chesapeake Partners, an event-driven hedge fund; and focusing on health care as an investment banking analyst at PaineWebber.

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Agenda for Today

Inflation and Central Banks' Response

Economic Data

Recent Banking Crisis with Securities Held to Maturity

Financial Market Update

Opportunities

Conclusion & Questions

What Is Inflation and What Caused It?

Inflation is an economic phenomenon in which the prices for services and goods rise.

Fiscal policy

The fiscal deficit expanded to a historic level. The unprecedented levels of spending has been inflationary.

Increase in money supply

When the COVID crisis began, the Fed injected trillions of dollars into the economy to help stimulate economic activity. While this helped support the economy, excessive stimulus has spurred inflation.

Robust demand and supply chain disruption

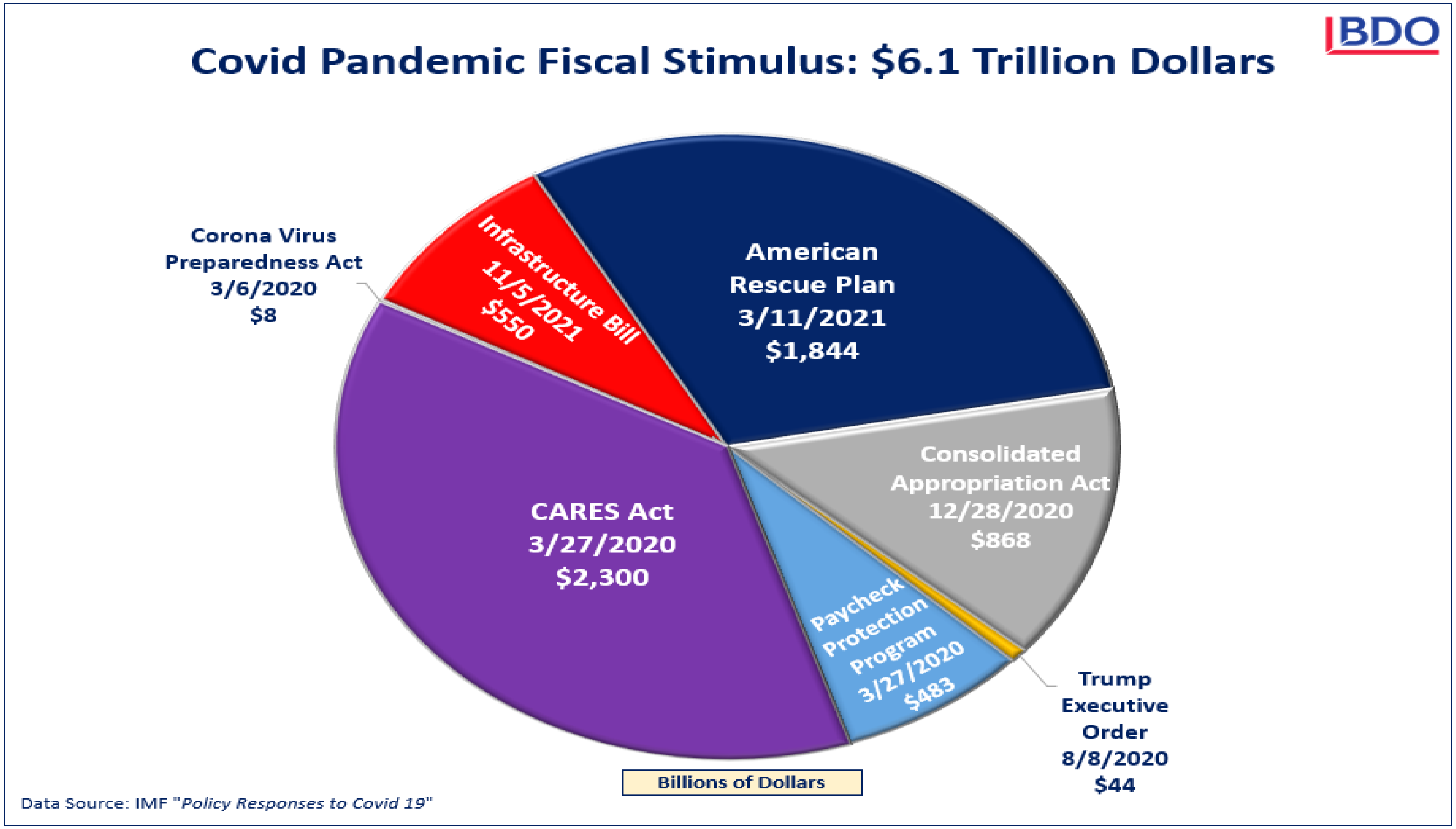
During the COVID crisis, the mismatch between supply chains shuttering while consumer demand remained robust caused prices to trend higher.

Geopolitical shifts

The fracturing of important geopolitical relationships (de-globalization, wars, protectionism) has contributed to higher prices.

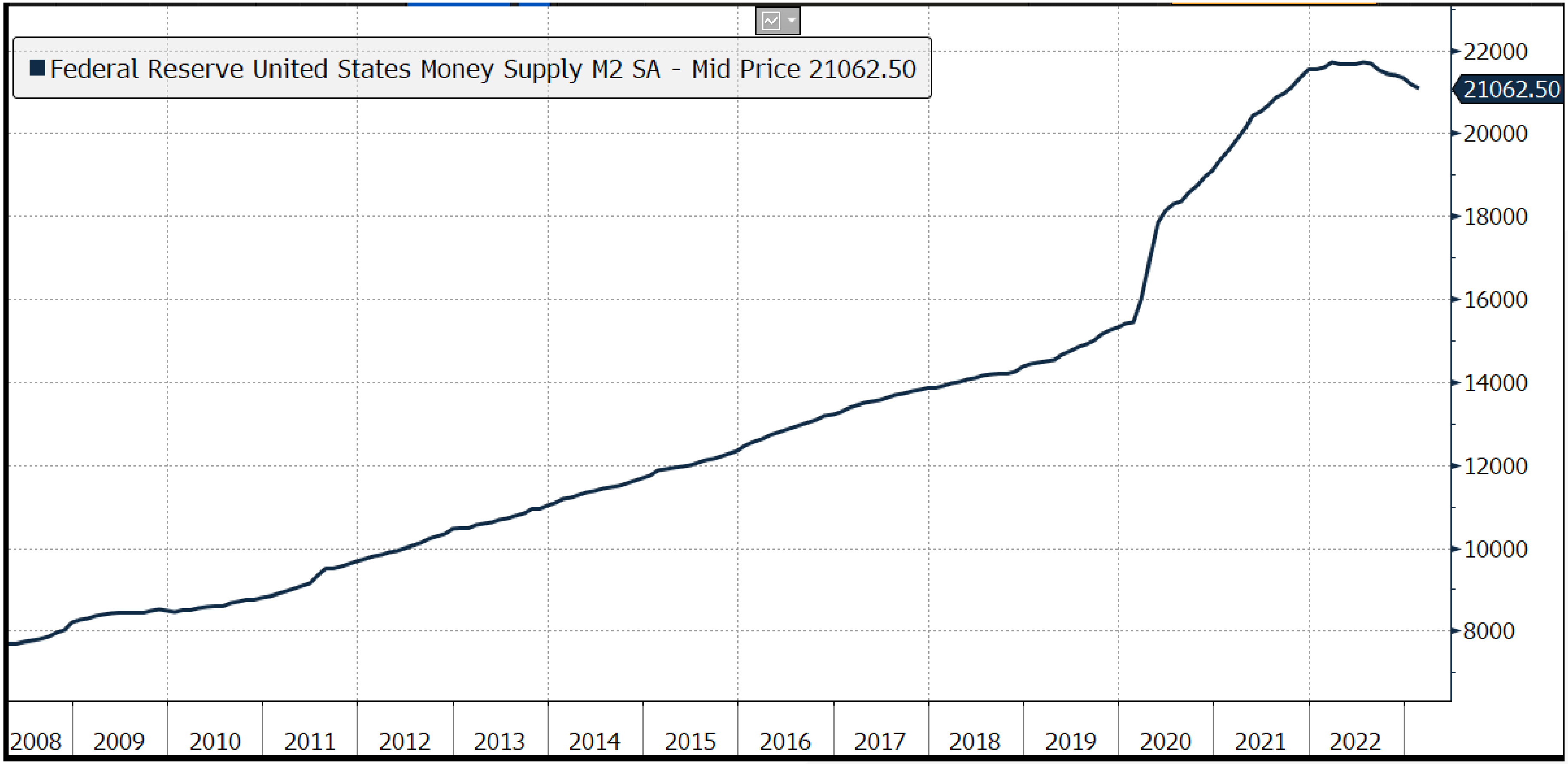
Unprecedented Fiscal Stimulus

Numerous stimulus packages poured trillions of dollars into the economy during the COVID-19 pandemic to stimulate economic activity. For comparison, during the GFC in 2008, fiscal stimulus totaled $750 billion. Prices are higher today, in part, because of the size of fiscal policy.



Money Supply Surged

The Federal Reserve implemented extraordinary measures to prevent the COVID-crisis from deepening further than it did. Those measures resulted in an extraordinary increase in the supply of money.



SOURCE: BLOOMBERG 4/5/2023

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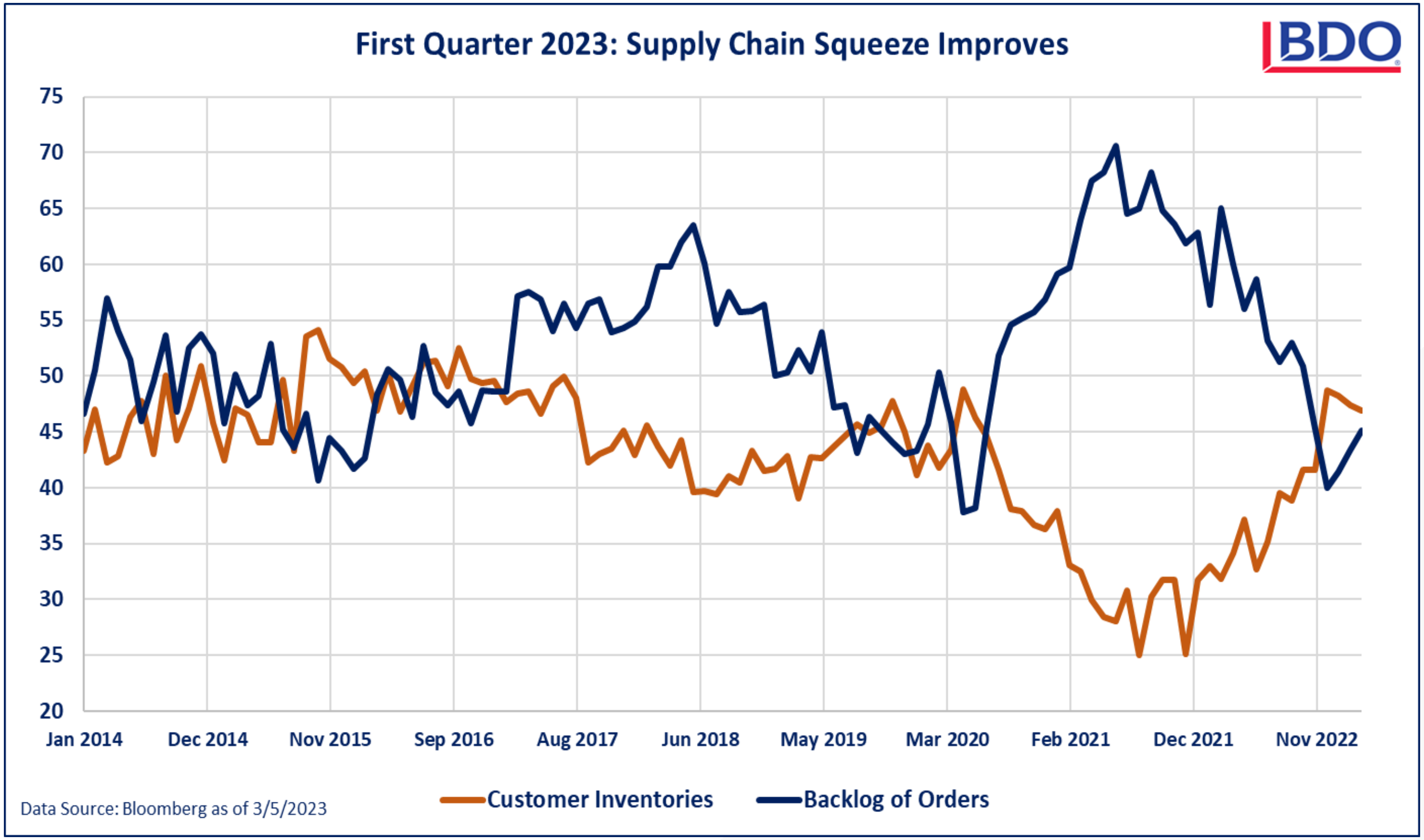
Supply-Demand Mismatch-Classic Economics 101

During the pandemic, global supply chains were altered by policymakers, shutting down the global economy (orange). Demand, however, remained robust throughout (blue). With supply unable to meet demand, prices rose rapidly.



Geopolitical Landscape has changed

The fracturing of key geopolitical ties are significant. Together, the geopolitical backdrop has amounted to significant economic costs.

US & China Relations

- Tariffs
- Sanctions
- COVID-19 and supply chains
- China's restrictive COVID-19 policies and slow reopening of the economy

Russia's Invasion of Ukraine

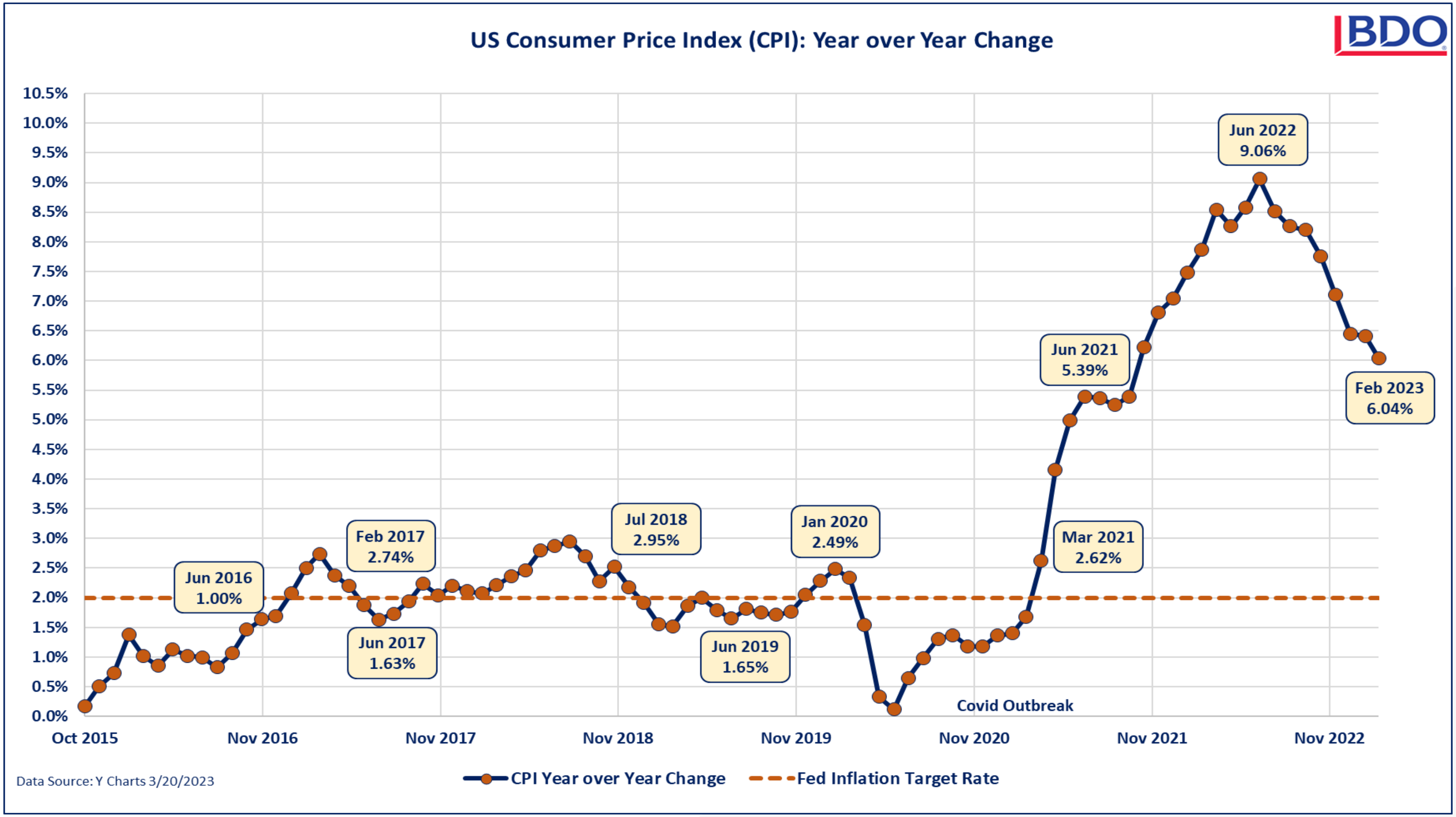
- Commodity disruptions
- Energy prices surged
- Agriculture prices surged
- Alliances are changing

Middle East

- Tensions between Israel and Iran
- Iranian nuclear program

Consumer Price Index

CPI (inflation) has returned, rapidly rising from 0% in May 2020 to 9% in June 2022. While inflation has retreated, it remains well above the Fed's 2% target.



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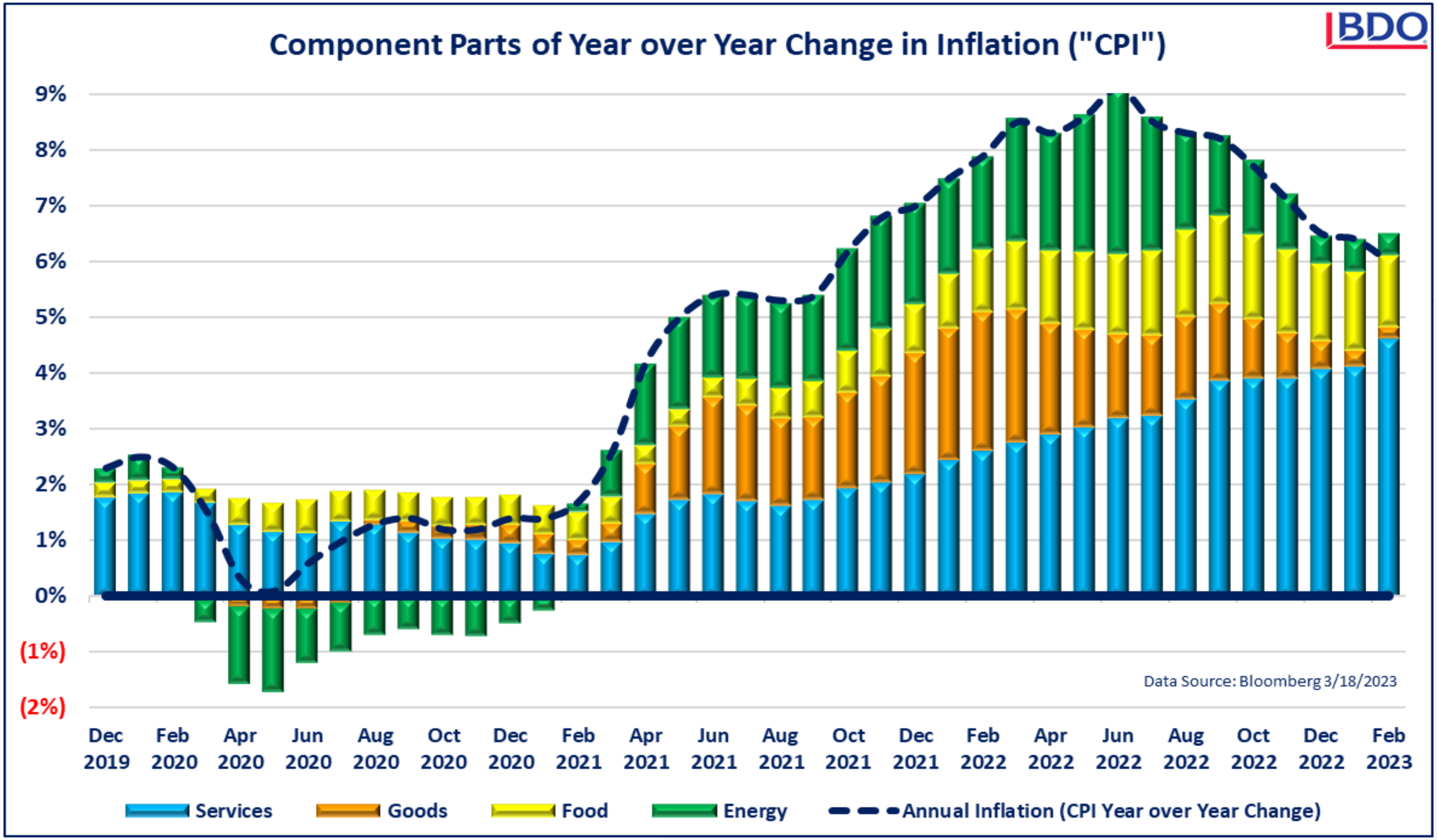
The Composition Matters

Rising prices of goods, energy and food were originally the main drivers of inflation. More recently, services prices, which can be stickier, have been the key contributor to higher prices.



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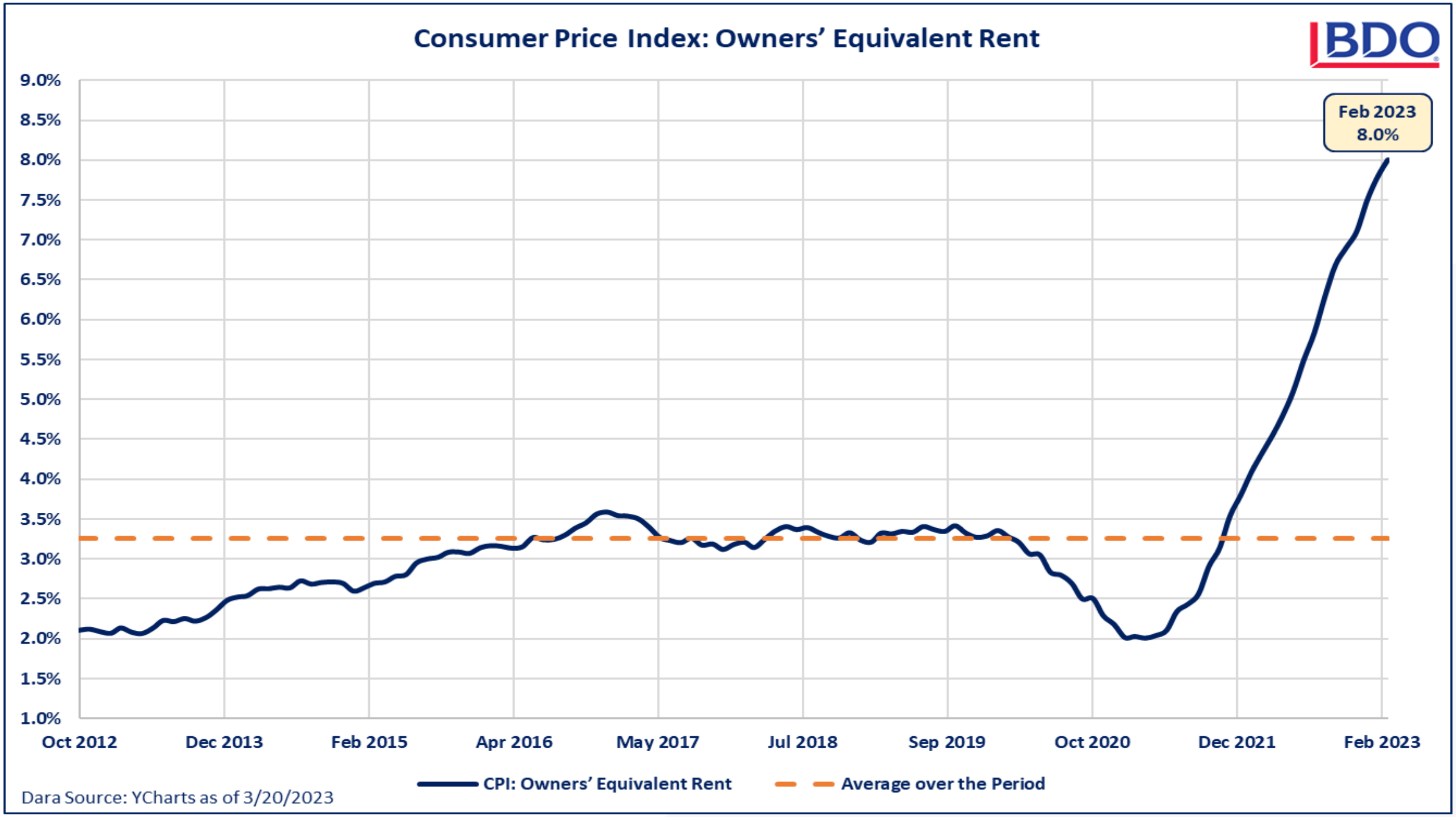
Shelter Has Been A Force Underpinning CPI

The change in Owner's Equivalent Rent (Shelter) accounts for 34% of CPI and 65% of Services CPI. Since shelter accounts for an outsize weighting in CPI measures, it is hard to see CPI slowing materially without a commensurate decline in y/y shelter prices.



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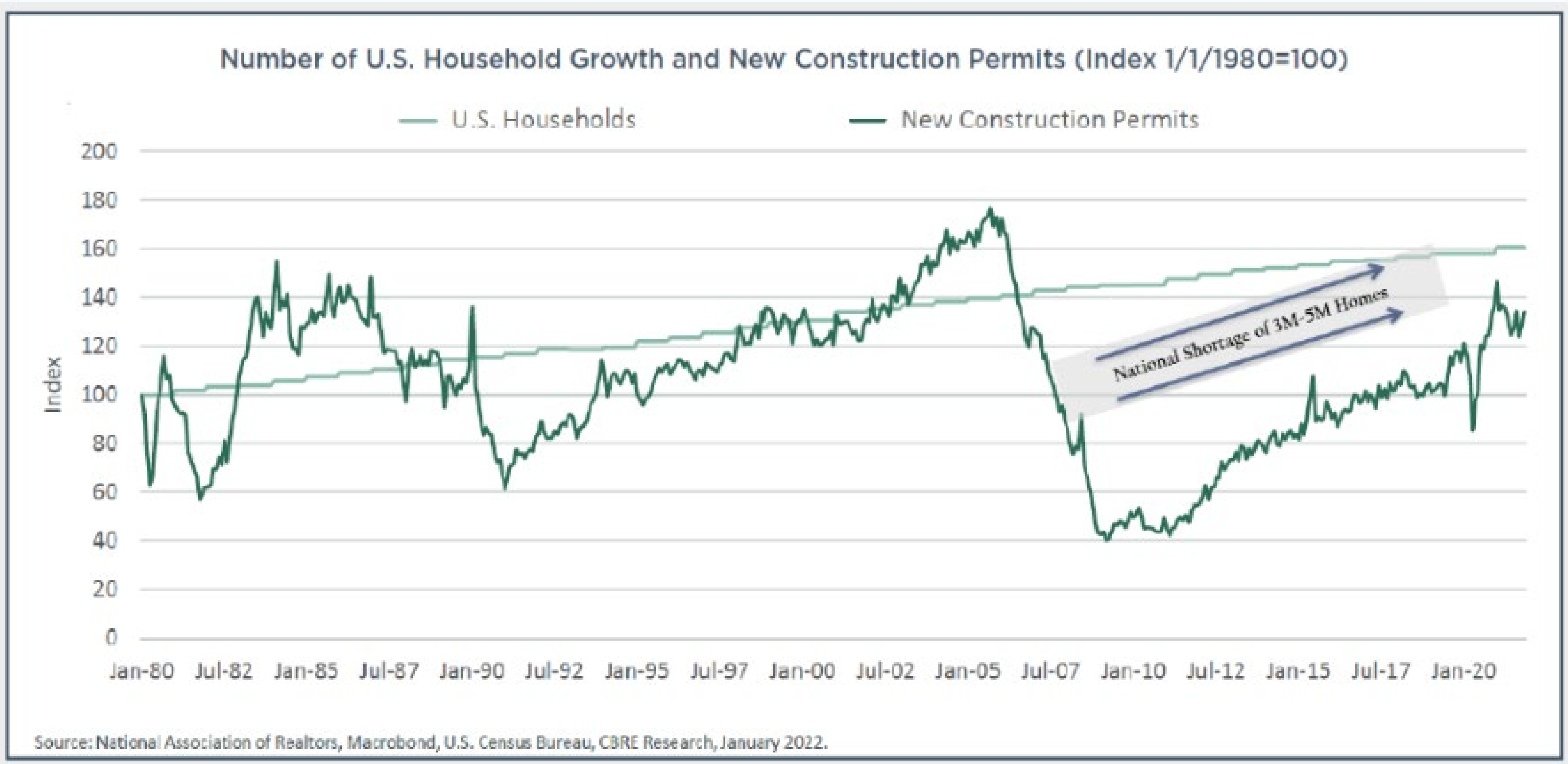
Housing Undersupply Could Keep Prices Higher

It is estimated the undersupply of housing is between 3-5 million units. Theoretically, this could keep shelter CPI higher for longer, something that could negatively surprise the market. This really helps illustrate the challenge the federal reserve has in bringing down inflation.



Source AION Partners 2022 Year End Update December 2022

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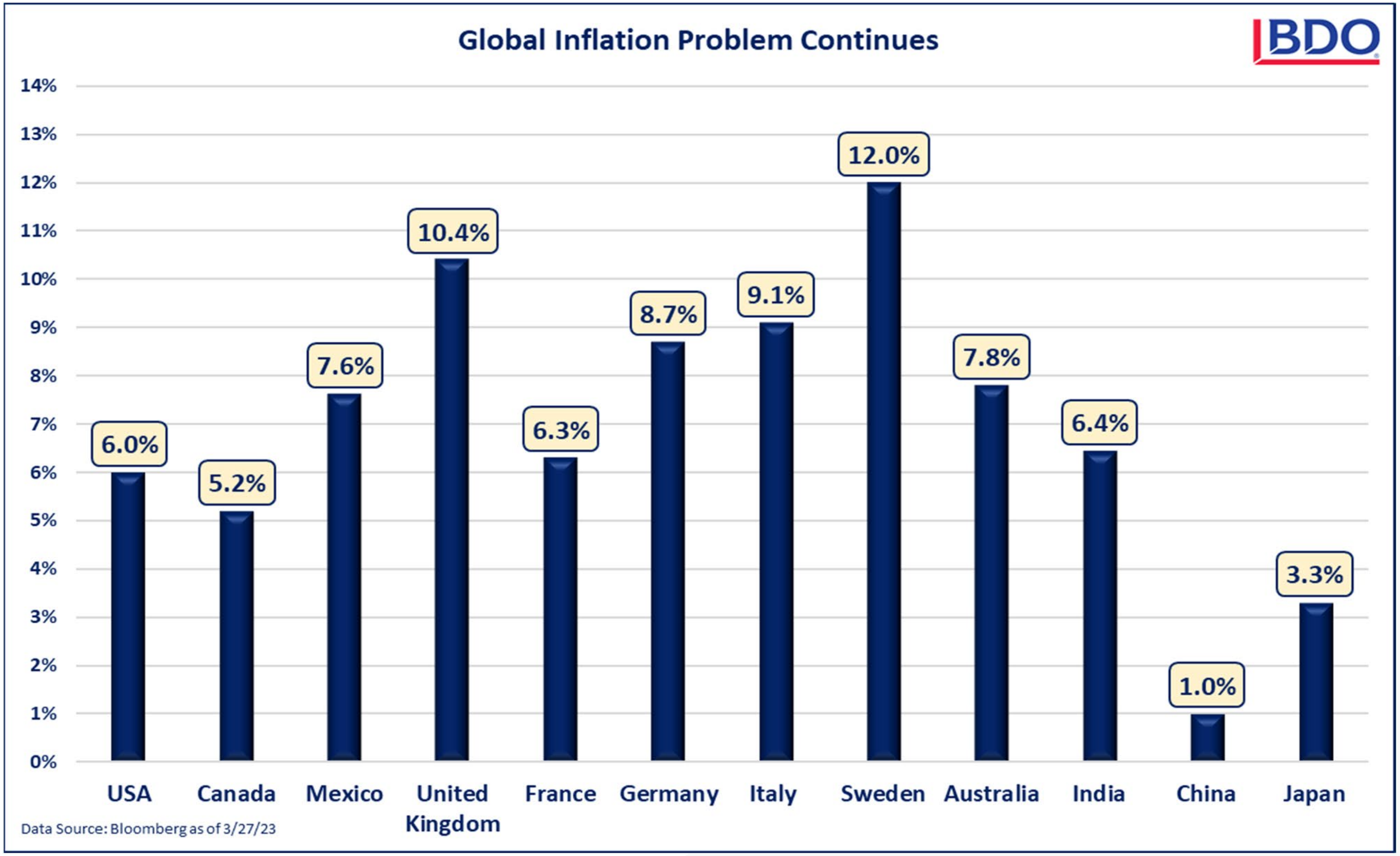
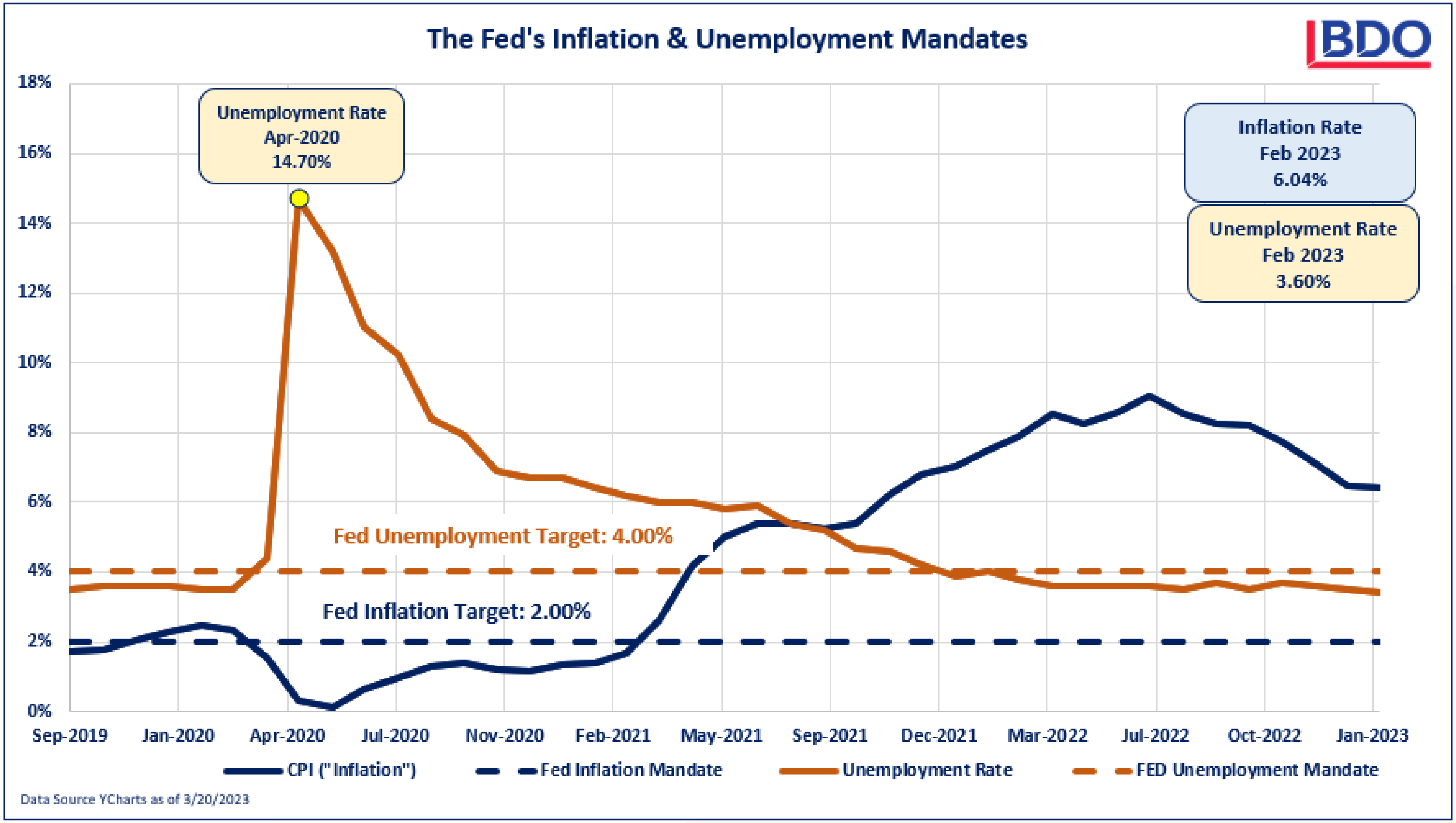
Inflation Is Global

The world was challenged by inflation in 2022, and that problem continues today. Below are current inflation data points for a selected number of developed and emerging economies.



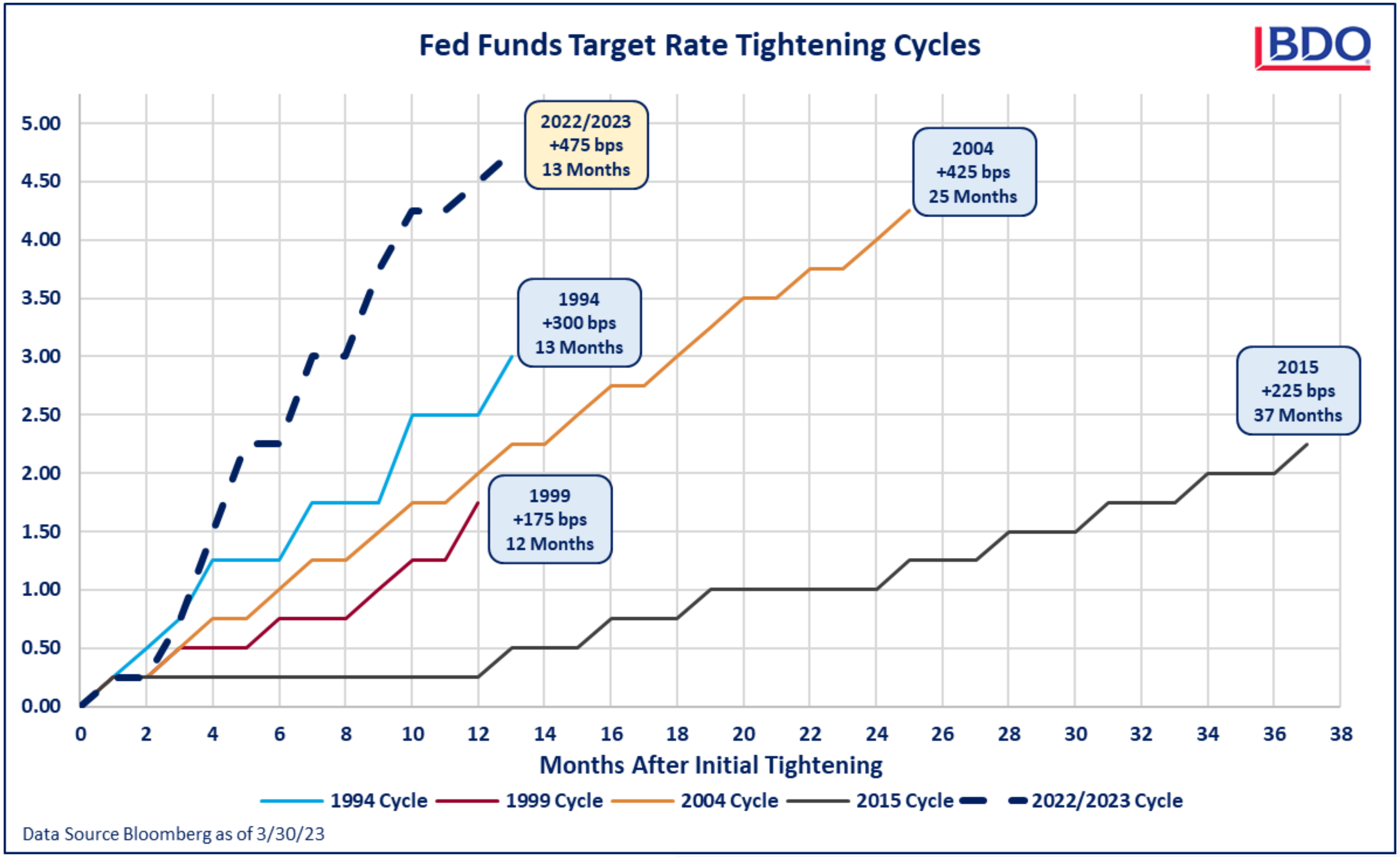
Dual Mandate Suggestive of Tight Policy Stance

Given the U.S. is at full employment and inflation remains well above the 2% target, the Fed’s tight policy is warranted. Again, the longer the Fed’s policy is tight the likelier it is to cause recession.



The Federal Reserve Has Responded Aggressively

Inflation reaching multi-decade highs has elicited an aggressive response from the Federal Reserve. In 2022, the Fed hiked short-term interest rates faster and more times than any of the 4 preceding tightening cycles.



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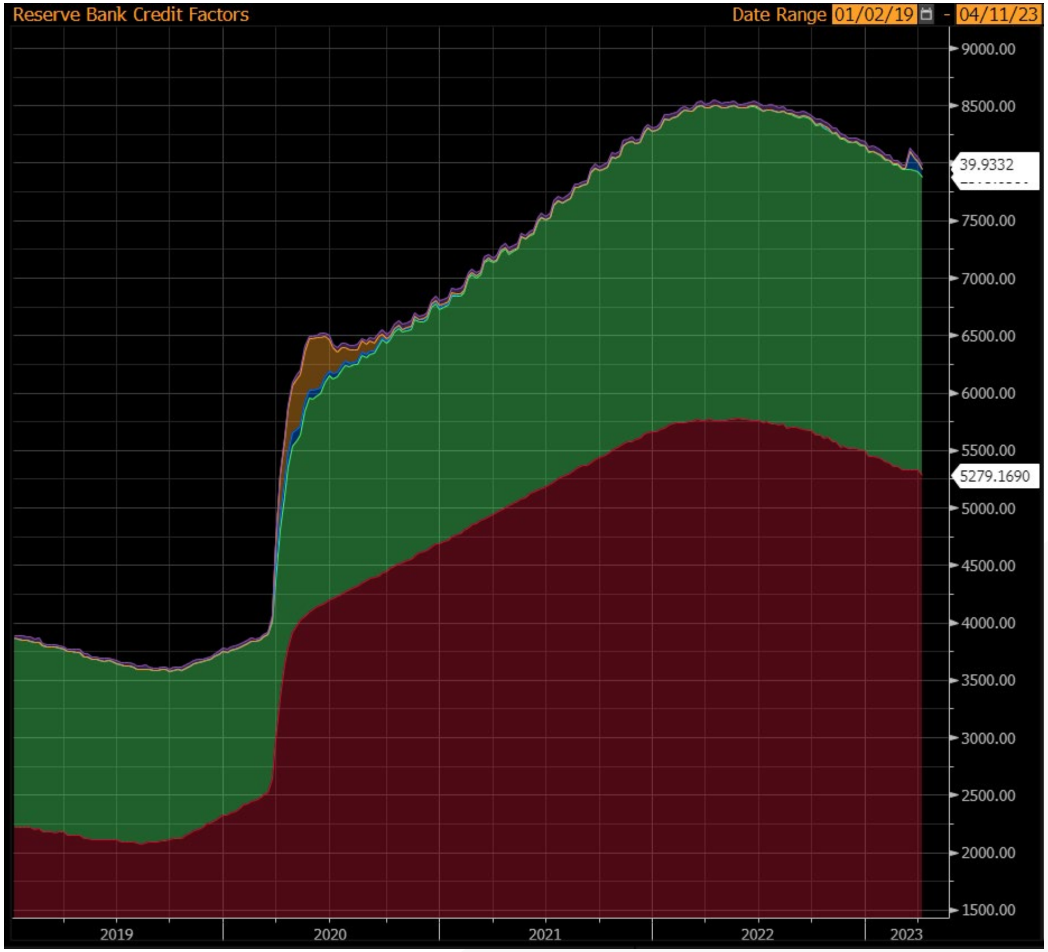
The Federal Reserve’s Balance Sheet

In addition to raising interest rates, the Fed has reduced its balance sheet. The Fed is aiming to reduce the balance sheet by $2.2 trillion - which is estimated to be equivalent to 25-75 bps of rate hikes.



SOURCE: BLOOMBERG 4/11/2023

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Central Banks Elsewhere Have Hiked Aggressively Too

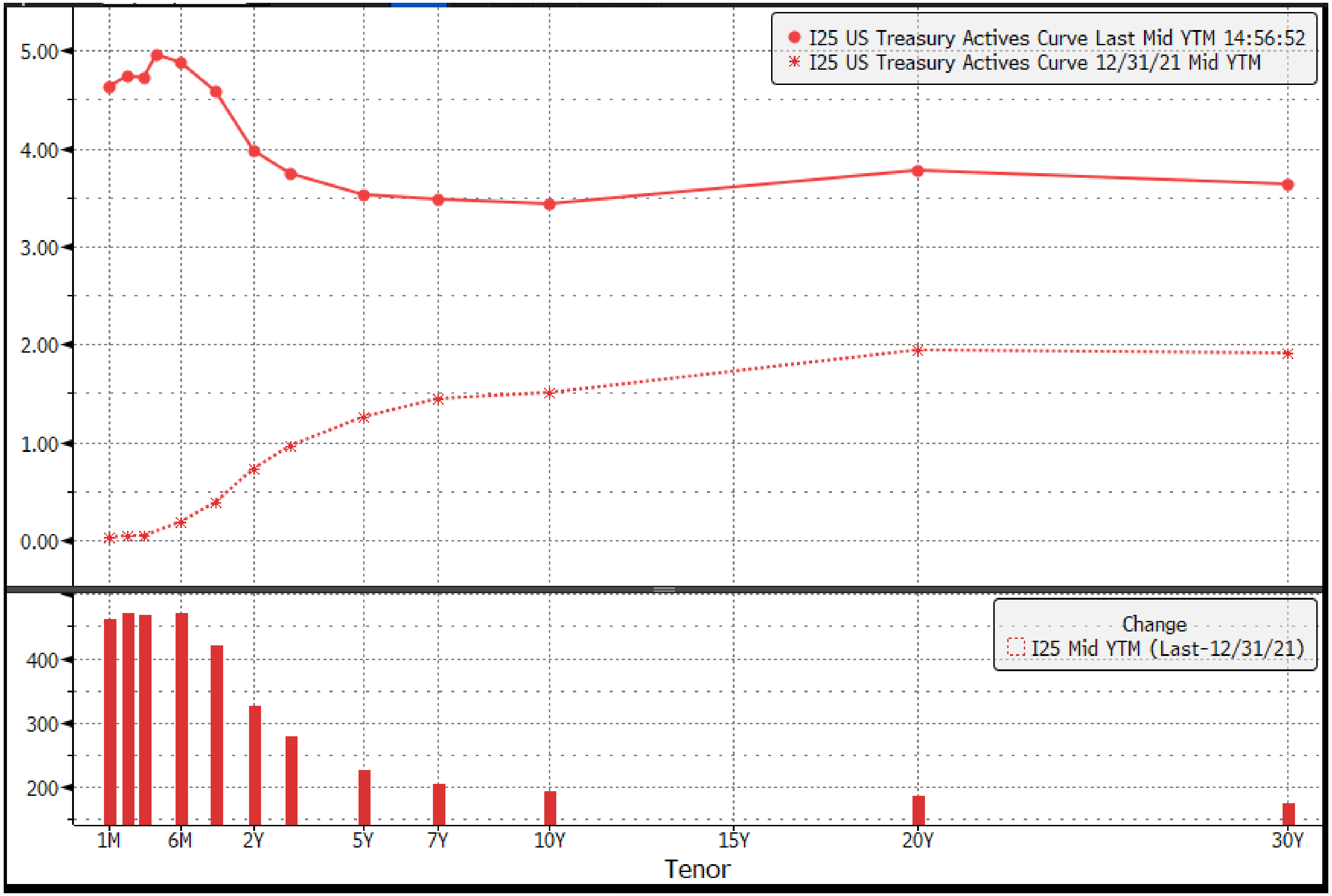
- *82% of G20 members hiked interest rates in the last 12 months.*
- *The average number of 25 bps rate hikes was 11.6.*
- *This marks a dramatic shift compared to recent years when central banks were highly accommodative, keeping interest rates low.*
- *The longer interest rates remain higher, the more likely recession occurs.*

Source Bloomberg as of 03/31/2023

Country/Region	3/31/2023	3/31/2022	Change From 1 Year Prior
Australia	3.60%	0.10%	3.50%
Belgium	3.50%	0.00%	3.50%
Canada	4.50%	0.50%	4.00%
China	4.35%	4.35%	0.00%
Germany	3.50%	0.00%	3.50%
France	3.50%	0.00%	3.50%
U.K.	4.25%	0.75%	3.50%
Italy	3.50%	0.00%	3.50%
Japan	-0.10%	-0.10%	0.00%
Netherlands	3.50%	0.00%	3.50%
Sweden	3.00%	0.00%	3.00%
U.S.	5.00%	0.50%	4.50%
Brazil	13.75%	11.75%	2.00%
India	3.35%	3.35%	0.00%
S Korea	3.50%	1.25%	2.25%
Mexico	11.25%	6.50%	4.75%
Saudi Arabia	5.50%	1.25%	4.25%
% of G20 Raising Rates			82%
Avg # of 25 bps Rate Hikes			11.6

The Fed and the Yield Curve

The Fed's actions has pushed yields across the curve higher, and short-term rates have moved the most. Presently, the yield curve is inverted (short-term rates are higher than long-term rates).



Source Bloomberg as of 04/03/2023

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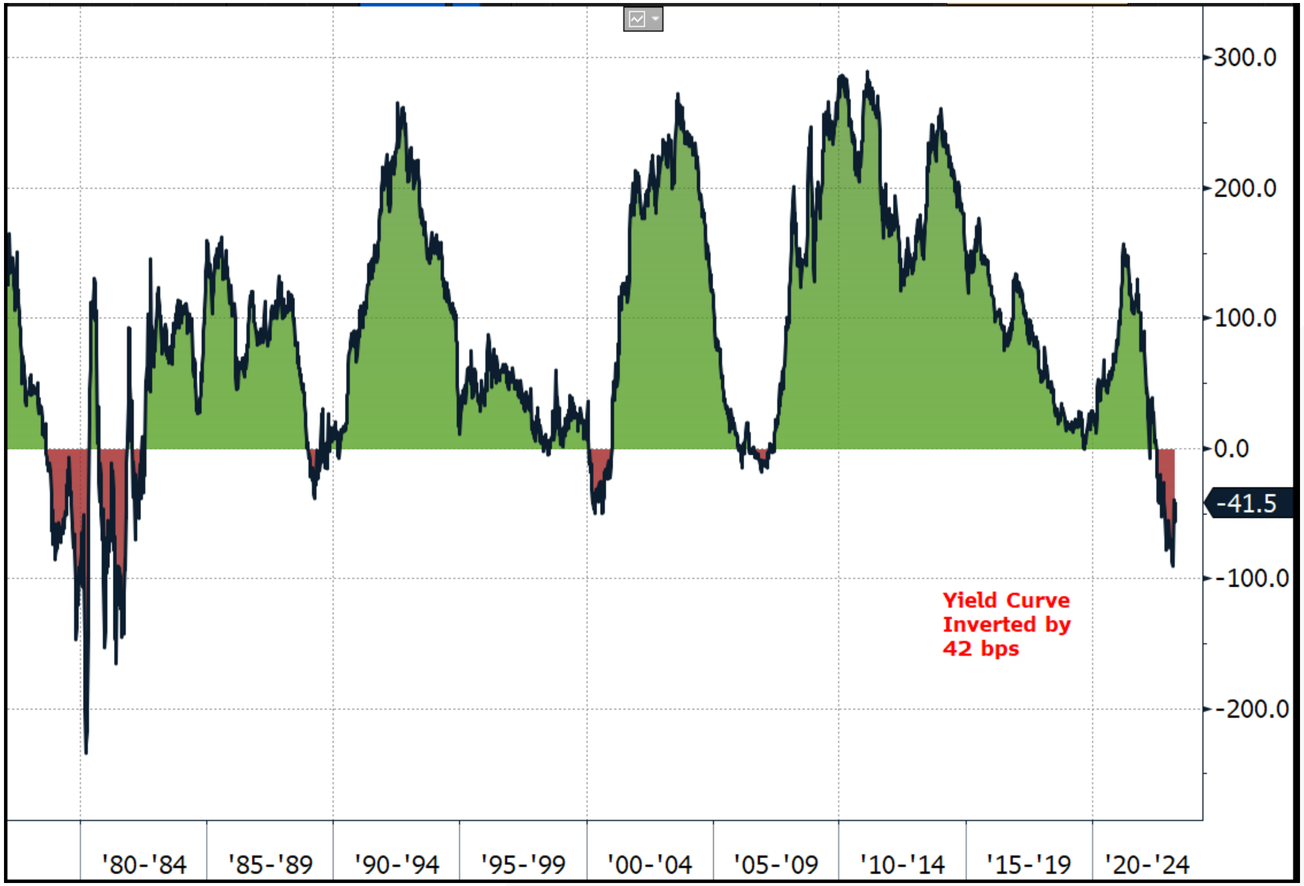
The Effect of Higher Short-Term Rates

- *Credit formation (lending) is the lifeblood of the U.S. economy and is the core business of banks.*
- *With the yield curve inverted, it is unprofitable for banks to lend.*
- *Ultimately, this can eventually lead to a slower pace of lending and reduced economic activity/recession*



Source Bloomberg as of 04/05/2023

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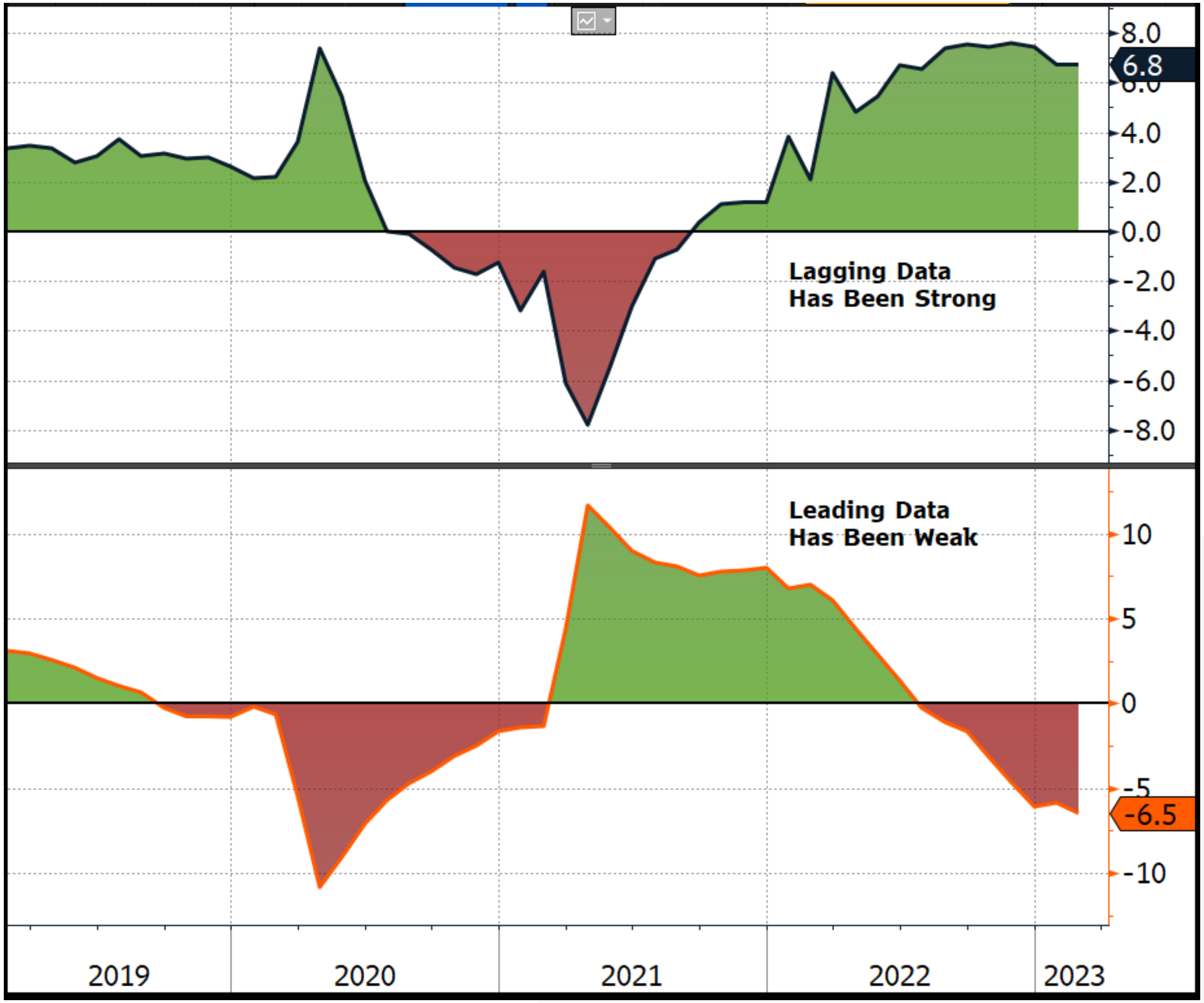
What is Economic Data Showing Us?

There are three types of economic data: lagging, coincidental and leading.

- **Lagging** indicators are only known after the event has occurred.
  - Examples: inflation and wages.
- **Coincidental** indicators are analyzed as they occur.
  - Examples: payrolls and industrial production.
- **Leading** economic data are used as a guide for the direction of the economy.
  - Examples: Housing data and new business orders.

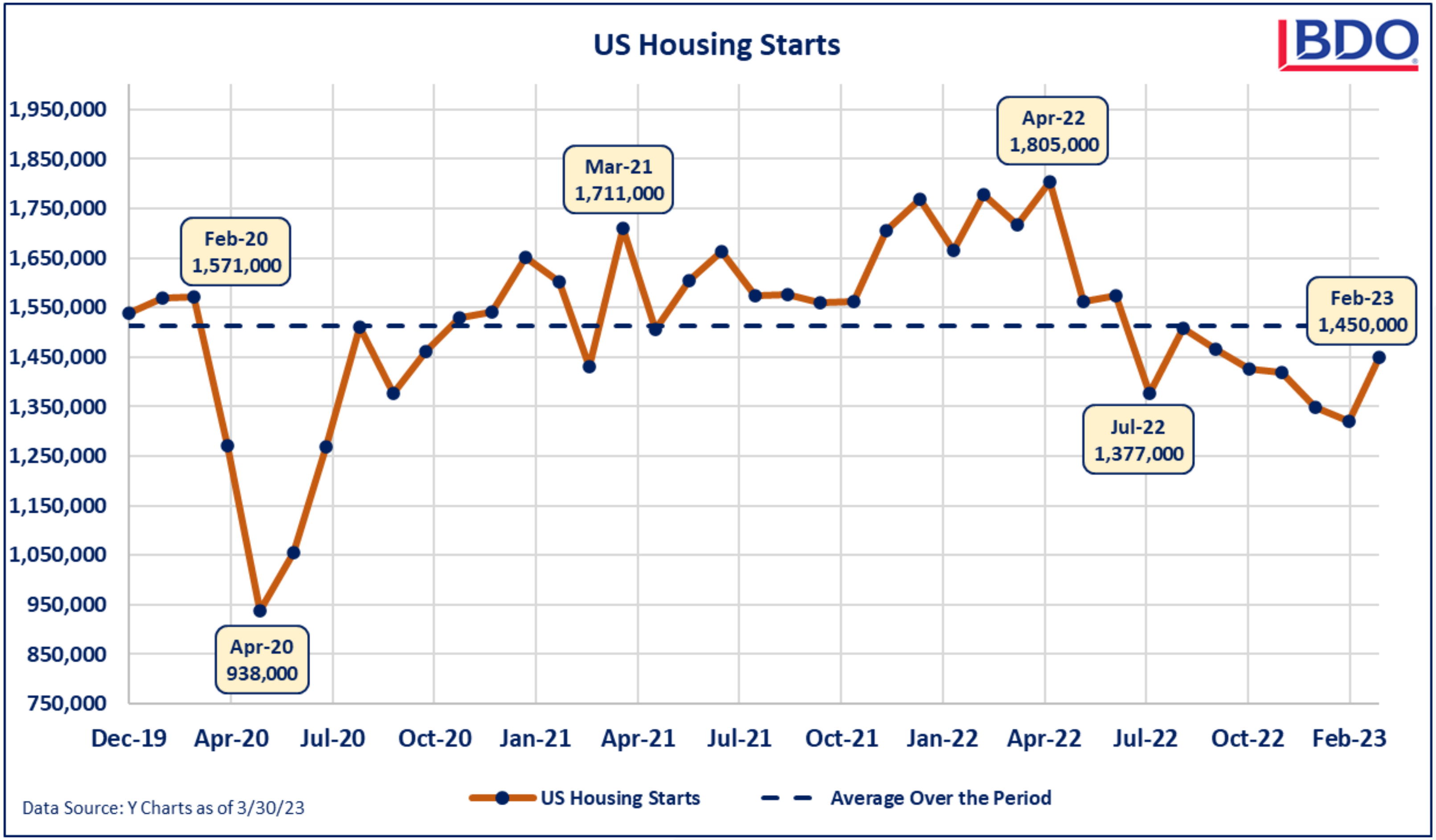
Leading Economic Data Heading Lower



Source Bloomberg as of 04/05/2023

Key Leading Indicators Are In Decline

With the economy constrained by higher short-term interest rates, leading economic data, like housing starts, have declined. Leading data points are guiding to reduced economic activity ahead.



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Additional Key Leading Indicators Are In Decline

Other leading data points, like new business orders, have also declined. Leading economic data points are pointing to reduced economic activity ahead.

Source Bloomberg as of 03/31/2023

Housing Affordability Has Worsened

The affordability for first time homebuyers' monthly payment has increased $950 from March 2020 through December 2022, well above prior levels.

Source Bloomberg 04/05/2023

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30 Year Fixed Mortgage

Mortgage rates have risen from 2.8% during the pandemic to 6.7% today.

Source Bloomberg 04/05/2023

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Silicon Valley Bank Fallout twitter and cell phones

Silicon Valley Bank Fails After Run on Deposits

The Federal Deposit Insurance Corporation took control of the bank's assets on Friday. The failure raised concerns that other banks could face problems, too.

Source: NY Times, 3/10/23

Too-Big-to-Fail Lenders Rake In Deposits After Three Banks Fail

Source: Bloomberg, 3/13/23

Government races to reassure US that banking system is safe

Source: ABC News, 3/13/23

Charles Schwab CEO says firm has liquidity, not seeking capital or deals

Source: Reuters, 3/14/23

Dramatic Rate Move Caused Asset-Liability Mismatch

SVB held mark-to-market losses in excess of $15 billion at the end of 2022 for securities held to maturity, just shy of its entire $16.2 billion equity base. This was according to SVB's 10-K dated 2/24/23. Comprehensive Capital Analysis and Review (CCAR) Bank stress test did not have a scenario that addressed rates rising in a rapid fashion.

KPMG US auditors signed off on Silicon Valley Bank, Signature Bank

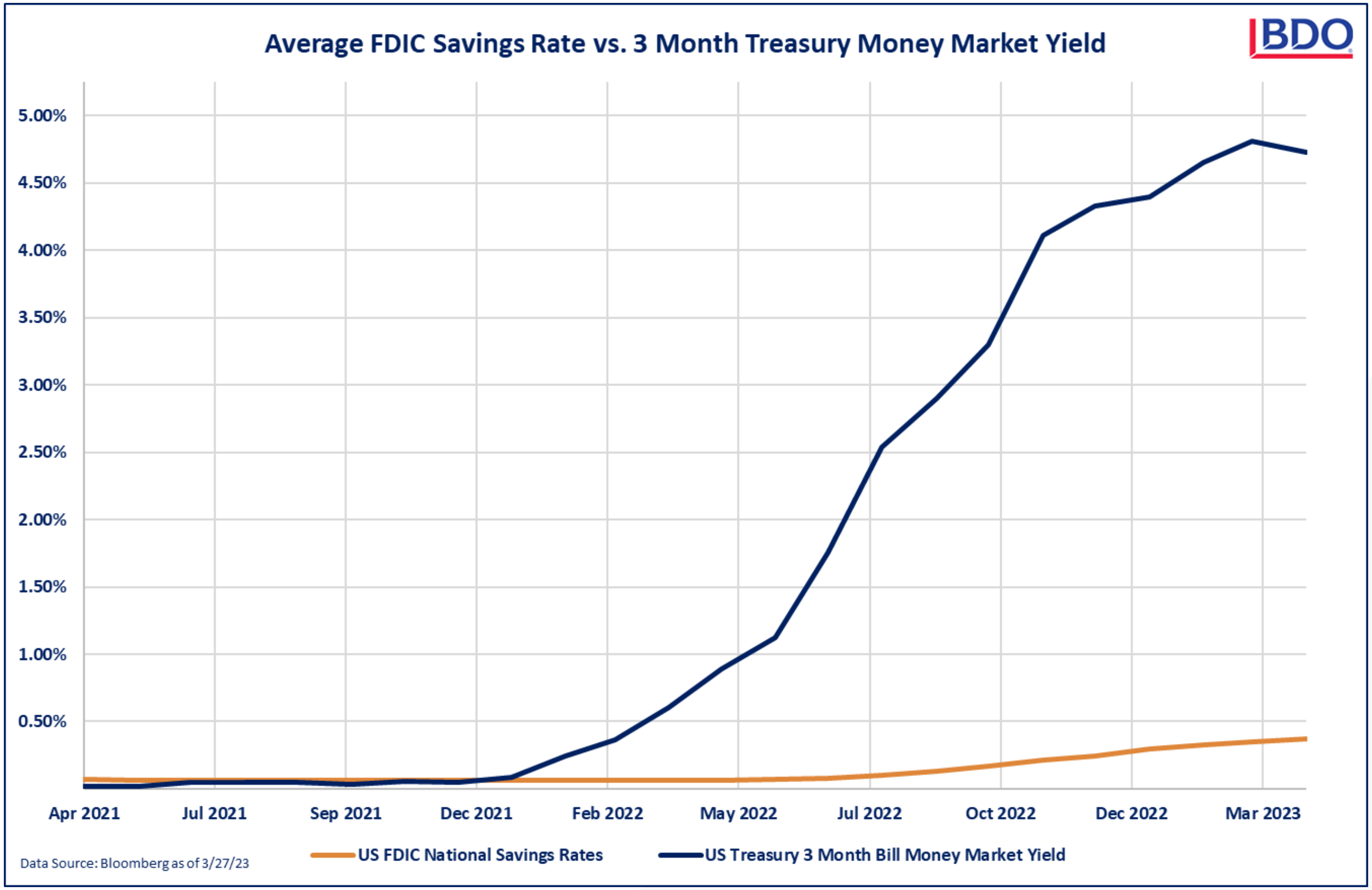
KPMG's auditors signed off on Silicon Valley Bank's 2022 accounts on February 24 and on Signature Bank's 2022 accounts on March 1. US regulators shut Silicon Valley Bank on Friday (Saturday AEDT) after a run on the institution's deposits, and closed Signature Bank on Sunday (Monday AEDT).

KPMG's letter to Silicon Valley Bank shareholders stated: "In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the company as of December 31, 2022 and 2021, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 2022, in conformity with US generally accepted accounting principles."

Source Financial Review 03/14/2023

Deposits Fleeing Regional Banks, Compounding Issues

A variety of reasons caused SVB to collapse, but depositors removing money from the bank were an important ingredient. At a high-level, not just at SVB, depositors are reducing cash held at the bank to earn a higher yield in money markets (and other instruments).



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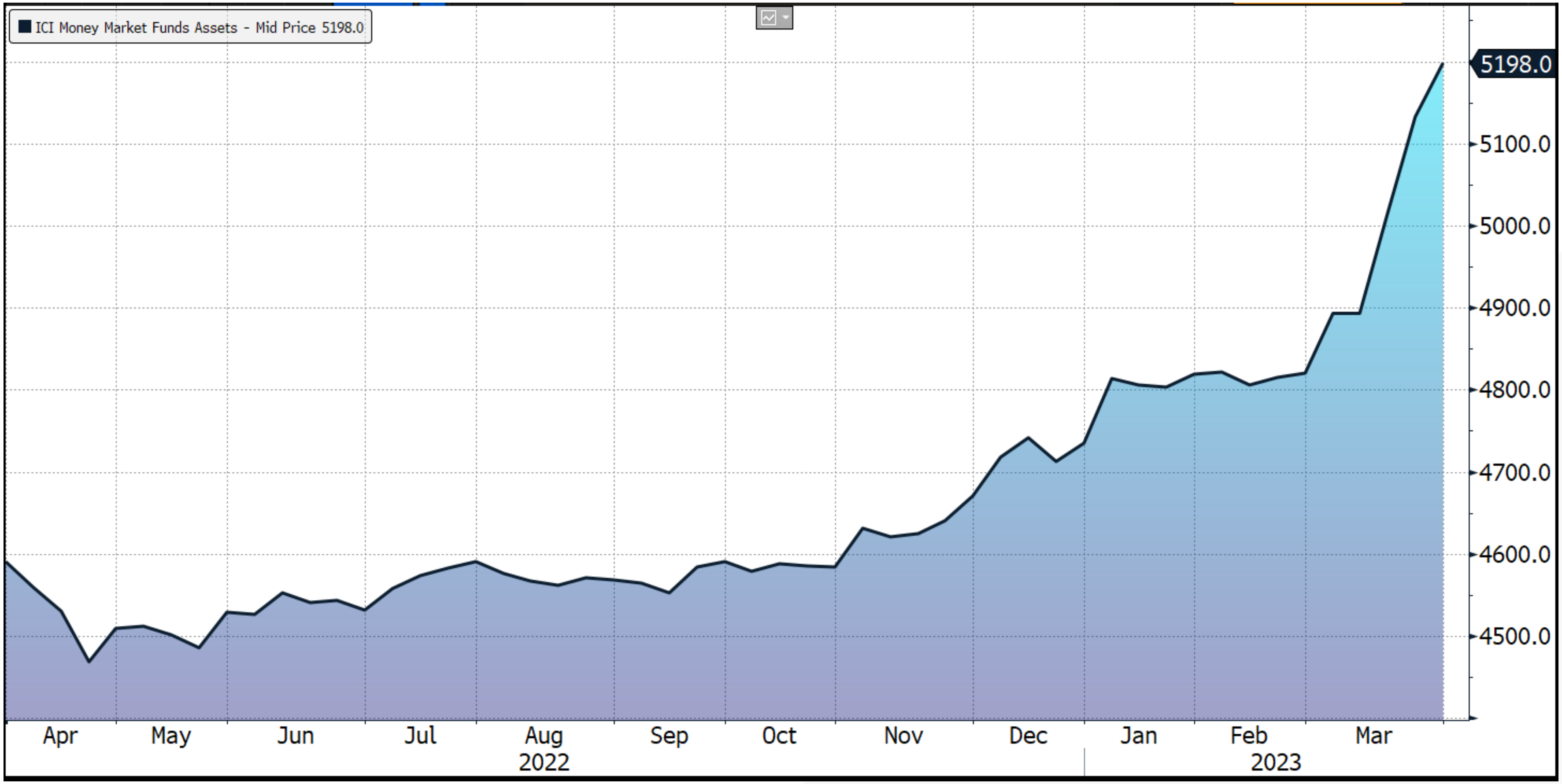
Money Market Fund Assets Have Skyrocketed

With bank savings rates well below the average money market rate, deposits are being pulled and put into money market funds. Money market funds have added close to $500 billion so far this year.



Source Bloomberg 04/05/2023

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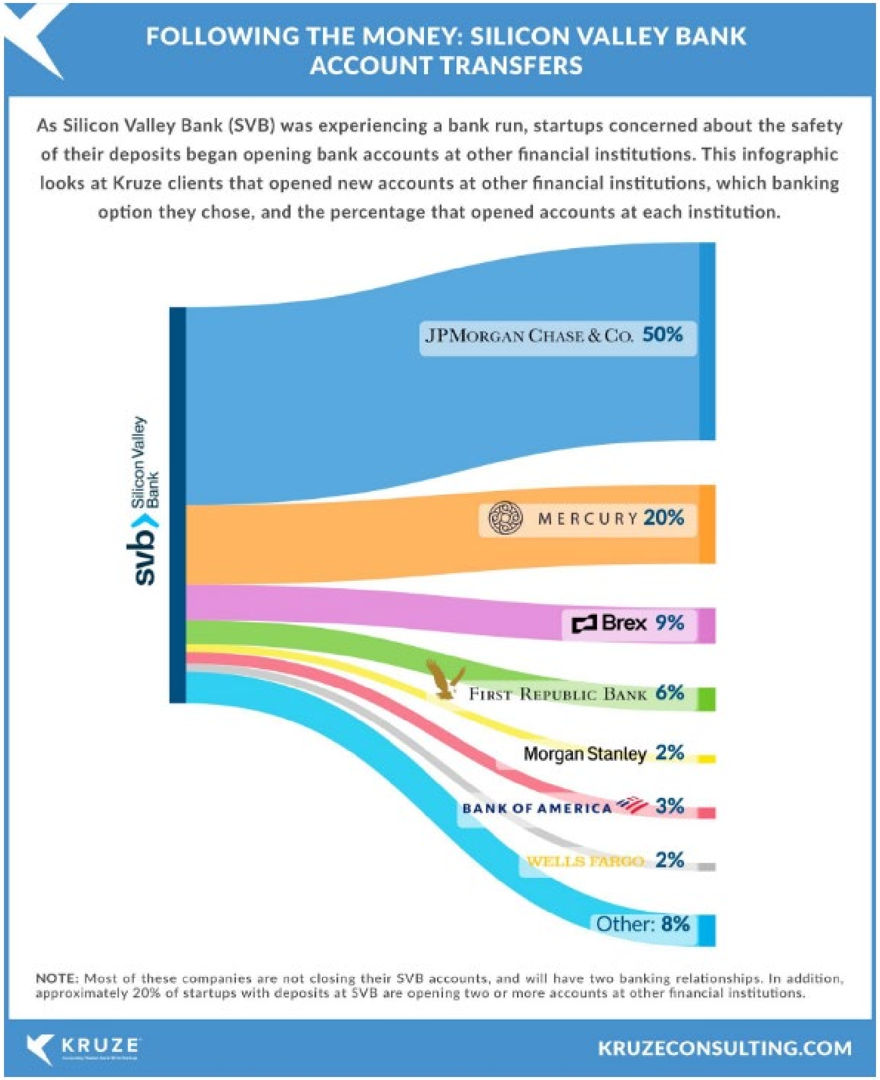
From Small Banks to Big Banks

- Following the collapse of SVB, SVB depositors have opened accounts with large, systemically important banks:
    - JPMorgan 50%
    - Morgan Stanley 6%
    - Bank of America 3%
    - Wells Fargo 2%

Source Hamilton Lane 03/28/2023



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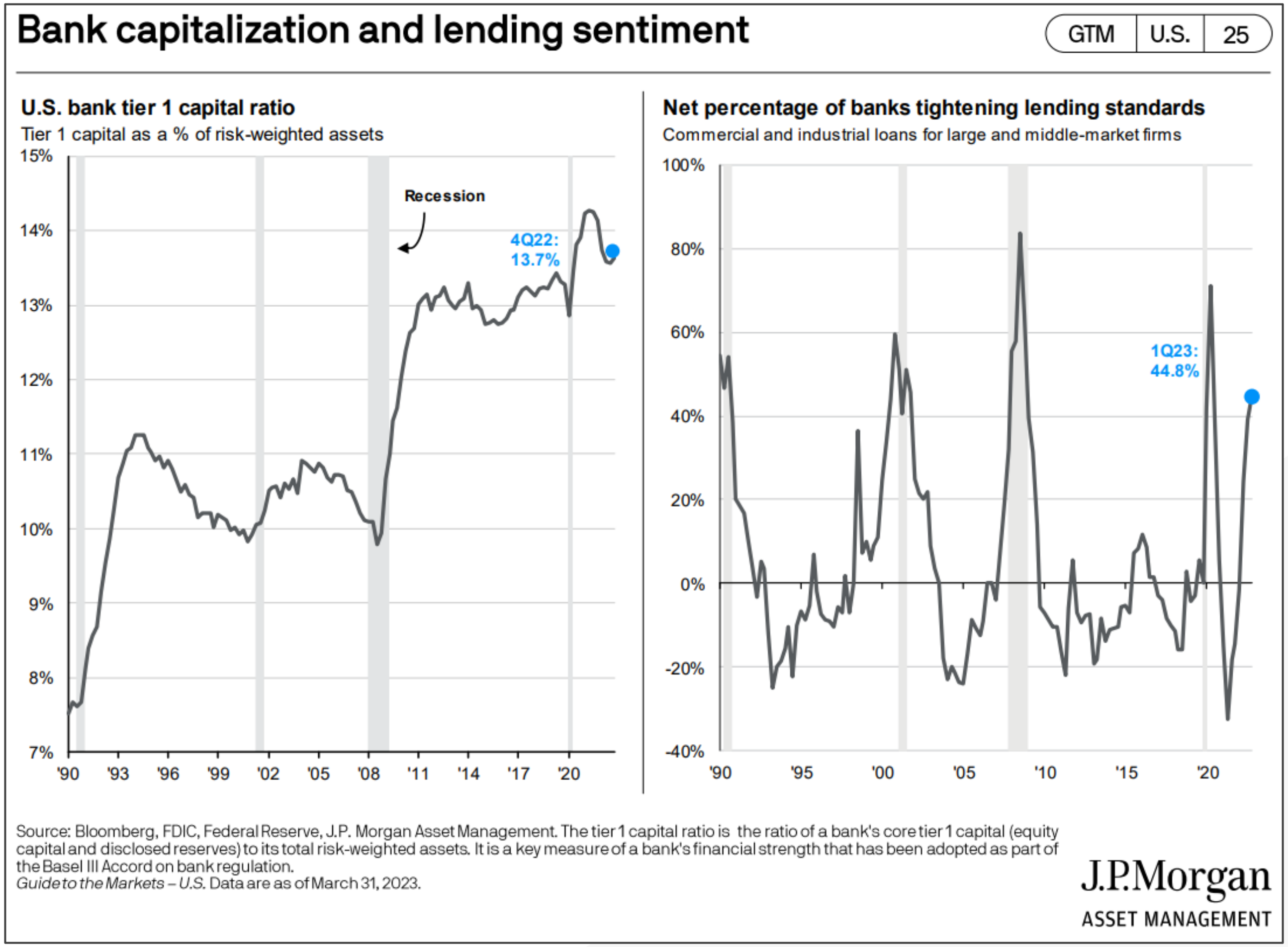
Lending Standards Are Tight

Given the uncertainty surrounding banks, lending is likely to decrease as tightening standards get incrementally tighter. The effect, weaker economic growth.



Source JPMorgan 04/03/2023

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Recession Probability is High

Restrictive monetary policy and a banking crisis have increased the odds of recession in the U.S.

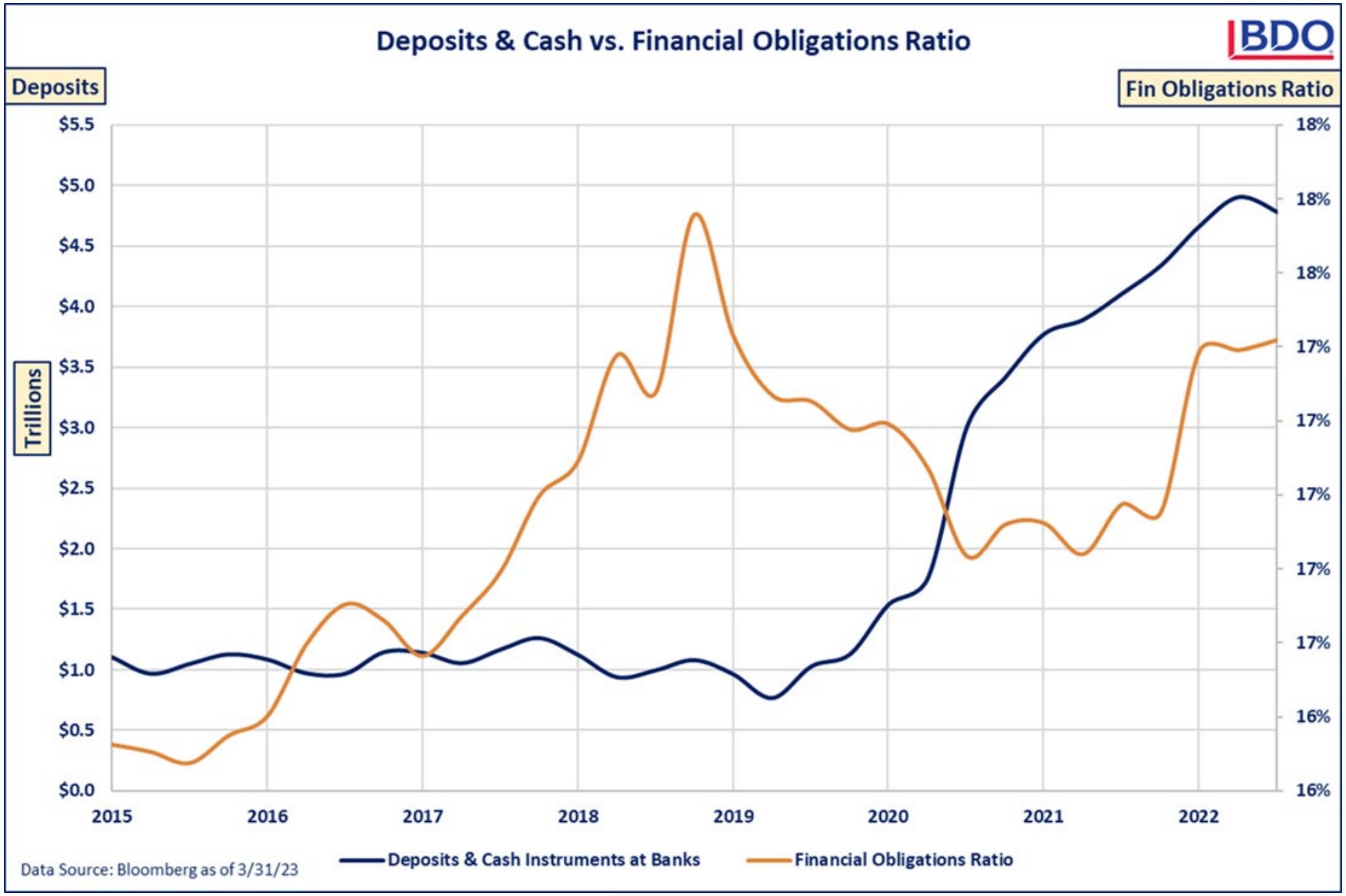
"Since 1950, when you have unemployment below 4% and inflation above 4%, recession always follows within two years."

-Lawrence Summers, Former Secretary of Treasury (Barron's 6/17/2022)

Today:
Unemployment 3.6%
CPI 6%

Policy Acts With A Lag

Importantly, consumer cash positions are high - $3.5 trillion above pre-covid trends (blue). Meanwhile, the consumer's financial obligations are still at a manageable level (orange). Consumer balance sheets are fine.



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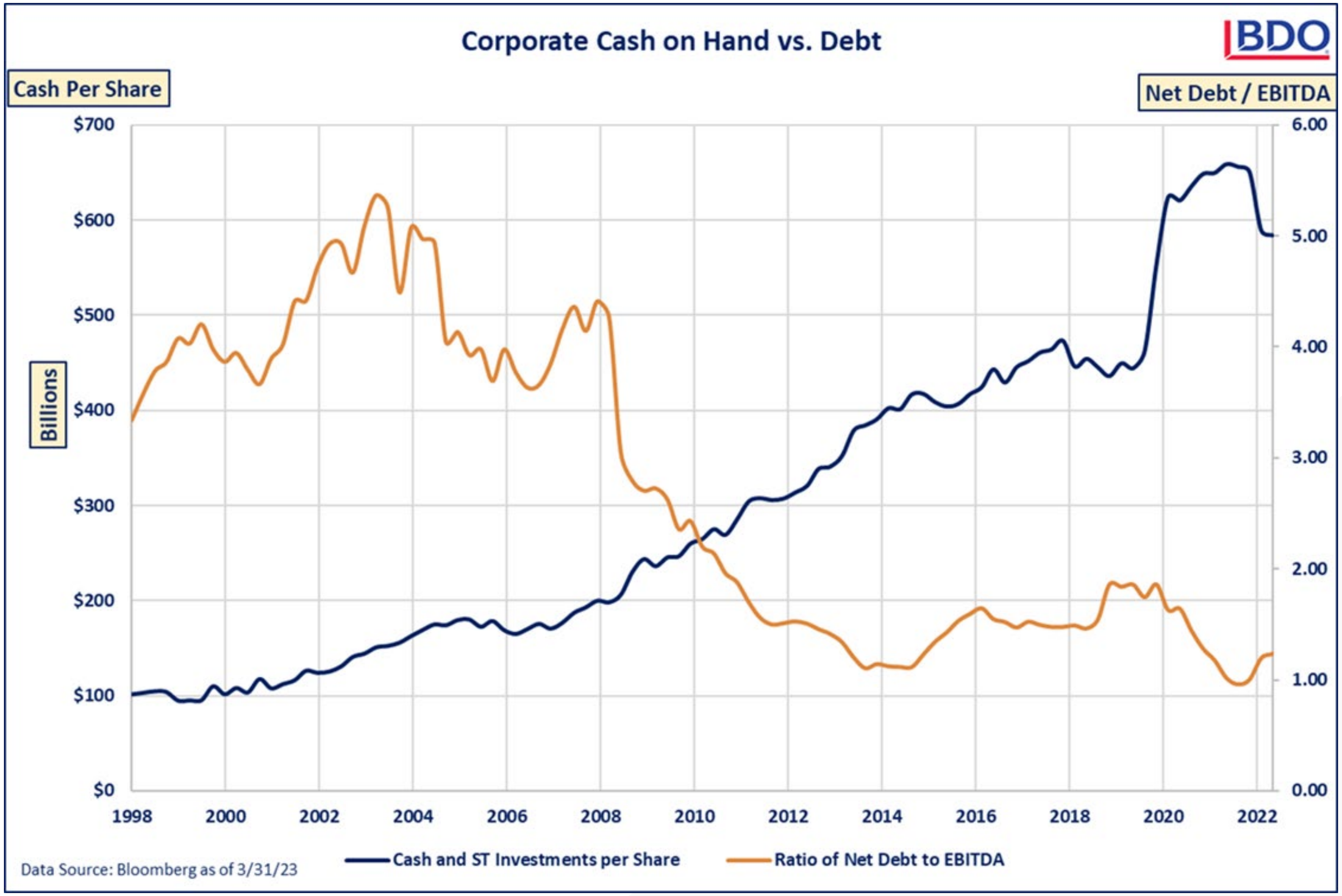
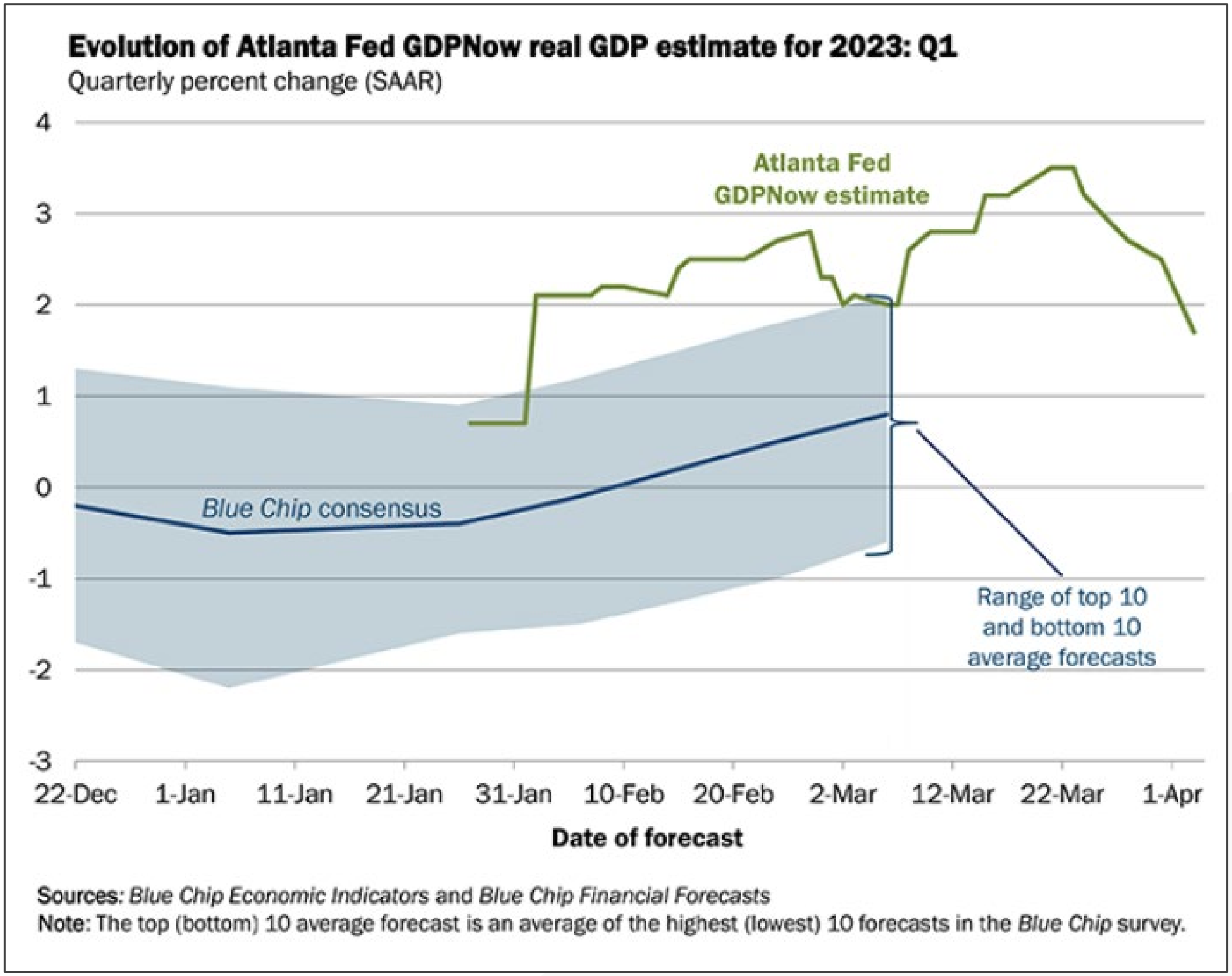
Policy Acts With A Lag

Also, corporate cash is near all-time highs (blue) and debt to EBITDA, a solvency ratio used to measure corporations' ability to meet its debt obligations, is near all-time lows. In other words, corporations are in good financial condition.



Economic Growth Likely Positive in Q1

Q1 economic data is likely to be positive, which diverges from the prevailing fears and forecasts of a looming recession. Current forecasts from the Atlanta Fed are for 2% growth in Q1.



Source Atlanta Federal Reserve as of 04/03/2023

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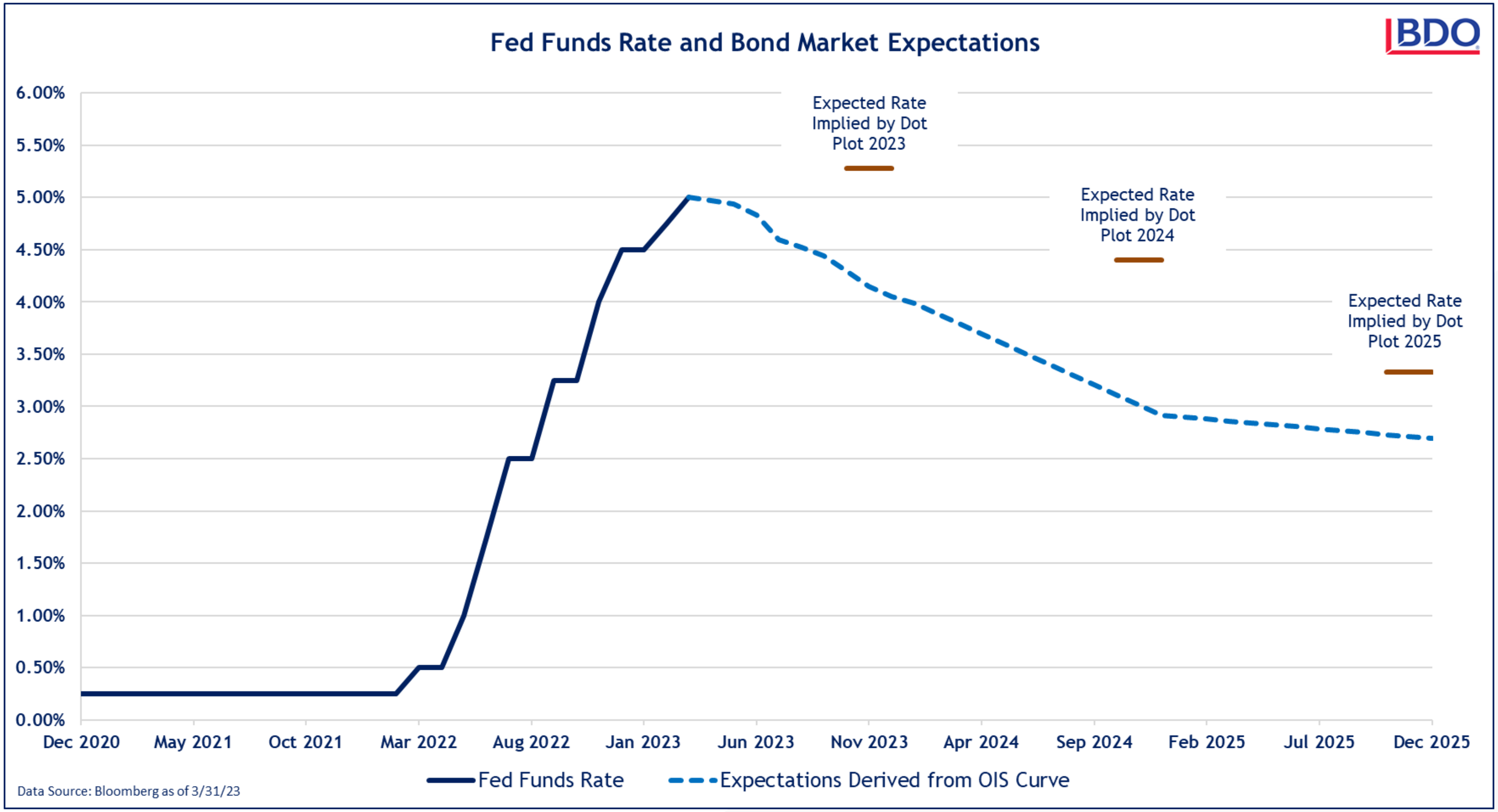
Economic Summary

- COVID-19 ushered in an unprecedented amount of stimulus. It pinched supply chains, while also serving as a turning point in many geopolitical relationships. Combined, these effects have caused inflation to return.
- The rapid rise of inflation elicited an aggressive response from central banks.
- The shift in monetary policy impacts economies and markets, and we are starting to see that affect today. Banks have come under pressure, and leading economic data is pointing to slower economic growth ahead, potentially even recessionary conditions.
- The U.S. economy has grown, inflation is still too high, and unemployment is at decade lows. As such, the Federal Reserve is likely to keep interest rates higher for longer.

Financial Markets

The Bond Market is Fighting the Fed

The economic backdrop warrants higher interest rates for longer, like what the Fed is saying. However, the bond market expects cuts starting later this year.



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Bond Market is Pricing in Cuts

The bond market expects the Fed to start cutting interest rates at the July meeting.

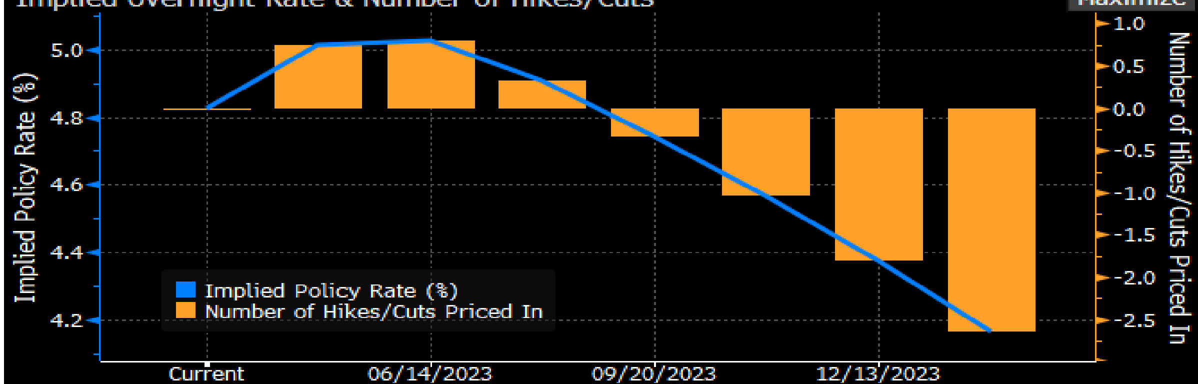
Region: United States »
Instrument: Fed Funds Futures »

Target Rate	5.00	Pricing Date	04/11/2023
Effective Rate	4.83	Cur. Imp. O/N Rate	4.826

Meeting	#Hikes/Cuts	%Hike/Cut	Imp. Rate Δ	Implied Rate	A.R.M.
05/03/2023	+0.736	+73.6%	+0.184	5.010	0.250
06/14/2023	+0.796	+6.0%	+0.199	5.025	0.250
07/26/2023	+0.325	-47.1%	+0.081	4.908	0.250
09/20/2023	-0.335	-66.0%	-0.084	4.743	0.250
11/01/2023	-1.038	-70.3%	-0.260	4.567	0.250
12/13/2023	-1.803	-76.4%	-0.451	4.376	0.250
01/31/2024	-2.645	-84.2%	-0.661	4.165	0.250

Implied Overnight Rate & Number of Hikes/Cuts

Maximize



Source Bloomberg 04/11/2023

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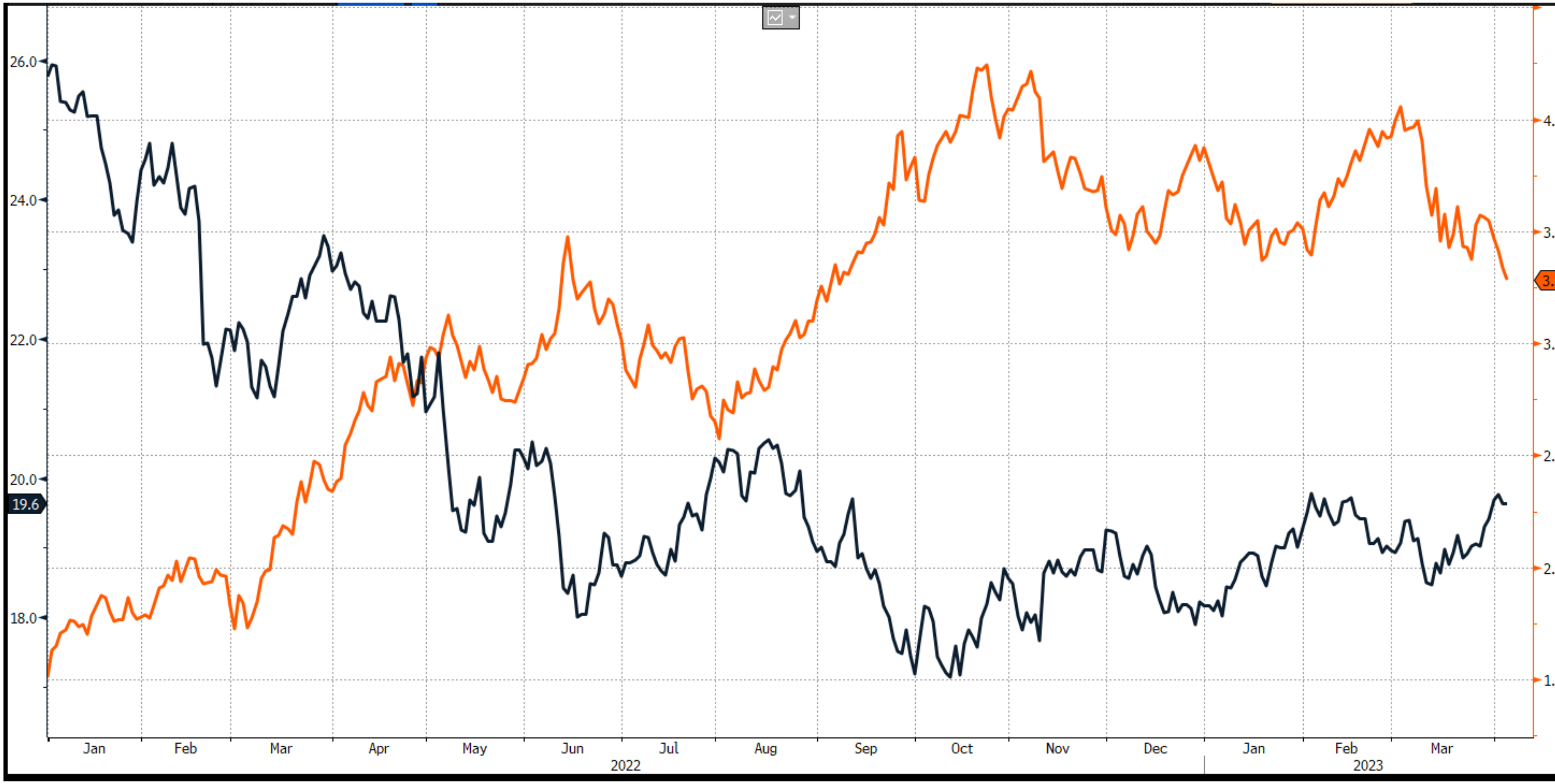
Interest Rates and Asset Valuations

As rates have risen, the P/E multiple of the S&P 500 has fallen.



Source Bloomberg 04/05/2023

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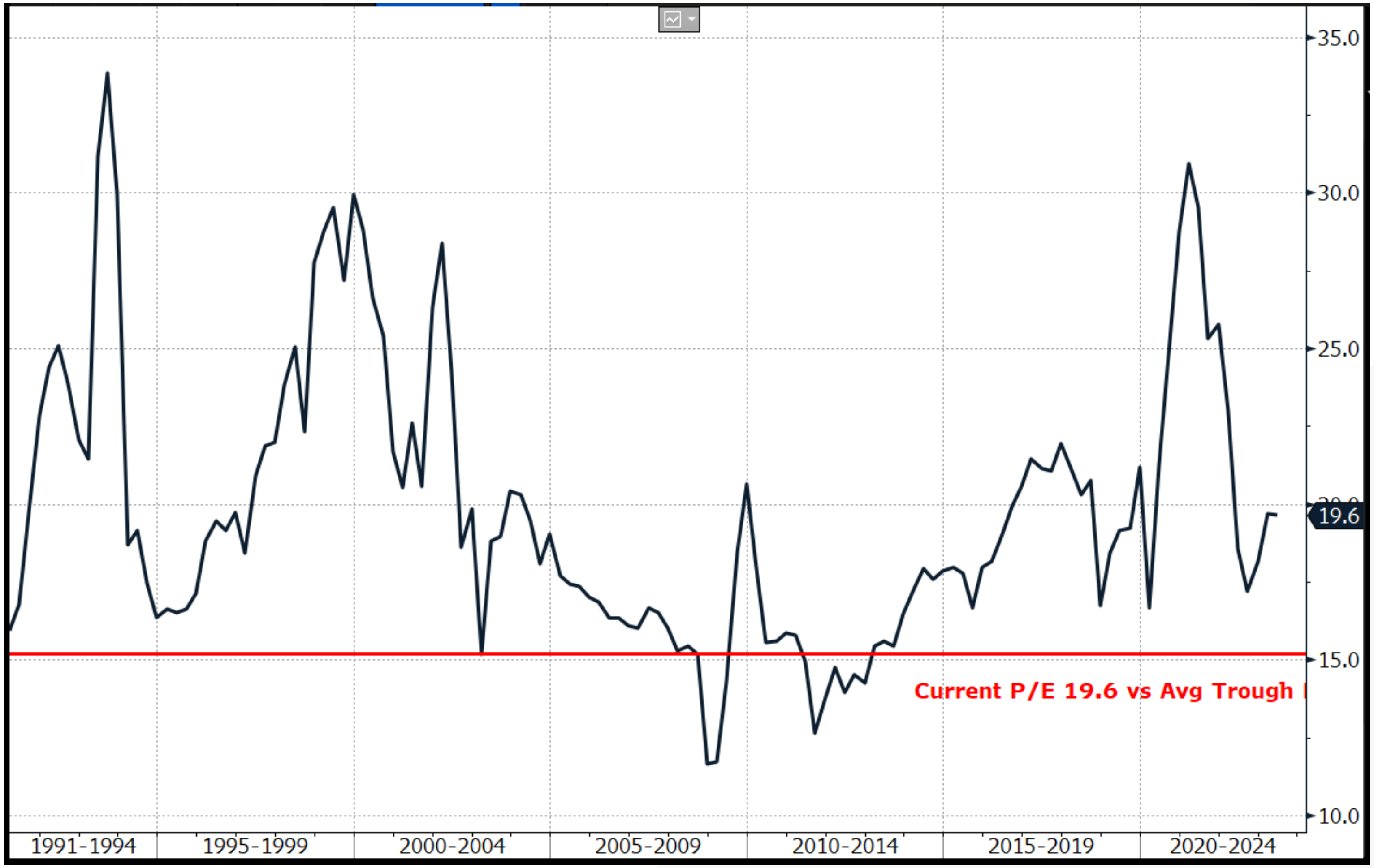
Valuations Can Compress Further

While valuations account for a large portion of the decline in stock prices, valuations can compress further from here. The P/E Ratio is still 30% above average trough recessionary multiples, 19.6 vs. 15.1.



Source Bloomberg 04/05/2023

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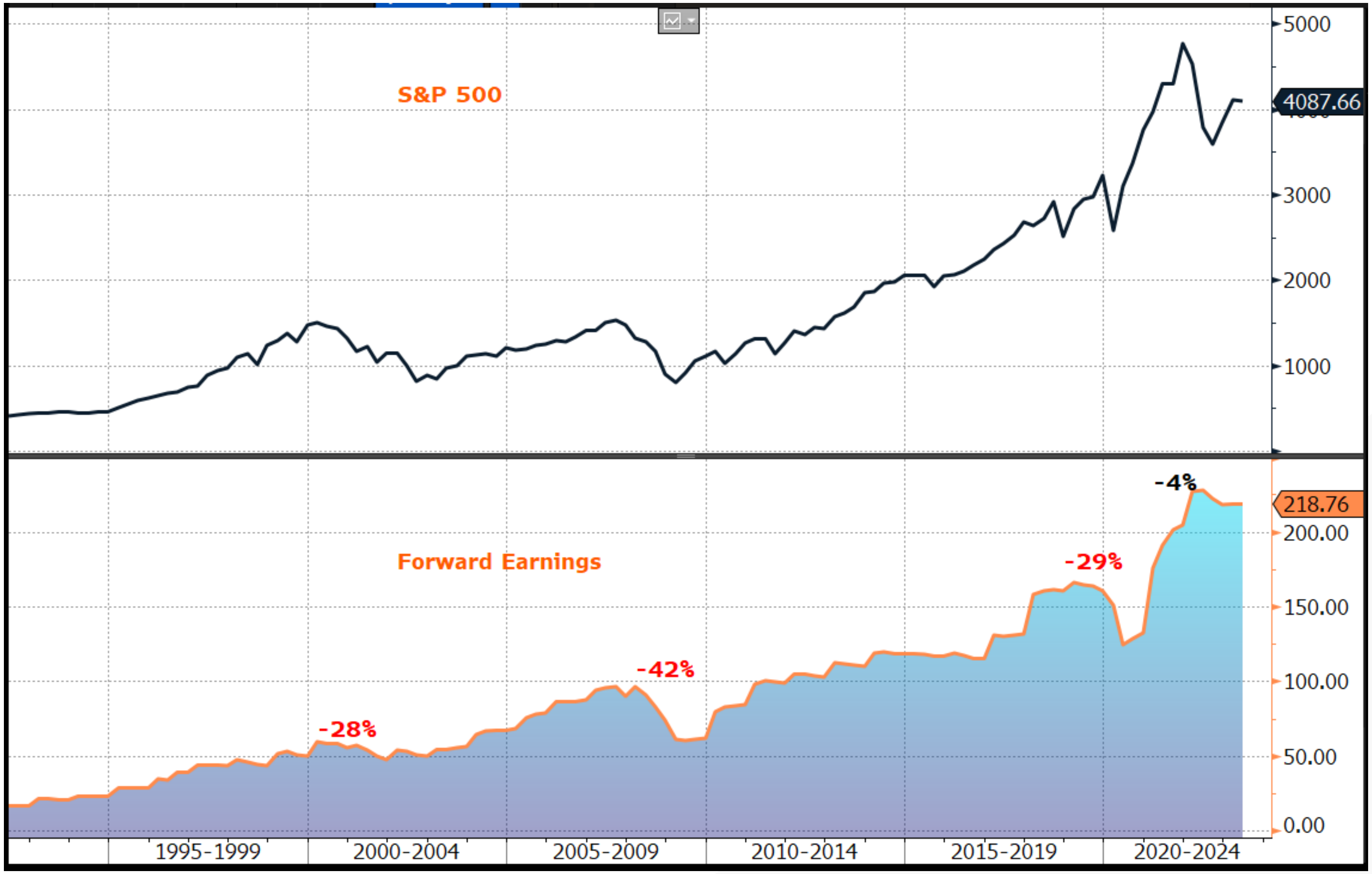
Earnings Estimates Still Elevated

In the last 3 recessions, earnings estimates were down -29% to -42%. Presently, earnings estimates are down -4% from recent highs. In other words, analysts are not pricing in recession.



Source Bloomberg as of 04/05/2023

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Earnings Revisions

Value stocks, which tend to be more sensitive to changes in the economy, are buoying the outlook for earnings. Should the U.S. enter a recession, value stocks' earnings may not hold up.

Source Bloomberg as of 04/03/2023

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Opportunities

Investment Considerations

- Time to consider investing outside of the U.S.
  - Markets are mean reverting, and for most of the last decade, U.S. stocks have outperformed international stocks.
  - International stocks tend to trade inversely with the U.S. dollar, and the dollar is near all-time highs today.
  - International stocks are cheap relative to U.S. stocks.
- High quality fixed income is investable again
- Direct lending
  - Floating rate loans provide inflation protection, they sit atop the capital structure, and they have equity-like returns with less volatility.
- Secondary private equity
  - The opportunity set is ripe with forced sellers starting to enter the market.
- Distressed debt

International Stocks Leading

For more than 10 years, U.S. stocks dominated international stocks. During bear markets, the handoff to new leadership usually takes place. Our view is that leadership change started 15 months ago. We would advise increasing ownership of international equities.

Country/Region Total Returns						
Country/Region	5 Day	1 Month	3 Month	YTD	6 Month	1 Year
France	2.68	2.21	12.23	15.14	34.10	13.29
Mexico	-0.86	-2.54	12.54	18.87	32.21	12.49
Germany	1.94	1.72	10.54	14.92	35.90	4.41
International	1.91	1.13	7.90	9.20	22.43	0.01
U.K.	2.76	0.12	5.75	6.85	21.04	-0.26
Japan	0.73	1.31	8.80	6.78	14.73	-3.24
World	1.45	0.64	6.71	6.99	11.55	-7.58
U.S.	**1.64**	**1.30**	**7.93**	**7.07**	**9.09**	**-8.02**
China	-1.19	-2.87	-5.60	3.28	11.31	-8.82
Emerging Markets	0.27	-0.80	-0.06	3.50	8.71	-12.40
Canada	2.86	-0.80	5.05	5.59	7.76	-12.41
S Korea	1.52	0.51	6.84	7.84	23.70	-13.01
Brazil	0.22	-0.66	-0.66	-3.22	-11.23	-20.35

Source Bloomberg as of 04/05/2023

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The U.S. Dollar is Near Multi-Decade Highs

While the dollar has retreated from multi-decade highs set in late 2022, the dollar is still relatively strong when compared to a basket of other major currencies. Importantly, we believe markets are mean reverting and over the next cycle, the dollar could decline on a relative basis. This would be a tailwind for international stocks.

Source Bloomberg as of 04/05/2023

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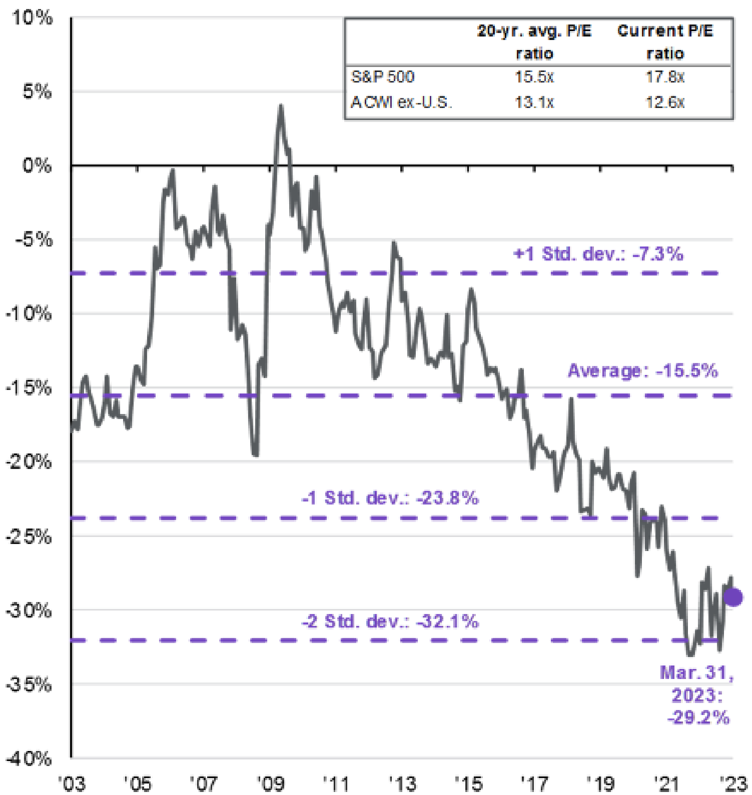
International Stocks are Cheap

Valuations are not a timing tool, however, over long periods of time cheaper stocks outperform expensive stocks. International stocks are cheap relative to U.S. stocks.

International: Price-to-earnings discount vs. U.S.

MSCI All Country World ex-U.S. vs. S&P 500, next 12 months



	20-yr. avg. P/E ratio	Current P/E ratio
S&P 500	15.5x	17.8x
ACWI ex-U.S.	13.1x	12.6x

International: Difference in dividend yields vs. U.S.

MSCI All Country World ex-U.S. minus S&P 500, next 12 months

Source JPMorgan 03/31/2023

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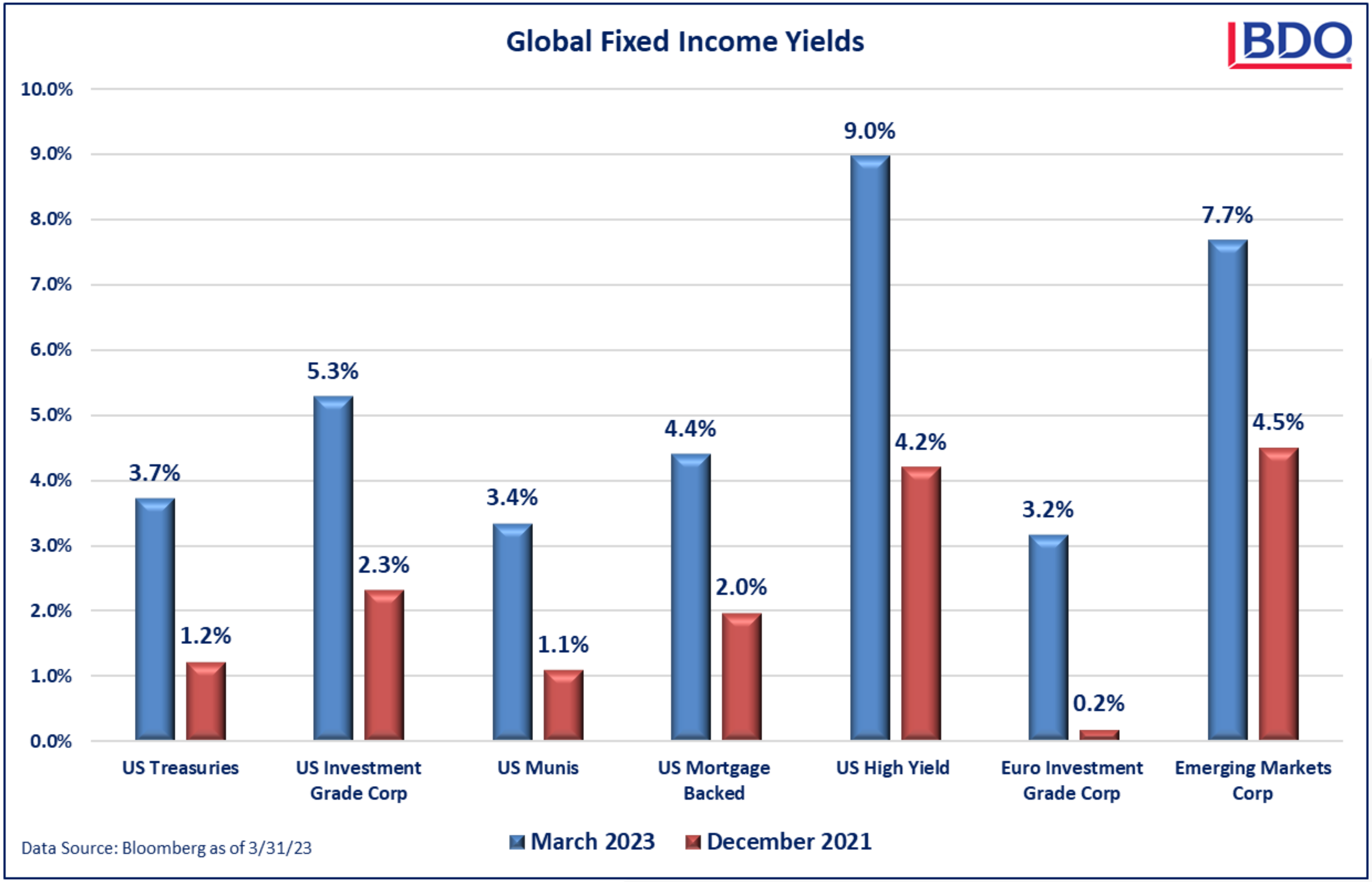
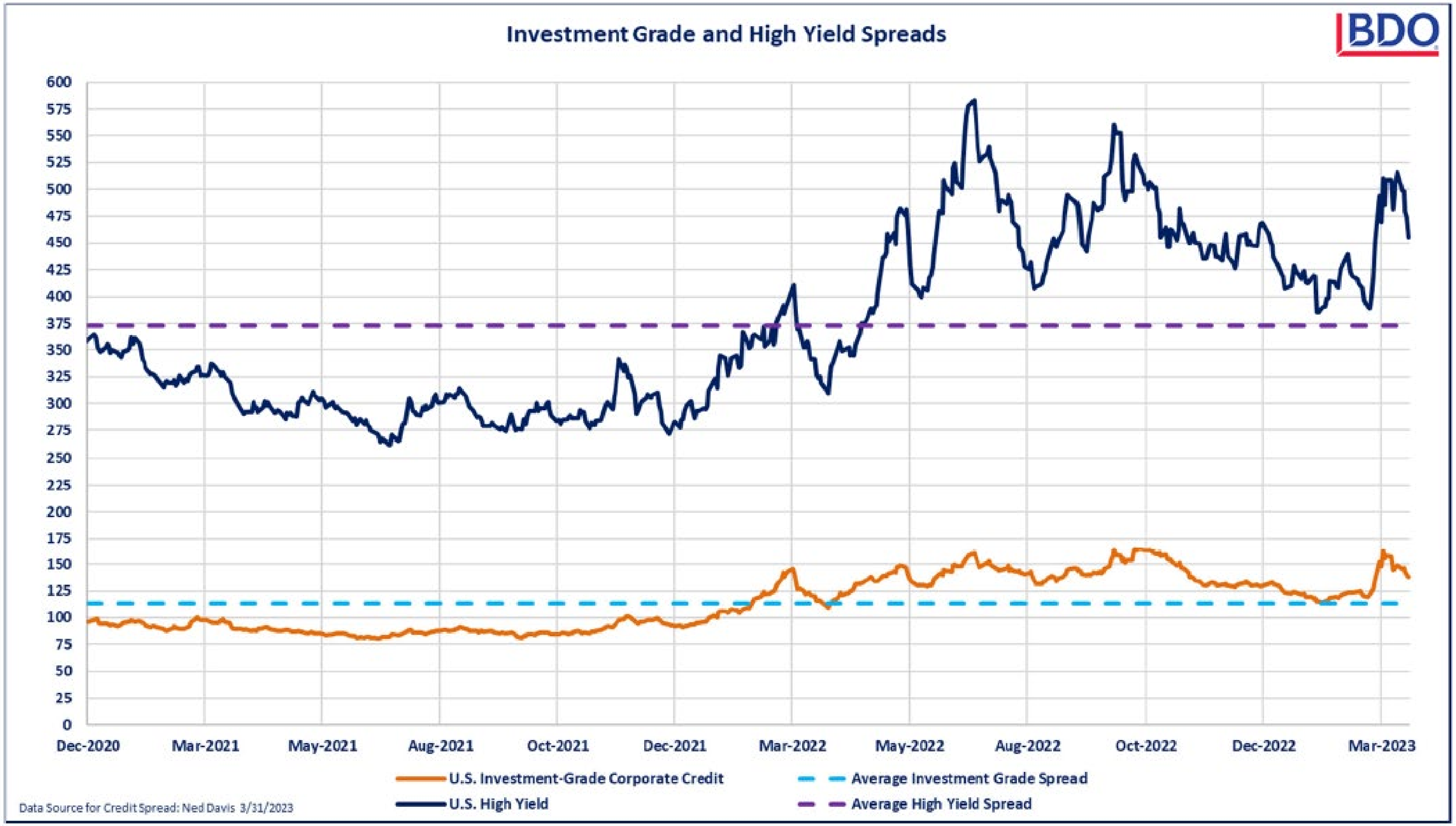
Yields Available For Investors

A dramatic rise in interest rates has created a more attractive entry point for bonds.



High Yield Bonds, Look Elsewhere

High yield bonds may appear attractive given their current YTW of 9%. However, investors should also consider spreads, a metric used to gauge credit risk. When spreads widen, bond prices decline. Should the market start to price in recession, we'd expect spreads to widen.



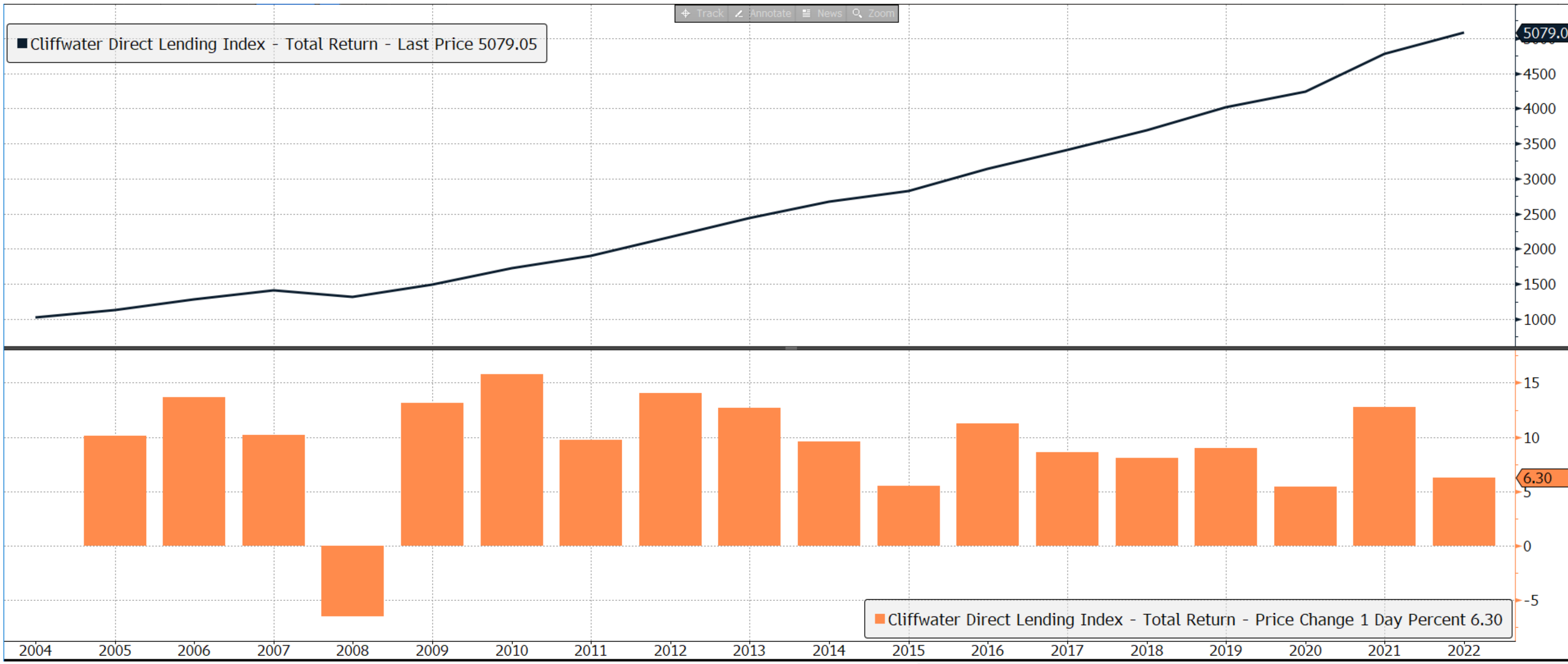
Private Investments – Direct Lending

Private Credit

- Direct lending investments typically have desirable attributes in today's environment:
  - Floating rates – provide protection against rising interest rates
  - Higher Seniority – loans are first in line in the capital structure to be paid out in the event of default
  - Strong covenants – often secured by assets
  - Illiquid – provides a premium to investors
  - Low correlation to public markets

Private Investments – Cliffwater Direct Lending Index

Cliffwater Direct Lending Index, one down year since 2005. The year in which it was down was during the Great Financial Crisis in 2008, and the index was down -6.5%.



Source Bloomberg as of 04/05/2023

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Private Investments - Secondaries

Secondaries

- In periods of market stress, asset prices are challenged by the evolving economic conditions and corresponding deterioration in liquidity. This period of illiquidity creates opportunity for investors capable of acting as liquidity providers.
- Traditional public equities and bonds have been under pressure since January 2022. Meanwhile, private investments have outperformed their public market counterparts in 2022 with the exception of venture.
- In turn, private strategies have grown to become outsized allocations in many university, hospital, foundation, and endowment portfolios. These types of organizations are governed by investment policy statements that have guardrails around asset allocation. Fundraising cycles have compressed in private equity fundraising.
- As such, these primary private equity holders need to rebalance portfolios to meet investment guidelines and must reduce their private investment exposure. Enter, secondary funds.
- Many LPs are overallocated to private equity and GP-led deal flow is at record levels. This dynamic has forced LPs and GPs to the secondary market for liquidity.

Conclusion

Three points of illiquidity are driving changes in markets and pushing the U.S. towards recession:

- The Fed is hiking interest rates
- The Fed is reducing its balance sheet
- Banks are tightening lending standards

As a result, there are investment opportunities:

- Consider adjusting allocation to increase international equity exposure
- High quality bonds are investable again
- Private strategies, direct lending, and private equity secondaries are appealing in this environment
- Distressed debt

Questions

“The best way to measure your investing success is not by whether you’re beating the market but by whether you’ve put in place a financial plan and a behavioral discipline that are likely to get you where you want to go. In the end, what matters isn’t crossing the finish line before anybody else but just making sure that you do cross it.”
— **Benjamin Graham, The Intelligent Investor (1949)**

"Finally, when one talks about risk for too long, it begins to cloud your judgment. Looking ahead, the positives are huge. However events play out it, is likely that 20 years from now, America’s GDP will be more than twice the size it is today, and hundreds of millions of people around the world will have been lifted out of poverty."
— **Jamie Dimon, JPMorgan Annual Letter (04/04/2023)**

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