INVESTMENT *UPDATE*

ROMANO BROTHERS & CO. WEALTH MANAGEMENT

Protecting Your Prosperity. Securing Your Future. Since 1962.

Member FINRA/SIPC

April 2023

ALL EYES REMAIN FIXED ON THE FED

The Federal Reserve has continued its tightening stance and just this past week hiked its benchmark rate by another 0.25%, making it the ninth consecutive increase. The vote was unanimous at the March 22nd meeting and puts the federal funds rate at a range of 4.75% to 5%.

Policy makers at the Fed are clearly walking a tightrope as they seek to balance their mission of stable prices and financial stability. Their announcement of only a quarter-point hike was a compromise as prior expectations were that the Fed would raise one-half a percentage point to counter stubbornly high inflation. But then came bank failures like Silicon Valley Bank (SVB) and Signature Bank and the fear of contagion to other financial institutions (later Credit Suisse).

The market seemed to take it all in stride, soothed by the Fed initially signaling that it may ease its rate increase ambitions and that one more increase could be contemplated for this year (the Fed "dot plot" or an indication of terminal rates, was left unchanged at 5.1%). But in the press conference shortly after the announcement, Chair Powell said a rate cut wasn't in the "base case" and noted that the current banking crisis likely resulted in a tightening of financial conditions. For her part, Treasury Secretary Yellen said in almost rapid-fire succession that regulators aren't considering a blanket guarantee for all U.S. deposits without congressional approval. The merits of that position aside, this was not the consolation the market was looking for. This one-two punch caused the Dow to fall 500 points in a late session slide that day.

In short, the combined effect of Powell's and Yellen's comments seems to have increased, not assuaged, market concerns about the risk of a U.S. recession later in 2023. In our winter newsletter written at the end of November, I cautioned that December would not be the Fed's last rate hike, that a recession might be the only way to tame inflation, and that we were still looking at a volatile next 6 to 9 months for the market after its dismal performance in 2022.

So far, these positions have largely proven true with the exception of an ensuing recession, which is still too early to call as we must look backward at the economic data to determine if we're experiencing one. But as I've alluded in the past, the Fed has a poor track record of engineering "soft landings", or raising interest rates to cool the economy and inflation without plunging it into outright recession.

What is for sure is that I wouldn't want Chairman Powell's job right now as he tries to balance these competing goals on a knife's edge. The collapse of SVB and the ensuing banking crisis shows how fragile that balance is and how too often the Fed raises rates until something breaks. What is also clear (at least to me) is that the odds of a recession are even higher today than they were in November.

In that last newsletter I did say—and it's worth repeating—that "economies sometimes contract and markets don't always go up. In general, staying the course is the best, albeit sometimes painful, option." All of us at the firm stand by that today. Our portfolio recommendations continue to focus on capital preservation and the higher rates offered from fixed income, while on the equity side of things we concentrate on companies with strong balance sheets, good cash flows and attractive fundamentals.

In response to all of this, the market has been searching for direction this year with the Dow down 3% and the S&P 500 up 3% since March 24. Only the NASDAQ is the lone outlier up 12% YTD but still a far cry from the +30% decline last year. While we don't make all or nothing bets that are reserved for traders and not investors, based upon recent market performance and our current analysis, it does not seem that now is the time to tweak and move away from our more conservative posture into a more aggressive stance.

The time will come but until then, thank you for your trust and confidence in all of us as we navigate through another year in the markets, our 61st together.

Warm Regards,

Joe Romano, PRESIDENT

A DEEPER DIVE INTO SILICON VALLEY BANK

For those of us who follow the market regularly, the failure of Silicon Valley Bank (SVB) has been the story of the year. Our readers might wonder why exactly they failed, and to what extent their failure may create concern for the broader banking sector. Although there have been other bank failures (such as New York based Signature Bank) and near-failures (Credit Suisse, being acquired by fellow Swiss bank UBS), it appears to us that a broader bank system failure is unlikely.

Though SVB had a unique cocktail of stressors, what it shared with many banks was exposure to the bond market. According to a report from JP Morgan, from late 2019 through early 2022, deposits at banks rose by $5.4 trillion. With limited loan demand (probably due in no small part to the Covid crisis), much of those deposits were invested in securities, typically US government and government agency bonds. In that time, SVB's securities investments grew from $28 billion to $126 billion, nearly a $100 billion increase. As 2022 was plagued by high inflation, interest rates rose dramatically, causing the bond market to fall; the aggregate bond index fell 13% for the year. SVB seems to have taken far greater risk than its peer banks and, according to JP Morgan's report, when adjusted for unrealized losses and tax, had close to 0% net capital. For reference, they estimated other banks' net capital from 4% to 11%.

On the other side of the equation was a problem with their deposits. From the news reports, we know that SVB ultimately failed because of a 'run on the bank,' when too many depositors were trying to withdraw all at once. But prior to that, their deposit base was shrinking on its own because of its un-diversified client base. SVB had a large concentration of early-stage venture capital-backed companies as depositors: well over 50%. With the slowdown in that space last year, these companies were making net withdrawals in the regular course of business. As a result, according to a Standard & Poor's report, net withdrawals accelerated: from $3.7 billion in the fourth quarter, to $8.0 billion in January through February. They quickly ran out of available easy cash with which to pay out the withdrawals and had to turn to securities sales.

When a bank holds a bond, even if it fluctuates in value, they need not show a loss unless they sell it prior to maturity. But now SVB had no choice but to sell bonds and realize losses on those bonds. Otherwise, they would not be able to pay out the withdrawals that their customers were requesting. With those losses realized, they fell below the regulators' required net capital.

The rest of the story happened quickly. They tried in vain to raise just over $2 billion of capital on Wednesday March 8th, and after failing to do so, a run on the bank ensued. On Friday March 10th they were placed into the hands of the California banking regulators and FDIC to protect depositors, and were functionally out of business.

What set SVB apart from most banks were two chief differences. First, they invested the deposits they received more riskily than their peers, opening themselves up to larger losses when bond prices fell. Second, their client base was highly concentrated in a single sector that simultaneously experienced a slowdown. It was a perfect storm, and indeed the ship sank. Though there are no certainties in life, we believe SVB was a unique instance. Other banks are feeling some pressure from a lack of confidence in the bank system following their collapse, but to the best of our knowledge there are no other banks with the same negative exposures. For that reason, although the banking system will feel stress, and there may yet be more ripples and waves in the sector, we believe that the US banking world is generally sound.

Osman Arain

ROMANO NEWS

JOIN US IN CONGRATULATING SCOTT MILLER ON A DECADE WITH ROMANO

Scott is celebrating his ten-year employment anniversary this spring. Scott joined the firm in 2013, having now spent 24 years in the industry and says his favorite part of the job is, "Helping good people meet their goals and retire the way they want to."

We know Scott's clients appreciate his tireless work ethic and attention to detail, all delivered with a dose of humor. Thank you, Scott. Here's to ten more!

VOLATILITY AND FINANCIAL PLANNING

As Joe mentions in his piece this quarter, and often has throughout the many market updates in these newsletters, we are investors rather than traders. Taking a long-term approach to investing is the only time-tested and proven method for a successful investment strategy. The day-to-day, year-to-year, and even decade-to-decade fluctuations and volatility of markets are a constant – they have always been present and there is no reason to expect anything different in the future. That volatility is particularly visible right now, as the Fed tries to engineer a "soft landing," while the economy and markets deal with holdover fears and concerns from the pandemic and its aftermath.

The ever-presence of volatility is not something that can be controlled. Rather, the best strategy accepts it, and makes investment decisions to minimize its impact. This is less of a problem for someone who is investing for a need many years in the future. But what about the need for money now, or over the next few years? It is for this reason that the financial planning process can be such a powerful exercise to achieve investing success. Through careful planning around the needs for liquidity in the short-term, we can unlock the benefits of the long-term investment perspective.

There are a number of different strategies that can create the money needed for expenses, both planned and unplanned.

Emergency Fund

An emergency fund represents the first line of defense against expenses that are unplanned. We would love to be able to project and plan for every expense, but it does not always work that way. The presence of an emergency fund allows us to be flexible when unexpected expenses arise rather than being forced to liquidate investments at the mercy of markets wherever they may be at that time.

The criteria for an emergency fund will be different for each person, but they all have some common characteristics. First, it should be highly liquid – that means it can be converted to spendable cash within a couple of days without risk of losing money. Some acceptable vehicles include savings accounts and money market funds. Second, it should represent a portion of normal expected expenses. A general rule of thumb is three to six months of normal monthly expenses, but the right amount depends on a number of other factors that should be discussed with your advisor.

Bucketing

For many people, there is not one singular thing for which they are investing. While almost everyone has retirement in their plans at some point, there are many other possible uses for money along the way.

Each of these goals may have significantly different time horizons, and thus different liquidity needs. A common approach to account for this is to separate investments by goal.

Some common shorter-term goals are buying a home or paying for children to go to college – rarely do these goals coincide with the long-term goal of retirement. Creating a separate pool of money specifically for that goal allows us to match the investment risk and cash flows more directly to its expected use.

Cash Flow Matching

Regardless of the goal and its initial time horizon, we inevitably reach the point where money is going to be needed. Whether that is a stream of income like retirement, or a lump sum cash outlay like a home purchase or tuition payment, a portfolio can be designed so cash is available when its needed, freeing up the remainder of the portfolio to remain invested for the long-term.

We often prepare for clients to have a "cash runway" when we reach the time of withdrawals – that is, liquidity is generated by the portfolio to meet a number of years of expected cash outflows. Liquidity is generated by 1) interest and dividends from investments, 2) maturing bonds, and 3) cash on hand. This gives us flexibility us to meet multiple years of needs without being forced to liquidate investments.

Peter Hemwall

ROMANO
BROTHERS & CO.
WEALTH MANAGEMENT
Protecting Your Prosperity. Securing Your Future. Since 1962.
Member FINRA/SIPC

1560 SHERMAN AVENUE
SUITE 1300
EVANSTON, IL 60201

OFFICE 847 866 7700
FAX 847 866 7054

ROMANOWEALTH.COM

PROTECTING YOUR PROSPERITY. SECURING YOUR FUTURE. SINCE 1962.

CLIENT NEWS

Dorrance Halverson, a Romano client since 2012, has been doing his part to prove that basketball can be a life-long sport. Nearing 80, Dorrance still plays in local pick-up games twice a week and will partake in this year's Hoops for the Ages Tournament in Evanston. Lace up your sneakers and consider supporting the Levy Senior Center by playing in an age-inclusive basketball tournament in May. Visit hoopsfortheages.org for more information.