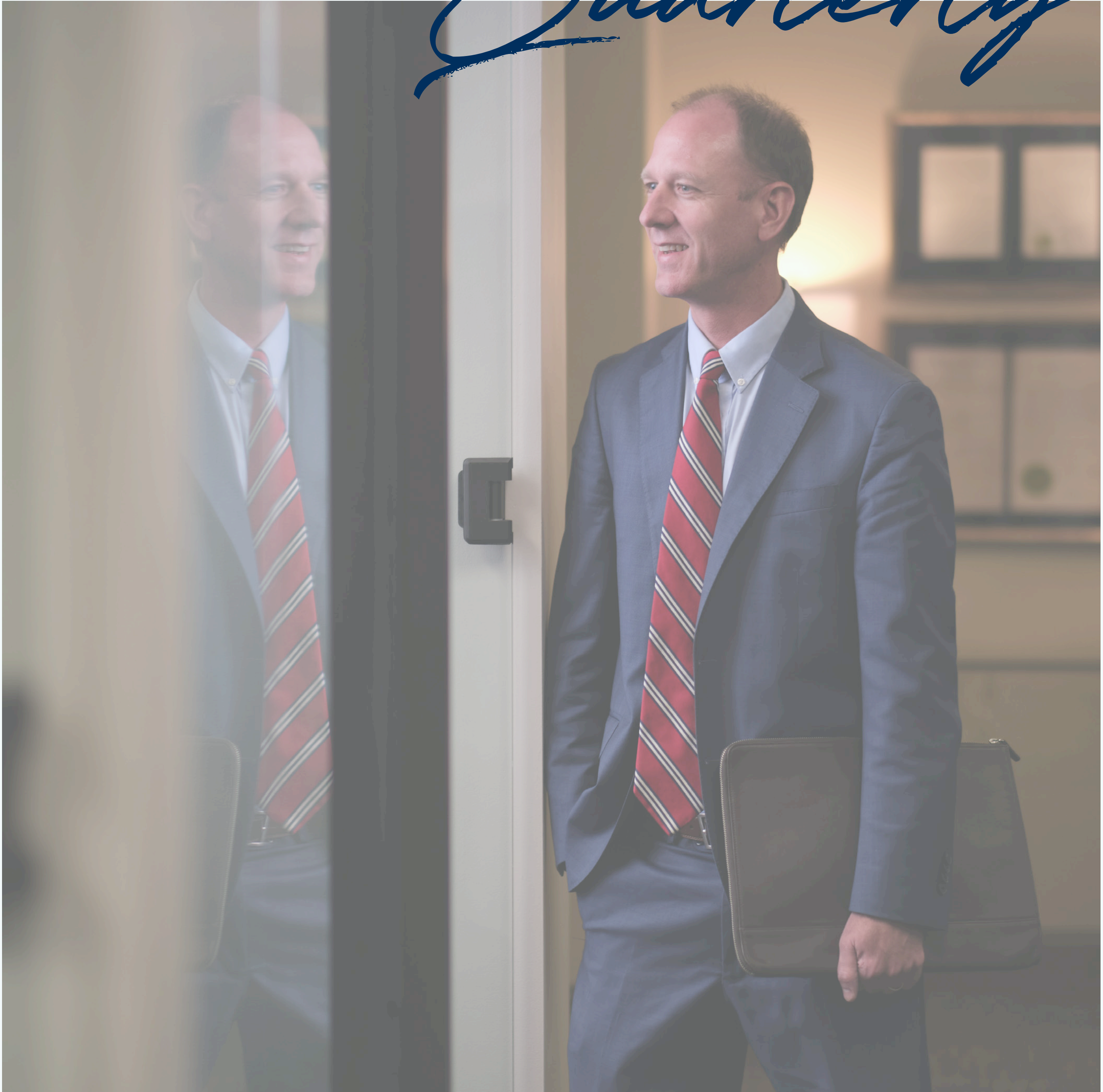
COLONIAL TRUST COMPANY
EST 1913

2ND QUARTER
2023

COLONIAL TRUST *Quarterly*



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1ST QUARTER IN REVIEW

As the first quarter ended, Yogi Berra's cheeky quote about predictions came to mind– "It's tough to make predictions, especially about the future". Predicting short-term market movements has proven no easier than picking the winning NCAA basketball championship teams this year. The quarter ended with the S&P up 7.5% and the NCAA basketball champion is four seed UConn.

The markets began the quarter on strong footing with all three large cap domestic indices performing well through late January. The market was surprised by the strength of the economic data as the year began, increasing the likelihood of a "no landing" rather than a "soft landing" or "hard landing". During the quarter, manufacturing and housing weakness continued, but the consumer remained resilient. This strength was most evident in the employment data, where job growth averaged 350 thousand new jobs in each of the last three months and the average monthly result was 145 thousand jobs greater than economists' forecast.

Employment and consumer spending data drove markets higher during the first half of the quarter; however, the stronger data increased the hawkishness of the Fed's guidance. In response, the 2yr Treasury yield rose from 4.1% in mid-January to 5.1% on March 8th, as markets anticipated the Fed would be forced to raise rates further to curb inflation. Markets gave back some of their gains in mid-February as expectations of rate hikes neared.

The market's expectations of Fed policy and the direction of the economy changed the week of March 6th. On Tuesday and Wednesday, Jay Powell testified to the Senate and House and was forceful in his language about combating inflation, causing interest rates to rise. On Thursday, Silicon Valley Bank (SIVB) saw 25% of its deposits withdrawn and failed on Friday morning. Over that weekend, Signature Bank failed, and the FDIC, the Fed, and the Treasury took emergency action to insure all deposits of both institutions and to provide liquidity to the banking system.

Volatility was elevated the next two weeks, in both the equity and bond markets. The next weekend, we learned UBS was "taking under" Credit Suisse in a buy-out facilitated by the Swiss National Bank. The following week, there were rumors that Deutsche Bank was under stress. Bank stocks sold off sharply as fears of contagion gripped the banking system, with selling particularly acute in regional banks as large banks were seen as too big to fail. Selling in bank stocks was met with buying in large cap tech companies with strong cash flows and strong balance sheets offering a port in the storm. As time passed from the failure of SVB, the market began to discern between troubled banks and those expected to manage through this rate environment.

This mini-banking crisis changed expectations of Fed policy. Prior to SVB's failure, the markets expected another 0.75% to 1.0% of further rate increases in 2023, after which the Fed would hold rates at an elevated level for some time. The Fed's March 22nd meeting brought a 0.25% rate increase, rather than the 0.5% anticipated just two weeks prior. Expectations of June's Fed Funds rate fell from 5.58% on March 8th to 4.92% at quarter end. The expectation for the Fed Funds rate at year-end has fallen from 5.5% on March 7th to 4.3% at the time of writing. The 2yr Treasury fell from 5.06% prior to SVB's failure to 4.02% at quarter-end, and the 10yr yield fell from 3.99% to 3.47% in the same period. The Fed defended their position, stating that tighter credit arising from these bank failures would have similar economic impact as higher interest rates, lessening the need for further rate hikes.

As the dust settled in the final weeks of the quarter, the market's fear index (VIX) fell, and markets rallied. The performance divergence

from 2022 reversed in 1Q23. The Nasdaq was the strongest performer for the quarter, up 17%, as beaten down tech stocks rallied. Large cap stocks outperformed small cap stocks. Developed international outperformed the S&P 500, while emerging markets trailed developed markets. The bond market, as measured by the Bloomberg Aggregate Bond Index, rose 3.0% as interest rates fell for the quarter. All major equity indices and the broad bond market index were positive for the quarter.

Total Return	1Q
S&P 500	7.48%
Dow Jones	0.93%
Nasdaq	17.05%
Russell 2000	2.73%
MSCI EAFE	8.65%
MSCI Emerging Markets	3.97%
Bloomberg Agg. Bond	2.96%

Source: Bloomberg, LP

WHAT DO THESE BANKING FAILURES MEAN FOR THE REMAINDER OF 2023?

It appears the worst is behind us from the mini-banking crisis of 2023. There have been three US bank failures and the Swiss arranged a shot-gun marriage of Credit Suisse and UBS. As mentioned, the two weeks post SVB failure brought speculation of "who's next" and contagion and fear. As the quarter ended, it appeared First Republic Bank may still be in search of a suitor to shore up its finances. The market is reacting as though most other regional banks can muddle through this rate environment and remain solvent.

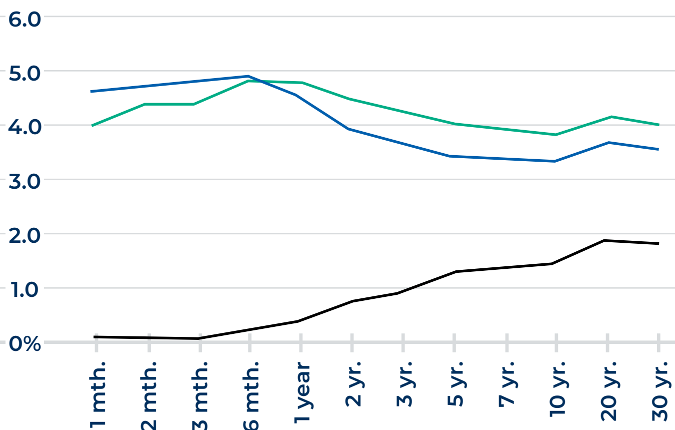
Much has been written about what occurred at SVB, SBNY, and FRC. Each bank had idiosyncratic issues – but the overwhelming issue facing each was a typical "bank run". The banking system saw a large increase in deposits during 2020 and 2021. This was due to expansionary monetary policy and aggressive fiscal policy, coupled with lower consumer spending during the pandemic lockdowns. Banks invested some of these deposits in longer dated Treasury and mortgage securities at a time of record low interest rates. As rates rose, the securities portfolios fell in value, which concerned investors and depositors. Depositors withdrew funds from their accounts and these banks were unable to sell their securities portfolios at a loss quick enough to meet the demand for cash.

The weekend after the failure of SVB and SBNY, the Fed created the Bank Term Funding Program (BTFP) which allows banks to take their securities portfolios and borrow against them from the Fed with an interest rate of 5.0%. Unlike traditional borrowing from the Fed, through the Discount Window, banks can put their securities to the Fed at 100 cents on the dollar, even if the fair value is less than par. This has provided banks with the liquidity they need to meet depositors' demand for cash. This program will be in place for a year and is intended to provide banks with time to reposition their balance sheets and prevent a fire sale of securities in choppy markets.

This policy had the desired effect to calm markets and depositors for most of the country's banking system. In the week ending 3/15, FDIC data showed $196bn of deposits left small banks, while $67bn of deposits flowed into large banks. This data set for the week ending 3/22 showed stabilization in small bank deposits and $90bn in outflows in large bank deposits. Banks require confidence from depositors that deposits are available when needed. When confidence is lost, depositors demand their deposits, not because they are needed but because they fear they will not be available. Confidence was shaken in early March, and while it is too early to say it is "all clear," it is much calmer than the middle of March.

Averting a banking crisis is a laudable goal and we commend the Fed for its actions in the aftermath of SVB. However, we do expect

economic consequences for the banking system and the economy as a result of what occurred in March. The most pronounced impact will be in tighter bank lending standards. At their core, banks are short-term borrowers (deposits) and long-term lenders (loans and securities). They pay their depositors a rate of interest and earn a rate of interest on their loan and securities books. In a normal rate environment, the rate they pay



their depositors is lower than the rate they earn on their loans and securities, and the spread between the two comprise a portion of bank profits.

Over the last year, banks have been slow to raise deposit yields and approximately $856 billion in deposits have moved from the banking system to short-term Treasury bills and money market funds for higher yields. This has forced banks to raise rates for deposits and CDs to fund their businesses. Banks face profitability issues when the yield curve is inverted – the yields on short-term rates are higher than yields on long-term rates. This chart illustrates the current Treasury yield curve and the curve at the prior two year-ends. Since December 2021, interest rates have moved higher across all maturities, while short-term rates have increased by a greater degree and are higher than long-term rates.

Banks are now forced to pay higher interest rates on their deposits than they can often earn on securities books. This crimps profitability and typically leads to a pullback in lending. A reduction in available credit has implications across the economy. First, companies with maturing debt will be required to pay higher interest rates, which will transfer a portion of operating profits from shareholders to lenders through higher interest payments. Second, businesses and consumers will reduce, postpone, or scrap new investments or purchases which are less economically viable with a higher cost of borrowing. Third, banks and companies will be more judicious with their capital in an environment where capital is more difficult to source.

All of these factors slow economic growth and are therefore deflationary. If a credit crunch is severe, it may cause the economy to go into recession. While averting a banking crisis is positive, economic growth will slow while banks repair and recalibrate their balance sheets in this higher rate environment.

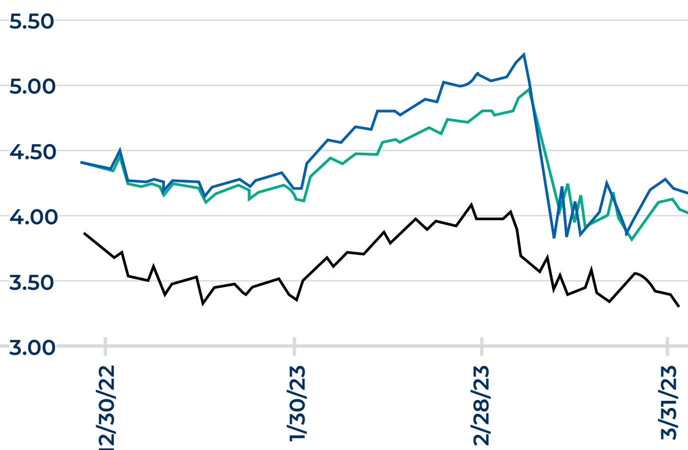
The prospect of less available credit is negative for economic growth. However, the economy and markets don't operate in a vacuum and the interest rate market has adjusted to this new reality. The increase in 2yr Treasury yields and expectations of a higher Fed Funds Rate in January 2024 reversed in Mid-March. In the face of tighter credit conditions, the market has lowered expectations for rate hikes and is now pricing in rate cuts in 2023. Short-term yields, as measured by both the 2yr Treasury and expectations for the January Fed Funds Rate, are now below where they began the year. Two-year inflation expectations, as measured by the difference between nominal and inflation-adjusted Treasuries, have fallen from 3.39% on 3/3 to 2.61% today. As we noted in one of our market update emails, this is not how Chairman Powell wanted to bring down inflation, but it may achieve his desired result via a different path.

WHAT ABOUT THE REST OF THE ECONOMY AND THE MARKETS?

As mentioned, the US economy proved more resilient than forecast in the first quarter. Going into 2023, expectations were for growth to temper in the 2nd and 3rd quarters before rebounding in the 4th quarter. The most recent Bloomberg, LLP® composite of

INTEREST RATES

FED FUNDS RATE FOR 1/24 · 2YR YIELD · 10YR YIELD



economists' forecasts, taken from 3/20-3/27, shows increased GDP growth expectations for 1Q23, 2Q23, and FY23, while full year 2023 GDP growth estimates have increased from 0.3% four months ago to 1.0% today.

The narrative on the strengths and weaknesses of the economy has not changed significantly since year-end. Perhaps the largest change is how strong the labor market and consumer spending has remained in the face of higher inflation and interest rates. The manufacturing economy is static; however, some parts are holding their own while others are faltering. The housing sector appears to have bottomed and new and existing home sales have recently bounced from low levels. We don't expect housing to be an engine for growth in 2023, but as mortgage rates have stabilized, some level of activity is returning. The area of strength continues to be the consumer.

The economy has added 815,000 jobs in the first two months of 2023. Wage gains have stabilized at around 4.5% for average hourly earnings. The year-over-year increase in retail sales was 7.7% in January and 5.4% in February, signaling the consumer is still spending. The US savings rate fell to 2.7% of disposable income in June 2022, but has ticked higher to 4.6% in February. While there have been many layoffs in tech and tech-adjacent industries, the number of job openings is 9.9 million – down 1.3 million job openings from year-end.

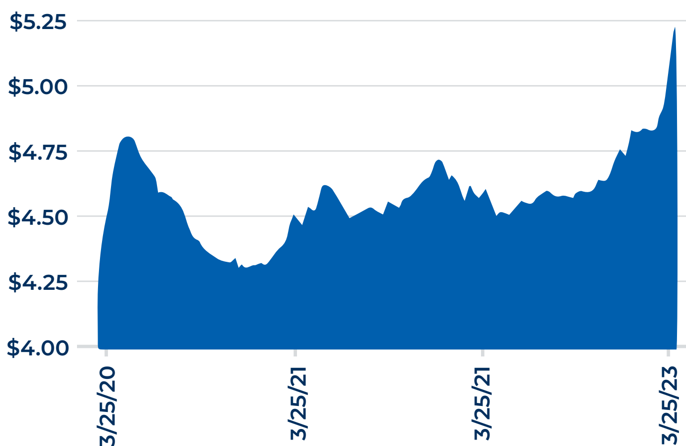
The ability of the consumer to remain the engine of growth is dependent on the interplay between slower overall economic growth and the continued resilience of the employment market. Fed policy and now tighter credit are slowing growth and reducing inflation, while a tight labor market continues to put upward pressure on wages. This encapsulates the internals of CPI and PCE inflation measures. Monetary policy was attempting to engineer a soft landing by curtailing demand, particularly for items purchased on credit. This has been evident with falling home prices, moderating used car prices, and a reduction in goods prices across the spectrum. Inflation has moderated but remains sticky in wages and rents. We believe changes in rental prices are measured with a lag and rental inflation has stabilized or reversed in many markets. Wage pressures have moderated but remain elevated. The second quarter began with positive news on this front, with a 632,000 reduction in job openings. Fewer job openings create less competition for labor and reduces wage inflation.

While economic growth in the first quarter was stronger than expected, we believe the trajectory of the economy before the banking crisis remains intact. That is a slowdown in economic growth resulting from tighter financial conditions, orchestrated to reduce inflation. Tighter bank credit will hasten the economic slowdown. We are starting to see positive news on wage inflation; however, more evidence is needed before the market signals "all clear". A soft-landing scenario

could occur if wage inflation continues to moderate, allowing the Fed to back away, while tighter credit conditions take the baton from the Fed until inflation falls closer to the Fed's 2.0% target. The probabilities of a hard landing have increased in the first quarter. The Fed can pivot its monetary policy every six weeks, while tighter credit conditions do not pivot with changes in weekly economic data. If credit becomes too tight, they will not loosen until bank balance sheets have improved and lender confidence has returned.

The markets appear to be in a trading range and neither discount a hard landing nor account for the beginning of the next economic expansion and bull market. The interest rate complex is forecasting lower interest rates in the future, with long-term yields below short-term yields. Additionally, short-term yields have fallen substantially since mid-March. Lower interest rates across the yield curve are positive for stocks and long-term bonds. This explains the rally in higher growth tech stocks in the first quarter. Wall Street analysts have reduced estimates for earnings from the levels at the end of 2Q22 to reflect the economic slowdown, higher interest rates, and margin pressure from higher inflation. Reducing growth expectations is part of a bottoming process for equity markets and typically happens

ICE ALL MONEY MARKET FUNDS, NET ASSETS



Sourc: bloomberg,LLP (In Trillons)

with a lag. Estimates will be reduced to the point where companies are easily able to surpass expectations and a new bull market is born. While estimates have been reduced for 2023, the consensus remains for 10.9% earnings growth for the broad market in 2023. We believe these estimates are reasonable under the soft-landing scenario; however, a protracted credit crunch would require estimates to fall further.

The equity market will likely remain in a trading range until there is more evidence that inflation is moderating, and credit is tightening. While there was a nice rebound in growth stocks in the first quarter, investors remain uncertain the market is ready to begin a new bull market. Investors have a surfeit of cash on the sideline that can be deployed, with money market balances up 13.2% in the last year. These money market balances will be the fuel for higher equity prices when there is more clarity about the economy and earnings.

A willingness to tolerate uncertainty and volatility are the costs of attractive long-term returns in the capital markets. The first quarter is evidence that trying to time the market, either between cash and risk assets, or between low risk and growth equities, is a futile task. The consensus going into this quarter was more pain for growth stocks and safety in lower risk, value stock. The results were the opposite, as the market proves once again it is wiser than individual investors. This is why we favor a diversified portfolio of high-quality investments, knowing that different investing environments will favor different positions. We believe investors have superior odds of finding high-quality investments than predicting the short-term investment environment. The challenges our economy faces today will not persist indefinitely and we are attempting to position our clients' assets to manage through this environment and benefit when the economy improves.

As always, we are grateful for the confidence you place in our firm and particularly so in uncertain times. If you have any questions about our assessment of the economy, markets, or your individual situation, please do not hesitate to reach out to your advisor.

Wall Street Earnings Estimates for S&P 500						
	2022	1Q23	2Q23	3Q23	4Q23	2023
6/30/22	$224.06	$58.79	$60.94	$63.80	$65.48	$249.01
Current	$196.95	$50.16	$53.78	$56.49	$57.95	$218.38
Reduction	-12.10%	-14.68%	-11.75%	-11.46%	-11.50%	-12.30%

Source: Standard & Poor's

IN THE SPOTLIGHT

GINA GROOMS
Assistant Trust Administrator

GINA JOINED COLONIAL TRUST COMPANY IN FEBRUARY 2020 AFTER WORKING AS A REAL ESTATE PARALEGAL AND AS A REALTOR. FACILITATING OTHERS IN ACHIEVING THEIR GOALS AND DREAMS HAS BEEN THE JOY OF HER CAREER. BORN IN CHARLOTTE, NORTH CAROLINA, SHE SPENT MOST OF HER CHILDHOOD IN GERMANY WHILE HER FATHER SERVED IN THE UNITED STATES ARMY. SHE GRADUATED FROM FRANKFURT AMERICAN HIGH SCHOOL AND ATTENDED THE UNIVERSITY OF MARYLAND AT THE MUNICH CAMPUS. SHE FINISHED HER STUDIES IN BEHAVIORAL SCIENCE AT LYNN UNIVERSITY IN BOCA RATON, FLORIDA. GINA IS RESPONSIBLE FOR TRUST ADMINISTRATION AND CLIENT SERVICE IN OUR GREENVILLE OFFICE.

IN THE LAST QUARTER OF 2022, GINA EARNED THE COLONIAL TRUST COMPANY CYBERSECURITY AWARENESS CHAMPION TITLE, ALLOWING HER TO DISPLAY THE GRANDIOSE CHAMPIONSHIP BELT. PAM MCCAULEY (LEFT), THE PREVIOUS CHAMPION, AND GINA GROOMS (RIGHT) EARNED LEGENDARY STATUS DUE TO THEIR SUPERSTAR CYBER TRAINING STATS. CONGRATULATIONS AND THANK YOU BOTH FOR BEING CYBER CONTENDERS! WE TAKE OUR CYBERSECURITY TRAINING SERIOUSLY AND HAVE FUN IN THE PROCESS.

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