MATTHEW B. KENASTON, CFP® THOMAS BAKER, CFA, J.D.

"Take a long lunch … "

The dot.com bust was a very challenging bear market in the earliest days of Blue Oak. While we had been through difficult markets previously, we were now the decision makers for clients, and it felt different. We asked a long-time mentor what advice he could share to help us remain grounded and less reactive in volatile times. His simple advice was to "take a long lunch". A "long lunch" is a wonderful mechanism to force us to slow down, to appreciate that market cycles come and go, and to re-anchor perspectives.

Intended and Unintended Consequences:

For the ninth time since March 2022, the Federal Reserve Bank announced a quarter percentage point interest rate increase. The intended consequence of the rate campaign has been to reduce inflation from its peak of 9.1% last June. The inflation rate has come down dramatically and today rests at 5.5%. So, on this metric, the Fed is in the process of achieving their stated objective.

Intended consequences are often easy to observe. Because monetary policy works with long and variable lags, the unintended consequences are often opaque. However, once revealed they quickly become an obvious outcome. Pressure has been building because of the rapid increase in rates and the once opaque consequences are now being revealed.

We would characterize the collapse of Silicon Valley Bank (and the two other banks) as an unintended consequence that today appears to be the logical result of the Fed's actions. Because all banks have been under pressure, risks remain in the banking system. It is important to note that since 2008-09, U.S. banks are much better capitalized and more heavily regulated, and do not appear to pose broad systemic risk. Nevertheless, we remain concerned that more unintended consequences linger. The economy is slowing, and more companies are eliminating job openings and announcing layoffs.

Questions:

"Could the banking problems be good for stocks?" The short answer is that it is too soon to tell. The longer answer is that:

> While the turmoil engulfing regional banks will slow growth, it is important to keep in mind that the Fed *wants* slower growth.
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> Arguably, it would be better for the broader stock market if growth slowed because banks became more conservative in their lending than if it slowed because the Fed had to raise rates to over 6%. In both cases, economic growth would decelerate but at least in the former scenario, the discount rate applied to earnings would not be as high. (*Global Investment Strategy, 16 Mar 2023, bcaresearch.com*)

"Will there be a recession in the US?" While impossible to predict with certainty, the weight of the evidence suggests it is prudent to actively position portfolios defensively. We have reduced our equity weights to the minimum of our available Investment Policy ranges. Meanwhile, we continue to celebrate the attractiveness of short-term US Treasuries and the higher yields being generated by our bond and preferred securities strategies.

Let's "Lunch":

If you need a "long lunch", we are here for it. If your "long lunch" is a walk in the park, a phone call, or even just an email exchange, we will meet you where you are.

Thank you for the trust you place in us.

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At the end of each year, we receive several research pieces that opine on the year ahead and thought we would share some of the most salient as well as our thoughts.

The four-decade period of largely stable activity and inflation, is behind us. The new regime of greater macro and market volatility is playing out. A recession is foretold; central banks are on course to overtighten policy as they seek to tame inflation. This keeps us tactically underweight developed market equities. We expect to turn more positive on risk assets at some point in 2023 –but we are not there yet. And when we get there, we don't see the sustained bull markets of the past. (BlackRock 2023 Global Outlook)

This somber introduction accurately captures the challenges investors face. We have endured an extraordinarily rapid increase in rates from the Federal Reserve and, given the lagged nature of interest rate increases, have not yet felt the full impact. Corporate earnings have yet to show the effects, and this has led us to a cautious approach for 2023.

A mild or average recession may see the Fed cut interest rates back close to zero, but the re-establishment of a long-lasting zero interest rate policy and the associated resumption of large-scale asset purchases is not likely to occur. (The Bank Credit Analyst, November 28, 2022 Monthly Report titled "How Much More Pain?")

Globally, interest rates were negative or zero far beyond what policy makers considered when first implementing their accommodative policies going all the way back to the financial crisis of 2008-09. Policy makers have wanted to end the use of many of the financial tools employed when conditions warranted, but the global pandemic precipitated an even more accommodative fiscal and monetary response. US Banks are much stronger financially and market liquidity is not in danger in the way it was previously. We agree that we are unlikely to be back at 0% soon, or for a lengthy duration.

We expect views to change more frequently than in the past. Our stance heading into 2023 is broadly risk-off, with a preference for income over equities and long-term bonds. (BlackRock 2023 Global Outlook)

Volatility has increased dramatically in 2022 – both up and down. We expect this to continue as markets process the new data which is increasingly suggestive of slowing economies. We appreciate the caution from BlackRock and believe that a slowing economy may create a positive environment for long-term bonds. Yes, they are riskier than either stocks or short-term bonds, but in a slowing economy, a longer duration can be beneficial especially if the accompanying yield provides a sufficient income cushion for price volatility.

Either the onset of recession in the US, or a further decline in risky asset prices in anticipation of an eventual US recession, will likely occur at some point next year. It is not yet clear that anything truly positive has emerged over the past year in terms of the long-term outlook for growth and inflation. From an investment perspective, the most obvious positive development is that government bonds, especially in the US, now offer a much higher yield than they have on average over the past decade. (The Bank Credit Analyst, November 28, 2022 Monthly Report titled "How Much More Pain?")

Bonds are poised to play a more significant role in the total return of our balanced portfolios for the first time in a decade. We are already benefiting from higher yields and anticipate low default rates. As painful as this year has been for bond investors, we often see the asset classes that are first into a bear market, are the first ones out.

2022 has been a difficult year no matter how you slice it. Blue Oak has guided client portfolios through good markets and bad. Neither last forever, and that is

certainly the case right now. As we look forward with clear eyes, there are reasons to be optimistic about 2023. Thank you for your trust and confidence.