WealthIQ: March 2023

March Mad-Mess

Executive Summary: Mid-March is well known for the beginning of the NCAA Men's & Women's college basketball tournament, colloquially referred to as 'March Madness.' However, for financial markets, March news flow has been a mess- particularly in the banking sector. While recent global central bank intervention has helped restore market calm in recent days, it has created questions about the Federal Reserve's interest rate path going forward.

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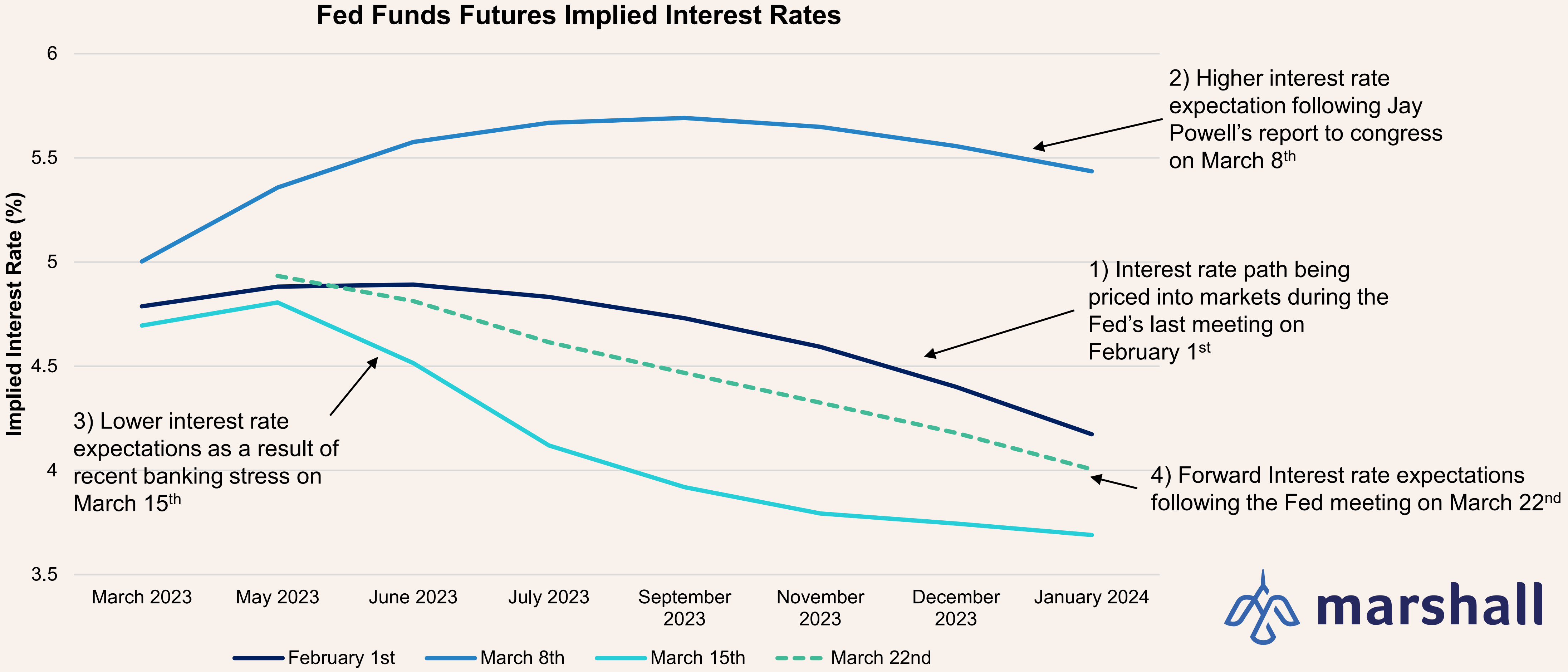
1) Following weeks of wild swings in market priced expectations, on March 22nd, the Federal Reserve settled weeks of economist speculation by raising interest rates 0.25%. Prior to the Federal Reserve's February 1st meeting, markets expected the central bank to raise interest rates a few additional times this year before cutting rates as the calendar approached year-end. However, following Chairman Jay Powell's Semiannual Monetary Policy Report to Congress on March 7th, the market began to price for more aggressive Federal Reserve action. This expectation was quickly erased only days later, following the failure of Silicon Valley Bank and reports of trouble at other institutions, such as Signature Bank, First Republic, and Credit Suisse. Following the Fed's most recent announcement, markets once again anticipate the Federal Reserve to pursue a less aggressive interest rate path.



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Data Source: Bloomberg, L.P.

2) Adjusted interest rate expectations are likely the result of markets digesting language changes between the February 1st and March 22nd Federal Reserve press releases. As seen below, one of the key changes consists of the Federal Reserve now stating, 'The Committee anticipates that *some additional policy firming may be appropriate*…' vs. the February release stating, 'The committee anticipates that *ongoing increases in the target range will be appropriate*…' While the language changes may seem nuanced, these press releases are handled with great care. As such, this may be the first indication the current tightening cycle is close to ending.

February 1st:

FEDERAL RESERVE press release

For release at 2:00 p.m. EST — February 1, 2023

Recent indicators point to modest growth in spending and production. Job gains have been robust in recent months, and the unemployment rate has remained low. Inflation has eased somewhat but remains elevated.

Russia's war against Ukraine is causing tremendous human and economic hardship and is contributing to elevated global uncertainty. The Committee is highly attentive to inflation risks.

The Committee seeks to achieve maximum employment and inflation at the rate of 2 percent over the longer run. In support of these goals, the Committee decided to raise the target range for the federal funds rate to 4-1/2 to 4-3/4 percent. The Committee anticipates that ongoing increases in the target range will be appropriate in order to attain a stance of monetary policy that is sufficiently restrictive to return inflation to 2 percent over time. In determining the extent of future increases in the target range, the Committee will take into account the cumulative tightening of monetary policy, the lags with which monetary policy affects economic activity and inflation, and economic and financial developments. In addition, the Committee will continue reducing its holdings of Treasury securities and agency debt and agency mortgage-backed securities, as described in its previously announced plans. The Committee is strongly committed to returning inflation to its 2 percent objective.

March 22nd:

FEDERAL RESERVE press release

For release at 2:00 p.m. EDT — March 22, 2023

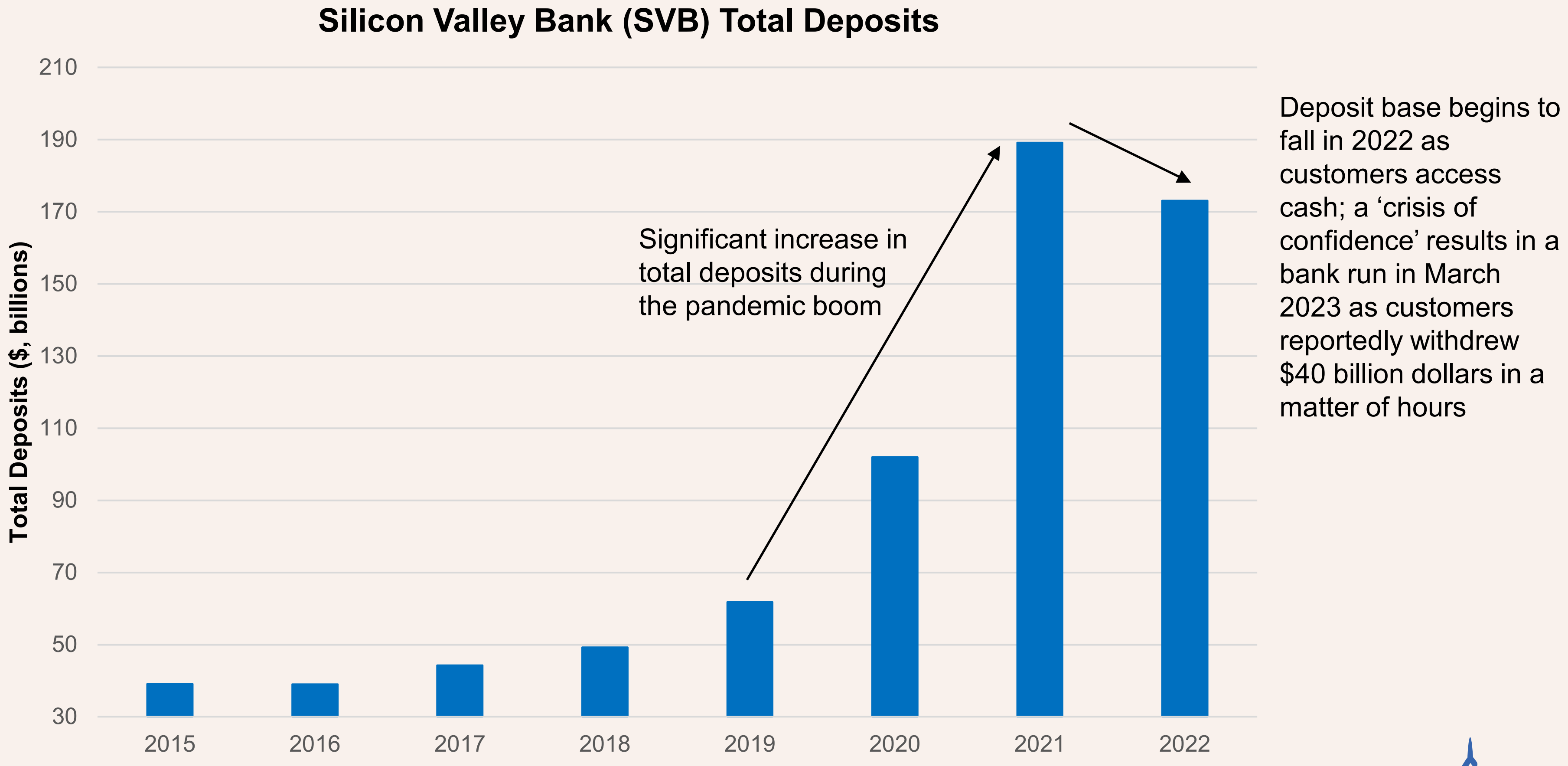
Recent indicators point to modest growth in spending and production. Job gains have picked up in recent months and are running at a robust pace; the unemployment rate has remained low. Inflation remains elevated.

The U.S. banking system is sound and resilient. Recent developments are likely to result in tighter credit conditions for households and businesses and to weigh on economic activity, hiring, and inflation. The extent of these effects is uncertain. The Committee remains highly attentive to inflation risks.

The Committee seeks to achieve maximum employment and inflation at the rate of 2 percent over the longer run. In support of these goals, the Committee decided to raise the target range for the federal funds rate to 4-3/4 to 5 percent. The Committee will closely monitor incoming information and assess the implications for monetary policy. The Committee anticipates that some additional policy firming may be appropriate in order to attain a stance of monetary policy that is sufficiently restrictive to return inflation to 2 percent over time. In determining the extent of future increases in the target range, the Committee will take into account the cumulative tightening of monetary policy, the lags with which monetary policy affects economic activity and inflation, and economic and financial developments. In addition, the Committee will continue reducing its holdings of Treasury securities and agency debt and agency mortgage-backed securities, as described in its previously announced plans. The Committee is strongly committed to returning inflation to its 2 percent objective.

Data Source: Federal Reserve

3) One of the strongest arguments for a pause in the hiking cycle comes from instability in the banking sector. Between poten tial congressional hearings and regulator reviews, Silicon Valley Bank's (SVB) failure will likely receive plenty of post-mortem analysis. From information known today, it seems SVB is a cautionary tale of a bank with an overly concentrated customer base, deficient asset/liability management, and poorly managed growth. The chart below helps demonstrate just how quickly SVB's deposit base grew following the pandemic boom, and how just a small drawdown in customer deposits eventually led to larger stability issues.



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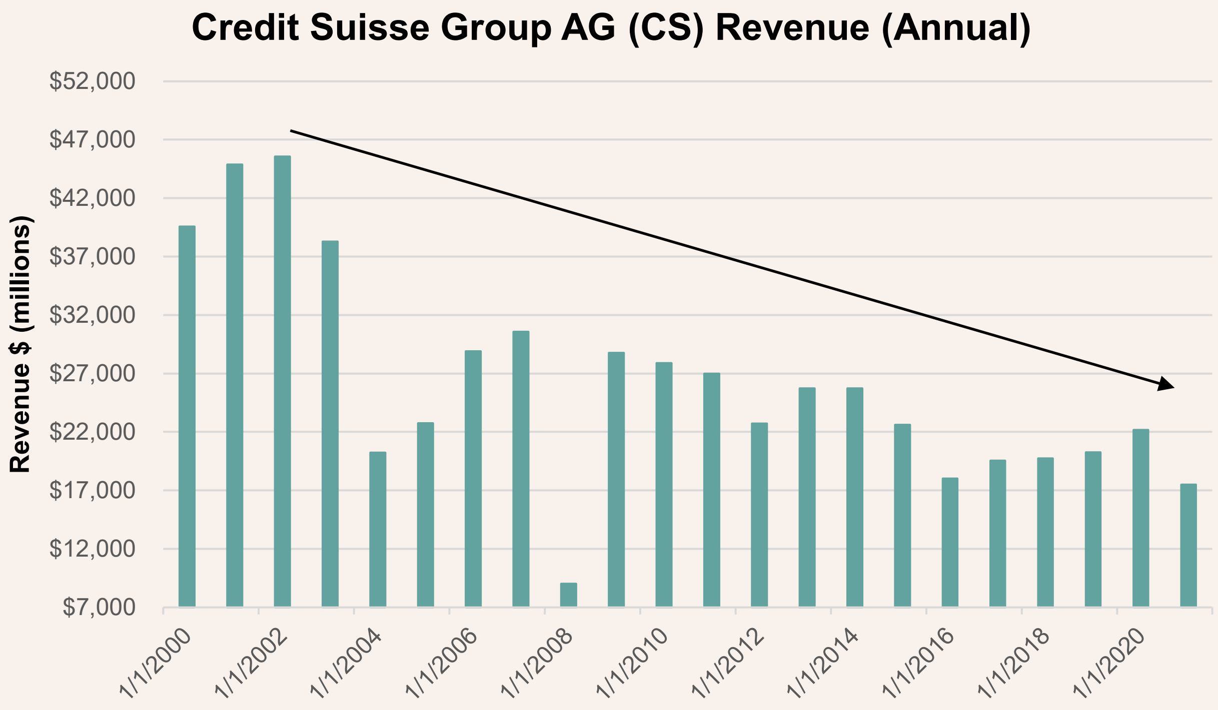
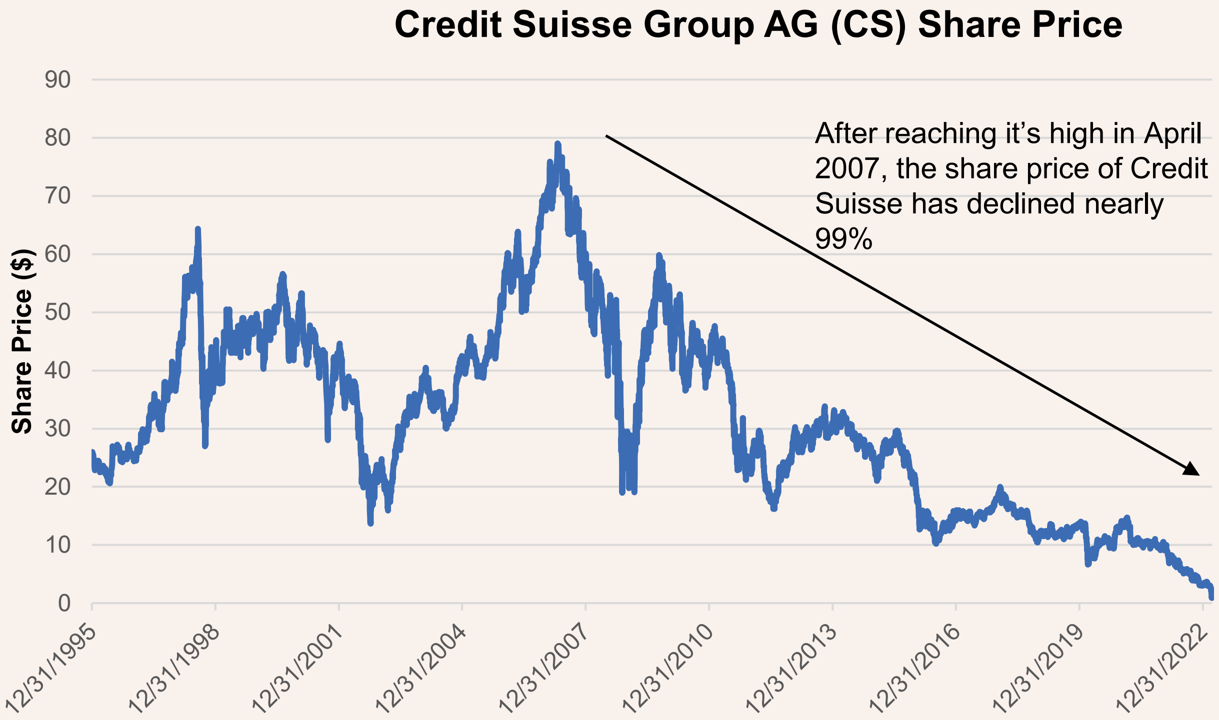
Data Source: Silicon Valley Bank Annual Report 10-K; Associated Press

4) Credit Suisse, a Swiss bank founded in 1856, also required a lifeline from the Swiss National Bank before agreeing to a ta keover by Swiss rival UBS. The acquisition marks the end of a once storied institution, that, in recent years, struggled to grow and was prone to scandal. Credit Suisse, designated as one of thirty globally systemic financial institutions, arguably posed greater contagion risk than Silicon Valley Bank. Fortunately, the merger with UBS appears to have helped ease some market uncertainty for now. For Credit Suisse shareholders, the UBS merger marks the end of a painful two decades that saw the stock price fall nearly 99% from its high.





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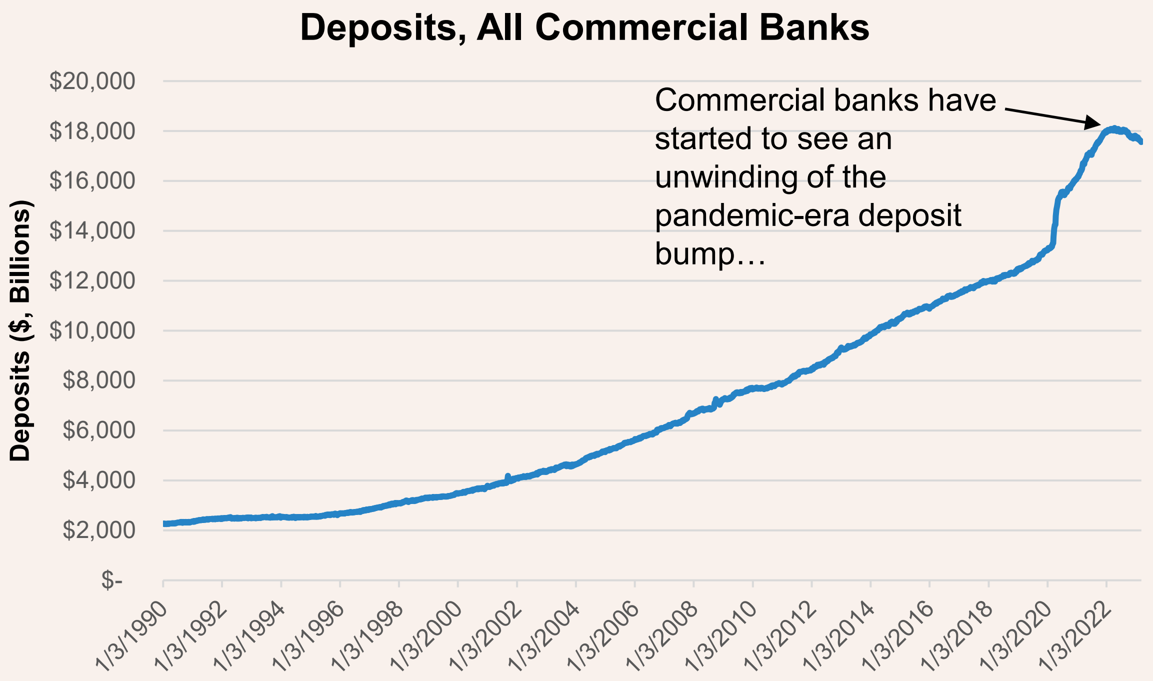
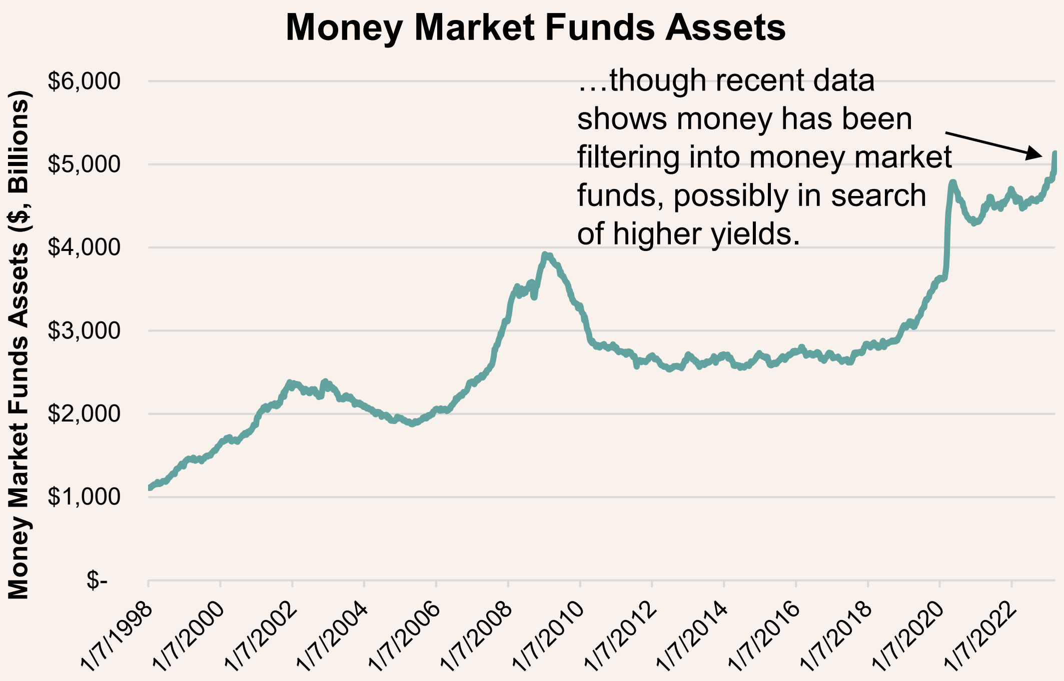
Data Source: YCharts; Financial Stability Board

5) Aside from regulations, the banking system operates largely on mutual confidence between the bank and its customers. In it s simplest form, banks expect customers to repay loans, and customers expect deposits to be available when they need them. Like SVB, bank deposits at commercial banks, in aggregate, appear to have peaked last year and have been slowly declining. There are several possible explanations for bank deposit drawdowns, including the expiration of pandemic era stimulus, rising costs, and depositors seeking higher yielding alternatives, such as short-term treasury bills or money market mutual funds. However, as we noted on slide 3, there were many factors unique to SVB's closure that may not be an accurate representation of the entire banking sector.





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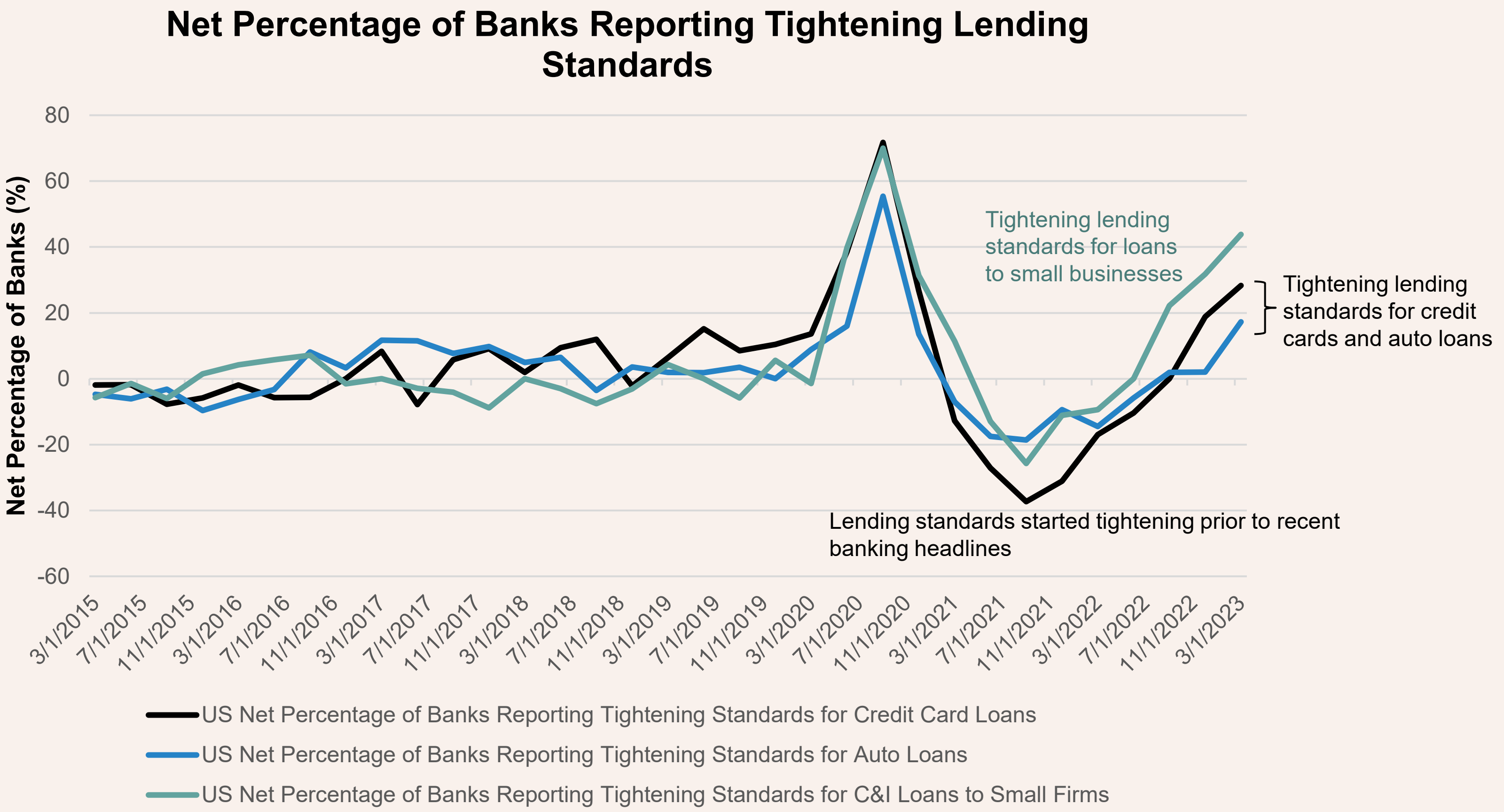
Data Source: Bloomberg, L.P.; Federal Reserve; Investment Company Institute

6) Prior to this week's interest rate increase, the Federal Reserve had to weigh the impact recent banking stress would have on the economy moving forward. One important area in particular is the lending market. The percentage of banks reporting tighter lending standards has been steadily increasing, even before the recent bank headlines. If banks continue to stiffen lending standards in the wake of recent events, this could further tighten financial conditions even in the absence of additional interest rate increases from the Federal Reserve.



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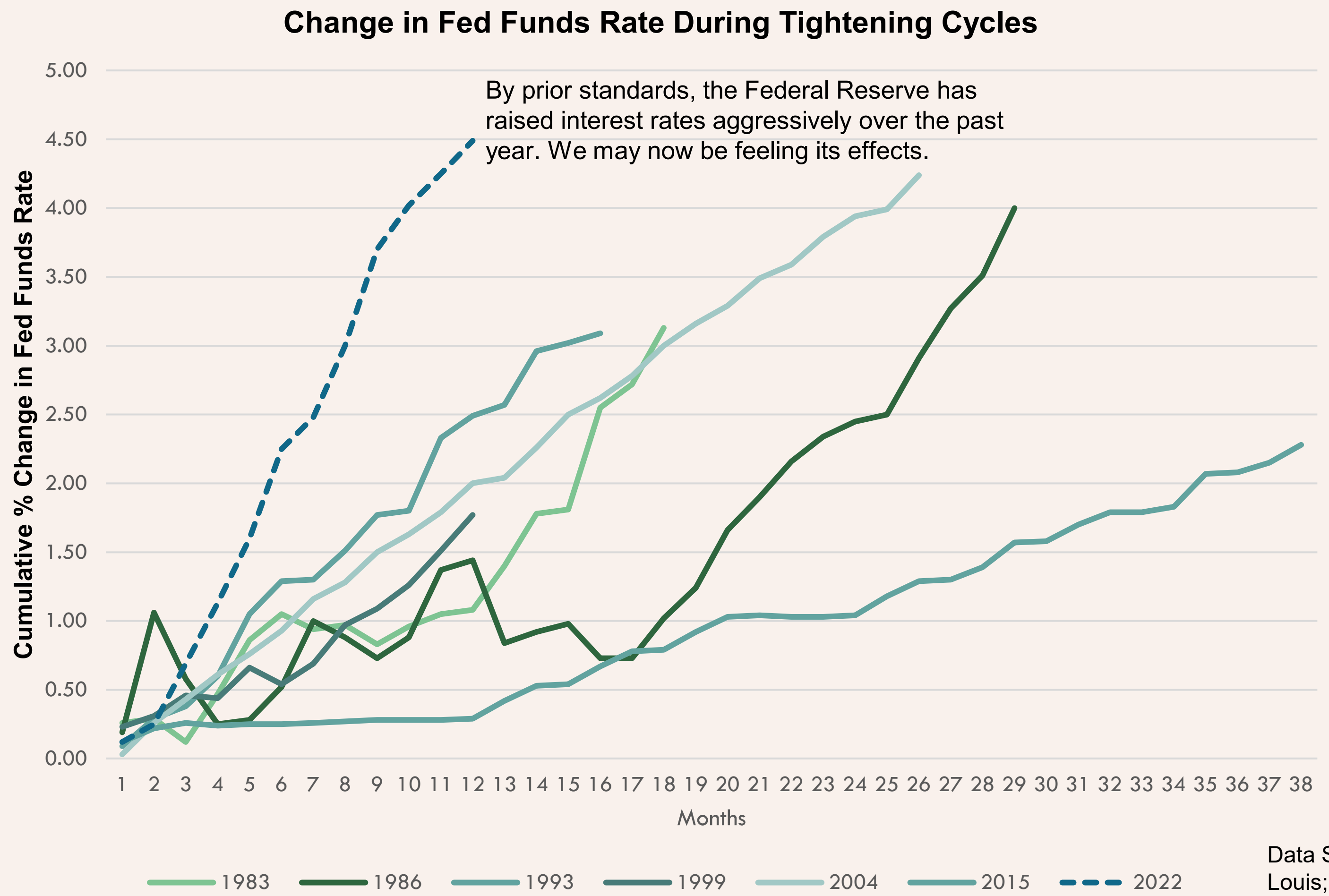
Data Source: YCharts; Federal Reserve

7) It is often said the Federal Reserve raises interest rates 'until something breaks.' Recent banking stress may have been just that, signaling interest rate increases are translating through the financial system. The Federal Reserve Bank of Atlanta states, "… it can take 18 months to two years or more for tighter monetary policy to materially affect inflation." Importantly, while interest rate increases are often felt first by consumers, such as in mortgage rates, it can take businesses slightly longer to adjust. This is because businesses are likely to continue business projects that may have been financed at lower interest rates. It isn't until new spending decisions need to be made that higher financing would come into account. Because interest rates only began rising sharply over the past 12 months, we may have not yet felt the full effects of tightening.



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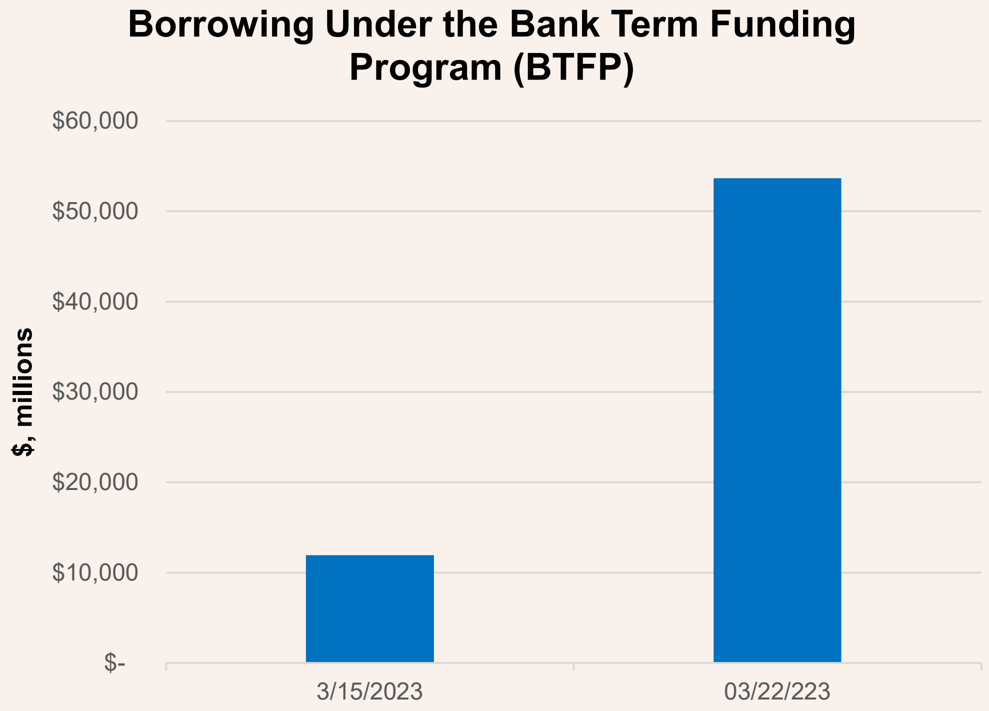
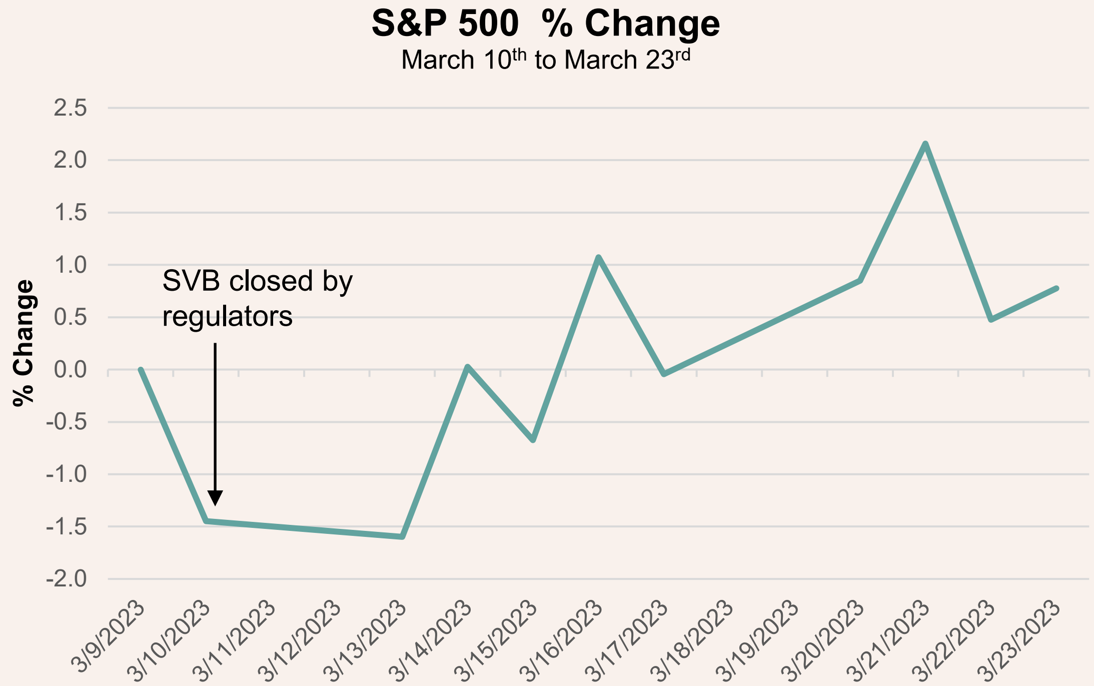
Data Source: Federal Reserve Bank of New York; Federal Reserve Bank of St. Louis; Federal Reserve Bank of Atlanta

8) While it may sound hopeful, current banking stress may have some benefits should it prove to be temporary. For one, it gives the Federal Reserve a real-time data point to pause and reflect on. Only two weeks ago it appeared the U.S. central bank was prepared to be more aggressive in their efforts to combat inflation. Today, the current environment provides an opportunity for the Federal Reserve to reassess and consider a more tactful approach in their efforts to restore economic balance. Since the failure of SVB, regulators have taken action to boost confidence amongst bank depositors and provide support to banks through newly established lending facilities. In a welcome display of resilience, the S&P 500 has held up well despite the negative headlines (as of the March 23rd market close). Our investment team continues to monitor developments in financial markets.



The Federal Reserve established the BTFP on March 12th. The program eliminates a bank's need to sell U.S. Treasury or agency securities that may have lost value as a result of interest rate increases during a time of stress. Rather, it allows for them to borrow against the par value, for up to one year.



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Data Source: YCharts; Federal Reserve, Bloomberg, L.P.

Interested in sending our investment team a note? Please send an email to wealthiq@marshallfinancial.com.

Adam Reinert, CFA, CFP®

Chief Investment Officer

George Evans II, MBA

Chief Investment Strategist

Sean Dann

Research Analyst

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Thank you for reading; please be well.

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