QUARTERLY INVESTMENT NEWSLETTER

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Welcome!

Every quarter the Investment Committee for Diversified puts together our thoughts on markets, the economy, and how it all pertains to our clients. We look to give our perspective on what it all means for investors and to share where our philosophy and processes are taking portfolios. Thanks for taking the time to give it a read...

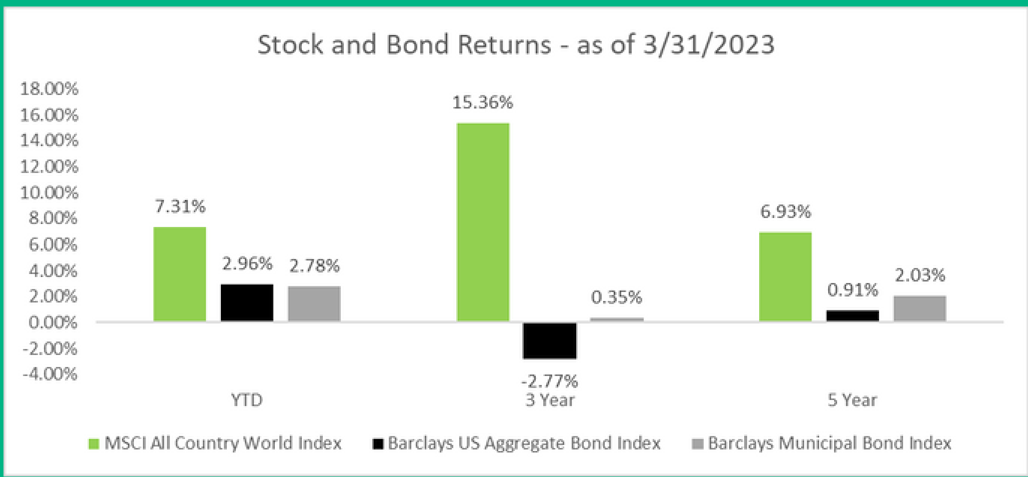
WALKING A TIGHTROPE

As we sit here three months removed from our last newsletter, it's hard to argue that much has really changed. Markets continue to be choppy and the same dynamics continue to dominate investor sentiment. There is also this new "bank issue thing (I don't believe this is the technical term)" that we need to discuss, so more on that to come. As quickly as markets and economic conditions seem to change, sometimes it takes patience to allow economic forces to take hold before making any drastic changes.

While I'm a gigantic work in progress, being the father of a two-year-old has certainly made me improve in the patience area and its times like this I'm grateful for that. Investors are being thrown curveball after curveball (baseball is back!) and it's important to always stay on your toes and have a plan in place. As we always do, we want to sift through all of the noise and recap what has happened so far this year, what we expect moving forward, and how we're positioning portfolios given that backdrop.

A QUICK QUARTERLY RECAP:

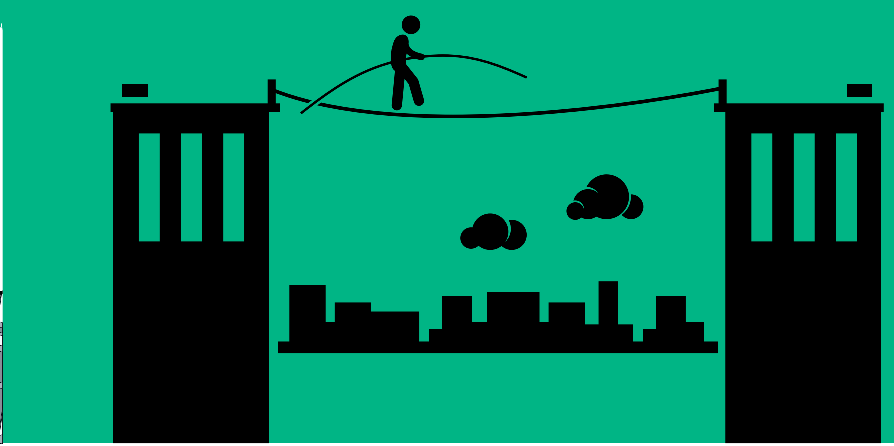
Coming off of a volatile year in both stock and bonds in 2022, the start to 2023 is surely a welcomed sight. As you can see below, both stock and bonds (both taxable and tax exempt) finished the first quarter in positive territory.

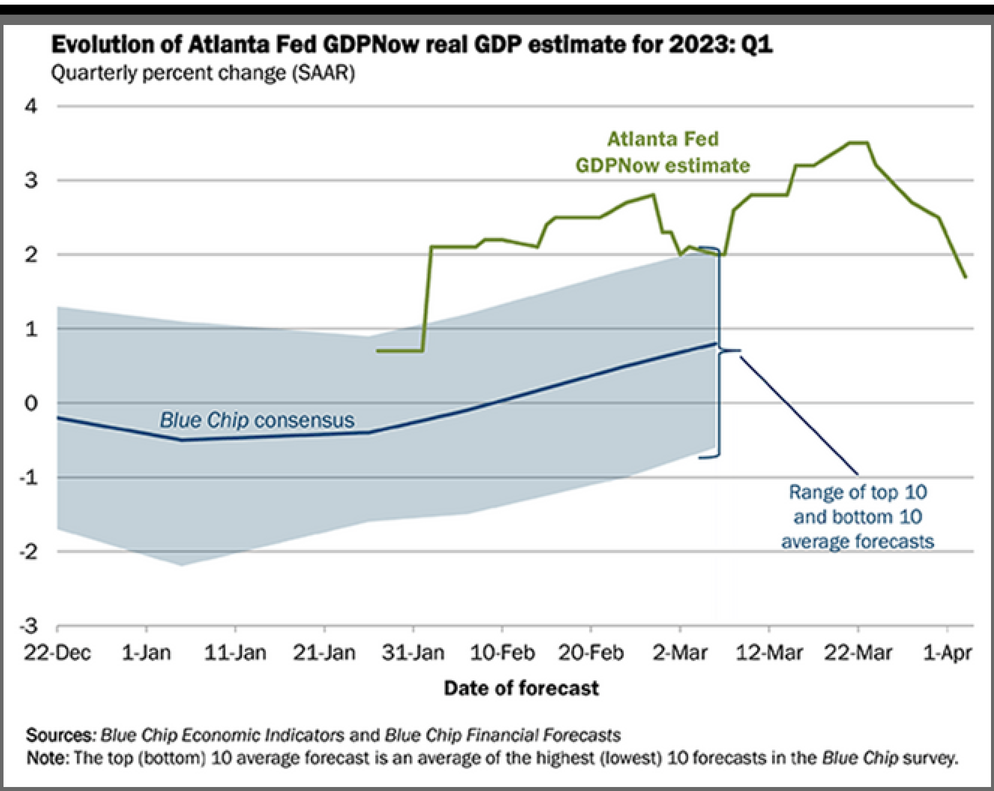


SOURCE: YCHARTS; DATA AS OF 3/31/2023; PERIODS OVER 1 YEAR ARE ANNUALIZED RETURNS, PAST PERFORMANCE DOES NOT GUARANTEE FUTURE RESULTS.

At the asset class level, it was growth-oriented equities that bounced back the most after a very rough 2022. For the quarter, the tech-heavy NASDAQ index was up 17.05%. We also saw international developed equities (as measured by the MSCI EAFE index) outperforming US equities. Lastly, at the sector level we saw those growth-oriented areas outperform with technology, communication services, and consumer discretionary leading the way. As you'd expect with the regional bank issues that popped up, financials were the worst performing sector.

So much of the conversation has been about hard landing, no landing, or soft landing for the Fed (don't yell at me, I didn't come up with these terms). What that refers to is whether or not they can get inflation down (through higher rates) without pushing the economy into a recession. Through the end of the quarter, the Atlanta Fed estimate shows GDP for Q1 as 1.7%, so that measure anticipates that any negative GDP conditions will be pushed to Q2 at the earliest.





As we look forward, there are some major questions we're focused on that will drive our market outlook and portfolio positioning:

1. What will the Fed do? Based on the last 18 months, good luck figuring that out. But really, much of this depends on a couple of factors, namely economic conditions and inflation. With the banking issues popping up and inflation measures retreating, markets have shifted from rate hikes to now expecting rate cuts in the second half of 2023. Our expectation would be rate cuts only happen if we start to see cracks in the foundation of the US economy.

2. What effect does recent banking turmoil have? Most retail investors are rightfully concerned about their deposits, but market analysts are more focused on what happens to lending standards. Smaller, regional banks have a huge presence in local communities when it comes to lending, especially towards real estate. As management of banks look to sure up their businesses, one aspect we need to keep in mind is that they'll likely continue to tighten credit standards.

3 What happens to corporate earnings and profit margins? While stock markets have become cheaper over the last 15 months, they're still not a bargain level prices. On top of that, market expectations for corporate earnings remain high, which up to this point has proven justified as profits have remained resilient. We're starting to see cost-cutting measures in various parts of the economy through labor market layoffs, so corporate America is going to the traditional playbook for how to maintain profit margins when top-line revenue concerns pop up.

While its philosophically in our DNA, diversification is our friend when the level of uncertainty is this high in markets. The good news for investors is that many areas of the equity market have remained resilient and bond portfolios are generating much more attractive yields than they have in over a decade. These are the types of markets where we remain patient and ready to adjust as conditions change.
With both the Fed and banking sector in the spotlight over the last few months, let's take a few moments on both...

Inflation & the Fed:

I wish we could stop talking about inflation. I really wish we could stop talking about inflation. Unfortunately, this topic has stuck its roots in the ground and become a consistent discussion point for nearly every single market update we do. As much as I wish it would go away, it is just too important to the path of economic conditions and financial markets to ignore.

The bad news -> inflation is still meaningfully above the Fed's 2% target with core CPI (which excludes food and energy) at 5.5% as of February 2023.

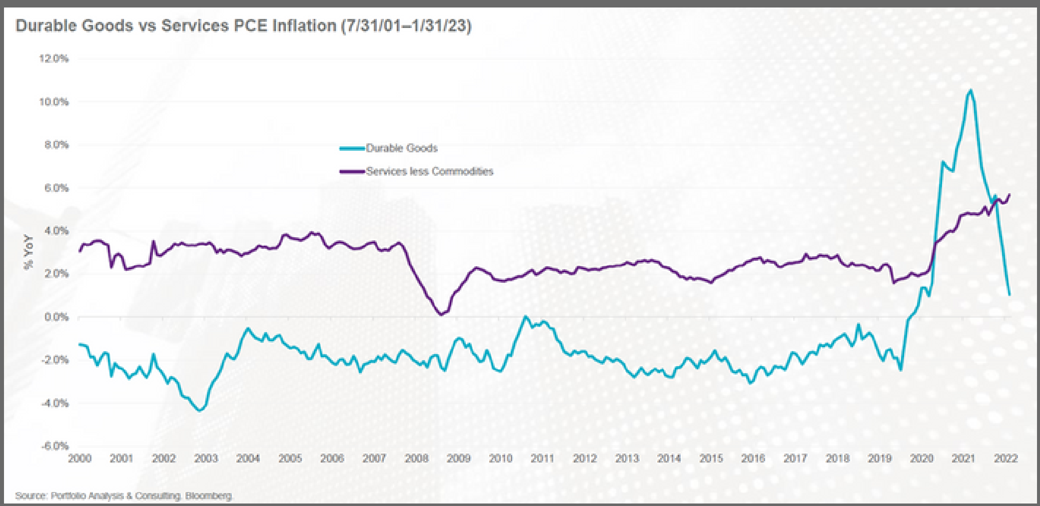
The good news -> inflation has peaked and is coming down slowly with several areas showing improvement.

The bad news -> the problem right now relates to the services part of the market, which is proving very sticky, especially with regards to shelter (housing/rent).

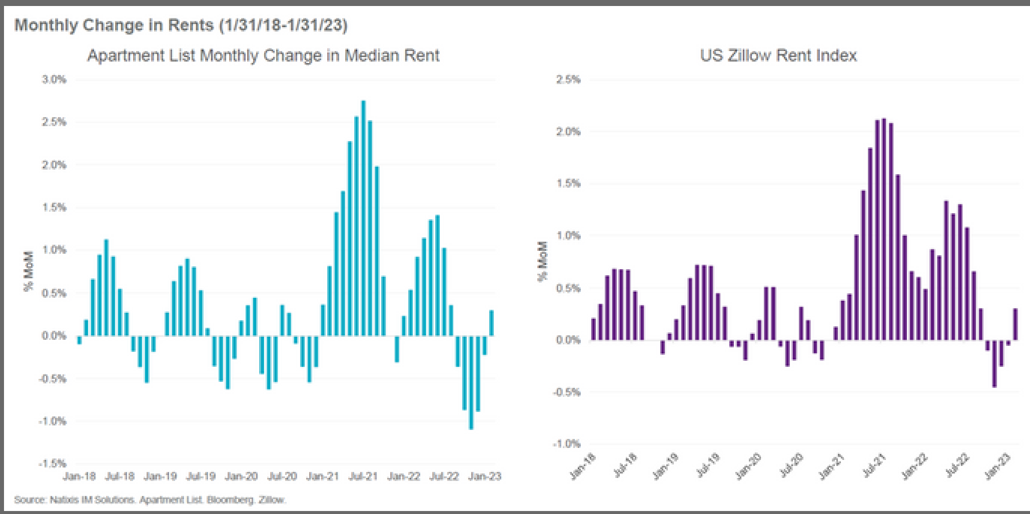
The good news -> we're seeing signs that services should continue to ease over the next several months.

Why is this all so important? The Fed is on a mission to get inflation down, which largely makes sense given that is their job and that unemployment currently looks very healthy. The primary tool at their disposal is the fed funds rate, which they've been increasing at nearly every meeting to make debt more expensive and slow the pace of economic growth. The market is constantly adjusting its expectation for where short-term rates will peak, which will impact the potential impact on economic conditions and where markets should be valued.

As I mentioned above, the good news is that inflation appears to have peaked, is coming down slowly, and the remaining "sticky" areas are also showing signs of easing. Below is a graphic of the breakdown between goods and services. You can see that goods have meaningfully pulled back and are a big reason why inflation has peaked, and services remain an issue.



So why do we think services will start to cool? A big part of this is the composition of core CPI (consumer price index), which is heavily weighted toward shelter (a combination of rents and housing). There is a natural lag in the data because of the way rents and housing are included in the data. Even though we're seeing an easing in rental prices, those new rental prices will take some time to flow into the data. Below is a good graphic showing that easing in rental prices:



So the combination of lowering shelter costs, better supply chains, and lower goods prices should continue to push inflation in the direction that the Fed wants. Markets are agreeing with this sentiment, as we're seeing market-based inflation expectations reflect the likelihood that inflation continues to fall.

With that being the backdrop, investors should be prepared for the Fed to pause their interest rate hiking cycle and continue to be data-dependent to figure out their next step(s). One potential, and even likely, scenario is that the Fed pauses in the near future, and then rate cuts become a discussion point for meetings later in the year. Our focus continues to be on where the Fed finishes, economic conditions, and what happens with corporate earnings/margins. This will continue to be a major factor in our portfolio decision process.

SVB & REGIONAL BANK ISSUES:

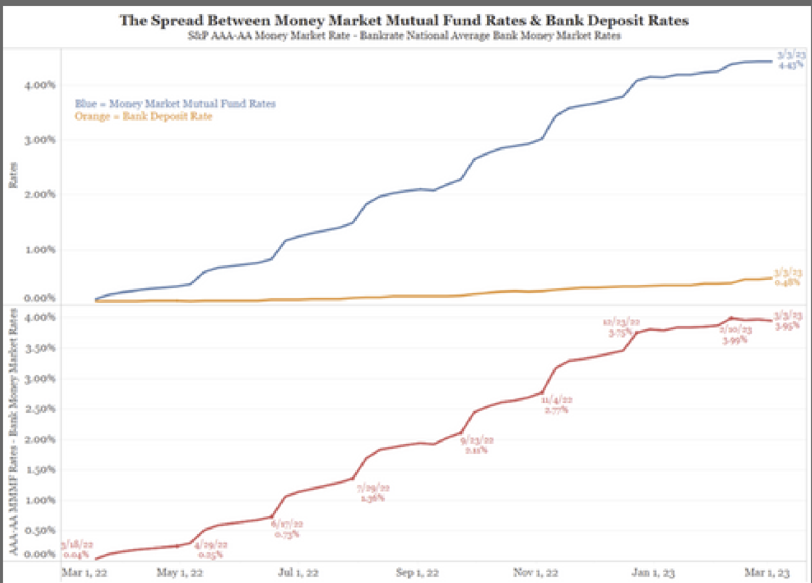
On top of all the fun that consumers are having with inflation and higher interest rates over the past year or so, the cherry on top was the announcement that many regional banks were coming under stress to meet deposit requests. The combination of Silicon Valley Bank (SVB), Signature Bank, and Credit Suisse have put both investors and depositors on alert ever since the announcement of liquidity issues. While we put out a detailed communication a few weeks ago, we wanted to reiterate what we're seeing and put things in perspective.

I think to understand what happened, its best to start with the business SVB ran. SVB ran a business that was unlike most traditional banks in that most of its customers were not retail depositors but instead mostly smaller, technology-oriented companies. As the name implies, the bank was based in California and catered its business to the venture capital world with smaller start-up businesses. According to the Federal Reserve, the bank was the 16th largest bank in the U.S. in terms of total deposits. To illustrate how different its business was, SVB only had 16 domestic branches while banks like TD, Citizens, Truist, Wells Fargo, and Bank of America all have over 1,000 domestic branches. It catered to a different clientele. That matters because traditionally retail deposits are stickier for banks than corporate cash.

With low interest rates and a healthy economy, the technology sector has grown dramatically over the last decade. As part of that, the deposits at SVB grew by the billions as these businesses took in more cash. The problem for SVB can be narrowed down into a few bullets:

·First, their clientele all largely look alike. By not diversifying, their business was exposed to the volatility of venture capital and technology/healthcare start-ups. With the economy slowing and high-growth businesses underperforming the broader market over the last year, it's not a surprise that these types of business may be burning through cash quickly.

·Second, as interest rates have risen, we've seen a disconnect between the yield on government money market funds and checking account deposit rates. Within money markets, we're seeing yields in the 4% range. On the other hand, go look at your checking account interest rate and I'll bet you're one of the many who hasn't seen any movement. Below is a great graphic that shows the difference of those two things over the last year. This all means that investors have alternatives to leaving cash in checking accounts and is a big reason why a bank like this would see outflows.



Source: Bianco, Data as of 3/10/23

·Lastly, banks often will invest excess deposits into high-quality treasury bonds to get some yield and hold them until maturity. With customers pulling out cash over the last several weeks, SVB had to sell some bonds to send the cash out. If you recall, we saw bonds just have their worst calendar year in history so many bonds are having to be sold at losses, putting the bank in a bad spot. This comes down to poor liability management on the part of the bank.

So, the combination of bad diversification, poor liability management, and lack of interest rate increases put SVB into a bad spot. The Federal Reserve and the Treasury Department stepped in during the early part of the news to provide comfort to depositors by ensuring people/businesses have full access to their money, even that in excess of the $250,000 in FDIC insurance.

We do not believe this is a systemic issue like 2008-2009, as most bank issues stem from credit problems rather than what we're seeing today. That doesn't mean we won't see scary headlines and market volatility as those are both commonplace anytime major economic, political, and corporate events occur. The banking sector is broadly much healthier than it was at that time. We look at the underlying issue as mostly a company-by-company issue and while the broader market may be choppy in the short term, we expect it to settle as time moves forward.

PORTFOLIO POSITIONING:

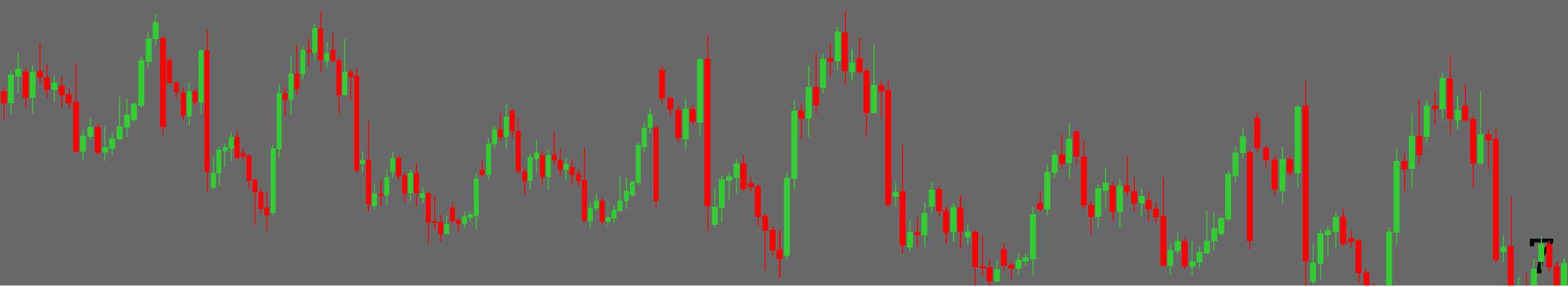
How much has changed from our outlook to begin the year? Candidly, not much and our portfolio positioning will reflect that. We have seen some opportunities in fixed income present themselves, but our overall sentiment in both equity and fixed income has remained largely the same.

·Overall Risk Positioning

- One major decision we take under consideration is how much risk we want to take within both equity and fixed income portfolios. As was mentioned earlier, the underlying fundamentals of corporations (leverage, earnings, margins, etc.) are in a very healthy place right now and the consumer is still pretty strong. What we see, however, is the impact of the Fed raising rates starting to have an impact. The market has quickly repriced assets to account for these higher rates, but earnings expectations haven't budged. As the uncertainty around what the true economic impact will be from rapidly increasing rates, we see downside potential if earnings do start to show signs of slowing. We believe all signs point to this being the end of the most recent economic cycle and a more defensive position is appropriate.

·Equity (stocks)

- We like to use the term "higher quality" when it comes to our positioning right now. What that refers to is our preference for more mature businesses, especially those paying healthy, consistent dividends.
- Overall, our largest overweight is to U.S. large cap stocks. We believe the U.S. is best insulated from a global slowdown and has already taken a hard hit from higher rates.
- In conjunction, we're underweight both U.S. small cap and international equities. With growth coming under pressure from higher rates, we're leaning away from the higher risk small cap asset class in favor of larger, more fiscally stable businesses. On the international front, we expect economic growth to be hit harder in Europe and international equities in general to struggle until the U.S. dollar weakens.
- At the sector level, we continue to maintain an overweight to energy as it, even with the strong returns last year, appears attractively valued compared to other sectors.



·Fixed Income (bonds)

- Coming into 2023, our outlook for the bond market was an optimistic one. Sometimes its hard to look past the horrible year that 2022 was for bond portfolios, but we saw, and continue to see a good starting place for fixed income investors.
- When we talk being defensive in our bond portfolios, that primarily means we're going to be higher on the credit quality side. What took place in 2022 was mostly driven by interest rates, where longer-term bonds were disproportionately hit harder than short-term because they're more sensitive to interest rate movement (referred to as higher duration). With economic growth and earnings coming into focus, our attention turns to credit quality.
- Historically, during times of economic slowdown and recession you see that bonds of lower credit quality lose value faster than higher credit quality because of the higher threat of default. While we expect default rates to remain low compared to past periods, we still see the risk in owning too much lower quality fixed income at this time.
- Our bond portfolio will own primarily core investment-grade bonds such as treasuries, mortgage-backed securities, and investment-grade corporate bonds. We also maintain a small CMBS (commercial mortgage-backed securities) allocation given its relatively cheap valuation right now.

Just like we were coming into the year, the Investment Committee is focused on when and where to rotate portfolios once we decide to add more risk. Within equities, we see small cap as somewhere we'll want to add to in the near future. Not only are small cap stocks trading as cheaper valuations relative to large cap, but they have also historically done well during the recovery phase of the economic cycle. In addition to that, the banking issues affected regional banks and pulled back on small cap stocks given their presence in small cap indexes.

On the fixed income side, our attention will be in the higher-risk spread sectors, such as high-yield corporate bonds. Today, high yield is trading at a pretty average level compared to history, so we see them as neither expensive nor cheap. If economic conditions do slow, we expect them to become cheaper and a good opportunity to be added to bond portfolios as economic conditions recover.

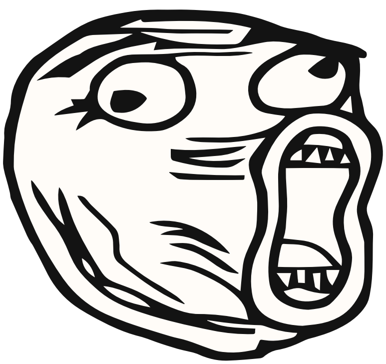
As always, we're remaining patient and looking for pockets of opportunity as conditions change.

MIKE'S QUARTERLY TANGENT - REMEMBER "MEME STOCKS?" LET'S REVISIT YEARS LATER

Back in February 2021, both Andrew and I sent out communications to our clients detailing all of the speculation in markets at the time, namely around both cryptocurrency and "meme" stocks. While the dramatic fall in crypto has been covered quite a bit in financial media, it hit me the other day that I haven't heard much about some of those high-flying stocks that became very popular at the time. So now that we're a couple of years removed (and much more gray hair by the way), I wanted to take a look back at what has transpired since then.

As a refresher, meme stocks refer to a category of publicly traded companies that often gain popularity through sentiment on social media. Back in those days, much of the sentiment was driven off of a website call Reddit, on one of the threads called "wallstreetbets." The two stocks that immediately come to mind are GameStop (GME) and AMC Entertainment (AMC), though there are certainly others that can be lumped into this category.

Our point back then was quite simple, these types of trends don't often end well. These stocks were pumped up through sentiment at a time when consumers had sizable excess savings. Over the long term, asset prices (especially stocks) will reflect the quality of the business and the underlying cash flows its able to generate. Sometimes the FOMO (fear of missing out) is hard to resist because others appear to be making money, but as you can see below the financial world has a way of efficiently normalizing over time. I've included the returns of GME, AMC, and the S&P 500 from 2/1/2021 through 3/28/2023 below. Isn't it amazing how some individuals/institutions will make others feel insecure for not jumping on board these types of trends, only to never hear again about how ridiculous it was at the time?



Keep Perspective

Just remember that your team here at Diversified is always working on your behalf to adjust portfolios in a quickly changing landscape. We promise to always remain unemotional, proactive, and transparent as to what we're seeing, thinking, and ultimately doing. We sincerely appreciate our partnership and just know that we're always here if you have any questions on your financial plan, portfolios, or just would like to talk. Thank you for the trust you put in the Diversified team.

Connect With Us

Mike Horwath, CFA®

Mike is the chief investment officer at Diversified LLC, where he heads the Investment Committee and is responsible for the investment direction of he firm. He works closely with financial planners to support the investment side of the financial planning process. Mike oversees the ever-changing global investment landscape and evaluates the impact on each of our client's strategies. He's a proud father and husband and loves spending time with his dog.

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S&P 500: The Standard & Poor's 500 Composite Stock Price Index is a capitalization-weighted index of 500 stocks intended to be a representative sample of leading companies in leading industries within the U.S. economy. Stocks in the Index are chosen for market size, liquidity, and industry group representation.

Russell 2000: The Russell 2000® Index is a capitalization-weighted index designed to measure the performance of the 2,000 smallest publicly traded U.S. companies based on in market capitalization. The Index is a subset of the larger Russell 3000® Index.
MSCI All Country World Index: The MSCI ACWI captures large and mid-cap representation across 23 Developed Markets (DM) and 24 Emerging Markets

(EM) countries. With 2,937 constituents, the index covers approximately 85% of the global investable equity opportunity set.
GDP: Gross domestic product (GDP) is the total monetary or market value of all the finished goods and services produced within a country's borders in a specific time period.

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