

# PETERSON FINANCIAL SERVICES

Limited Liability Company ♦ Registered Investment Advisory Firm

## FINANCIAL FOCUS

*DISRUPTIONS TO  
EFFICIENT  
MARKETS COME  
WITH  
UNINTENDED  
CONSEQUENCES.*

### In This Issue:

- Quarterly Market Recap
- An overly heavy policy hand by various government agencies creates problems, makes them more severe, and prevents swift recoveries.

## First Quarter 2023

April 3, 2023

### **QUARTERLY MARKET RECAP**

After last year's bear market rout of growth stocks, gains returned to all of the indexes, with last year's most beaten-up sector, rate-sensitive technology, leading the way.

Last quarter, the DJIA, which was last year's best-performer by losing the least, nudged up 0.38%, the S&P 500 added 7.03%. The healthiest gain came from the NASDAQ at 16.77%. The small-cap Russell 2000 rose 2.34%. Foreign equities added 7.07%. The Fed continued its interest rate tightening cycle but in their last two meetings have reduced the pace to quarter point moves. The Barclay's Aggregate Bond Index gained 3.10%. Recent upheaval in the banking sector

suggests further rate increases may be limited, although from an inflation fighting standpoint, we hope that is not pre-mature. Inflation is moderating, but not at the pace that would suggest the tightening cycle should end entirely at this point. Labor markets are still healthy, along with wage gains, and corporate earnings are still surprising to the upside. The recent banking developments appear to be contained, so barring other dominoes dropping we don't yet know about, avoiding a serious recession could be expected. When the Fed telegraphs an end to the tightening cycle, growth stocks should perform quite well, and reinvesting in bonds will be in order very soon.

### **GOVERNMENT POLICIES DISTORTING THE WORKINGS OF THE MARKET CONTINUE TO CAUSE PAIN**

There are just two main reasons for the last couple years of historically-high inflation. One is the excessive level of government spending amounting to trillions of dollars beyond what the economy could absorb. This fiscal stimulus created bidding wars for scarce goods and services and turbocharged demand. Supply and demand equilibrium suggests that when demand outstrips supply, prices will rise. And that happened big time. One of the adverse consequences to the last few years of this "emergency" spending is that it is now baked into the baseline budget, so it will be with us indefinitely. Policies issued in response to the pandemic, which have continued well beyond its end, such as allowing deferral of paying for rent, student loans, and other items adds to inflation.

The second reason is the monetary stimulus that came with the Federal Reserve holding interest rates too low for too long. This also added to spending demand by consumers and businesses because money was cheap, and it inflated asset prices. Unwinding this has been painful and the pain is not entirely behind us. And this has caused another

problem which has led to the recent banking instability. These cause-and-effect relationships are all inter-related. Policies matter.

Other regulatory policies added fuel to the fire. By keeping rates at near-zero levels for about a dozen years with little abatement, the Fed virtually guaranteed that banks would search for yield in long Treasuries in order to satisfy the Dodd-Frank mandate for "safe" liquidity reserves. Exclusive emphasis in this aspect of the law, which was birthed from the last credit and mortgage meltdown, focused on safety and capital reserve amounts. There's nothing wrong with that, but what hasn't been considered is duration and interest rate risk, and liquidity.

Silicon Valley Bank and Signature Bank, and others, loaded up on long Treasury securities to satisfy this regulatory demand for safety. But since interest rates and bond values have an inverse relationship, values of these securities declined as rates rose. This is the primary reason why we divested of all bond positions in early 2022 in all of our portfolios that held fixed income assets, just prior to the Fed starting its tightening cycle. But because these banks were not required to "mark to market"

these asset valuations, it concealed the true health of their capital reserve portfolios. These banks were allowed to classify these investments as being held to maturity, so they appeared on their balance sheets at full par value, even when they were trading in the marketplace at steep discounts. This would be like your bond positions being listed falsely on your account statement as worth more than you would actually get if you sold them.

These specific banks were loaded up with loans to unprofitable and risky politically-favored green energy and other rate-sensitive tech start-ups, and they were also heavily participating in the crypto markets. Things unraveled when fractures started to occur in those markets late last year, and eventually many depositors cashed out their accounts, and encouraged other venture capital firms like them to do so as well. This is the “run” on the banks reported in the news.

SVB’s website boasted, “We serve those creating positive environmental change” and do business with about 1,550 companies in the “climate technology and sustainability sector.” Among these politically-correct pronouncements, there is no evident consideration for viability and having loans actually be paid back. The Wall Street Journal reported, much of SVB’s popularity was due to it supplying “banking services to startups that often weren’t profitable, in some cases didn’t have a product, and would otherwise have a hard time getting a line of credit or a loan from a larger bank.” This, along with the deaf ear to this bank’s apparent lack of consideration for the bond portfolio’s aforementioned risks, is

precisely the kind of thing that regulators should be watching for and correcting deficiencies. How many times now have we seen regulations and laws put in place, and then bad actors in these industries flout them, and no agency remedy is applied? What’s the point of the regulations if the regulators don’t catch these disasters beforehand?

In order to satisfy those withdrawal demands, cash liquidity depleted quickly and SVB had to dip into their portfolio of long Treasuries. But these were underwater to the reported value on their balance sheet, and from what they had bought them for. So, to raise money, they sold off the bonds at a loss, thereby endangering their reserves.

Things got worse, in our view, when the Fed, the Treasury Department, and the FDIC panicked and immediately arranged for receivership before options had been exhausted to shore up, or sell, these banks to healthier competitors. To add to the cascade of regulatory mistakes, the government announced that they would waive the FDIC insurance limit of \$250,000 per account, and backstop insure all deposits, regardless of account value, even for large and sophisticated investors. This is a dangerous precedent that has added to the moral hazard in our system. What incentive is there now to evaluate prudent risk management when the government declares that they will cover all blown-up risk management decisions? Why wouldn’t banks now swing for the fences on yield, regardless of market risk, when they know they’ll reap huge profits if the bets pay off, but suffer no losses if they don’t? These distortions of the consequences of bad decisions make the system riskier, not safer. It invites irresponsibility.

*“If you have 10,000 regulations you destroy all respect for the law.” - Sir Winston Churchill*

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*Pursuant to SEC Rule 204-3 (C) of the Investment Advisors Act of 1940, we hereby offer, without cost, a copy of our “Disclosure Statement”, Form ADV Part II, which is the document attached to your copy of our Service Agreement. Please e-mail us, or mail us, a written request if you’d like another copy and we’ll send it in February after we update our annual filing. Also, in conformance with Regulation S-P of the Gramm-Leach-Bliley Act, we are required to provide annual notice of our Privacy Policy. Our policy is posted to our website, and is mailed to each client.*

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## **ABOUT PETERSON FINANCIAL SERVICES, LLC**

**As an aside, we wish to remind our clients of our various services. While we specialize in portfolio management, we continue to provide financial planning and insurance services. Longtime clients may have forgotten this, and newer clients may not be aware of this. Additionally, we build our business through referrals, and much appreciate them. Please keep us in mind as you come across friends, family and colleagues who might benefit from our financial services. We appreciate your business.**

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*Financial Focus is a quarterly market letter published by Peterson Financial Services, LLC, a Denver, Colorado Registered Investment Advisory Firm specializing in investment portfolio management and financial advisory services.*

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