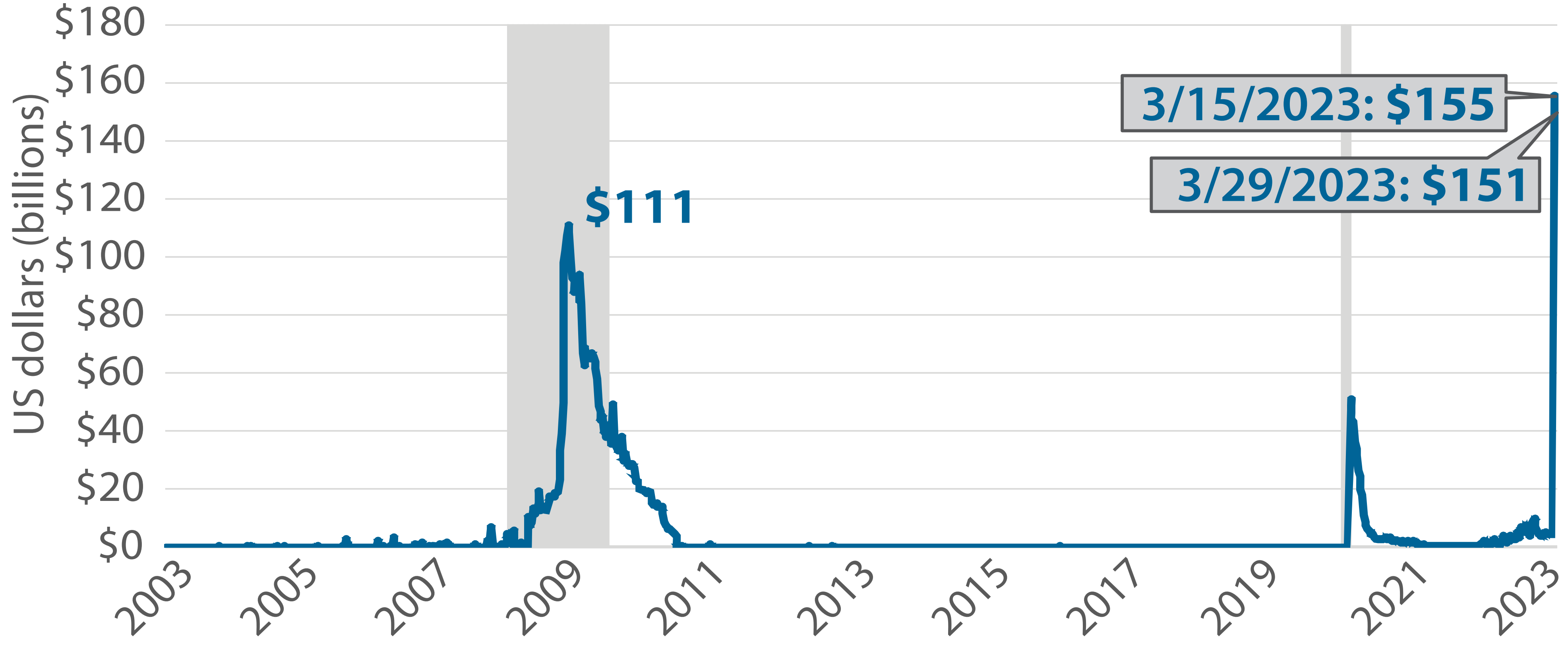
Miller Howard INVESTMENTS

Banking Turmoil Adds to Risks

QUARTERLY REPORT 1Q 2023

When inflation swells, hawkish economists typically advise the Fed to raise interest rates until something breaks. Mission accomplished! The banking turmoil started with Silicon Valley Bank (SIVB, not held). SIVB became vulnerable—not by making bad loans, but by buying long-dated bonds prior to the recent rise in interest rates. SIVB's deposit base was dominated by tech companies with balances well above the FDIC guarantee. It was the perfect setup for a bank run.

Banks Have Heavily Borrowed from the Fed To Increase Liquidity



As of March 29, 2023. Data reflect credit supplied by the Federal Reserve, including the Federal Reserve's Primary Credit and Bank Term Funding programs.
Source: Federal Reserve Bank of St. Louis.

On Wednesday, March 8, SIVB issued a press release announcing they had raised capital by selling equity and convertibles, but crucially, they had sold $1.8 billion in bonds at a loss. The entire package was meant to soothe the market, but their tech savvy depositors proved to be quick on the trigger. Armed with mobile phones, depositors pulled their money with lightning speed, forcing SIVB to sell even more bonds at a loss. The panic of the depositors pushed SIVB into bankruptcy despite the solid credit quality of their assets. By Friday, March 10, regulators had taken control of SIVB branches. Ultimately, most of the SIVB assets were sold to First Citizens (not held).

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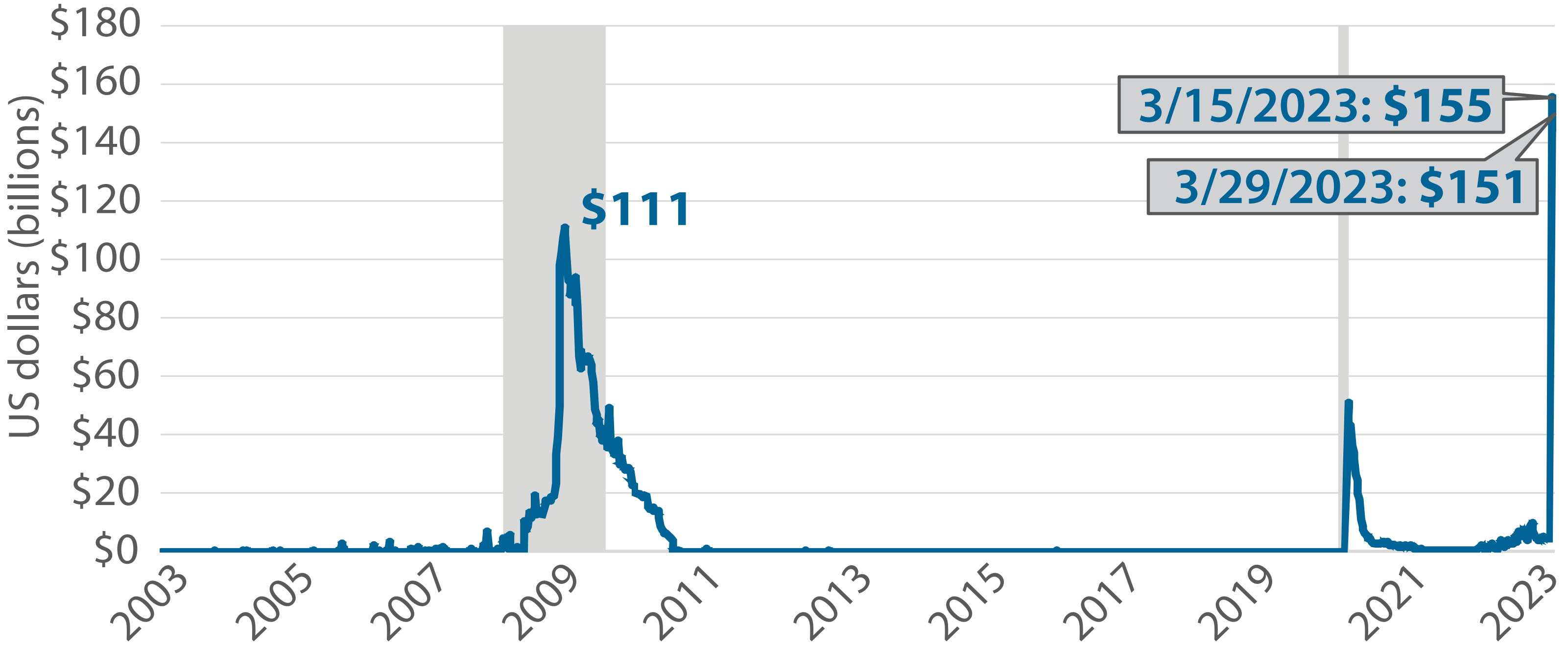
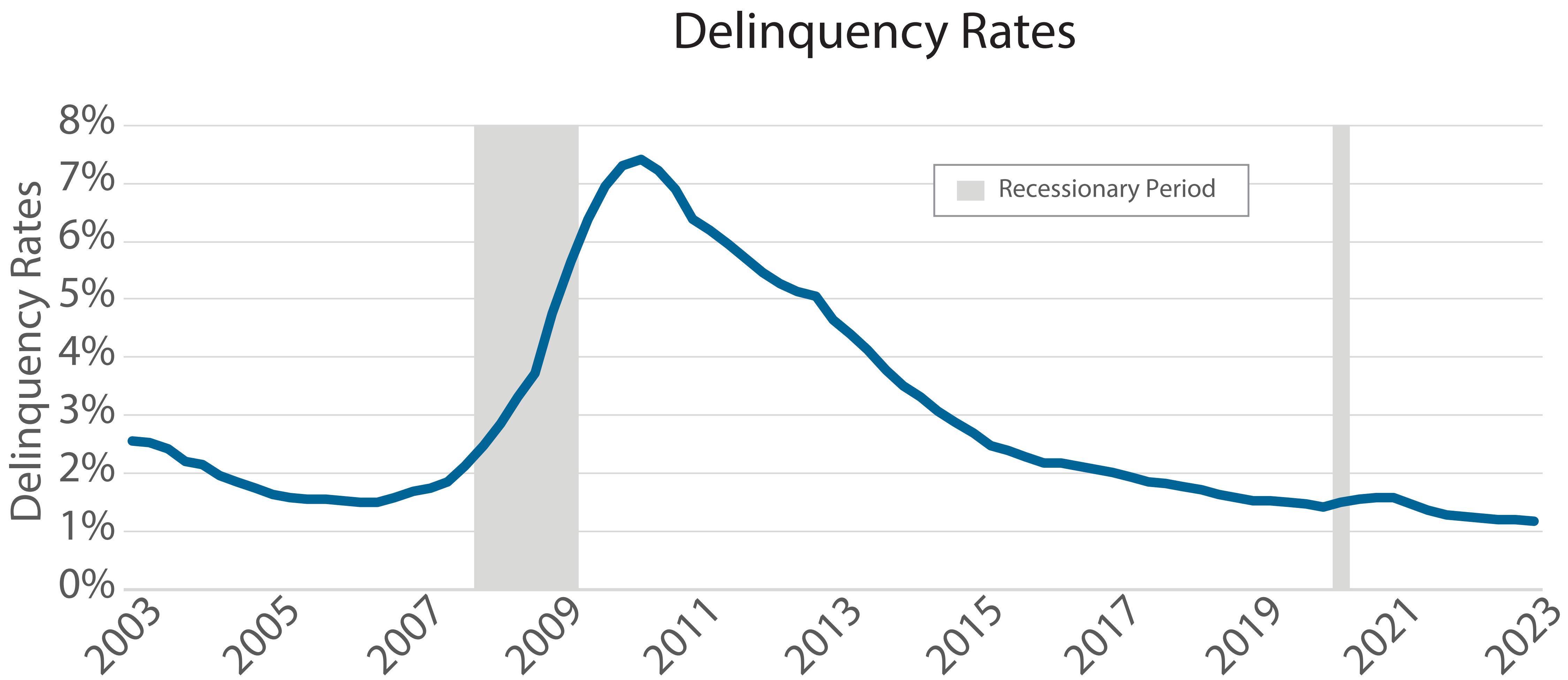


As of March 29, 2023. Data reflect credit supplied by the Federal Reserve, including the Federal Reserve's Primary Credit and Bank Term Funding programs. Source: Federal Reserve Bank of St. Louis.

Most banks have a much more diversified deposit base than SIVB, but most also own some longer-dated bonds that could only be sold at a loss at current levels. Working with regulators, banks have increased their liquidity by borrowing heavily from the Fed using both the discount window and the newly created Bank Term Funding Program. Historically, there has been a stigma to using these types of facilities, causing banks to only go this route in times of stress. Meanwhile, sources close to the Federal Home Loan Banks have indicated that lending from these "next-to-last resort" facilities has grown at almost twice the pace of loans from the Fed.

Overall, the banking system now seems ready to handle runs on deposits in our view, although the chance remains that another weak player may run into trouble.

Credit Metrics Remain Strong



As of December 31, 2022.
Source: Federal Reserve System.
Delinquency rate is based on charge-off and delinquency rates on loans and leases at commercial banks (seasonally adjusted).

While US banks were bolstering liquidity to fend off any runs on deposits, credit metrics remained remarkably strong. The classic way to lose money in banking is to make loans that are not paid back. The most forward-looking credit metric, loan payments more than 30 days delinquent, still looks good across loan types.

On the same Friday that regulators took over SIVB branches, Signature Bank (also not held) experienced a run on deposits and was shut down that weekend. Signature had high exposure to the cryptocurrency industry, giving it a concentrated deposit base like at SIVB. Regulators arranged a sale of Signature a week after it closed.

The turmoil among financials did not stop with US regional banks. On March 14, Credit Suisse (not held) announced that it was delaying its annual report after finding material weaknesses in past reports. As with Silicon Valley Bank, the story played out very quickly. Over the following weekend, Swiss regulators engineered the takeover of Credit Suisse by UBS (not held).

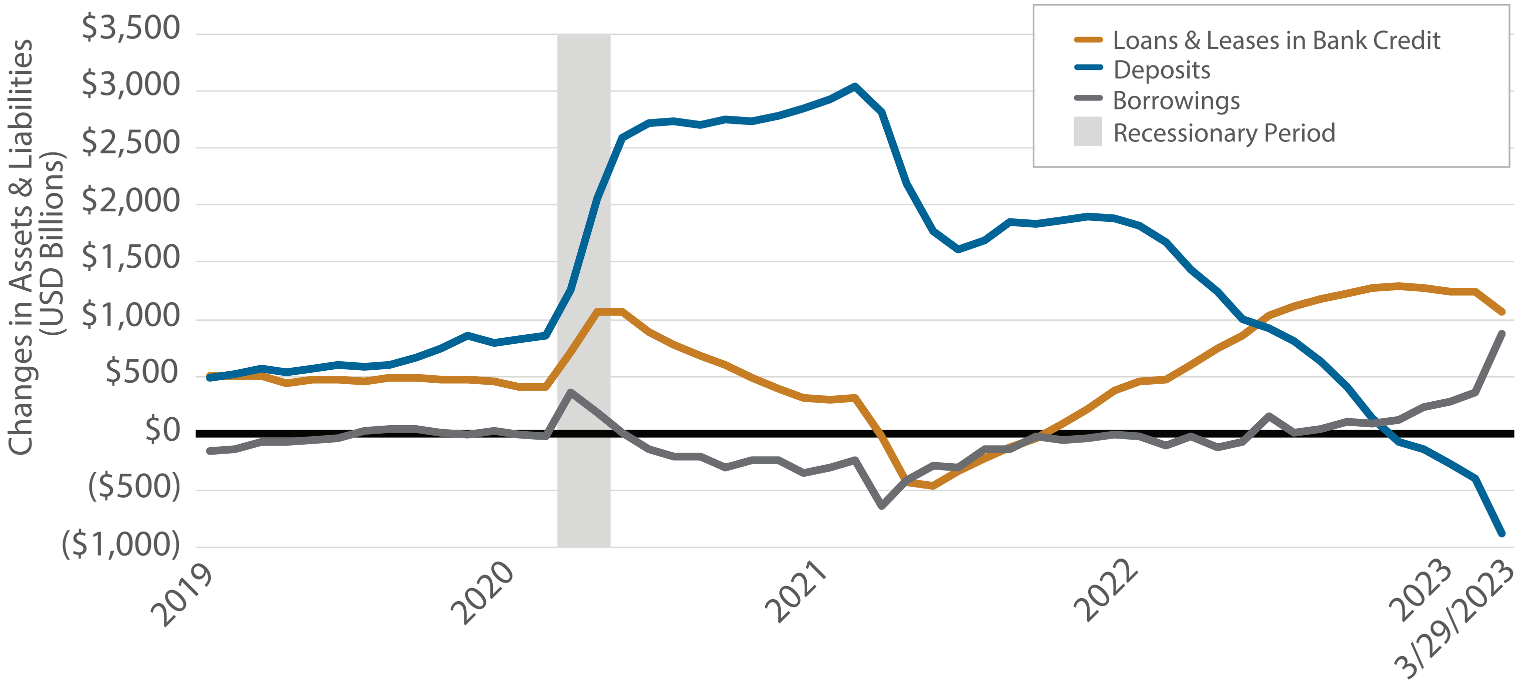
Why should US investors care? Credit Suisse had a levered balance sheet with global assets worth over half a trillion dollars. Fortunately, Swiss regulators did not allow a Lehman-like outcome, but without a doubt, the financial system is stressed.

It's the Interest Rates

Even prior to the failures of Silicon Valley Bank, Signature Bank, and Credit Suisse, higher interest rates were having an impact on banks. **Beginning in mid-2022, deposits began to shift in two directions: toward time deposits within the banking system and toward money market funds**. Clearly depositors made these shifts to earn higher interest rates. Overall, bank deposits have only dropped from $18 trillion to $17.5 trillion so far, but the muted decrease was likely caused by higher interest rates on deposits. Banks have had to depend more on borrowing for funding, putting negative pressure on margins.

Bank Funding Shifts from Deposits to Borrowing

US Banks: Loans Flat, Deposits Down, Borrowing Up



As of March 29, 2023. Source: Federal Reserve Bank of St. Louis. Data reflect monthly year-over-year changes in the assets and liabilities of US commercial banks.
Note: Weekly data for March 29, 2023 is calculated against weekly data for March 30, 2022.

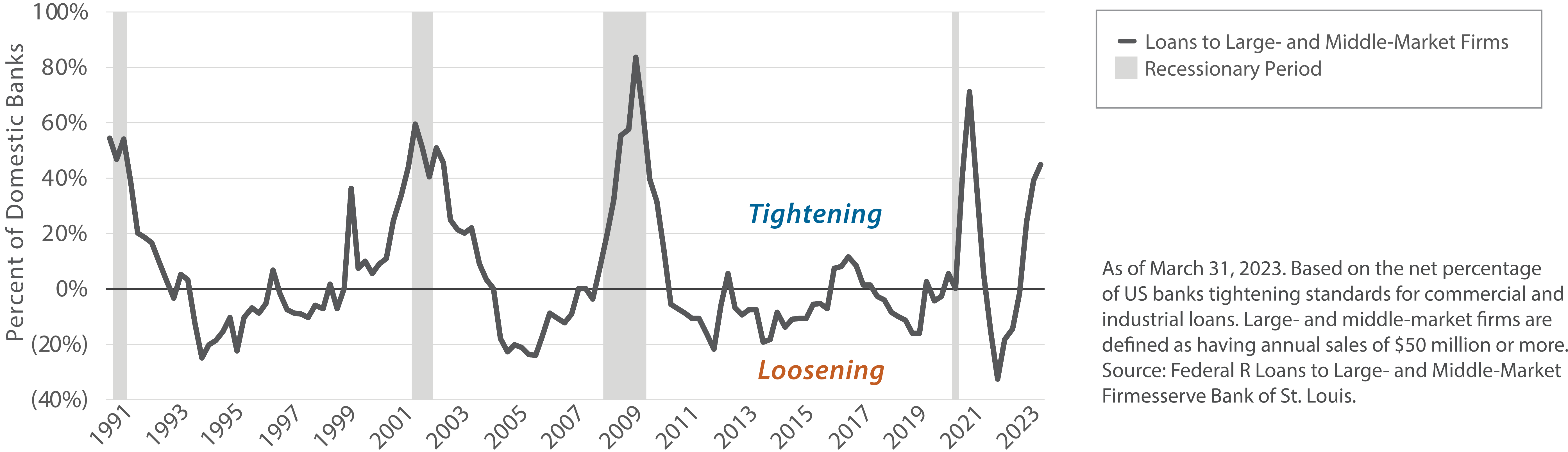
Loan growth began to slow in 4Q 2022, most likely a response to higher interest rates. This was a change from earlier in 2022 when bank loan growth finally broke out of its pandemic funk, with total US bank loans growing above 12% in the second and third quarters.

Slower loan growth means the Fed's hawkish monetary policy is having its desired effect, putting the brakes on the economy.

Note, this was happening before the recent bank failures. The critical question—both for the banks and the overall economy—is how will lending change now that the sector is under stress?

Following the bank run scare, **we expect the banks to pull back on lending in order to preserve capital.** The Fed's survey of senior loan officers indicates that standards were tightening for commercial and industrial loans, as well as a range of consumer loans, even before the demise of Silicon Valley Bank, Signature Bank, and Credit Suisse. We believe upcoming survey results will reflect further contraction. Historically, the senior loan officer survey has been an excellent predictor of recessions. The contraction in credit standards combined with the Fed's continued interest rate hikes make a recession more likely than not, in our view.

US Banks Are Tightening Lending Standards



As of March 31, 2023. Based on the net percentage of US banks tightening standards for commercial and industrial loans. Large- and middle-market firms are defined as having annual sales of $50 million or more. Source: Federal R Loans to Large- and Middle-Market Firmesserve Bank of St. Louis.

Recession More Likely than Not

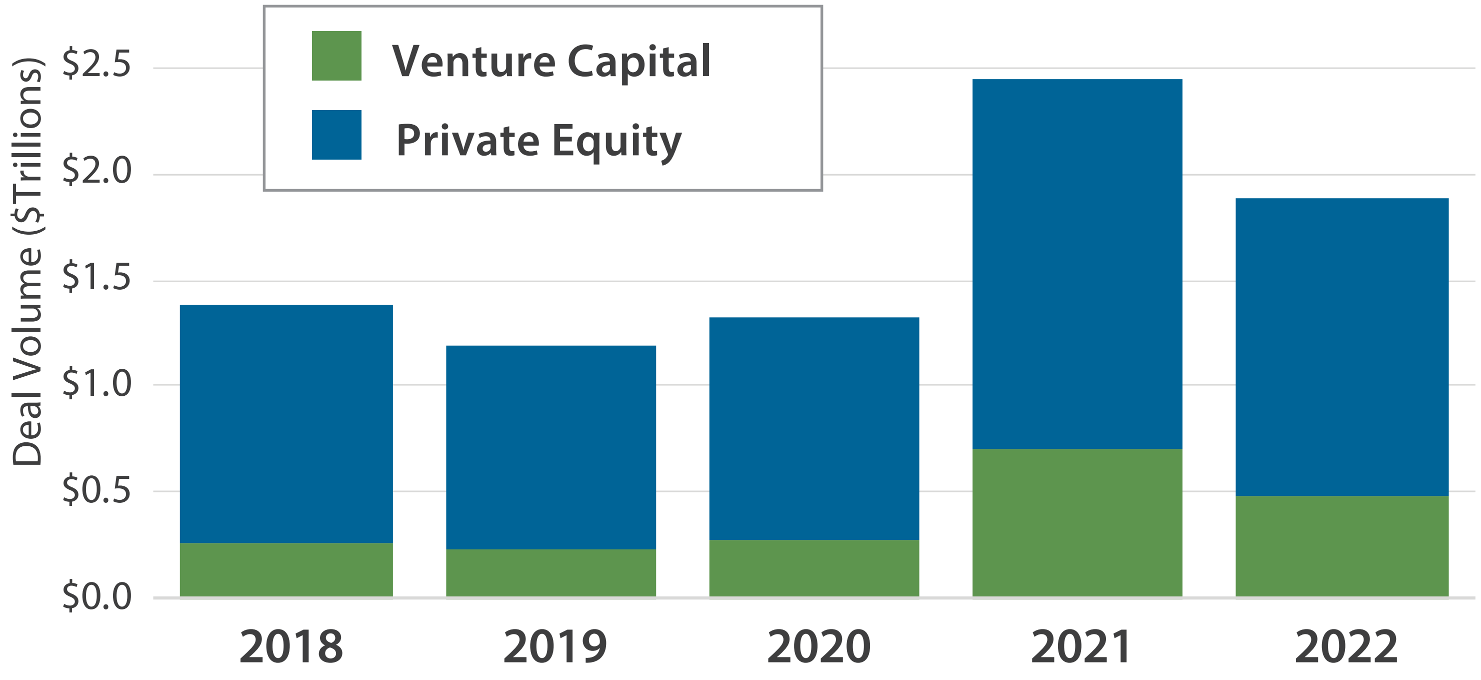
Currently, the interest rate on a 2-year Treasury bond is roughly 1% below the Fed funds rate —meaning the bond market is predicting that the Fed will begin cutting interest rates within a year. In essence, **the bond market believes that economic growth will turn negative soon,** and it suggests that we'll see at least some evidence that inflation is coming under control —the two conditions the Fed would require before reducing rates.

A mild recession, like a spring rain, could create the conditions for economic growth to resume without causing undue hardship. In that scenario, unemployment would rise moderately, suppressing wage inflation. Capital spending and consumer spending would slow, without an abrupt stop. The banking sector would have narrower net interest margins and modestly higher credit losses. The best argument for a mild recession is that we would begin with buffers that we did not have in 2008: higher personal saving and lower debt loads for both consumers and businesses.

High Leverage Lurks in Private Equity

Historically, the typical company has operated profitably through a recession, and so we expect that most dividend-paying companies will continue to make regular dividend payments, with a significant fraction even raising the dividend. Our concern should not be with the average company, but with outliers.Just as Silicon Valley Bank had unusual characteristics that made it more vulnerable in the current environment, companies in other industries may be similarly at risk.

High Private Equity & Venture Capital Deal Volume Drive Risk



As of December 31, 2022. Sources: Bloomberg. All global private equity & venture capital deals announced between 1/1/18 and 12/31/22.

Debt is always the leading cause of financial fragility, in our view. Talking heads on TV will occasionally bemoan the amount of leverage at US companies, but we view this as largely a private equity problem. Flows into private equity have been massive over the past two decades, creating a large swath of highly-levered companies that could create vulnerabilities for the economy as a whole.

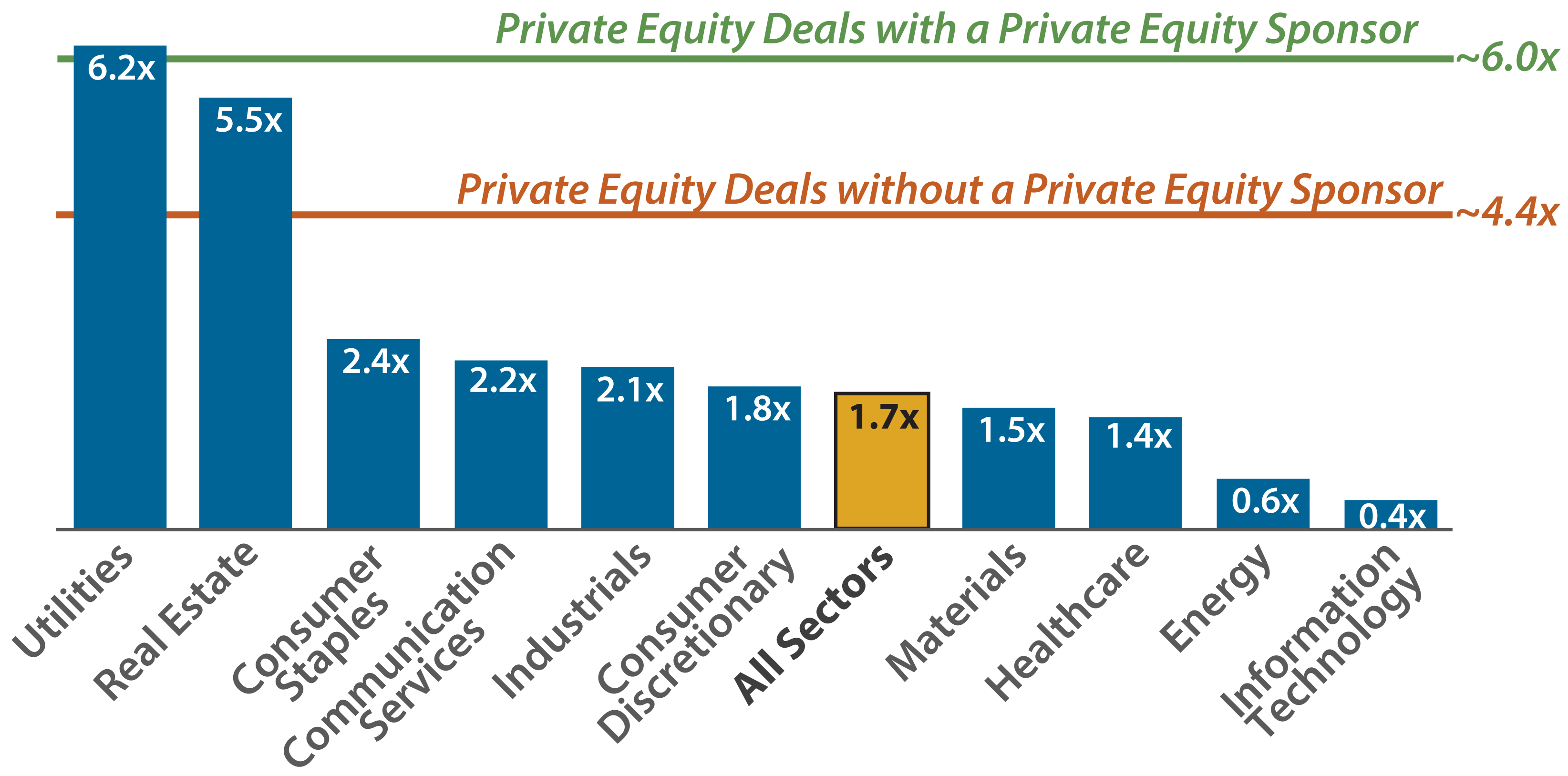
As originally conceived, private equity was meant to allow for messy restructurings away from the prying eyes of the public market. In our view, however, much of the attraction over time came from a perceived lack of volatility and the ability to lever up using low-interest rate debt.

Leverage at most public companies is substantially lower than exists in private equity. For companies with private equity sponsors, leverage reportedly averages six times net debt to EBITDA, well above the levels seen in public equities. Today's higher interest rates will make similar deals hard to initiate, and will make it difficult to roll debt when it matures.

Excessive leverage can lead to bankruptcy, but more frequently, it forces asset sales or capital raises at unfavorable terms. Companies flush with cash can take advantage of these situations, making one firm's crisis another's opportunity.

We view companies with low or no leverage and strong free cash flow as best positioned to prosper through difficult times.

Average Public Company Leverage Is Well-Below Typical Private Equity Levels



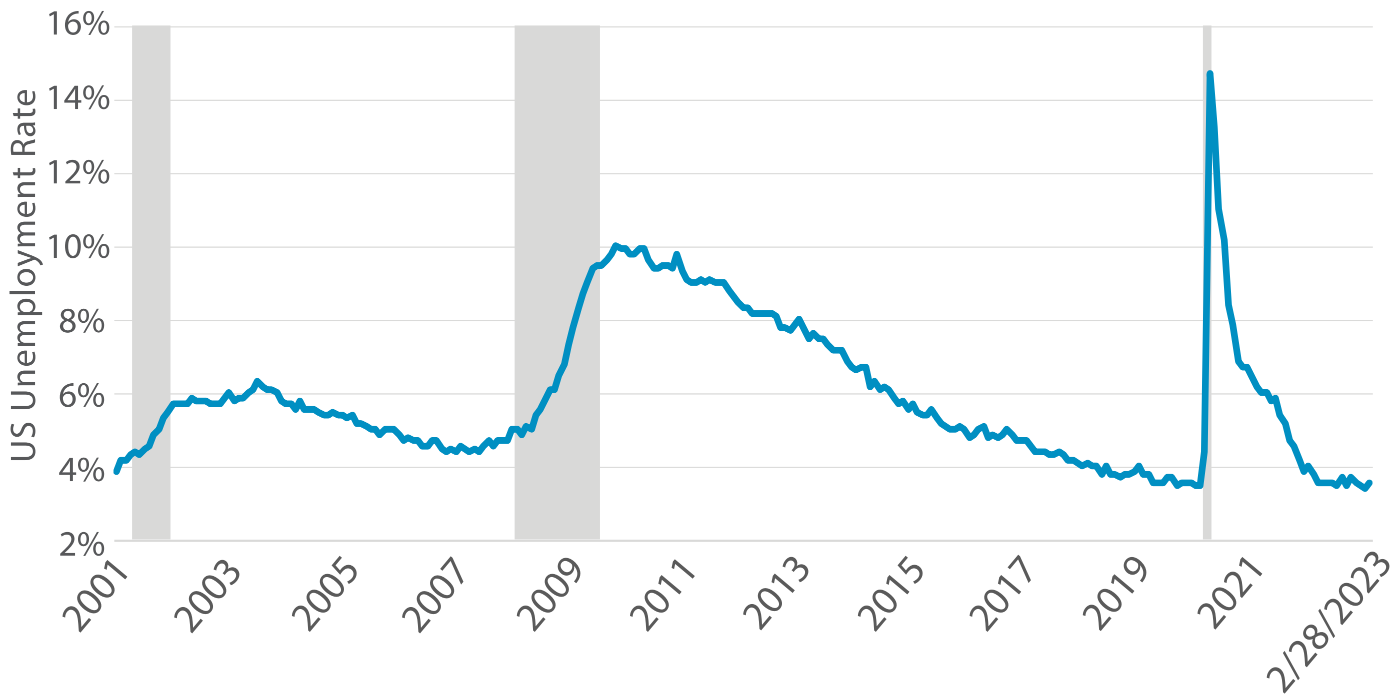
As of December 31, 2022. Source: Bloomberg. Leverage is based on 2022 net debt to EBITDA. Net debt and EBITDA are aggregate for the trailing 12-month period. Sector members are based on members of the S&P 500 Index. GICS sector financials has been excluded. Private equity deals with and without a private equity sponsor are as of calendar year 2021 per Bloomberg News report "Private Equity's Latest Deal Wave Brings More Leverage Than Ever" published January 13, 2022.

The Optimistic Economic View

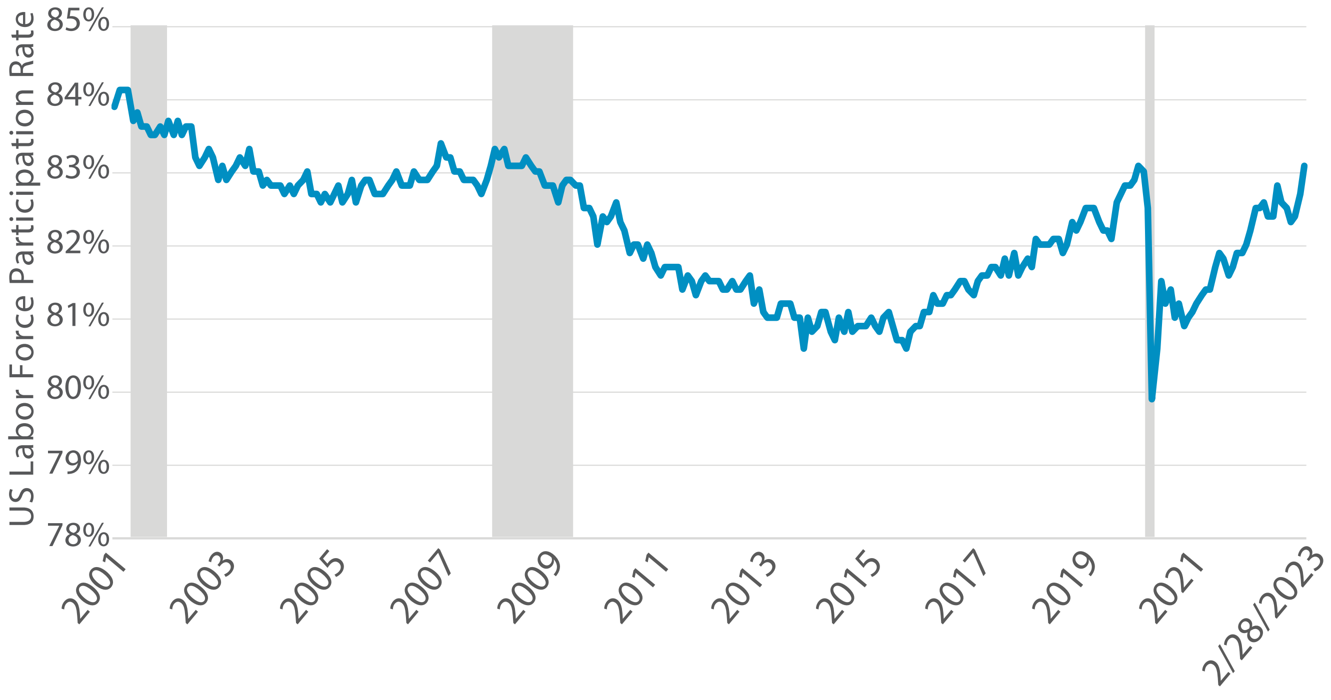
While we believe that a recession is now more likely than not, a declining number of analysts are still arguing for a soft landing. The unemployment rate is very low at 3.6%, but past recessions have started with low unemployment rates. Labor force participation is still rising off the pandemic bottom. If this trend continues, it could serve to dampen wage growth—the Fed's key inflation concern.

US Labor Market Remains Strong

Low Unemployment Rate



High Labor Force Participation Rate



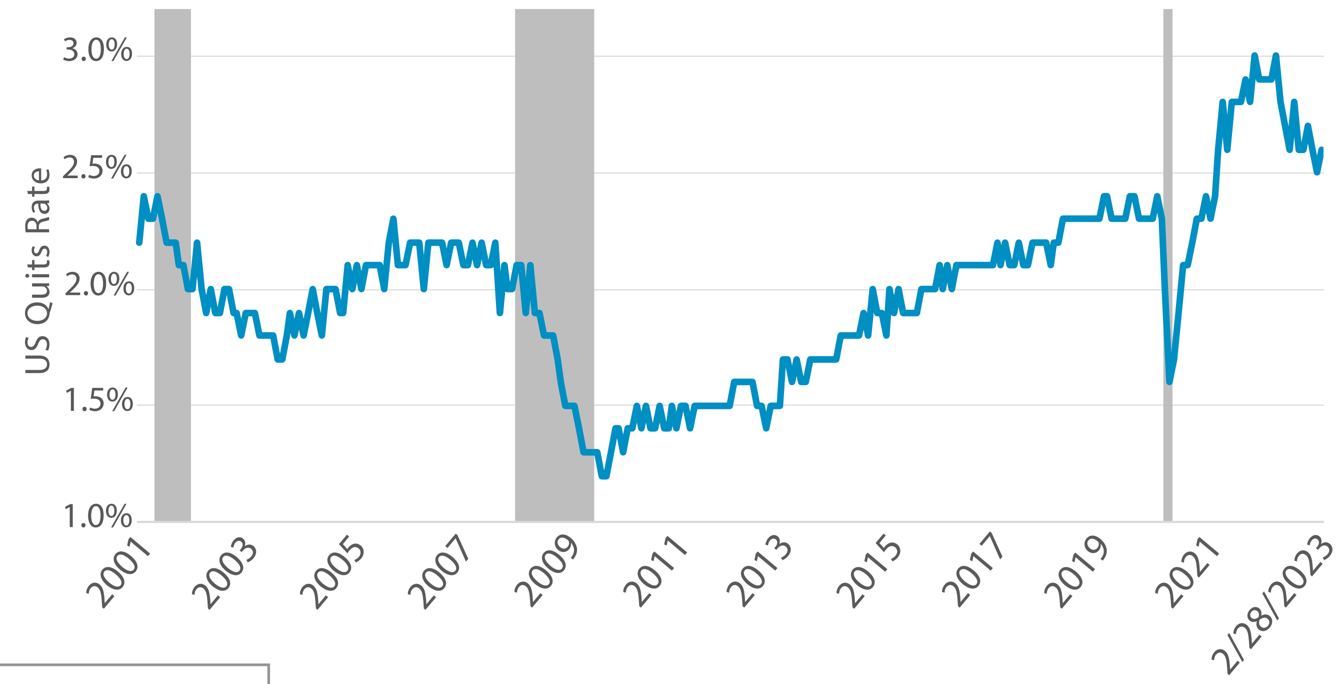
Recessionary Period

As of February 28, 2023. Source: Bloomberg. The unemployment rate tracks the number of unemployed persons as a percentage of the labor force (the total number of employed plus unemployed). These figures generally come from a household labor force survey. The labor force participation rate is the total labor force as a percent of the working age population (25-54 years).

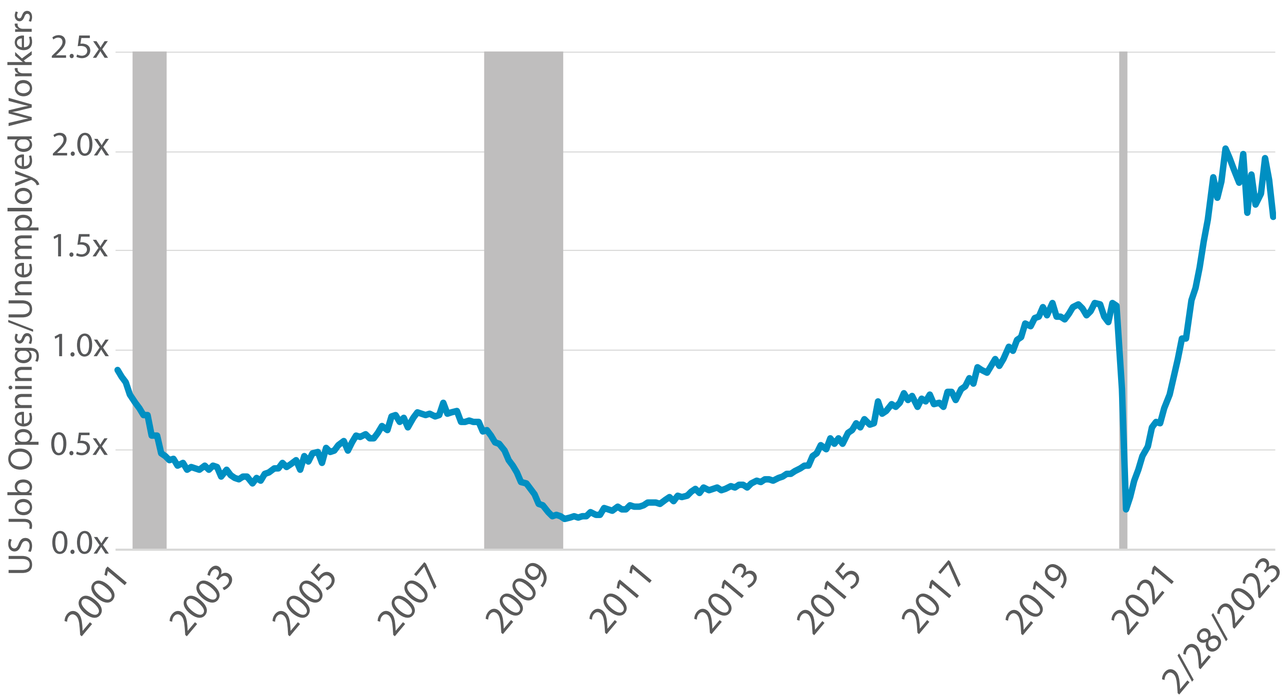
The best measure of job market tightness is the number of job openings per unemployed person. Historically, there are fewer openings than unemployed, but currently, there are roughly two jobs for every unemployed person. This creates a buffer, allowing for continued employment even when some companies announce large layoffs. The high frequency of quits indicates that workers remain confident that a better job is out there.

US Labor Market Remains Strong

High Quit Rates



High Job Openings/Unemployed Workers



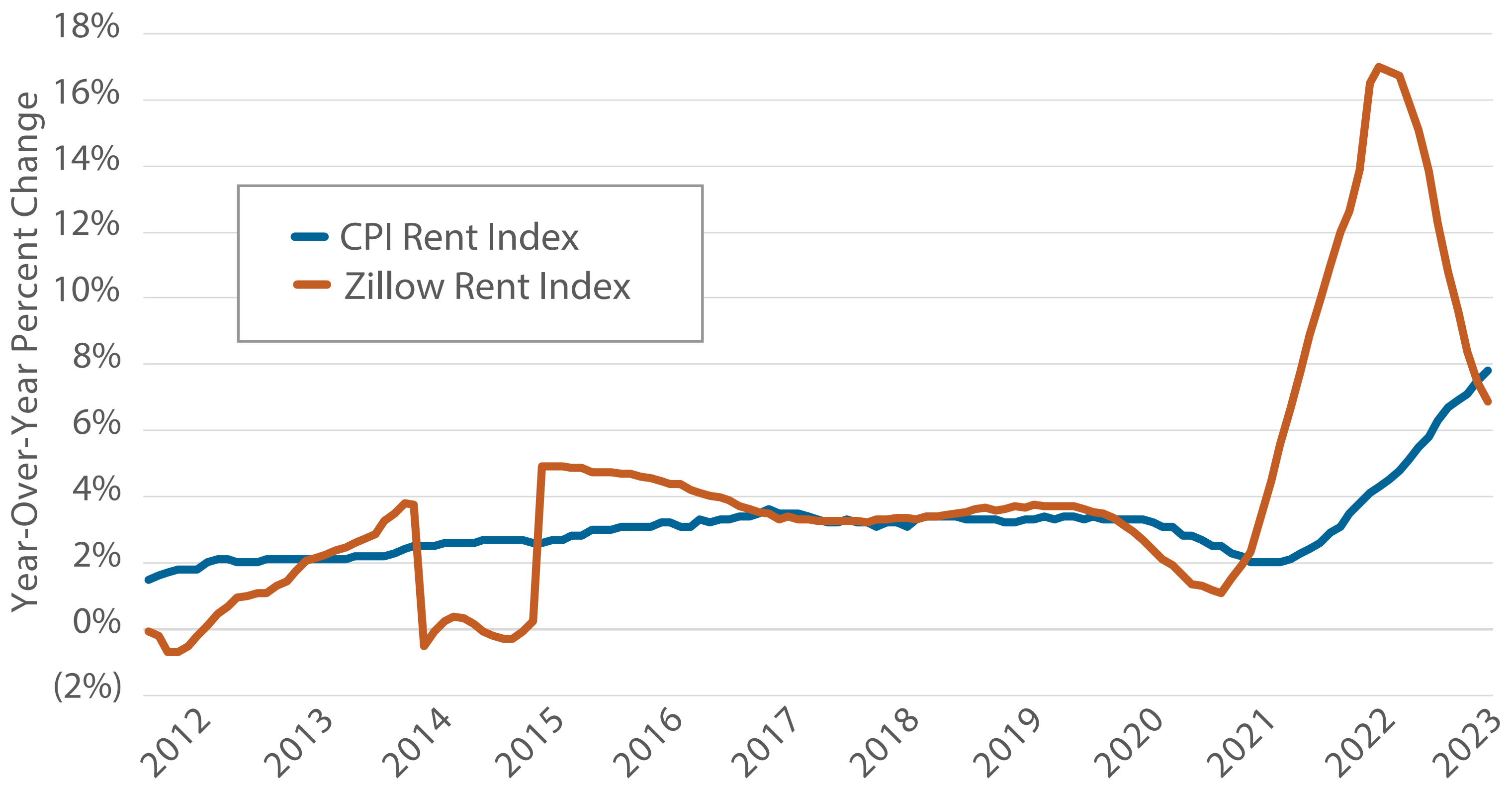
Recessionary Period

As of February 28, 2023. Source: Bloomberg. Quits Rate: This concept tracks voluntary job separations initiated by the employee. Job Openings is measured using the US Job Openings By Industry Total seasonally adjusted. This concept tracks the number of specific job openings in an economy. Job vacancies generally include either newly created or unoccupied positions (or those that are about to become vacant) where an employer is taking specific actions to fill these positions. Unemployed Workers is measured using US Unemployment Unemployed Workers Total in Labor Force. Unemployment measures the number of people who are without work (not in paid employment or self-employed), currently available for work and seeking work (taking specific steps to find work).

The Fed is determined, however, to force inflation down to 2% and is willing to drive up unemployment to achieve that end. It seems like the only escape from the recession scenario is for some major categories of inflation to prove "transitory," the Fed's favorite word back when they were dovish.

While it feels overly optimistic to predict that overall inflation will, at long last, prove to be transitory, housing is one category where the description may be apt. Rising housing costs have been a major contributor to inflation this cycle. For owner-occupied units, the Consumer Price Index (CPI) is based on a survey question that asks what owners think they could get in rent if they decided to be landlords. Frankly, it's a poor metric. Zillow constructs a much better index based on what people actually pay for rent. The Zillow Home Value Index (ZHVI) shot up during 2021 and early 2022, but it has since been moderating. In contrast, homeowners in the CPI survey are belated in recognizing that rents are higher, but we should expect their answers to roll over soon, following the Zillow index to lower inflation levels.

Housing Inflation Should Begin To Ease



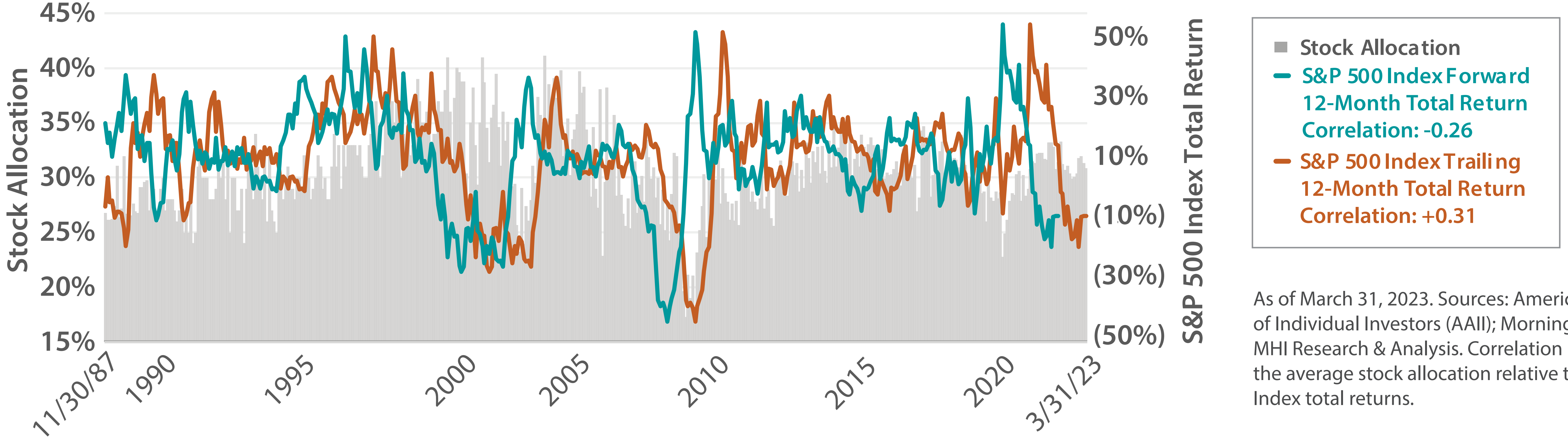
As of February 28, 2023. Sources: Bloomberg; US Bureau of Labor Statistics.
Zillow Index begins September 30, 2011.

The energy and food components of the Consumer Price Index also have the potential to drop in the coming months, driven by lower wholesale prices for certain commodities, including corn, wheat, soy, oil, and natural gas. There is some reason for hope, but overall, high wage inflation seems far from tamed.

Without a doubt the current environment is challenging. Some investors may be tempted to make a heroic move such as going to cash, precious metals, or some other strategy viewed as "risk free."

As always, we strongly discourage market timing. Good markets have always followed bad, and missing a sharp upturn can be very costly.

Stock Allocations Tend To Chase Past Performance



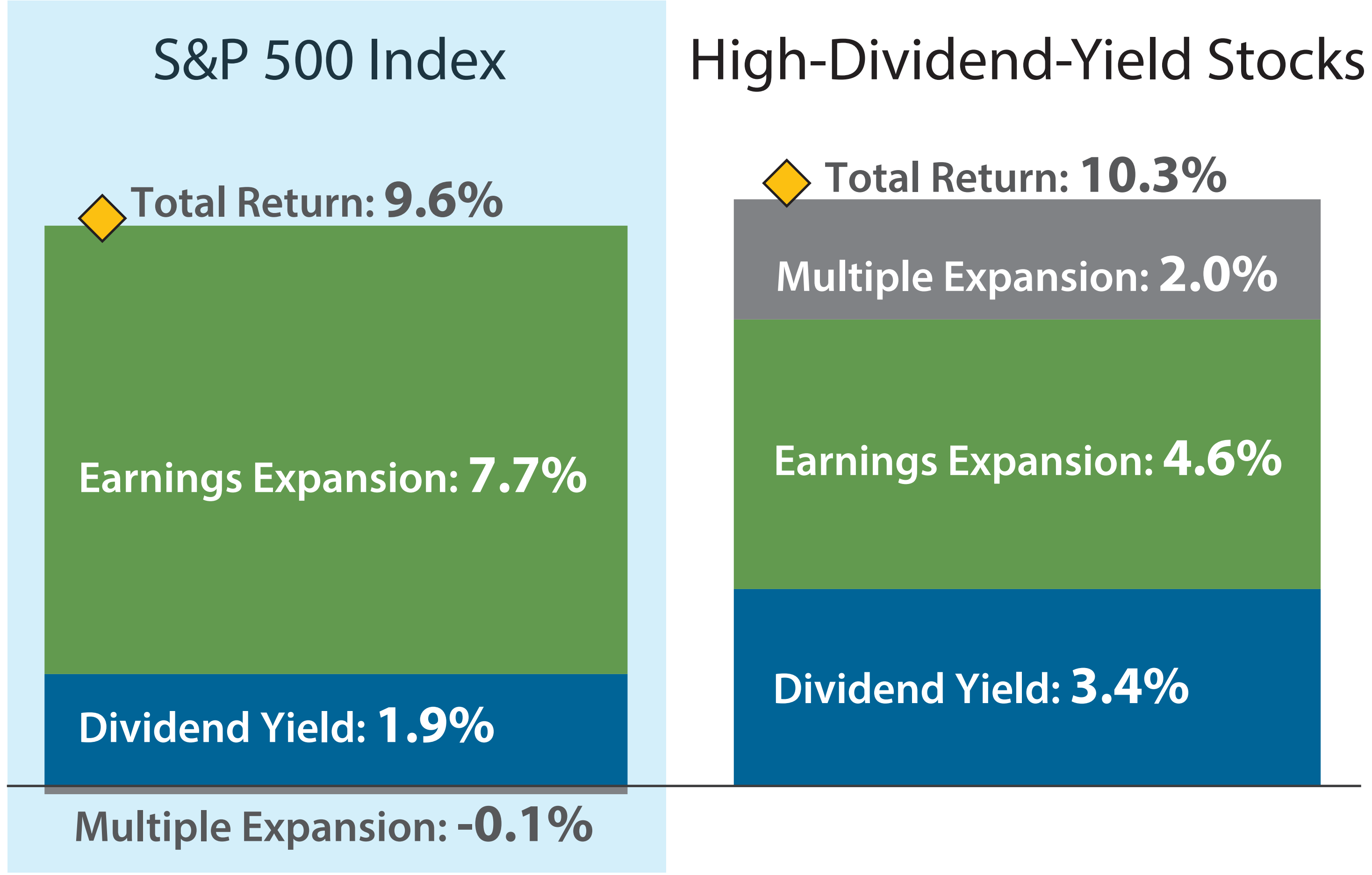
As of March 31, 2023. Sources: American Association of Individual Investors (AAII); Morningstar Direct; MHI Research & Analysis. Correlation represents the average stock allocation relative to the S&P 500 Index total returns.

The Market Timing Trap

Investors as a whole have not proven themselves adept at market timing. We recently tested this proposition by examining the results of the American Association of Individual Investors monthly survey on asset allocation. Ideally, we would like to see equity allocations rise before stock market returns increase. Unfortunately, the opposite held true—respondents' equity allocations were negatively correlated with forward stock market returns. Even worse, the equity allocations were positively correlated with trailing returns. **Human nature causes us to extrapolate what we have just seen, not what is coming.** If you feel it defies human nature to stay in the market during turbulent times, we would agree. But it has always been the right thing to do for the long term.

It's easy for investors to become obsessed with short-term market fluctuations. In fact, sometimes TV business shows will allocate serious airtime to cover the vagaries of intraday equity prices. Yet long-term investors can be seriously misled by excessive focus on the short term.

Sources of Stock Returns Vary



As of December 31, 2022. Sources: Bloomberg; Miller/Howard Research & Analysis. Annualized period is 1993 - 2022 (30 Years). High-Dividend-Yield Stocks are defined as deciles 7 through 9 of S&P 500 Index dividend payers by indicated yield; Members are weighted by market captilization as of each calendar year end. Members without an available historical estimated forward price-to-earnings ratio have been excluded from the group.

In an effort to balance the discussion, let's examine buy-and-hold total returns over the past 30 calendar years. An investor putting $1,000 in the S&P 500 Index in 1993 would have seen a compound average growth rate (CAGR) of 9.6%, turning $1,000 into almost $15,000. Driving the return were annual dividends of 1.9% and earnings growth of 7.7%. The price-to-earnings (P/E) multiple for the S&P 500 gyrated immensely over the course of 30 years, but it ended just a tick below where it started.

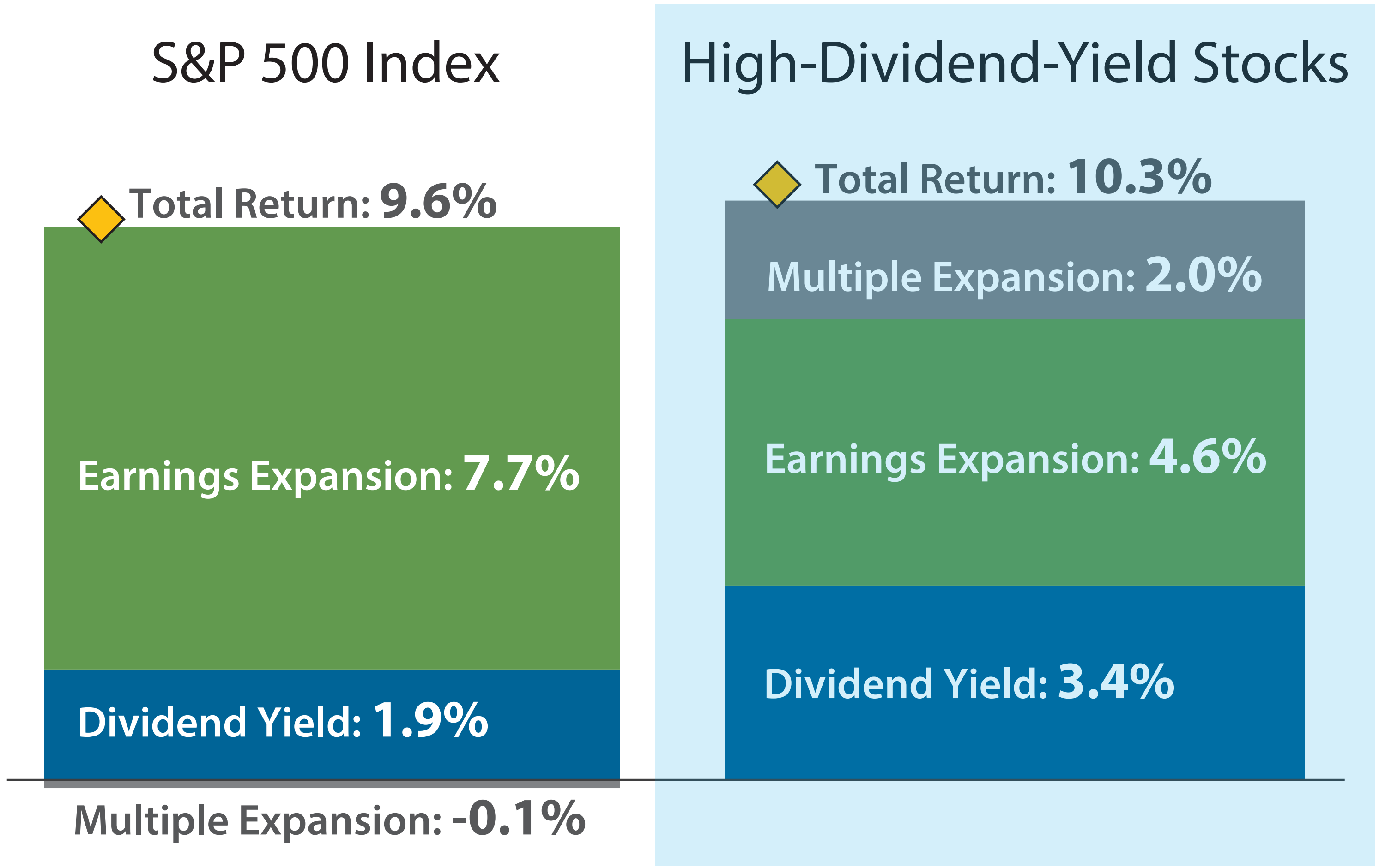
At Miller/Howard:

We favor dividend-paying stocks because we like the discipline it imposes on managements to run their businesses for the benefit of shareholders.

We also believe that commitment to a regular dividend represents a signal from management that they actually see their cash flows as safe and stable.

But how do total returns stack up?

Sources of Stock Returns Vary



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Over the past 30 calendar years, high-dividend-yield stocks within the S&P 500 had a total return CAGR of 10.3%, turning $1,000 into almost $18,000. The composition of returns looks quite different from the S&P 500. Dividends contributed 3.4% annually while earnings growth was lower at 4.6%. P/E multiples expanded modestly for high-dividend stocks over this period, adding 2.0% to annual returns.

Not only did high-dividend-yield stocks outperform the S&P 500 over the past 30 years, they also generated those higher returns *with lower volatility.* We believe these results demonstrate the immense wealth that can be generated by owning profitable, dividend-paying companies and allowing those investments to compound over long periods.

Miller/Howard INVESTMENTS

DISCLOSURE
Miller/Howard Investments Inc. is an independent, research-driven investment boutique with over three decades of experience managing portfolios for major institutions, mutual funds, and individuals in dividend-focused investment strategies. The firm is 100% employee-owned through an Employee Stock Ownership Plan (ESOP).

We continue to evolve and develop strategies that strive to provide investors with various levels of current income and dividend growth. Our objectives are to generate total returns in line with the broad equity market and provide a high and rising stream of income with the lower volatility that an investor might seek from bonds or other income alternatives. With a primary goal of reliable income and long-term returns, coupled with a belief that investors can play an important role in securing a sustainable future, our shareholder advocacy efforts include environmental, social, and governance (ESG) research and/or screening, direct engagement with companies, filing shareholder resolutions, proxy voting, coalition building, and public policy involvement.

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DEFINITIONS:
S&P 500 Index® widely regarded as the best single gauge of large-cap US equities and serves as the foundation for a wide range of investment products. The Index includes 500 leading companies and captures approximately 80% coverage of available market capitalization.
Price-Earnings Ratio (P/E)—The ratio of a company's share price to its earnings per share. The ratio is used as a valuation tool and can help determine whether a company is overvalued or undervalued.
Earnings Before Interest, Taxes, Depreciation, and Amortization (EBITDA)—A non-GAAP measure used to provide an approximation of a company's profitability. This measure excludes the potential distortion that accounting and financing rules may have on a company's earnings; therefore, EBITDA is a useful tool when comparing companies that incur large amounts of depreciation expense because it excludes these noncash items, which could understate the company's true performance.
High-Dividend Yield Stocks consists of Decile 7, 8, and 9 of a universe of US dividend paying common stocks with a market capitalization equal to or greater than $1 billion.
Net Debt to EBITDA—A measure that computes the company's ability to pay off its debt by utilizing the earnings before interest, taxes, depreciation, and amortization (EBITDA).
Russell 1000 Index® measures the performance of the large-cap segment of the US equity universe. It is a subset of the Russell 3000 Index® and includes approximately 1,000 of the largest securities based on a combination of their market cap and current index membership. The Russell 1000 Index® represents approximately 92% of market capitalization of the US market.
US Treasury 10-Year Yields are yield to maturity and pretax. Indexes have increased in precision as of May 20, 2008, to 4 decimal places. The rates comprise Generic US Government on-the-run government bill/note/bond indexes.

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