LYELL WEALTH MANAGEMENT

MAY 10, 2023

Rearview Mirror

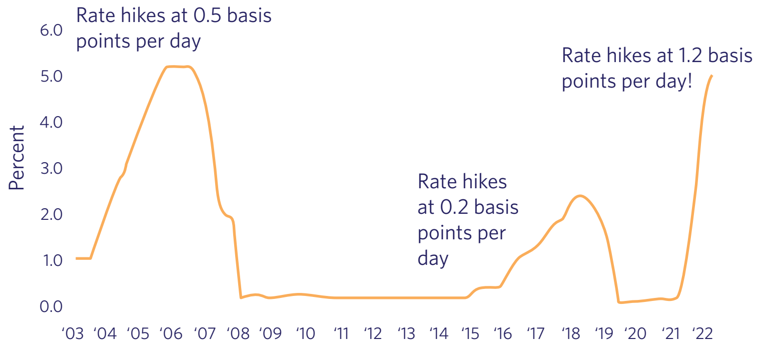
The Federal Reserve ("Fed") has a dual mandate for maximum employment and price stability. It seeks to achieve these goals through monetary policy by controlling short-term interest rates and money supply. Achieving these two objectives is complicated by the reality that non-monetary factors, such as pandemics, fiscal profligacy, wars, and weather, can overwhelm the Fed's efforts. The Fed is the largest employer in the world of doctorate-level economists with over 900 PhDs on staff. Despite this immense brain power and academic pedigree, the Fed is reliably wrong at critical turns in the economic cycle. The Fed's monetary policies impact with a six- to twelve-month time lag, while it admits to being "data-dependent" on lagging or coincident indicators, such as employment or inflation. Hockey great Wayne Gretzky's famous quote to "skate to where the puck is going" would not describe recent Fed policy decisions. A more apt description would be looking in the rearview mirror to drive your car.

Lyell Wealth Management sees the Fed as having made a policy error by raising interest rates too high, too fast. The Fed views the labor market as too "tight" and sees higher rates as a means to increase unemployment and alleviate wage pressure. In our view the Fed should have stopped raising rates a few hikes ago and let the impact of its prior tightening flow through the economy. The Fed has tightened rates at more than 2x the speed as compared to the prior tightening cycles this century, averaging ~1.2 basis points per day (Chart 1).

The Fed's incessant pace has contributed to instability in the financial system and helped cause a series of bank failures. Although the number of bank failures is thus far less than during the Global Financial Crisis ("GFC"), 2023 is already in the ballpark of 2008 in terms of cumulative bank assets and deposits at failed banks (Chart 2).

CHART 1

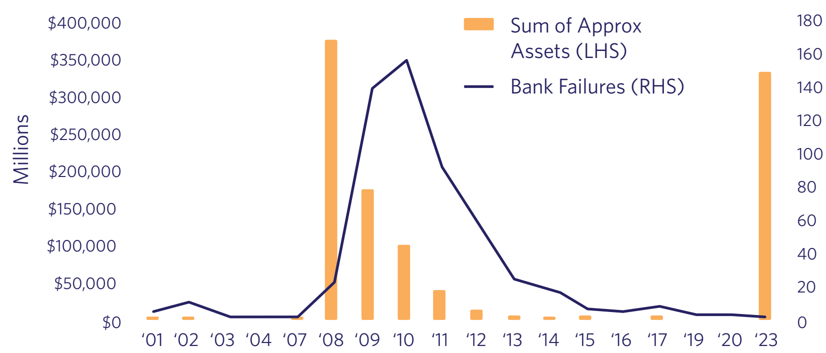
Historical Fed Funds Rate



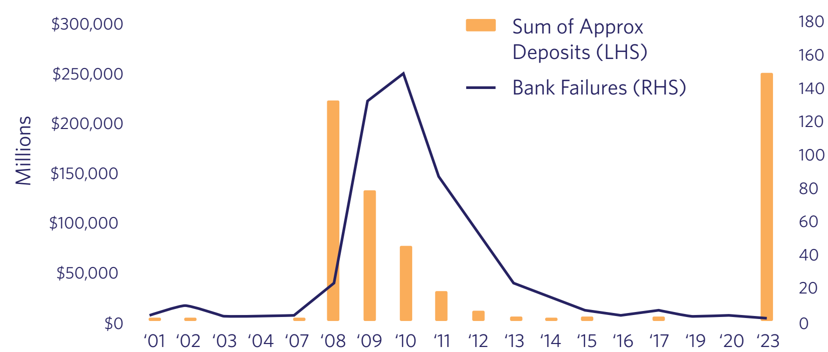
Source: Bloomberg, Atalaya Capital

CHART 2

History of U.S. Bank Failures By Assets



History of U.S. Bank Failures By Deposits



Source: FDIC, Strategas Securities

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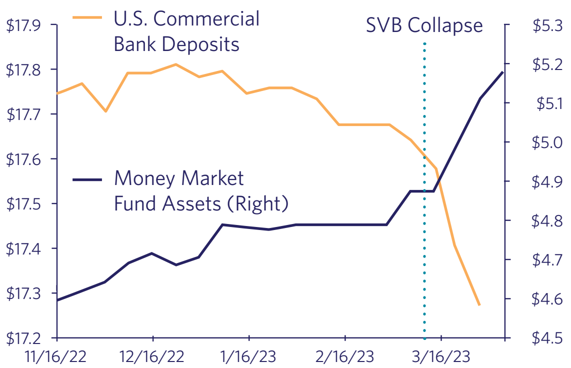
CHART 3

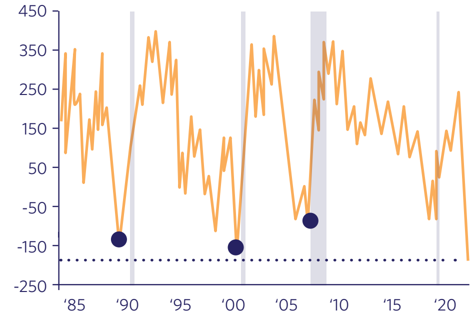
Commercial Bank Deposits & Money Market Fund Total Assets ($ Trillion)



Source: Strategas Research Group

CHART 4

U.S. 10-Year minus FED FUNDS
May 4: -185bp e



Source: Evercore ISI

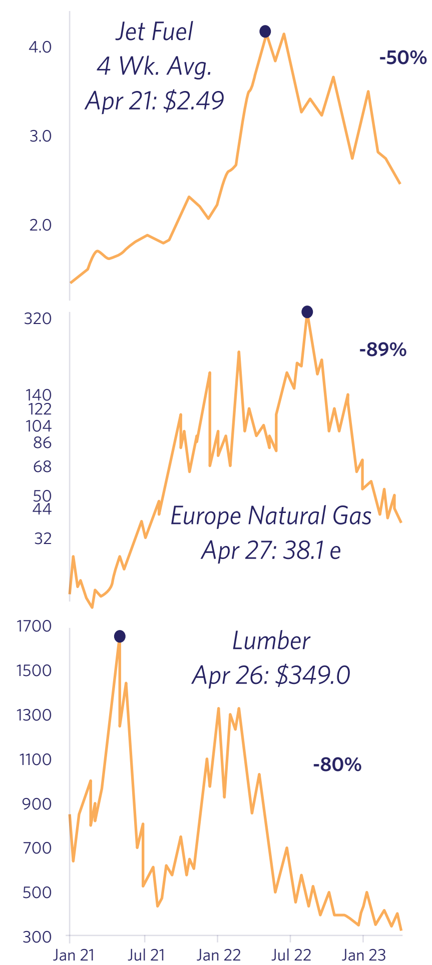
The dramatic loss of confidence surrounding Silicon Valley Bank's March 10th failure is well illustrated by the shift out of banking system deposits and into brokerage money market funds (Chart 3).

It is almost humorous how willfully the Fed Governors have been snubbing market signals that they are overtightening. St. Louis Fed Governor Henry Bullard recently declared that the "market should listen to me," when the more appropriate observation would be that the Fed should be listening to the market. The yield curve has become increasingly inverted since mid-2022, signaling that the Fed's short-term rate hikes have been excessive and that it will need to decrease rates in the not-too-distant future. When the Fed tightened rates by another 25 basis points on May 3rd, the 10-year Treasury bond was 185 basis points lower than the overnight Fed Funds rate (Chart 4). More distressingly, the 2-year Treasury was fluctuating over 100 basis points lower, signaling that the Fed should soon begin reversing its recent moves.

The Fed's impatience ignores substantial progress towards normalization. Price levels had been distorted by an extraordinary period of pandemic, economic shutdown, shortages, and fiscal deficits. Various products, such as lumber, jet fuel, and European natural gas, are well off their price highs (Chart 5). The U.S. Producer Price Index, which reflects key

CHART 5

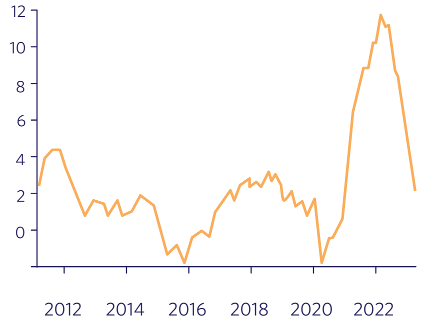
Select Commodity Prices



Source: Evercore ISI

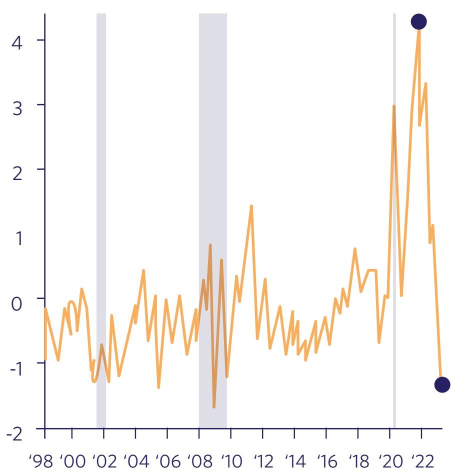
inputs to consumer prices, is dropping at the same rate it had previously increased (Chart 6). Global supply chain pressure has dropped below pre-Covid levels (Chart 7). Commodity prices, which tend to experience wide swings, are back to price levels from fifteen years ago (Chart 8). Meanwhile, technology has reestablished its traditional deflationary force and declining digital prices will subtract from overall inflation moving forward (Chart 9).

CHART 6
Inflation Cooling, U.S. PPI
Y/Y % Apr: 2.4%



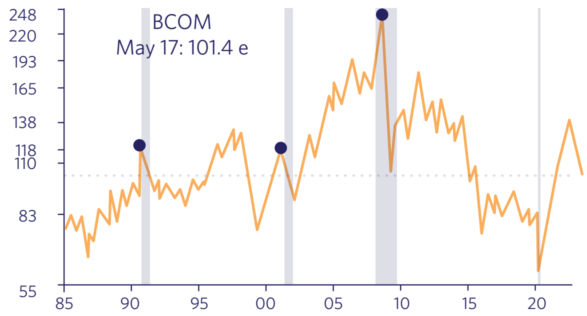
Source: Evercore ISI

CHART 7
Global Supply Chain Pressure Index (NY Fed)
Apr: -1.32



Source: New York Federal Reserve, Evercore ISI

CHART 8
Bloomberg Commodity Index



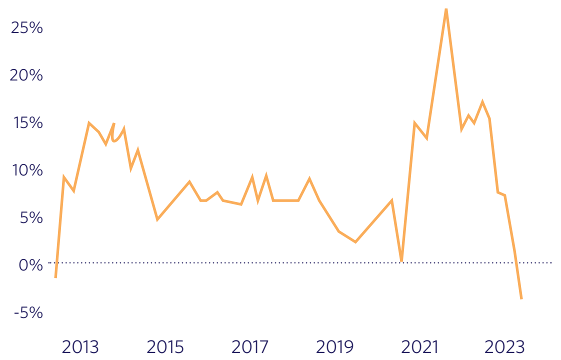
Source: Bloomberg, Evercore ISI

CHART 9
Adobe Digital Price Index
Y/Y% Mar: -1.7%

Source: Adobe, Evercore ISI

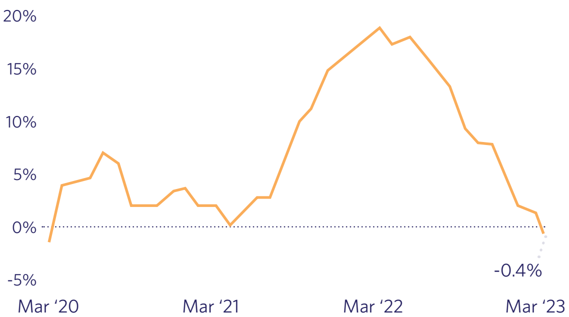
CHART 10

House Prices | Median Sale Price



Rents Post First Annual Decline Since Start of Pandemic

Year-over-year change in median U.S. asking rent



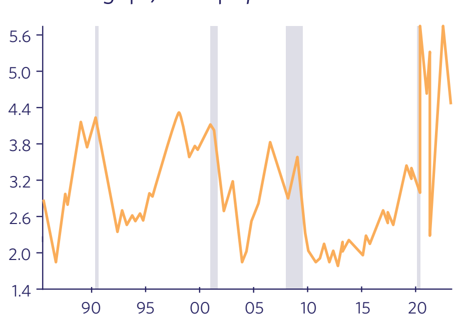
Source: Redfin, Evercore ISI

Perhaps the most frustrating part of the narrative that overstates the level of inflation is the focus on data that relies on significantly lagging metrics. For example, the Consumer Price Index ("CPI") release for April was announced on May 10th and reported that year-over-year inflation remained at 4.9%. "Shelter" accounts for almost 35% of the CPI index, and the government's measure of shelter inflation in this report came in at over 8% on a year-over-year basis. However, real-time, high frequency datasets, such as those compiled by RedFin, show a year-over-year decline in both house prices and rents as of March (Chart 10). It is simply a matter of time until the government's data catches up to these real-time datapoints, and its CPI index is significantly lower.

CHART 11

U.S. Average Hourly Earnings

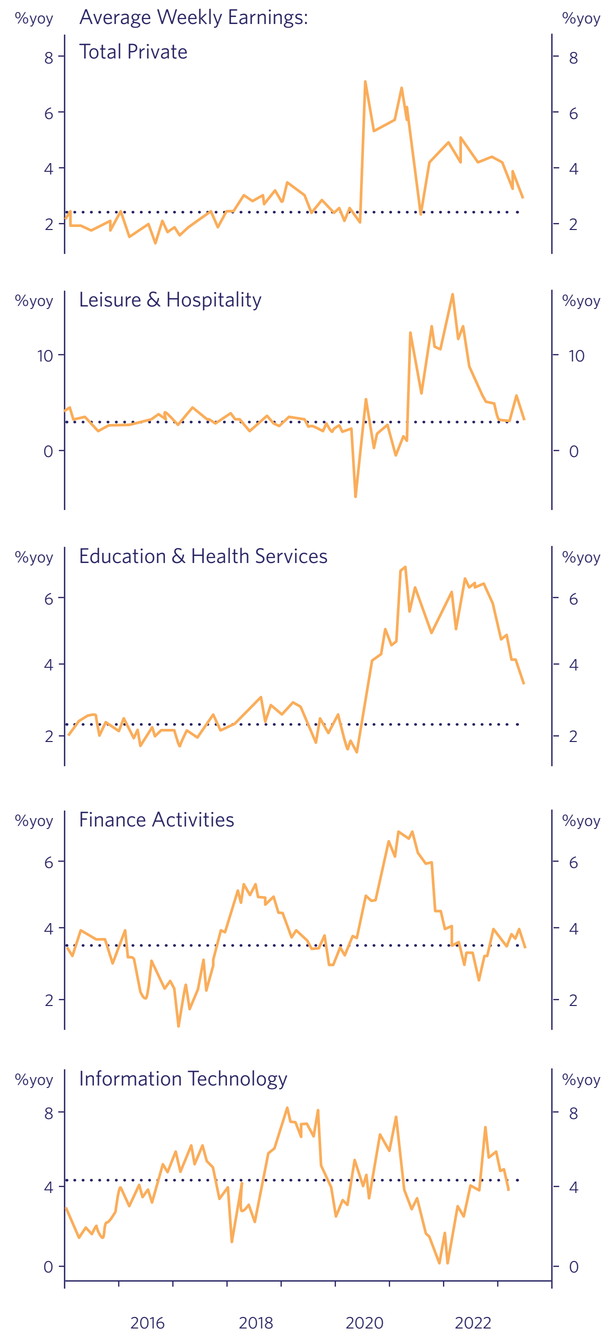
3 Mo. Avg. | Y/Y % | Apr: 4.48%



Source: Evercore ISI

CHART 12

Wage Growth Reverting Toward Pre-Pandemic Mean



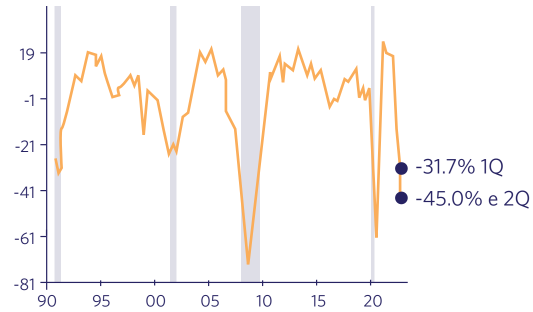
Source: Alpine Macro

Granted, current wage inflation readings are still too high with key U.S. wage metrics running over 4% and not consistent with the Fed's 2% inflation target (Chart 11). Again, it is important to have perspective on where the data is headed rather than where it has been. Although varying across sectors, wage growth is clearly reverting toward pre-pandemic averages (Chart 12). In addition, there is abundant qualitative data supporting a significant shift in business sentiment that should act as a headwind on future wage growth. CEO confidence

has plummeted (Chart 13). U.S. Small Business optimism has also plunged and indications of whether it is a good time to expand are at decade lows (Chart 14). Banks' willingness to lend are well into recessionary levels (Chart 15). Auto dealers are reporting the worst environment to get customer financing since the GFC (Chart 16). Credit application rejections are also hitting their worst levels since the GFC (Chart 17).

CHART 15

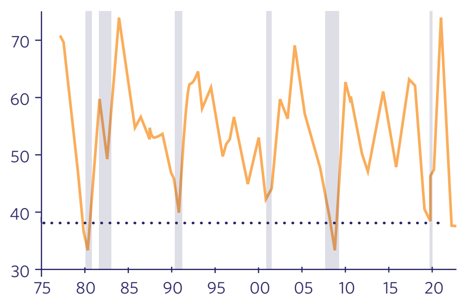
U.S. Banks' Willingness to Make Loans
% More Willing Minus % Less Willing
2023:2Q: -45.0% e



Source: Evercore ISI

CHART 13

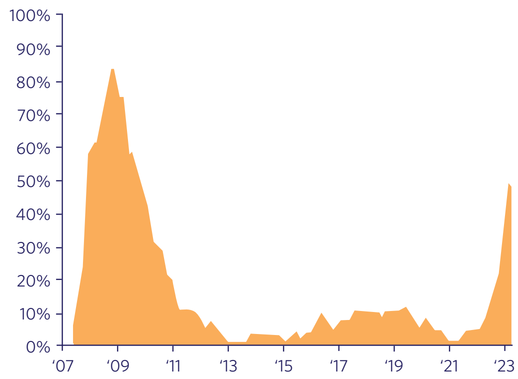
U.S. CEO Confidence (Conf Bd)
4 Qtr. Avg. | 2023:2Q: 37.8%



Source: Conference Board, Evercore ISI

CHART 16

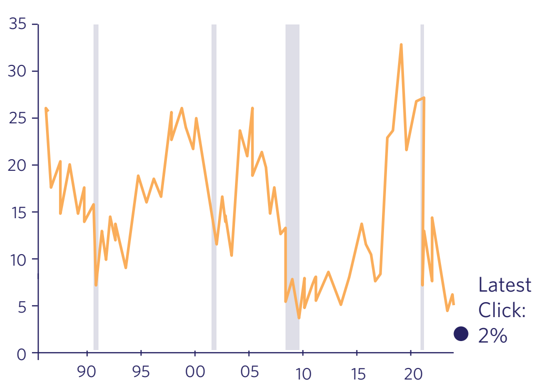
Evercore ISI Auto Dealers Surveys
47% of Auto Dealers Reporting Financing is Harder to Get for Customers



Source: Evercore ISI

CHART 14

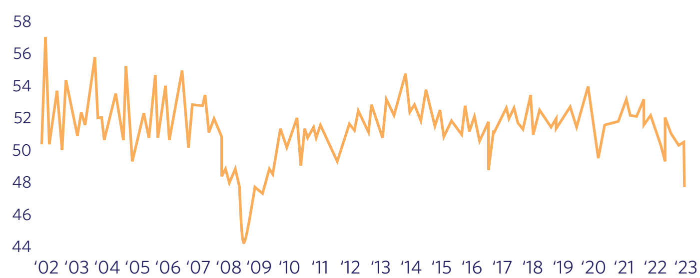
U.S. Small Business Trends (NFIB)
% Firms Reporting Now Is a Good Time to Expand
3 Mo. Avg. | Mar: 5%



Source: National Federation of Independent Business, Evercore ISI

CHART 17

NACM U.S. Credit Managers Combined Sectors
Rejection of Credit Applications
(NSA, % Balanace / Diffusion Index)

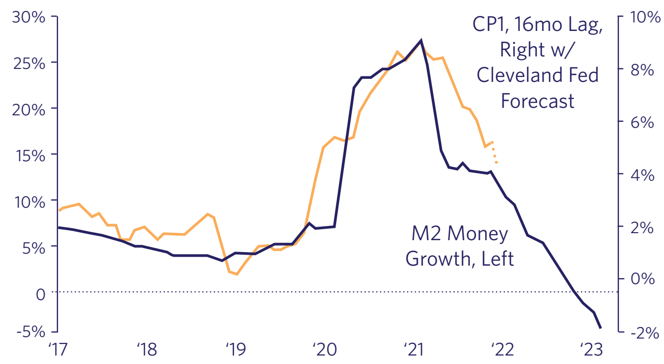


Source: National Assocation of Credit Management, Strategas Securities

More Chief Financial Officers expect lower wage growth than higher ones (Chart 18). Hiring plans stalled in April and the first four months of 2023 are the weakest since 2016 (Chart 19). Lastly, the most common measure of U.S. money supply, M2, is contracting, which is typically a good forecast for the future Consumer Price Index (Chart 20).

CHART 20

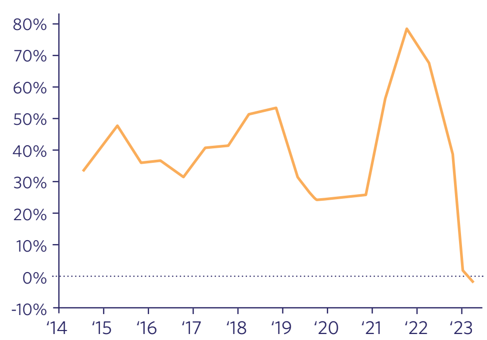
M2 Money Growth & CPI



Source: Strategas Research Group

CHART 18

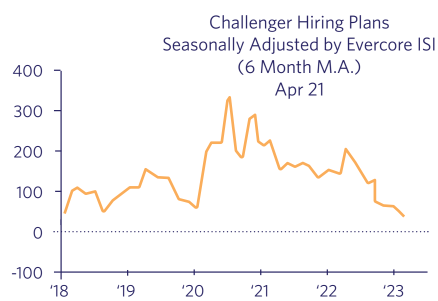
CFO Next 12 Mos. Expectation of the Growth Rate on Wages Paid to Employees % Increase minus % Decrease



Source: Evercore ISI

CHART 19

Hiring Plans Stalled in April

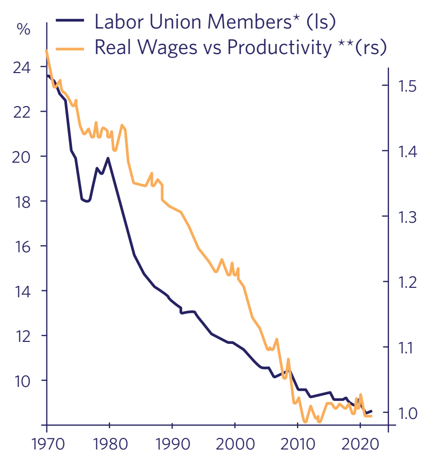


Source: Department of Labor, Challenger, Evercore ISI

The Fed fears a 1970s scenario in which poor fiscal and monetary policies resulted in waves of high inflation. While Chairman Powell has made note that "embedded inflation expectations" have remained anchored to date, the Fed is clearly concerned that a wage/price spiral could explode at any moment. Although there are certain similarities to the 1970s (such as social unrest and volatile energy markets), there are significant differences that make a repeat unlikely. Trade and technology are both much larger and more efficient economic contributors today, and labor dynamics are more fluid with unionization being substantially lower (Chart 21). Inflation expectations as measured by the New York Fed remain firmly

CHART 21

Low Unionization Will Cap Real Wage Gains



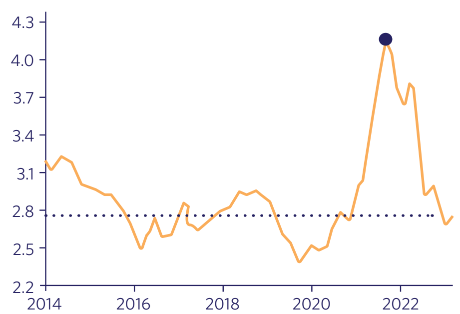
*Union members as % of labor force
**Nonfarm real hourly compensation divided by output per hour

Source: Alpine Macro

anchored at this point, and there is no data to support that they will soon spiral out of control (Chart 22).

CHART 22

U.S. Inflation Expectations (NY Fed)
Three-Year Ahead
3 Mo. Avg. Apr: 2.8%

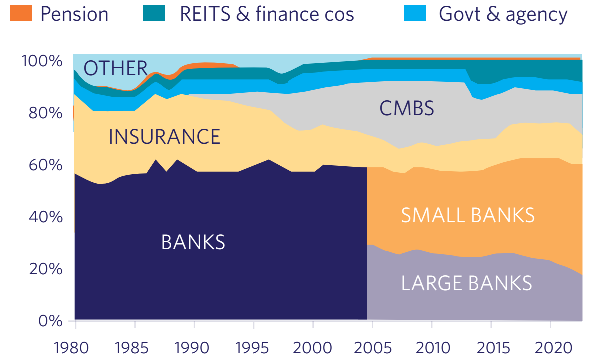


Source: New York Federal Reserve, Evercore ISI

As intended, the Fed's efforts are contributing to rising unemployment claims and surging corporate layoff announcements. Job openings dropped to their lowest level in nearly two years in March. Market expectations have been shifting towards the likelihood of a recession this year. The current instability among regional banks will no doubt result in further credit tightening for consumers and small businesses. Commercial real estate ("CRE") is a particular worry as small banks are major lenders to this sector (Chart 23). There is certainly distress in some corners of the CRE market, most notably for office buildings, but also in other situations where there are overleveraged borrowers with floating rate mortgages. Fortunately, small banks' CRE exposure is a much lower percentage of bank assets as a share of GDP versus the 1990 S&L crisis or 2008 subprime mortgage crisis (Chart 24). In addition, CRE debt is a smaller part of the economy

CHART 23

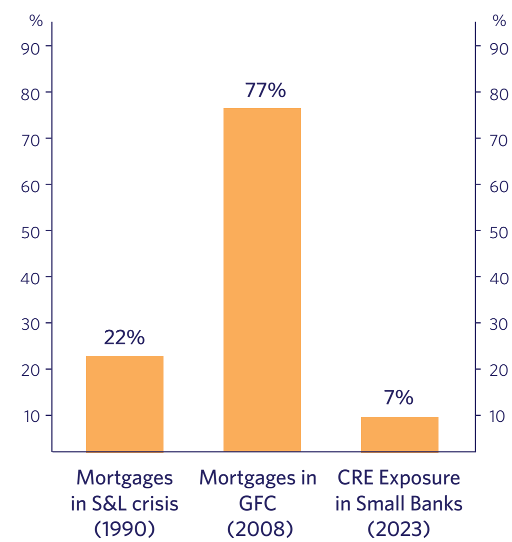
% Ownership of Commercial Mortgages



Source: Federal Reserve Board, Bloomberg, JP Morgan Asset Management

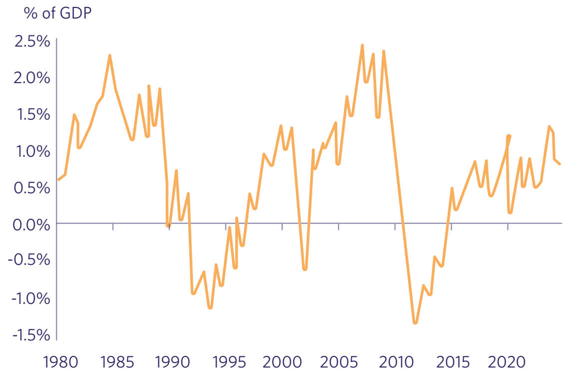
CHART 24

Bank Assets At Risk As A Share of U.S. GDP



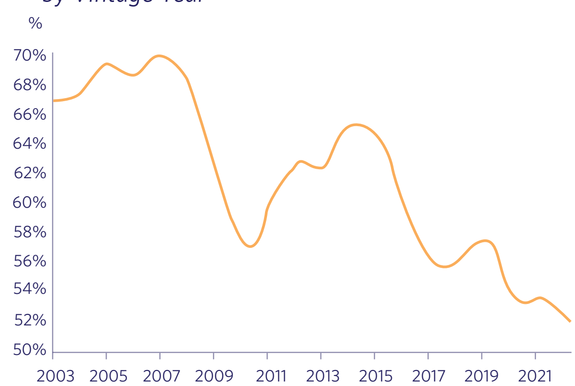
Source: Alpine Macro

CHART 25
Commercial Real Estate Borrowing Well Below Prior Peaks



Source: Federal Resrve Board, BEA, JP Morgan Asset Management

CHART 26
CMBS Weighted Average Loan-to-Value by Vintage Year



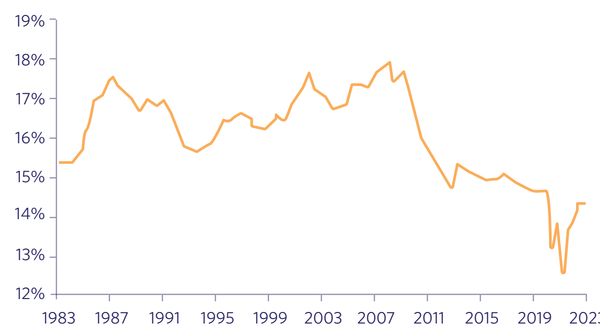
Source: JP Morgan Asset Management

than at prior peaks, and the loan-to-value has been trending meaningfully lower over many years (Chart 25 and 26). CRE will be an economic drag in the upcoming years, but it doesn't appear to represent the kind of problem that creates a major financial contagion.

It has been Lyell's contention since March 2020 that nothing would be "normal" in terms of the ensuing economic cycle or market behavior following the pandemic's onset. The extraordinary circumstances surrounding the shelter-in-place and economic shutdown mandates, remote work, and unprecedented fiscal and monetary stimuli would likely negate comparisons to earlier periods. Our view has not changed in this regard. The Fed's desperate efforts to manage the pandemic-induced inflation with a conventional mindset over the past year has been suboptimal.

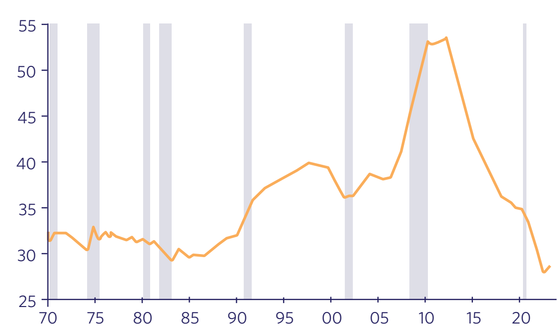
Fortunately, the U.S. consumer is overall in good financial condition. U.S. consumer financial obligations as a percent of disposable income is low relative to recent decades. Along with the strong labor market, this is likely a major explanation for the economy's resilience over the past year despite the rising rate environment (Chart 27). Household real estate loan-to-value balances are at multi-decade lows and almost half pre-GFC levels (Chart 28). The cumulative lack of new housing construction, large home equity balances, and most mortgages

CHART 27
U.S. Financial Obligations Ratio % of Disposable Income



Source: Bloomberg, JP Morgan Asset Management

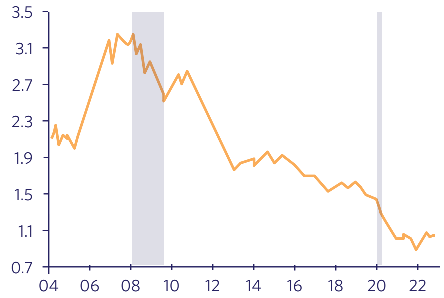
CHART 28
U.S. Household Real Estate Loan-To-Value Ratio 2022:4Q: 28.8%



Source: Evercore ISI

CHART 29

U.S. Existing Houses for Sale

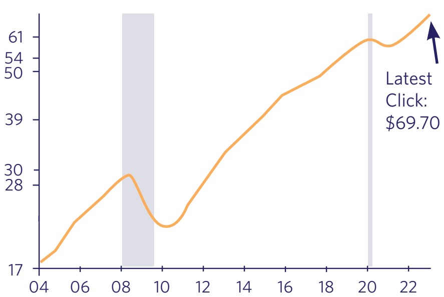


Source: Evercore ISI

CHART 30

S&P Dividends

4 Qtr. Avg. 2023:1Q: $68.21



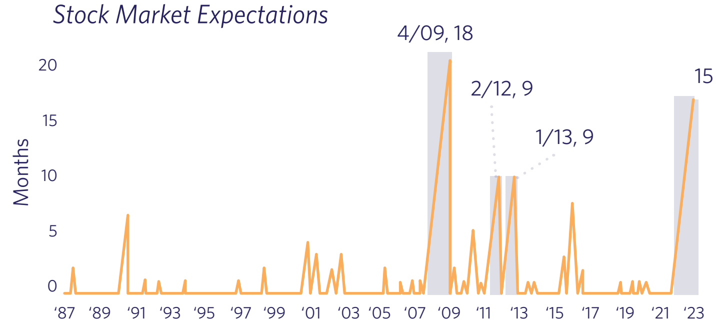
Source: Evercore ISI

fixed at low rates has resulted in very few existing homes for sale (Chart 29). This data strongly suggests that while housing prices are softening as the economy weakens, the residential real estate market won't crash like in 2008.

Likewise, much of corporate America is performing better than some might have expected. Q1 revenues and earnings have exceeded expectations, although they have slowed from earlier periods. S&P 500 net profit margins increased for the first time in six quarters, suggesting that they may have bottomed. Another measure of strength is that S&P Dividends increased 8% from the prior year and are now over 16% above their pre-pandemic level (Chart 30).

CHART 31

Conference Board Consecutive Months of Negative Stock Market Expectations

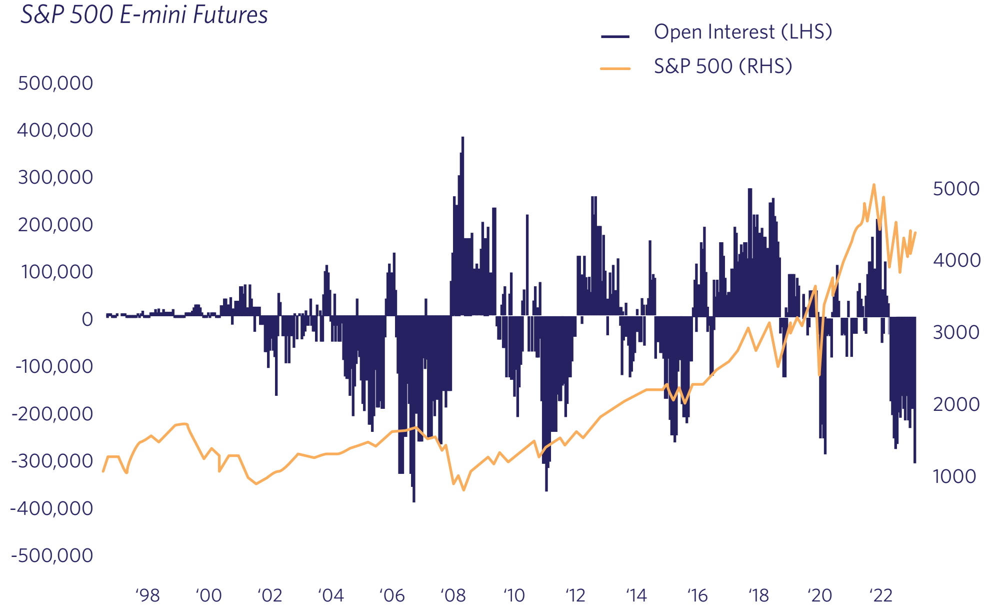


Source: Bespoke Investment Group

Lyell's investment philosophy incorporates an aversion to market timing. We focus on holdings that we expect to appreciate over multiple years. Quality will ultimately win out over the economic cycle if we have selected correctly. The past two quarters certainly surprised those investors who sold in the fall of 2022 to "wait for the coast to clear" only to miss solid performance. The two likely reasons for the stock market's strength are a) that many good companies' stock prices had already reflected a dire scenario and b) investor positioning. Negative investor sentiment towards the stock market has been a constant for many months and has only been exceeded by the GFC period (Chart 31). This bearish sentiment is also reflected in the Commodity Futures Trade Commission's Large Speculators' short positions (Chart 32). The stock market famously climbs a "wall of worry" and prior periods of bearishness typically resolve to the upside.

CHART 32

CFTC Net Positioning - Large Speculations: S&P 500 E-mini Futures



Source: CME Group, Bespoke Investment Group

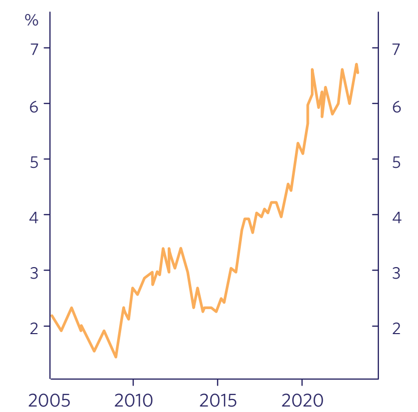
However, we have been very mindful of the market headwinds presented by the Fed. We are also tracking the U.S. debt ceiling negotiations and understand that it often takes market volatility to force an agreement. We are not, however, particularly concerned about any consequential longer-term impact from this debt ceiling impasse.

There have been many recent articles about "de-dollarization" as a result of our increasing multipolar world and financial sanctions against Iran and Russia. However, this remains a misplaced fear, as the $20 trillion U.S. Treasury market offers the most attractive destination for global central banks and institutional investors to convert trade surpluses and maintain high-quality asset balances. There are, paradoxically, benefits to running our massive deficits! Lyell continues to view gold as an attractive asset in such a volatile environment, and it is clear that global central banks agree. The percentage of total reserve assets held in gold has been increasing in recent years (Chart 33). Although the U.S. dollar's share of global reserves has declined over the past couple decades, its role as the primary reserve currency is intact for now (Chart 34). It remains the case that there are no good substitutes for the U.S. dollar's status as the world's reserve currency.

Lyell has been agnostic towards the market's near-term direction and only slowly deploying new capital in the market. We have continued to emphasize diversification and liquidity in client portfolios. Despite a nice start to 2023, we expect to have our share of volatility throughout the year.

CHART 33

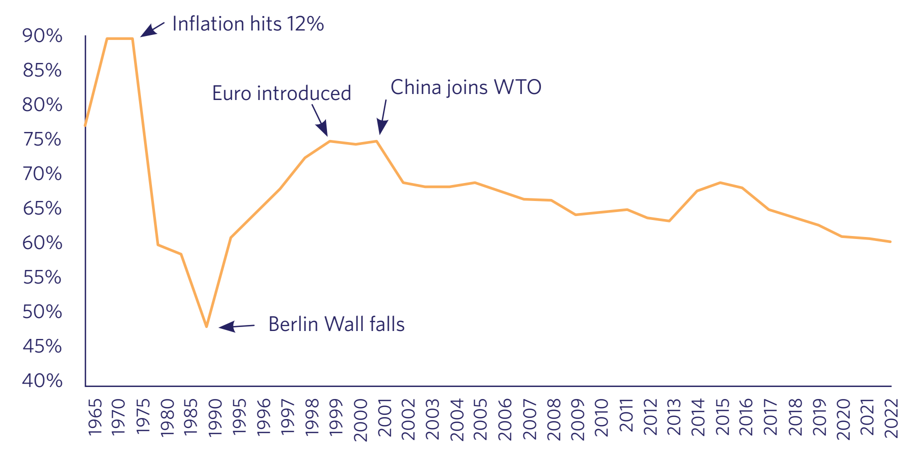
Gold Holdings as a % of Total Reserves



Source: Alpine Macro

CHART 34

U.S. Dollar Share of Global Allocated FX Reserves



Source: Strategas Research Group

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