COMMENTARY BY GLENN WESSEL, CFA, CPA, CFP®

THE MOST ANTICIPATED RECESSION, EVER

Before I attempt to unravel the probability of the U.S. falling into recession and the potential investment ramifications of that, I'd like to address a few topics that might be of general concern in a climate where a few sizeable financial institutions have recently failed.

A BIT ABOUT PERSHING, LLC

If we oversee a brokerage account for you, that account is carried by Pershing, LLC. Although Shareholders Service Group's name is emblazoned across the top of each statement you receive, Pershing is the institution that actually carries the account.

Pershing was founded in 1939. In 2003, Pershing became a wholly-owned subsidiary of The Bank of New York which later became Bank of New York Mellon (BNY Mellon). As of December 31, 2022:

⇒ Pershing custodied in excess of $2 trillion worth of global assets.

⇒ BNY Mellon as a whole custodied assets of $44.3 trillion making it the largest asset custodian in the world.

⇒ **Pershing maintained regulatory capital of $2.73 billion, $2.46 billion in excess of the minimum regulatory requirement and over 10 times the required minimum.**

Being large and having a large capital cushion doesn't eliminate the risk of failure, but all else being equal, larger capital cushions are apt to provide more protection than smaller ones.

PERSHING IS A MEMBER OF SIPC

Whereas banks are often members of the Federal Deposit Insurance Corporation (FDIC), brokerage firms such as Pershing are often members of the Securities Investors Protection Corporation (SIPC). This means that if Pershing were to fail and securities (i.e., stock and bond certificates, mutual fund shares, etc.) were to go missing, SIPC would work to recover them. If SIPC were unable to recover missing securities, SIPC would endeavor to replace them.

If Pershing were to fail, SIPC would liquidate Pershing's assets and establish a claims process to return missing securities to covered accountholders.

In general, SIPC coverage may protect covered accounts up to a limit of $500,000, $250,000 of which may be cash, but such coverage is not intended to indemnify investors against market-related investment losses. To access official literature on this topic, visit www.SIPC.org.

PERSHING MAINTAINS COVERAGE IN EXCESS OF THE SIPC LIMIT

In addition to SIPC protection, Pershing maintains private coverage in excess of SIPC limits from certain underwriters in Lloyd's insurance market and other commercial insurers.

As of this writing, Pershing has obtained “excess-of-SIPC” coverage that runs through February 10, 2024. This coverage provides the following protection for Pershing LLC's global client assets:

⇒ An aggregate loss limit of $1 billion for eligible securities, in total for all client accounts custodied at Pershing.

⇒ A per-client loss limit of $1.9 million for cash awaiting reinvestment.

An excess-of-SIPC claim would arise only if Pershing failed financially and client assets for covered accounts, as defined by SIPC, could not be located due to theft, misplacement, destruction, burglary, robbery, embezzlement, abstraction, failure to obtain or maintain possession or control of client securities, or to maintain the special reserve bank account required by applicable rules.

As with SIPC coverage, Pershing’s excess coverage is not intended to indemnify accountholders against market-related losses. To access official literature on this topic, visit www.pershing.com/about/strength-and-stability.

FDIC COVERAGE ON CASH UP TO 10 TIMES THE USUAL LIMIT

In general, I would expect general market volatility, the various forms of interest-rate risk, the potential for credit-related losses and the erosive effects of inflation to command more investor attention than losses pertaining to cash and cash reserves. However, I do want to take a moment to explain how we have directed Pershing to handle cash balances in the accounts we oversee.

FDIC coverage typically covers each eligible account to a limit of $250,000. However, our current practice is to have Pershing sweep all cash balances into a deposit product that offers as much as $2.5 million worth of FDIC protection (10 times the usual limit). This program, the “Dreyfus Insured Deposits Product C” (ticker = DIDC), is summarized as follows:

⇒ All idle cash balances are automatically swept into this fund (DIDC).

⇒ DIDC maintains relationships with at least 10 FDIC insured depository institutions.

⇒ **DIDC will direct cash balances held within a given Pershing account to at least one FDIC-insured institution and to multiple FDIC-insured institutions when necessary to achieve FDIC coverage above the usual $250,000 FDIC coverage limit.**

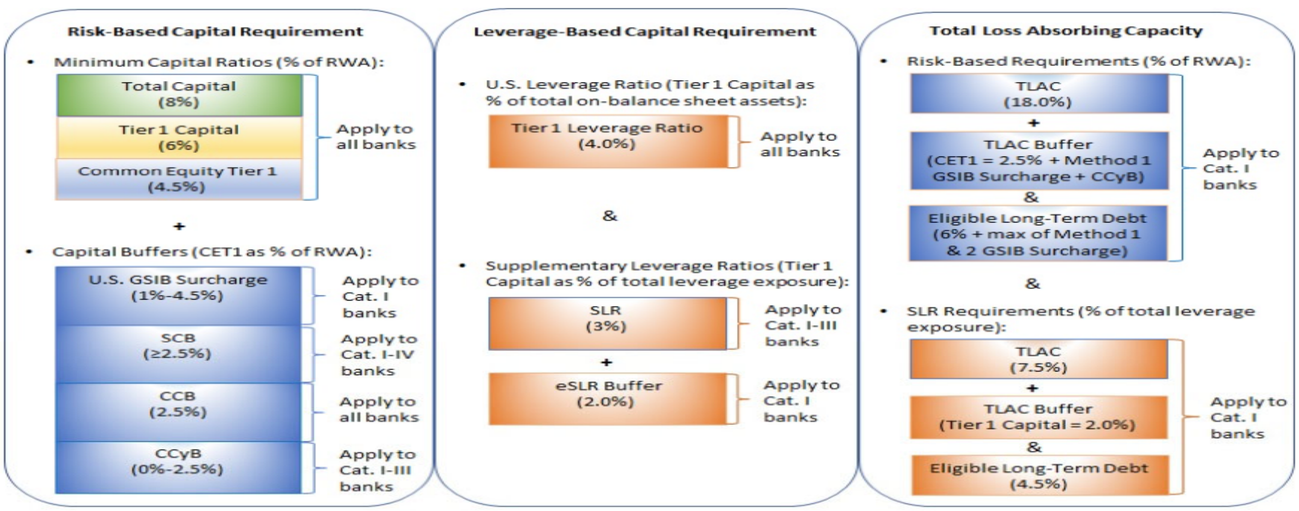
⇒ To the extent an account’s cash exceeds the expanded, $2.5 million coverage limit DIDC is able to achieve using this multi-bank approach, **DIDC sweeps excess funds to a secondary Dreyfus money fund that invests only in securities that are guaranteed as to principal and interest by the U.S. government or its agencies or instrumentalities.**

To access official literature on this topic, visit www.dreyfus.com/sitelets/insured-deposits/dreyfus-insured-deposit-program-c-didc.html.

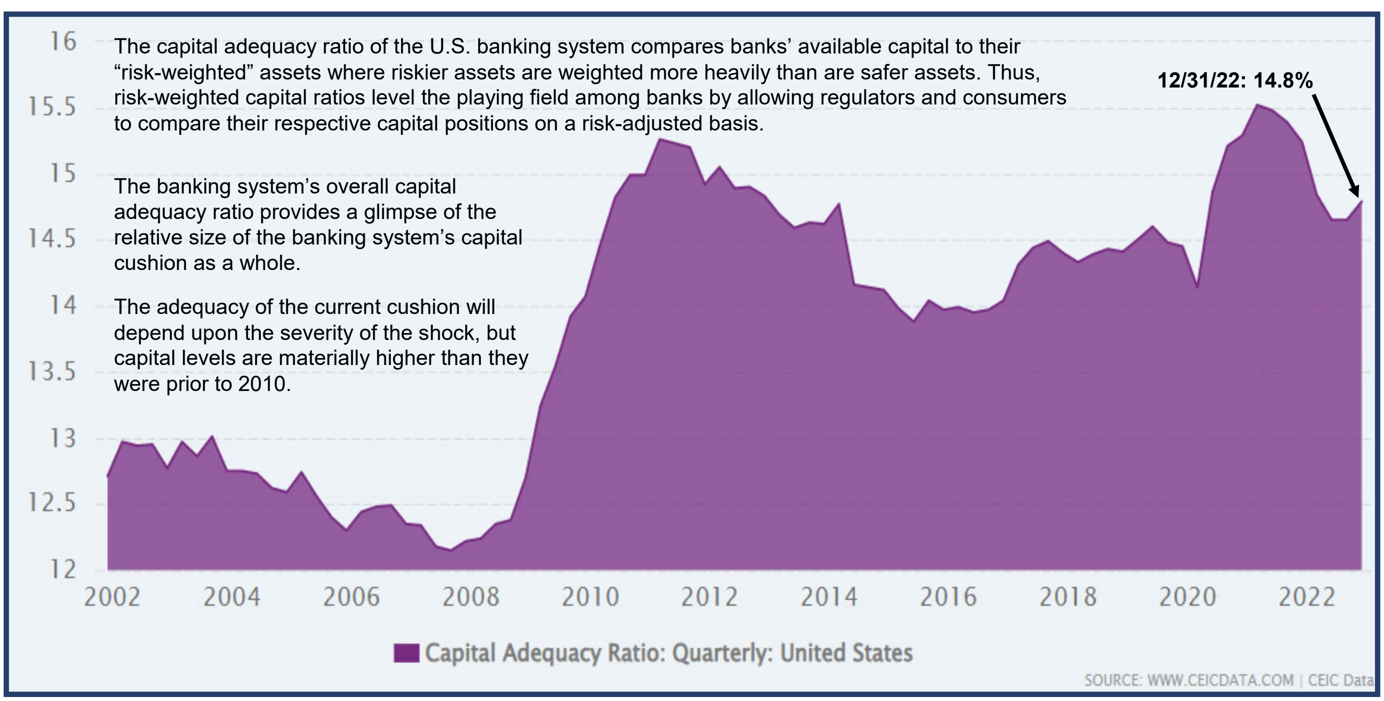
U.S. BANKING SYSTEM REMAINS WELL CAPITALIZED

Bank capital performs the financial equivalent of a car's shock absorber. A shock absorber that's too short in length may be overwhelmed by even routine bumps in the road resulting in a lack of stability and an increased risk of accident. Similarly, banks that hold too little capital may be overwhelmed by an unforeseen change in the economic climate or a flood of withdrawal requests.

The following image is presented only to hint at some of the complexity and lingo involved when assessing the adequacy of bank capital. As with the sun, get a sense of it and look away.



The next image is more useful inasmuch as it depicts the overall level of bank capital within the U.S. from 2002 through the end of 2022. **Although overall capital levels peaked at about 15.5% during 2020, they are still high by historical standards.**



FINDING THE SWEET SPOT FOR BANK CAPITAL LEVELS

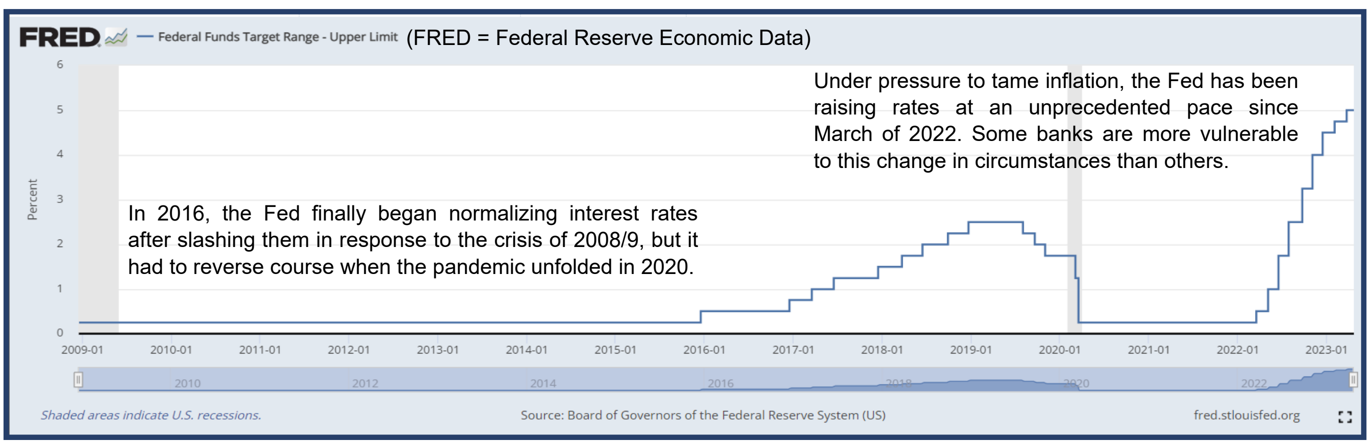
A natural tension occurs with respect to bank capital requirements. If those requirements are set too low, bank failures are apt to occur with enough frequency to undermine the faith in the entire banking system, culminating in its disuse. If capital requirements are set too high, banks will have difficulty earning an adequate return on shareholder capital, the results of which will trickle down to consumers in the form of suppressed deposit yields for depositors and overly high loan rates to borrowers.

As shown in the previous image, the U.S. banking system is relatively well capitalized by historical standards, but we already know that does not mean a confluence of events could not coalesce to ruin one or more institutions that otherwise satisfy regulatory capital standards.

FORMULA FOR EVEN AN ADEQUATELY CAPITALIZED BANK TO FAIL

Sudden changes in the level of interest rates wreak havoc on all financial instruments, and banks are pretty much a repository for all that havoc. Here's the formula that recently brought a couple of adequately capitalized banks to their knees:

START WITH UNPRECEDENTED RATE OF INTEREST RATE INCREASES



⇒ Rising interest rates tend to push asset values lower, especially longer-term assets.

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⇒ Bank assets are typically of longer maturity than bank deposits. **When rates rise, bank assets tend to decline in value more than bank liabilities which erodes bank capital.**

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⇒ But, **banks are <u>not</u> required to mark down certain long-term assets if they intend to hold those assets until maturity** (known as "held-to-maturity" assets).

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⇒ **In 2018, regulations** that previously required banks with at least $50 billion worth of assets to undergo annual stress tests **were relaxed** to apply to banks having assets of at least $250B, although the Fed did retain the ability to periodically test banks with at least $100B worth of assets.

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⇒ Although it's more efficient for banks to gather deposits from a **relatively small number of depositors whose balances exceed FDIC coverage limits, those depositors are inclined to be extremely sensitive to any whiff of instability** coming from their bank since they already know that deposits in excess of FDIC coverage limits are at risk of loss.

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⇒ Even if the whiff of banking information that makes its way to a bank's depositors is false, uninsured depositors are apt to flock to the bank to demand their deposits as they conclude that it's better to withdraw all funds as soon as they can and while they can.

+

⇒ No bank is structured to be able to satisfy more than a very small portion of depositor demand for funds at any given time. **If deposit demand exceeds available lines of credit and other emergency sources of liquidity, a bank may be forced to sell its "held-to-maturity" assets**. Even though those assets may *eventually* have matured at full value, a premature sale of those holdings will cause the bank to realize losses that, in the absence of a run on deposits, may never have occurred.

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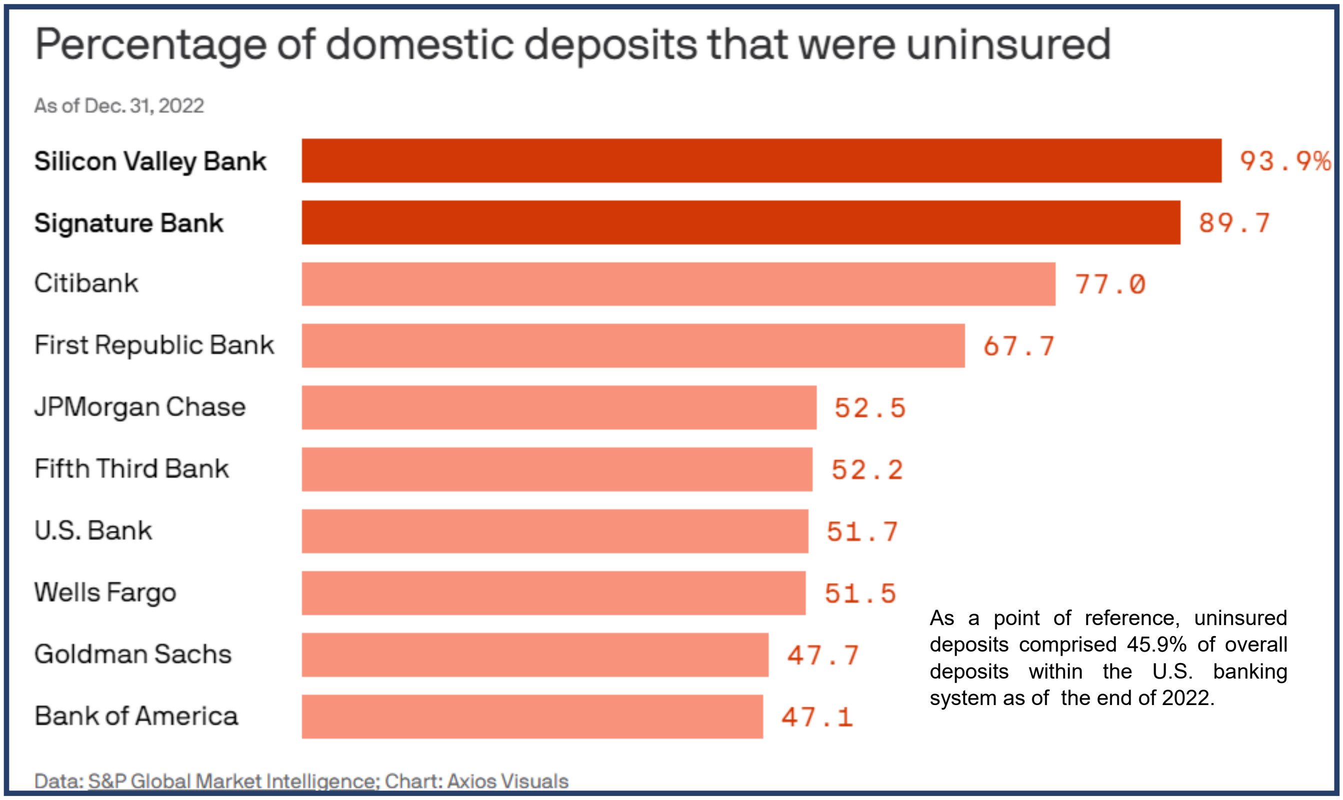
If or when depositors learn of the losses realized on the sale of a bank's held-to-maturity holdings, they may conclude that their initial instinct to have immediately demanded their deposits was correct, further exacerbating the run on deposits until the bank finally fails.

At the end of 2022, both Silicon Valley Bank and Signature Bank reported assets below the $250B threshold that would have necessitated annual stress tests prior to 2018 and each bank relied upon a deposit base that was largely comprised of uninsured deposits.



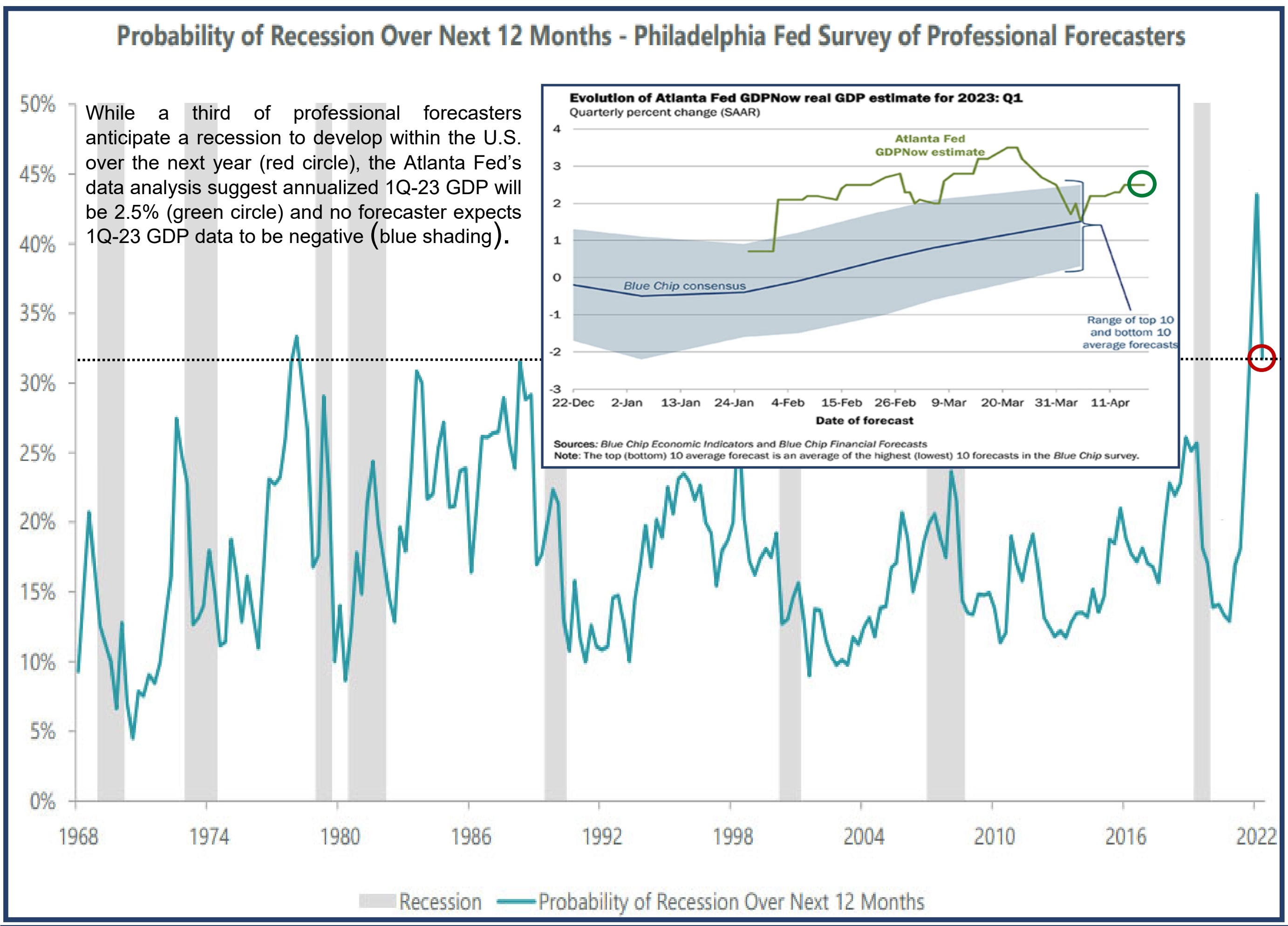
As a point of reference, uninsured deposits comprised 45.9% of overall deposits within the U.S. banking system as of the end of 2022.

IF IT WEREN'T FOR ACCIDENTS, WE WOULDN'T HAVE SEAT BELTS

Although a large percentage of deposits at Silicon Valley Bank and Signature Bank were uninsured, policymakers have concluded that it would be better to guarantee repayment of all deposits, including uninsured deposits, in an effort to stave off contagion that could unsettle the entire financial system. For what it's worth, I agree with this approach.

Resolution for the failed institutions will primarily be covered by proceeds the FDIC receives from the liquidation of failed-bank assets. Banks that are members of the FDIC pay quarterly insurance premiums to the FDIC's insurance fund in exchange for deposit insurance coverage. To the extent the FDIC's liquidation of failed bank assets is inadequate to cover the cost of making all depositors whole, the FDIC is likely to levy a special assessment on the rest of its member banks the same way an insurance carrier might raise premiums to rebuild its loss reserves after a hurricane. In this sense, taxpayers are unlikely to absorb the losses associated with recent bank failures, but those costs may still be indirectly borne by consumers in the form of reduced deposit yields, elevated loan rates, and by shareholders in the form of reduced earnings and dividends.

A THIRD OF FORECASTERS EXPECT RECESSION IN 12 MONTHS



FUND MANAGER SETS RECESSION ODDS AT 75%

The upper image on this page is from ClearBridge Investments which is a leading global equity manager and a division of Franklin Resources. It depicts the deterioration in a series of economic indicators that began last summer. As shown on the bottom row of this image, the "Overall Signal" developed by this model began suggesting the eventual occurrence of a recession last August (circled). ClearBridge currently assigns a 75% probability to a recession developing within the U.S. during the second half of this year.

The Recession Risk Dashboard update through March 31 shows no change from the previous month. Our view continues to be that a recession is forthcoming and will occur with 75% probability in the second half of 2023.

		Current[1]	Rapid Summer Deterioration		
		March 2023	August 2022	July 2022	June 2022
Consumer	Housing Permits	✗	↑	↑	↑
	Job Sentiment	●	↑	↑	↑
	Jobless Claims	↑	↑	↑	↑
	Retail Sales	✗	✗	✗	●
	Wage Growth	✗	✗	✗	✗
Business Activity	Commodities	✗	✗	✗	●
	ISM New Orders	✗	●	●	●
	Profit Margins	✗	↑	↑	↑
	Truck Shipments	↑	↑	↑	↑
Financial	Credit Spreads	✗	✗	✗	✗
	Money Supply	✗	✗	●	●
	Yield Curve	✗	●	●	↑
	Overall Signal	✗	✗	●	↑

↑ Expansion
● Caution
✗ Recession

1. Data as of March 31, 2023. Source: BLS, Federal Reserve, Census Bureau, ISM, BEA, American Chemistry Council, American Trucking Association, Conference Board, and Bloomberg. The ClearBridge Recession Risk Dashboard was created in January 2016. References to the signals it would have sent in the years prior to January 2016 are based on how the underlying data was reflected in the component indicators at the time.

Where are we in the economic and market cycle?

Monetary policy takes time to impact the economy: long and variable lags[2]

Start of Persistent* Hike Cycle	Start of Recession	Recession Within 3.5 Years?	Length from Start of Hiking Cycle (Months)
Nov. 1958	April 1960	Yes	17
July 1963	Dec. 1969	No	76
Nov. 1968	Dec. 1969	Yes	12
Jan. 1973	Nov. 1973	Yes	9
Aug. 1977	Jan. 1980	Yes	29
Aug. 1980	July 1981	Yes	11
March 1984	July 1990	No	75
March 1988	July 1990	Yes	27
Feb. 1994	March 2001	No	85
June 1999	March 2001	Yes	20
June 2004	Dec. 2007	Yes	41
Dec. 2016	Feb. 2020	Yes	38
		Average for All Hiking Cycles	**37**
		Average in Recessions	**23**

- On average, a recession has historically begun a little over three years after a rate hike cycle gains momentum.
- In hard landing (recession) scenarios, this timeframe is condensed to just under two years.

The lower image is from Franklin Templeton Investments which is a separate division of Franklin Resources. As noted in the bottom of that image, **recession within the U.S. has often begun a little over three years after the Fed begins raising interest rates** or about two years after the first rate hike in cases where the economy suffers what is often referred to as a "hard landing" (also circled).

With respect to the Fed's current tightening cycle, the Fed implemented its first interest rate increase in March of 2022. In summary, then, **these images suggest the U.S. might fall into recession <u>anywhere between July of this year (upper image) to as late as September of 2025, … 27 months later</u>** (lower image).

I'm not clear how information like this might aid the investment process. Even if it could I think it might be worth remembering that **markets have tended to act well in *<u>advance</u>* of the events and hard data points that drive them,** as discussed next.

HOW DO STOCKS PERFORM AROUND RECESSIONS?

On average, **stocks performed worse one year *before* the onset of a given recession than during the recession, itself** (boxed in red). Although it seems intuitive for investors to flee the fire that is a recession, investors who are inclined to try to time the markets typically prefer to react to signs of smoke rather than to wait around for actual fire.

Recession Start	Length (Years)	During Recession	6M Before	12M Before	6M After	12M After	2Y After
7/31/1953	0.83	18%	-6%	-3%	17%	30%	55%
8/31/1957	0.67	-4%	5%	-5%	18%	33%	25%
4/30/1960	0.83	17%	-5%	-6%	7%	10%	1%
12/31/1969	0.92	-5%	-6%	-11%	14%	8%	34%
11/30/1973	1.33	-13%	-9%	-18%	1%	23%	18%
1/31/1980	0.50	7%	10%	14%	6%	8%	-12%
7/31/1981	1.33	6%	1%	8%	-19%	20%	18%
7/31/1990	0.67	5%	8%	3%	3%	8%	20%
3/31/2001	0.67	-2%	-19%	-23%	-6%	-18%	-7%
12/31/2007	1.50	-37%	-2%	4%	21%	12%	44%
2/29/2020	0.17	-1%	1%	6%	12%	44%	?
Average Return		-1%	-2%	-3%	7%	16%	20%
% Positive Return Periods		45%	45%	45%	82%	91%	82%

Cumulative price return of the S&P 500 during past recessions. Past performance is not indicative of future returns.
Table: Darrow Wealth Management • Source: YCharts; Nber • Created with Datawrapper

Since a recession's end is always declared with a lag, market-timers risk missing these returns.

To illustrate the difficulty of forecasting the market's twists and turns, note that even though fears of recession became a focal point as soon as the Fed began raising rates to tame inflation last March, and even though equity returns have largely been negative over the past year, equity returns have been notably positive since the beginning of the year, despite the fact that the long-waited recession has still not materialized.

If you refer back to the Fed-related inset on page 6, you'll see that the Fed's mid-April projection for 1Q-23 GDP is not only quite positive, it's actually higher now than it was at the end of March.

And now that the Fed has done much to normalize the interest rate environment within the U.S., investors are finally receiving a fair return on the fixed-income portion of their invested capital (also boxed).

U.S. EQUITIES (%) As of March 31, 2023	March	QTD	YTD	1 Year	3 Year	5 Year	10 Year
DJ Industrial Average	2.1	0.9	0.9	-2.0	17.3	9.0	11.1
S&P 500	3.7	7.5	7.5	-7.7	18.6	11.2	12.2
Russell 1000	3.2	7.5	7.5	-8.4	18.6	10.9	12.0
Russell 1000 Value	-0.5	1.0	1.0	-5.9	17.9	7.5	9.1
Russell 1000 Growth	6.8	14.4	14.4	-10.9	18.6	13.7	14.6
Russell Midcap	-1.5	4.1	4.1	-8.8	19.2	8.1	10.1
Russell 2000	-4.8	2.7	2.7	-11.6	17.5	4.7	8.0

INTERNATIONAL EQUITIES (%) As of March 31, 2023	March	QTD	YTD	1 Year	3 Year	5 Year	10 Year
ACWI	3.1	7.3	7.3	-7.4	15.4	6.9	8.1
ACWI ex USA	2.4	6.9	6.9	-5.1	11.8	2.5	4.2
MSCI EAFE	2.5	8.5	8.5	-1.4	13.0	3.5	5.0
Emerging Markets	3.0	4.0	4.0	-10.7	7.8	-0.9	2.0
China	4.5	4.7	4.7	-4.7	-2.6	-4.0	3.4
Japan	4.0	6.2	6.2	-5.2	7.4	1.3	5.0
Germany	4.0	14.7	14.7	2.2	12.8	0.4	4.1
United Kingdom	-0.6	6.1	6.1	-0.8	14.6	3.0	3.4
India	1.2	-6.4	-6.4	-12.2	22.2	6.1	7.0

FIXED INCOME (%) As of March 31, 2023	March	QTD	YTD	1 Year	3 Year	5 Year	10 Year
Government Bond	2.9	3.0	3.0	-4.4	-4.1	0.8	0.9
Municipal	2.2	2.8	2.8	0.3	0.3	2.0	2.4
U.S. Aggregate Bond	2.5	3.0	3.0	-4.8	-2.8	0.9	1.4
Investment Grade Corporate	2.7	3.5	3.5	-5.3	-0.7	1.5	2.2
High Yield	1.1	3.6	3.6	-3.3	5.9	3.2	4.1

I don't have space to cover this, but if you notice any type of **"buffered"** instrument in your portfolio, **it exists to reduce downside risk while preserving the potential for upside growth**. — Glenn Wessel