Marble Harbor Investment Counsel, LLC
Third Quarter, 2023 Letter

We are pleased to send an excerpt from our quarterly client letter that discusses our current thinking. We welcome your thoughts.

Sincerely,

Paul Davis, L.J. Harrington, Eric Robb, Daniel Rosenblatt and Howie Cowan

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Financial repression was what some called it. From 2008 until last year, frustrated savers and retirees lamented that artificially low interest rates deprived them of much needed income. A mere 24 months ago, $1 million invested in one-year Treasury bonds would generate a paltry $1,000 in income – enough for a careful traveller to spend a weekend in a New York City hotel. At the same time, gleeful borrowers – such as younger home buyers – were locking in historically low sub-3% 30-year mortgages, and companies like Berkshire Hathaway were borrowing for 30 years at a pittance.

Today, the tables are turned. Savers have the upper hand, and $1 million can generate $50,000 in a year – enough for a new car. Gen Z home buyers have to borrow at 7% to get a mortgage to buy their first house. Interest rates have become a generational double-edged sword. You might think that these mortgage rates would be dreadful for the housing market and the economy, but that hasn't proven to be the case to date. Why is that, and what implications does it have for your portfolio?

The average of all outstanding homeowner mortgages is about 3% with a fixed rate. No matter if the prevailing market interest rate is approaching 8%, if they had a $1,000 monthly payment two years ago, they still have a $1,000 monthly payment. The rise in interest rates has encouraged homeowners to stay put in their homes and stick with their low interest rate mortgages. At the same time, Millenials and Gen Zs, who got a slow start compared to past generations, have now started to form households at a rapid clip. The U.S. is still recovering from a dearth of homebuilding in the wake of the Great Financial Crisis: we still have millions too few homes. These factors have all combined to support a healthy, if slow, housing market.

In the 2008 housing debacle, many mortgages used floating rate debt, but homeowners learned their lesson, and so their homes are now mostly financed with long fixed-rate mortgages. On the asset side of a homeowner's balance sheet, cash has accumulated from COVID and rising wages. Right now, many U.S. homeowners are generating a profit because they have borrowed at a low rate and are lending their cash out at 5% or more simply by buying U.S. Treasury bonds, making 2% in profit. This is quite a stimulus for the U.S. consumer and a support to the global economy.

Large U.S. companies similarly borrowed long-term debt at low rates and are earning much higher returns in cash. Their balance sheets are mostly in excellent shape. Berkshire

Hathaway borrowing for 30 years at 0.5% looks oracular now that Mr. Buffet is investing his cash in 5% Treasuries.

With homeowners and companies enjoying strong balance sheets with largely fixed interest payments, the U.S. economy is less sensitive to changes in interest rates than it was in the past. This has helped to maintain the housing market and the whole economy. What does this mean for the role that bonds may play in your portfolio?

For 15 years through early 2022, interest rates were historically low. Bonds were a "weather anchor" for your portfolio since they generated little income, but they did preserve value and decreased the volatility of your investments in times of stress. With paltry yields on offer, we were not compensated for lending for a long period of time and had to make do reinvesting in short-term maturities. We owned bonds not to generate a return on capital, but only to return your capital. We turned to equities to generate both higher income and returns on your capital. That worked out nicely.

Today bonds are a bit more exciting. Treasury securities start at about 5.5% at 6 months and range down to approximately 4.8% at ten years. Importantly, these rates are about 2% above inflation: real rates (that is, net of inflation) haven't been this high since before 2008. Municipal bonds – without state or Federal tax – have yields of about 3.5%, and high-quality corporate bonds have yields of between 5 and 6%. On the more venturesome end of the spectrum, Floating Rate Funds can yield 10%. This is a more volatile asset class, closer to investing in an equity than a Treasury bond; however, you are getting paid for the additional risk, which is appropriate as a portion of a bond portfolio.

While the bond returns are lower than the historical returns for equities, they offer a more alluring alternative than they have for years. You may see more bonds in your portfolio, and some that have longer dated maturities, as we actively take advantage of the higher yields to generate better risk- adjusted returns for you.

Even money market and savings accounts can yield between 3 and 5%, which keeps you at least keeping pace with inflation. We encourage you to look at the rate your bank is offering on your savings accounts. Many banks have not raised their savings rates to be competitive – choosing to keep that money for themselves. For each $100,000 sitting in a savings account paying 1% interest, you are contributing about $4,000 in income to the bank. That's a whole closet full of shiny new wingtips, brogues and loafers for your banker. You can buy a CD with some of those funds, or purchase Treasury Bills and earn 5% or more.

For the past 8-10 years, most of the bonds we have bought have matured within a few years. With higher rates, we are now taking advantage of the more attractive yields and selectively buying some medium-term maturities to lock in these rates in the event that they fall again in the future.

From the Financial Crisis up through today, a combination of demographics and globalization kept interest rates persistently low, favoring borrowers over lenders. The Baby Boomers, the

largest U.S. generation, stayed in the workforce longer than their predecessors, keeping wage rates low. Now as the Baby Boomers (25% of the workforce) retire and globalization is in abeyance, tighter wage growth may result in continued elevated interest rates. This new environment smiles upon lenders and investors. With the renaissance in yields, bonds are a reenergized tool with which we can actively position your portfolios to profit from higher rates. We are finally seeing that two- edged blade cutting our way.

Sincerely,

Paul, Eric, LJ, Dan and Howie

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