ALBION FINANCIAL GROUP

Guiding Clients
To A Lifetime of
Good Decisions

APRIL 2023

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INTRODUCTION

In the first quarter of 2023 we saw the second largest bank failure in US history, the Fed Funds rate hit 5%, and Alta set a new season record with a total of 847 inches of snow and counting. We were also reminded that our national debt is still an issue, something John Bird breaks down for us in this letter. Will we see a recession in 2023? We believe the answer is yes. Jason Ware explains our thinking in **Economy & Markets**. In the wake of the Silicon Valley Bank crisis, there has been much discussion about FDIC insurance. In **Planners Corner**, Patrick Lundergan details the coverage provided by FDIC and SIPC insurance. Finally, we introduce the 3 newest members of the Albion Financial Group team. You can learn more in **Albion Community**.

FROM JOHN BIRD'S DESK

To assess near-term prospects for the financial markets we must dig into the current state of our economy and its likely future course. In doing so we cannot ignore federal spending which at present accounts for 25% of GDP. Where does that come from? How is it spent? Is it sustainable?

The United States has served as the stabilizing bulwark of the global financial system since World War II and the dollar has served as the global reserve and benchmark currency for that period. There are significant advantages to being the reserve currency for the world including the ability to borrow money at low cost. However, for several decades we've been unable to implement a consistent and fiscally prudent

federal budget policy. We continue to generate deficits leading to an ever-growing federal debt.

In 2022 federal spending was $6.272 trillion (25.1% of GDP) revenues were $4.896 trillion (19.6% of GDP) for a deficit of 1.375 trillion (5.5% of GDP) which was borrowed from financial markets and is now part of the total debt. Regardless of political affiliation most of us agree that this is a lot of money. Further, most of us agree that deficits of this size, and the debt they create, are ultimately unsustainable.

Where does this money go? Social Security accounts for $1.2 trillion. Health – which includes Medicaid, health grants to states, health insurance for federal employees, premium assistance and a number of other categories accounts for $914 billion. Income security which includes food and nutrition assistance, federal employee retirement and disability, general retirement and disability, housing assistance and other income security programs amounts to $865 billion. National defense totaled $767 billion, Medicare came in at $755 billion, and Education, Training, Employment, and Social Services came in at $677 billion. Net interest expense on our national debt totaled $475 billion while veterans benefits and services totaled $274 billion - this is in addition to the national defense spending. Transportation cost $132 billion, general government cost $129 billion and the catch-all other was $65 billion.

This can be further subdivided into mandatory, discretionary, and supplemental spending. Mandatory spending is typically a long-term spending commitment enshrined in law. Social Security, Medicare, federal employee retirement programs, and interest on the federal debt are all examples of mandatory spending. Discretionary spending includes those items approved by congress each year. Typically half of discretionary spending goes toward national defense with the other half funding the administration of other agencies and programs. Supplemental programs are those that fall outside the budgeting process and are intended as responses to one-off events such as spending to mitigate the impact of Covid.

If mandatory spending is off the table, which to date it has been, we could cut all non-national defense spending and still be running a significant deficit.

If a balanced budget, or much smaller deficits, are an objective we have a handful of levers to get us there. We can work to increase the rate of economic growth, reduce spending, increase taxes, and use inflation to make the existing debt less expensive. Any one of these alone is unlikely to solve the issue. It will likely take a combination of all four to put our fiscal house in order. However overreliance on any one of them entails significant risk. We're currently experiencing the challenges of inflation and recognize that it's something that can only be accepted in extreme moderation. Wholesale spending cuts clearly hurt certain segments of the population and economy as do dramatic increases in tax rates. Economic growth is everyone's favorite as in theory greater growth shouldn't be painful for anyone. Unfortunately measures taken to encourage economic growth tend to exacerbate deficit spending.

We do not believe a budget crisis is imminent – with the exception of the political risk around raising the national debt ceiling. However we do believe that over time difficult choices must be made to ensure our country remains on a solid financial footing. Rigid positioning and vilification of those who have different perspectives is not helpful and works to ensure no real progress can be made. Most of us have programs that we absolutely don't want to see cut. Further, most of us do not want to see our taxes increase. That's normal self-interest. However that perspective multiplied by millions of voters makes it near impossible to plot a course toward fiscal responsibility. There is no easy answer and anyone who suggests otherwise is up in the night. If we are flexible, willing to live in the grey rather than the black and white, and are open to compromise solutions will appear. I have confidence we as a nation can do this.

ECONOMY & MARKETS by Jason Ware

This letter begins in similar fashion as our last. Two quarters ago we shared our recession call.

"Our current appraisal of the economic information suggests that a recession in 2023 is probable."

Nothing from the first quarter has altered this view. In fact, things have only moved further along this path since our original declaration as the Federal Reserve has *doubled* their target interest rate (Fed funds) to ~5%. This restriction of financial conditions has shown up in a variety of ways. Stocks are erratic. Housing has sharply corrected. Manufacturing is already contracting. Tech is too. Construction has slowed. Real liquidity and M2 (a measure of US money supply) are negative. Lending standards have tightened meaning less credit creation. We could go on. Speaking of banks, recently a troika of failed institutions involving SVB, Signature, and Silvergate surprised just about everyone. Forceful monetary policy – the kind where you jack up rates from zero to 5% and go from QE (quantitative easing) to QT (quantitative tightening) all in one year's time – has consequences. And while for numerous reasons, one part anatomical and two parts governmental (i.e., "backstops"), we trust this situation *won't* spiral into a wider banking crisis, it *is* likely to further slow lending. This is significant because at its root recessions are caused when money *availability* dries up – a process already under way and perhaps now worsened by stresses at small and mid-sized US banks. All told, our favored leading indicators continue to suggest a high probability of an impending slump. Despite this, what was once "*the most forecasted recession ever*" has given way to a mounting tone of hopefulness regarding a "soft landing," and hence a jump in stocks to open the year. Regrettably, we aren't as sanguine.

It is thus reasonable to ask: *if accurate*, *how will I know when recession has arrived*? Among other items, our

preferred *real-time* guidepost is what's known as the 'Sahm Rule' (named after its creator, economist Claudia Sahm). Historically this measure has identified *the start* of a downturn when the three-month moving average of the national unemployment rate (U3) rises by +0.50% (or more) relative to its low during the previous twelve months. Admittedly that all sounds a bit wonky. In plain English, when applied to the current cycle if / when U3 finds itself averaging 4% (or higher) over a three month stretch we can conclude that recession is upon us. The jobs market has been incredibly resilient post-pandemic. Arguably the strongest remaining pillar in this economy, so any meaningful weakening here may be particularly portentous. As with everything, no single indicator is perfect. Accordingly, we will evaluate this rule and other vital data points using a weight of the evidence approach. Stay tuned.

Back to the Fed for a moment. It's probable we're near the end of the hiking cycle. This was true before SVB blew up. It's truer in its aftermath. It has been said that Jerome Powell & Co. in their dogged inflation fight were on course to push until something breaks – either inflation or the economy (or both). However as is common what broke first was something unexpected: America's sixteenth largest bank folded, plus two others, sent into FDIC receivership … the direct result of a tetchy concoction of falling bond values, constrained capital conditions, and overconcentrated deposit bases. This disinflationary shock coupled with an already cooling general inflation trajectory has left the US central bank on track to wind down its rate increases. Two consecutive +0.25% moves so far this year after going +0.50% in December and +0.75% four times before that exhibit this leveling glidepath. Appropriately, investor focus has shifted toward *what's to come*. We have no edge in the interest rate forecasting game, yet we do reason that strictly thru an economic lens an imminent pause is warranted. Markets, both bonds and Fed Funds futures, seem to largely concur with this judgement. The current debate now centers on whether the Fed will *cut* later this year or simply stop but stay "*higher for longer*." The answer carries with it real implications for investors. Naturally, we have our

opinions. But Mr. Powell has yet to call us for our counsel, so we wait along with everyone else to see how it all plays out.

Of course, macro conditions matter because variables like inflation and interest rates matter to real growth (slower) and valuations (lower). With both elevated, they exert a gravitational force on stock prices. Add to this pressure on corporate earnings and you have an ideal environment for equity volatility. Waning business profits as of late have chiefly been a function of tough annual comparisons (2021 was a boom year!) and margin compression borne from input cost inflation – everything from raw materials, to transportation, to wages. Meanwhile revenues have held up thus far, but if recession takes hold we expect this to change. Indeed, Wall Street expectations for profits, in our view, remain too high. If we're right, as these numbers come down so too should stock prices in what could be a final leg lower in this lengthy drawdown period.

This is the financial physics and interplay of recessions and bear markets. How low? Hard to say, though with a robust study of markets and the history of cycles we don't envisage a crash.

Nevertheless, a downside bias for now is our base case. Consequently, we've been humbly turning the dials on our growth equity portfolios over the past many months. To be clear, we remain *fully invested,* guided by our core philosophy of own great investments while thinking and acting long term. We're not swinging for the fences. The future is inherently unknowable, so we employ a healthy dose of humility in our outlooks. Rather, the changes we've made are incremental, selectively pruning from spots where valuations are higher, position sizes are larger, and forward returns look comparatively tempered.

With the proceeds we've added a slice of lower volatility, higher dividend equities to the portfolios – a prudent arrangement for the time being. We will continue to monitor economic conditions, assess trends, and find opportunities on your behalf, all while making the ride as agreeable as possible and staying true to who we are as investors. Thanks for your enduring trust in us.

PLANNERS CORNER by Patrick Lundergan

When it comes to investing and banking, it's essential to understand the protections in place to safeguard your money. The Securities Investor Protection Corporation (SIPC) and the Federal Deposit Insurance Corporation (FDIC) provide two common forms of insurance in the United States. While they both provide insurance coverage for your assets, they differ in the types of assets they cover.

The SIPC is a nonprofit corporation created by Congress in 1970 to protect investors from losing cash and securities in case of a brokerage firm's failure. The Securities and Exchange Commission (SEC) has a Customer Protection Rule that requires registered broker-dealers such as Schwab or Fidelity to hold customer assets separate from the firm's assets. The purpose of this rule is to protect customers from losing their assets if the broker-dealer goes bankrupt. SIPC insurance comes into play if the broker-dealer is negligent in segregating client assets, and thus a bankruptcy results in the loss of customer assets.

There are some essential distinctions in the previous paragraph. For SIPC insurance to kick-in, the firm must fail, AND investor assets must be missing or at risk. Just because a brokerage firm fails doesn't necessarily mean customer assets are at risk. In fact, if the broker-dealer is

complying with the SEC regulations, customer assets should not be impacted by the firm's financial struggles. But in the uncommon instance when they are, SIPC provides coverage up to $500,000 per customer, including up to $250,000 in cash. SIPC protection for customers with multiple accounts is determined by "separate capacity." Each separate capacity is protected up to the limits discussed above.

Examples of separate capacities are:

- Individual account
- Joint account
- An account for a corporation
- An account for a trust created under state law
- An individual retirement account
- A Roth individual retirement account
- An account held by an executor for an estate
- An account held by a guardian for a ward or minor

e.g., Albion Client Jill has a Roth and Traditional IRA at Charles Schwab, managed by Albion. Jill would have full SIPC coverage for BOTH accounts - effectively doubling her coverage based on the separate capacity rule.

In addition to SIPC protection, Brokerages like Fidelity and Charles Schwab provide their brokerage customers with additional "excess of SIPC" coverage from Lloyd's of London and other insurers. The excess of SIPC coverage would only be used when SIPC coverage is exhausted. Like SIPC, excess of SIPC protection does not cover investment losses in customer accounts due to market fluctuation.

On the other hand, the FDIC is an independent agency of the federal government created in 1933 to protect bank deposits. FDIC insurance covers up to $250,000 per depositor per insured bank. Like SIPC, FDIC protection for customers with multiple accounts is determined by ownership categories. It can provide coverage up to $250,000 for accounts with unique ownership (e.g., individual vs. joint vs. retirement account). This coverage means that if a bank fails and you have money deposited in the bank, FDIC insurance will cover up to $250,000 of those deposits.

Some firms (including Albion's custodians) provide an FDIC-insured bank sweep option. An FDIC-insured bank sweep program is an investment program offered by many financial institutions such as banks, brokerage firms, and investment advisors. It is designed to provide investors with a way to earn interest on their cash balances while maintaining their funds' safety and security. With this program, any cash balances in your investment account are automatically transferred to a bank account insured by the Federal Deposit Insurance Corporation (FDIC) - providing a way to maintain FDIC insurance on cash balances above $250k held in investment accounts.

FDIC insurance covers all types of deposit accounts, including checking, savings, money market accounts (not money market mutual funds), and certificates of deposit (CDs). It does not cover investments, such as stocks, bonds, mutual funds, or annuities.

Not all banks are FDIC-insured, so it's important to check if your bank is FDIC-insured before opening an account. The FDIC provides a tool on its website to search for FDIC-insured banks by name or location.

In summary, SIPC insurance protects investments held at brokerage firms in case of failure. In contrast, FDIC insurance protects bank deposits in case of failure. Both types of insurance provide essential protections for your money, but it's crucial to understand their differences and ensure your investments and deposits are adequately insured.

ALBION COMMUNITY UPDATE

Please Give a Warm Welcome

Albion is growing! We recently added Tyani Joseph, Zack Amacher and Brad Curtis to our ranks.

Tyani joins us in the role of Administrative Assistant. You will have the opportunity to speak with her when you call the office or be greeted by her, in person, when you arrive for a meeting.

Zack recently graduated from Texas Tech University with a degree in Personal Financial Planning. The mountains of Utah appealed to Zack and after graduation he moved to Salt Lake City and joined the Albion team in the role of Associate Wealth Advisor. Zack is working on a team with Sarah Bird and Kari Moon Brown.

Brad Curtis is a Certified Financial Planner who has a degree in Personal Financial Planning from Utah Valley University. Brad joined Albion in the role of Financial Planner and is working closely with Devin Pope and Daymian Vajda.

We are excited about the enthusiasm, energy, and expertise they each bring to our team.

FYI

Albion will be conducting an offsite planning seminar for our team on **Friday, April 28th**. Our office will be closed, and limited trading services will be available.

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