After a difficult 2022, both stocks and bonds got off to a strong start in the new year. Softer-than-expected data on inflation in January led to falling long-term interest rates and optimism that the Federal Reserve rate-hiking cycle was coming to an end. This led the S&P 500 to post its second strongest return for the month of January since the 1980's. This favorable environment gave way to hotter inflationary readings in February and turmoil in the banking industry in early March that culminated in the failure of three banks, including two of the 50 largest banks in the country (Silicon Valley Bank and Signature Bank). Despite the volatility that accompanied this banking turmoil, U.S. stocks, as measured by the S&P 500, finished the first quarter up 7% (excluding dividends). One caveat is that this performance was not broad based; the top 20 stocks in the index accounted for almost all the market value increase in the quarter. Indeed, the Russell 2000 index, which has much higher exposure to smaller companies and the regional banking industry, was only up 2.3%. U.S. bonds, as measured by the Bloomberg Barclays Aggregate Bond Index, were up 3% for the quarter, supported by falling interest rates. Gold, as it often does during times of turmoil, turned in a strong performance, rising 8% during the quarter.

Equity Indexes	Q1, 2023	2022
S&P 500	7.0%	-19.4%
Russell 2000 (Small Cap)	2.3%	-21.6%
MSCI EAFE (Developed)	7.6%	-16.3%
MSCI Emerging Markets	3.5%	-22.3%
MSCI ACWI Ex USA	6.2%	-17.9%

Note: All returns exclude dividends

Fixed Income Indexes	Q1, 2023	2022
Bloomberg Barclays US Agg Bond	3.0%	-13.0%
Bloomberg Barclays Municipal Bond	2.8%	-8.5%

Source: FactSet, Orion, S&P Website.

The failure of several large banks was obviously the biggest news in the quarter. The challenges facing the industry today are based on two key developments:

1. **Securities losses threaten to impact capital ratios -** Banks experienced a large influx of deposits over the past decade – $5 trillion during the pandemic (2020-2022) alone – at a time when interest rates were very low and there weren't attractive options for them to lend/invest. Rather than make a lot of risky loans, the banks were conservative and invested in government bonds (loans to the government) at relatively low rates. However, when the Fed changed course and began to aggressively raise interest

rates, the value of these securities declined leading to significant unrealized losses in banks' securities portfolios. This is not a problem if the banks can hold these securities to maturity, however, if the banks are forced to sell securities and realize losses it would cause a meaningful hit to bank capital ratios.

2. **Deposit flight** – After holding the Fed Funds rate (which banks use to determine deposit rates) near zero for the better part of 10 years, the Fed raised the Funds rate nearly 5 percentage points in 12 months. Since banks had made loans and purchased large amounts of securities at very low rates over the past few years, they cannot afford to raise deposit rates as fast as the Fed has raised short-term interest rates (doing so would significantly hurt margins). As a result, there is a growing spread (over 4 percentage points) between the Fed Funds rate (proxy for yields on money market funds and short-term bonds) and the deposit rates offered by banks, which is driving investors to pull deposits out of the banks and move them into money market funds and other short-term investment options like Treasury bills. In order to fund the deposit outflows, banks must either sell securities (likely realizing losses which would hurt capital ratios) or borrow money from other higher-cost sources (which puts significant pressure on profitability).

The net result of all of this is that capital adequacy and profitability in the banking industry is going to be under pressure. In past letters, we have highlighted the aggressive Fed rate-hiking cycle and the inverted yield curve (short-term interest rates being higher than long-term interest rates) as key risks to the economy and markets. We view the current problems in the banking sector as largely a byproduct of these risk factors. While the market seems to have largely shrugged off the current problems in the banking industry, we believe those problems will serve as another material headwind to the economy and to financial conditions (along with elevated inflation, higher interest rates, fading fiscal stimulus, and negative growth in liquidity/money supply). Even if we avoid more bank failures, it is highly likely that banks will have to conserve capital and tighten lending/credit conditions. Tighter credit conditions could precipitate a negative credit cycle, which would present further challenges for the banking sector (thus far the problems are mostly a function of rising rates, not deteriorating credit). As such, we think the probability of a recession is rising and we continue to expect elevated market volatility over the next several quarters.

Heading into this year, we felt prospects for future returns looked more favorable given the reset we experienced last year. We were particularly favorable on bonds. With stocks, we were thinking the first half of the year could prove challenging, and we expected to use significant weakness to get more aggressive with our portfolios.

So far, our views on bonds are playing out, as fears of a recession drove a 40-basis point decline in the benchmark 10-year Treasury yield and pushed bond prices higher. We continue to like the setup for bonds, as we maintain high quality bond portfolios that yield 4% to 6%. Moreover, if the economy continues to slow down as we expect, it should enable both inflation and interest rates to decline, further supporting bond returns.

The strong performance of stocks has been somewhat surprising, especially given the problems in the banking industry. We have used the strong start to the year for stocks to shift the equity portfolio back toward a more defensive positioning by reducing equity exposure, raising cash, and reducing exposure to cyclical stocks. We see the banking sector and the commercial real estate sector, particularly office and retail segments of commercial real estate, as potential problem areas. We note that we only own one bank – J.P. Morgan Chase –

which is widely viewed as the strongest bank in the country, and we have zero direct exposure to the most challenged areas within commercial real estate.

In closing, we acknowledge that times of increased volatility can be stressful, and we recognize that there is a tendency during these times to make big moves to de-risk your investments. With money market funds earning 4%+, it can seem even more appealing now. However, if you had done that at the end of last year, you would have missed a nice rebound in stocks in the first quarter. Instead of making big moves in and out of asset classes, we construct a balanced portfolio of uncorrelated asset classes (stocks, bonds and other assets like gold) and target a mix of those assets to suit your situation. We then use volatility in the markets to make small adjustments to these allocations, typically reducing exposure to asset classes that have generated strong performance and increasing exposure to asset classes that have lagged. We manage this portfolio for the long-term. We want to assure you that we continue to assess the risks we see in the market. We will remain vigilant on your behalf and believe that your portfolio will be able to benefit from the inevitable recovery in both the market and the economic cycle.

As always, please feel free to reach out with any comments, questions or concerns.

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