Investment Strategy
April 2023

The S&P 500 posted a 7% gain during the 1st quarter of 2023 as the mega-sized technology companies covered up weaknesses elsewhere in the market. The technology sector is up nearly 20% this year while the remainder of the market is essentially unchanged. 2023 has been a complete reversal from last year when technology stocks led the market down, with many of the more speculative stocks falling over 70%. More interestingly, the S&P 500 index has now been flat since last May. This would surprise most investors given cratering real estate activity, the failure of several banks, and an increasing number of bankruptcies. Thus far, we have only seen the weakest players get into trouble. However, we expect problems to spread as the overall economy continues to slow, corporate profitability declines, and financial stress builds.

The major market indexes have now gone sideways for the past 10 months. This is rather incredible given the tightening of financial conditions over the past year as interest rates moved sharply higher. It was only last March that interest rates were still at 0%. Since that time, short-term rates have rapidly increased to 5%. This means a new mortgage has gone from less than 3% a year ago to over 6.5% today. As a result, current sales of existing homes have declined to the same level as following the housing bubble. Loan applications for new home purchases are at a 28-year low. Despite this incredible deceleration in a crucial part of the economy, the S&P 500 is still roughly 22% higher than it was prior to the COVID outbreak in early 2020.

The major indexes (S&P 500 and NASDAQ 100) have managed to remain elevated largely because of the outsized impact of the mega-sized tech companies. In fact, this is one of the most "top-heavy" eras in history. To give perspective, the following chart shows how significant both Apple and Microsoft have been to these major indexes in 2023.

Company	YTD Return	% of S&P 500	% of Index Return[1]	% of NDX 100	% of Index Return
Apple	26.9%	7.2%	**27.7%**	12.3%	16.1%
Microsoft	20.2%	6.2%	**17.9%**	12.6%	12.4%
	Total:	13.4%	**45.6%**	24.9%	28.6%

As you can see, Apple and Microsoft represent 13.4% of the S&P 500 Index and 24.9% of the NASDAQ 100 index. Following strong returns during the 1st quarter, these two stocks accounted for 45.6% of the total gain for the S&P 500 this year as well as 28.6% of the total gain of the NASDAQ 100. These stocks produced this stellar performance despite both companies missing 4th quarter earnings and revenue expectations, Apple suspending forward earnings guidance (always a bad sign), and Microsoft announcing plans to lay off 10,000 workers. Needless

[1] (YTD stock return x % of S&P 500)/YTD S&P 500 return

to say, we believe there is a major disconnect between the indexes and the stresses that are building across the economy and markets. Investors may have been awakened to these growing problems in recent weeks as several sizable banks collapsed, reigniting memories of 2008.

We believe the recent bank failures are a symptom of tighter financial conditions rather than representing systematic issues in the REGULATED banking sector. The banks that collapsed all had unusual business models that made them unstable and vulnerable to a run on their deposits. The banks that failed (Silvergate Bank, Signature Bank, Silicon Valley Bank, and Credit Suisse) were not your typical neighborhood-focused deposit institutions.

Silvergate and Signature can be grouped together because both were crypto-friendly banks. They served as major on/off-ramps to the crypto currency exchanges, allowing customers to move (real) dollars in and out of crypto. As such, they were both negatively impacted when FTX (a major crypto exchange) imploded back in November. In addition, both banks engaged in questionable business practices given their involvement with the crypto industry. Their failure was to be expected as financial conditions tightened, losses mounted, and indictments were launched.

The downfall of Credit Suisse (hastily merged with UBS) was the most financially dangerous bank failure over the past few weeks. The Swiss banking giant has two divisions: high-end wealth management and investment banking. While the company managed to largely avoid trouble during the U.S. housing debacle 15 years ago, the bank has recently seemed to be at the center of every major banking scandal. In recent years, Credit Suisse has been fined billions of dollars by the U.S. and several European governments for money laundering and hiding assets for wealthy individuals. In 2021, the bank suffered a sizable loss after steering $10 billion of client wealth management funds into a fraud scheme perpetuated by Greensill Capital. Credit Suisse then lost another $5 billion due to the fraud and collapse of family office Archegos Capital Management. Just from this abbreviated list, Credit Suisse has shown no ability to properly manage risk or conduct themselves with integrity over the past decade. Once again, their failure was not much of a surprise once financial conditions became more difficult.

The most interesting recent failure was Silicon Valley Bank. As their name suggests, this was the bank for tech startups, venture capital funds, and their owners. As the tech bubble grew over the past decade, their deposit base exploded by 10 times as the industry was flooded with capital. The massive growth in deposits was invested in new loans and tradable securities to earn a return. A sizable portion of the funds went into long-term mortgage and treasury bonds at the lowest interest rates in human history. As rates rose last year, these bonds lost roughly 15% of their value. Meanwhile, the startup tech industry had grown accustomed to incinerating capital with loss-making operations. When new funding got cut off last year, the industry started

consuming their large bank accounts at Silicon Valley. Eventually, a few prominent members of the industry yelled "fire" in a crowded theater and everyone panicked to remove their deposits from the bank. Due to modern online banking and viral communications, Silicon Valley Bank lost roughly $42 billion of deposits, or 25% of their total, on a single Thursday a few weeks ago. The bank was seized before it opened on Friday before another $100 billion was expected to exit. In total, the bank was set to lose roughly 80% of their deposits in two days!

In all four cases, the bank's existing problems came to light as the cost of money increased. In the same way, venture capital, private equity, crypto investments, and profitless technology companies have also been struggling. These businesses require cheap and abundant (new) capital to work. As money became more expensive, these companies almost immediately ran into trouble. While only the most financially fragile companies and investments have run into problems thus far, there were many more financial decisions that appeared perfectly sound at ultra-low interest rates. Unfortunately, many of these decisions will turn out to be huge mistakes at current rates. A perfect example is Silicon Valley Bank, they clearly didn't put much thought into purchasing "ultra-safe" U.S. Treasury and mortgage bonds. Management overlooked the risk of higher interest rates and it caused them to destroy a company that had been around for 40 years.

We are ending the greatest era of cheap money in recorded history which encouraged companies and investors to make poor financial decisions. Over the past 13 years (2009-2022), central bank policies have helped make capital extremely inexpensive and readily available to almost everyone. As a result, companies that have never made a profit have grown to enormous sizes and now employ hundreds of thousands[2] of workers. At the same time, the ultra-low borrowing rates triggered generational housing bubbles in China, Canada, Australia, and New Zealand, among other places. In the U.S., stocks, corporate bonds, commercial property, and high-end residential housing look particularly overdone. The bottom line is there is still a huge amount of overpriced assets in the world that need to be marked down to more realistic prices. As trillions of dollars of perceived value disintegrate, the owners of these assets will be forced to make difficult decisions and alter their behavior. Unfortunately, the "hang over" from this party might result in years of poor global growth. As a result, it is still time to be highly conservative in client portfolios as the owners of these assets come to terms with the new reality. At some point in the eventual unwinding, high-quality assets will go on sale and it's our responsibility to patiently wait for those opportunities.

Sincerely,

Keating Investment Counselors, Inc

[2] Millions indirectly

Disclaimer

The information provided is for informational and educational purposes only. It is not intended to provide specific advice or recommendations. All efforts have been made to report true and accurate information. The information on this publication is subject to change without notice and may become outdated or otherwise rendered incorrect due to subsequent new research or other changes. Although we conduct reasonable due diligence on any third party information provided, Keating Investment Counselors, Inc. is unable to always verify the content from third party sources. Please refer to our **privacy policy**. For additional information and disclosures about Keating Investment Counselors, Inc., please visit the SEC Website at **www.adviserinfo.sec.gov** (CRD #110134) and the **ADV Part 2**.

Investing in securities involves risk of loss that you should be prepared to bear. Markets are volatile and funds needed for specific purposes within a short to intermediate time period should not be committed to stocks, long-term bonds, and related securities. We do not represent or guarantee that our services or methods of analysis can or will predict future results, successfully identify market tops or bottoms, or insulate clients from losses due to market corrections or declines. We do not offer any promises that your financial goals and objectives will be met. Past performance is not an indication of future performance. For additional information on risk of loss, please refer to the **ADV Part 2**.