SAPPHIRE
FIDUCIARY ADVISORS

October 10, 2023

Dear clients and friends,

At Sapphire, we focus on what is knowable, meaningful, and actionable. On the investment front, these criteria help us muffle hype and disregard forecasters. They also prevent us from agonizing over things that cannot be known or controlled. The same approach guides the relationships we have with our clients. We actively cultivate and maintain a shared understanding of each client's financial situation, risk tolerance, and aspirations. This process enables us to center on the facts that are meaningful to our clients, their families, and their businesses.

Here's a fact that is having an extraordinary effect on the financial markets and on the real economy. The yield on the 10-year US Treasury Note has risen from 0.66% in April 2020 to 4.80% as of the last close. A "back-up" in interest rates with such speed and of this magnitude has not occurred since Paul Volcker led the Federal Reserve and consciously triggered recessions to fight double-digit inflation between 1979 and 1982.[1]

In the financial markets, this significant shift has resulted in negative total returns for bonds. (Bond prices and yields are inversely related.) Bonds are expected to mitigate portfolio risk, but they have not produced a positive calendar-year return since 2020. As measured by the Bloomberg US Aggregate index, bonds saw a decline of 1.5% in 2021, a substantial 13.0% drop in 2022, and a further 1.2% decrease year-to-date through September 30, 2023.

It is worth noting that the average maturity and duration of the Aggregate index make it considerably more sensitive to rising interest rates compared to our clients' fixed income portfolios. While many on Wall Street were hopeful that the Federal Reserve's stance on restrictive monetary policy was mere rhetoric, Sapphire took advantage of attractive yields on the short end of the curve to simultaneously reduce risk and increase income for our clients that have targeted fixed income allocations.

In the real economy, mortgage rates, which are highly correlated to the 10-year US Treasury Note, have jumped from less than 3% to roughly 8% over the past two years. This shock to the system has ended the refinancing boom, dramatically reduced the inventory of existing homes for sale, and resulted in affordability measures that haven't been this bad since the mid-1980s. Homeowners who have a choice are choosing not to relocate or to trade-up. Such moves would double monthly interest payments for most mortgage holders in the United States.[2] Higher rates are typically detrimental to the value of real estate (and most financial assets). Although the median price of homes sold in the US has fallen from its peak, the supply-demand imbalance has supported prices that remain 27% above year-end 2020 prices.[3]

Inflation in the United States remains persistently high, hovering at approximately double the level that the Federal Reserve has targeted. The Fed Funds rate currently stands at 5.5%, resulting in a prime rate of 8.5% – a level not witnessed since the year 2000. This economic landscape presents a formidable challenge to working families, as evidenced by widening income and wealth disparities, and the stark decline in household excess savings figures, which have plummeted nearly $2 trillion since 2021. The convergence of persistent inflation and rising interest rates poses significant financial pressure to households and small businesses across the nation.

Banks, previously optimistic about the prospect of rising interest rates and resultant net interest margin expansion, are now grappling with the unfortunate reality of net interest margin compression. Typically, retail deposits are a cheap source of funding for loans, but banks have had to "pay up," due to new competition from Treasury Bills and money market funds that yield over five percent. In addition, high-quality borrowers have had negotiating power, so many banks have not realized the full benefit of higher interest rates on the asset side of their balance sheets. To make matters worse, many banks find themselves in a situation where their bond portfolios yield less than the current cost of overnight borrowing.

(So, Mrs. Lincoln, how was the play?)

In spite of these formidable headwinds, the stock market, as measured by the S&P 500 index, advanced 13.1% year-to-date through September 30, 2023. That said, the rally can be attributed to the ten largest (as measured by market capitalization) stocks in the S&P 500 index – they did 97% of the lifting.[4] The Energy and Utilities sectors, which are often susceptible to changes in interest rates, have trailed all other industry sectors year-to-date through September 30, 2023. The Communication Services and Technology sectors contributed the bulk of the index performance during the first nine months of the year and were buoyed by enthusiasm about the potential of natural language processing, a branch of artificial intelligence.

With respect to non-US equities, the MSCI All-Country World Index (ex-US) advanced 5.8% year-to-date through September 30, 2023. Although some of our clients restrict us from investing in companies that have foreign domiciles, portfolios with targeted allocations to international equities hold funds that are managed by firms in England and Scotland that we have selected and monitor. Consistent with Sapphire's investment approach, these international equity allocations emphasize quality growth companies that typically exhibit distinct competitive advantages, proven management with aligned incentives, free cash flow growth, high returns on capital, attractive reinvestment opportunities, and financial strength. While not impervious to macroeconomic factors, such as rising interest rates, market sentiment, and recessions, we expect our clients' domestic and international equity portfolios to be less susceptible to interest rate volatility and economic cycles than portfolios of lower quality businesses.

Sapphire News

Last month, Sapphire repurchased ownership interests from Independent Community Bancorp, Inc. (ICBI). In connection with this transaction, we are pleased to report that Greg T. Watkins acquired additional membership interests in Sapphire. We are grateful for the relationships that ICBI developed for Sapphire during our affiliation and look forward to continuing to work with the outstanding financial professionals at Citizens Bank (Mount Vernon), Farmers National Bank (Lebanon), and The Peoples Bank (Marion).

Please contact Sapphire at any time if you would like to discuss your portfolio or to learn more about how we can be of service to you.

Respectfully,

Paul Stropkay

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Sources

• J.P. Morgan Asset Management *Guide to the Markets*® U.S. 4Q 2023 as of September 30, 2023

Disclosures

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[1] Bloomberg *Law of Unintended Consequences Caused the Great Bond Rout* by Niall Ferguson, October 9, 2023
[2] CNN, *Homebuyers must 'learn to live' with near-7% mortgage rates, says RE/MAX chairman* by Matt Egan, July 14, 2023
[3] https://fred.stlouisfed.org/series/MSPUS
[4] AllianceBerstein L.P. *Concentrated US Growth Performance Commentary 3Q 2023* by James Tierney, October 6, 2023