Alley Company Quarterly Letter
Wall of Worry

April 12, 2023

In the face of ongoing geopolitical tensions, the Federal Reserve hiking rates further, and recent banking industry woes, the S&P 500 *counterintuitively* climbed higher during the first quarter. This now marks two quarters in a row of positive returns and a rebound of approximately 15% from the market correction lows this past fall. Pundits often quip that markets "climb a wall of worry" and recent action suggests that investors may well be looking beyond present-day concerns. In this letter, we touch upon the banking sector, the Fed's ongoing battle with inflation, and current investor psychology.

Banking Sector

On March 9th, customers at Silicon Valley Bank in California exerted classic "run on the bank" behavior by pulling more than $40 billion in deposits from the institution in a single day. With an even larger amount set to flee the next day, regulators stepped in and closed the bank. Unlike the 2008-2009 Global Financial Crisis (GFC), Silicon Valley Bank was not sitting on toxic securities. Rather, bank executives invested excess customer deposits into the exact opposite investment vehicle --- high-quality, liquid government-backed securities!

The rise in interest rates over the past year, however, created unrealized losses on these securities and a concern that the bank had solvency problems. Ironically, if allowed to hold these high-quality securities to maturity, the unrealized losses would have eventually dissipated as the bonds reached maturity and the perceived solvency issue would have faded.

While bank failures are as old as the industry itself, they can be emotionally charged when depositors are reminded of the basics of banking and the Federal Deposit Insurance Corporation (FDIC) limit of $250,000. The good news is that regulators acted decisively to stem contagion and the largest, systemically important banks in the country actually saw deposit inflows. Importantly, asset quality on bank balance sheets is generally thought to be strong, with capital ratios substantially higher than 2008-2009. That said, the industry will continue to face headwinds as it deals with unrealized losses on securities portfolios along with cash sorting, whereby deposit customers seek out better yield opportunities in Treasury bonds and money market funds.

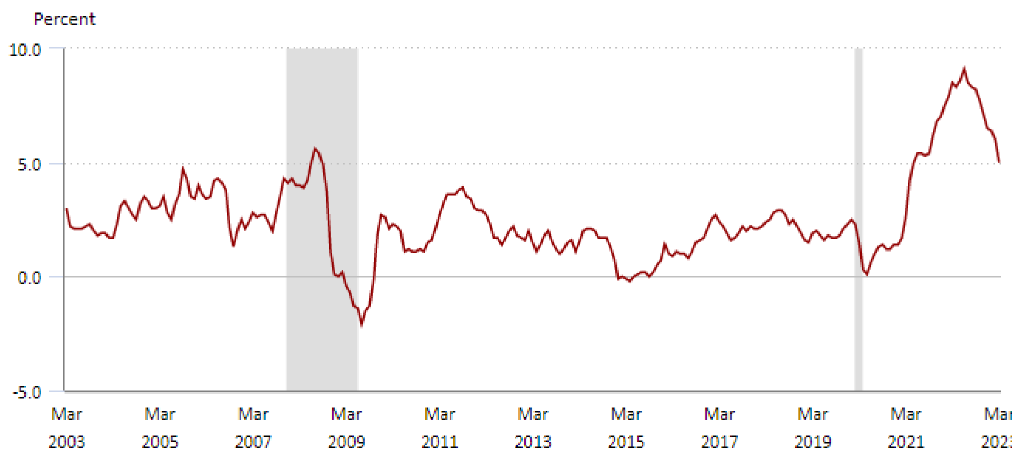
Alley Company
585 Bank Lane, Suite 2400
Lake Forest, IL 60045
Phone 847-482-0938
Fax 847-482-1237
www.alleycompanyllc.com

Going forward, banks may be more restrained in extending loans to customers and, as a result, ease the burden of the Federal Reserve to raise rates to slow down the economy and arrest inflation.

Federal Reserve and Inflation

As the chart below shows, inflation remains elevated, but the good news is that inflation appears to be in retreat. After peaking at +9.1% in June of 2022, the consumer price index continues to fall with the latest reading coming in at +5%. Moreover, there is likely a lag effect from the 4.75 percentage point increase in the Fed Funds rate over the past 12 months and this could portend inflation readings continuing their descent.

Consumer Price Index (CPI) 12-month percent change: 2003-2023



Source: US Bureau of Labor Statistics

Directional changes in inflation have a noticeable impact on market returns and may well provide the best explanation of the market's resiliency in the face of numerous concerns. Since 1928, returns for the S&P 500 annually have been 6.7% when inflation is rising, but when inflation is falling returns have been a robust 16.5% annually[1].

Investor Psychology

The rise in interest rates has not only impacted the banking sector, but it seemingly has also dented the psyche of investors. Despite current inflation readings at approximately 5%, investors have parked a record $5.1 trillion in money market funds that currently yield approximately 4% and thus have accepted negative real rates of return in the short term.

At some level, this is not surprising as a decade of low rates provided little incentive to hold cash equivalents. Furthermore, the turbulence of living through a pandemic, rising inflation, interest rate volatility, geopolitical conflict, and continual chatter about a lurking recession has left investors increasingly risk-averse.

While dividend income is not guaranteed, we view a portfolio of high-quality dividend payers as an attractive alternative within an asset allocation framework for those who desire growing income and also want to participate in the potential long-term upside of owning stocks. We would offer the following table as food for thought for investors analyzing the current income landscape both presently and down the road.

Hypothetical Dividend Yield-on-Cost Analysis[2]:
3% Starting Portfolio Dividend Yield
with Varying Annual Dividend Growth Rates

Dividend Growth Rate	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
9.0%	3.27%	3.56%	3.89%	4.23%	4.62%	5.03%	5.48%	5.98%	6.52%	7.10%
7.0%	3.21%	3.43%	3.68%	3.93%	4.21%	4.50%	4.82%	5.15%	5.52%	5.90%
5.0%	3.15%	3.31%	3.47%	3.65%	3.83%	4.02%	4.22%	4.43%	4.65%	4.89%

Source: Alley Company

A portfolio of high-quality dividend payers stacks up well from an income perspective in today's environment and also has the potential for capital appreciation, a feature that is unavailable to cash equivalents. As the table depicts, dividend growth can also have a profound impact on an investor's future income stream. Furthermore, while today's cash equivalent yields are attractive on an upfront basis, they are short-term in nature and may potentially be lower in future years, particularly if the Fed is successful in reigning in inflation.

The current environment does not lack for things to worry about, and record levels of money market fund assets capture that emotion and psychology. Being an investor requires staying the course, so that one can prosper as markets ultimately climb the proverbial wall of worry.

1 Source: New York University.
2 Dividend yield–on–cost is calculated by taking the current dividend per share for a security and dividing it by the original cost basis. For a portfolio, it would be the total dividend income received divided by the original investment cost basis for the portfolio.