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March 13, 2023 – Investment Commentary

Pinball Wizard: Market Developments

Last week, equities had their worst week since September 2022 (S&P500-4.6%). All sectors were down, with banks being the biggest decliner due to the Silicon Valley Bank ("SIVB") failure. Treasuries rallied across the curve, with two-year yields recording their largest two-day move since 1987. Earlier in the week, Fed Chair Powell's recent testimony sparked the U.S. two-year yield to jump 12bps and the 2year -10 year spread inverted further, hitting its most negative level since 1981 (signaling recession). By week's end, this had more than reversed due to the bank turmoil and "flight to safety" by investors to own U.S. short-dated government paper and hope the "Fed Put" was coming back. The recent market pricing for peak Fed Funds was 5.80% early last week but fell to 5.25% by the week's end. According to the CME, the next Fed hike on March 22nd was expected on 3/8 (after Powell's conference) to be 50bps with a 79% probability vs. 25bps at 21%. On March 13th (intraday), investor hiking expectations were 0 bps @27%, 25bps @73% and 50bps @0% probability. The 2-year has plunged from 5.07% on 3/8 to 4.05% on 3/13 a material 100+ bps move. In sum, the markets lack conviction and are pinballing off various market developments.

What We Know the Government Decided

1. Shutdown of Silicon Valley Bank and Signature Bank.
2. Guarantee all deposits at Silicon Valley and Signature Bank.
3. Implicit FDIC guarantee for all uninsured banking industry deposit accounts with amounts greater than $250,000 for one year.
4. Create a new Federal Reserve fund to fund bank assets to make it less expensive to borrow and provide time for banks to reposition their balance sheets and capital levels. In other words, now banks no longer must sell assets to cover a deposit outflow, and realize a loss, but can borrow from the Fed against those assets as collateral, at par value.

Transitioning from Bending to Breaking…

The banking sector volatility surrounding the collapse of SVB and SBNY and material stock price decline in other banks such as First Republic ("FRC") are likely to lead to more stringent regulatory capital and liquidity requirements. In addition, we anticipate bank credit will be harder to access, resulting in tighter financial conditions, which will help the Fed achieve its objective to tackle inflation. However, we believe the traditional markets playbook to anticipate a "Fed Put" where it massively cuts rates and provides liquidity through quantitative easing (buying securities such as high yield) is unlikely to happen due to "sticky inflation" concerns.

Over the last several months, the Investment Office has published the Fed tightening risk of lagged and variable effects where it may cause the economy and markets to bend with the risk of breaking. Beyond unprofitable speculative tech businesses breaking, there are now idiosyncratic examples of certain banking models breaking while economic activity and job growth remain resilient.

Crisis of Confidence: "Perception is Reality"

Beginning last week, we believe fears about the health of bank securities' portfolios surged, aggravated by banking models with poor asset liability management as measured by high loan to deposit ratios, inferior emphasis on large uninsured commercial deposits, and long duration interest sensitive assets. While it's too early to conclude, our view is the large unrealized losses in bond holdings do not threaten a liquidity choke hold on the entire U.S. banking system because few banks will be forced sellers with the new government announced initiatives. However, investors should not confuse efforts to protect depositors as equivalent to shielding shareholders. The stock prices of SIVB, SBNY and FRC are recent evidence. In addition, these poor asset liability management practices are being evaluated now in the European banking system, which has lots of long duration government bonds underwater and some business models which may be vulnerable to the same issues.

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In sum, as the “risk free” rate rises investors are increasingly challenging bank business models based on the excesses of “Free Money” – two crypto focused banks, Silvergate Bank and Signature Bank and the startup/venture focused, Silicon Valley Bank. We believe these are exceptions to the rule to that the overall U.S. and European banking system is sound.

The forces behind the two biggest bank U.S. failures Washington Mutual (“WaMU”) in 2008 and SVB in 2023 are different. SVB had a unique and substantial share of uninsured deposits from tech companies. Against a backdrop of “wildfire social media chatter” rising interest rates, poor asset liability management, and scarce investment capital, Silicon Valley Bank’s shares plummeted after the firm said it would book a $1.8 billion loss related to securities sales. That, in turn, sparked a run on the bank. With WaMu, it was all about bad mortgages and the housing downturn — neither of those are factors here. However, it’s worth paying attention in 2023 and beyond to banks with a substantial concentration to commercial real estate. Finally, the rate of change has accelerated in this online world, where SVP experienced $42 billion of attempted withdrawals in one day while WaMU experienced $18 billion of deposit withdrawals over approximately 15 days.

Portfolio Considerations: High Quality Bonds

A lot of investors are struggling with the decision of how to time going back into intermediate high-quality bonds. In 2022, there was over $300 billion in outflows from taxable and municipal bond mutual funds and ETFs, according to Morningstar. In the wake of the selling, high quality bond yields have risen to near 15-year highs. The U.S. aggregate bond index hit as high as 5% on a yield-to-worst basis in the fall of 2022, but today stands below 5%. There are clearly income opportunities available and relative value, but what would be a potential catalyst to cause yields to fall?

As said above, the Fed has historically raised rates until something “breaks.” The problem is no one knows when something will “break,” but it typically happens in a late cycle environment after the Fed tightens meaningfully. The tightening causes liquidity to dry up as investors find short-term interest rates attractive for capital and borrowing costs for corporations/consumers become prohibitively high. As this happens, those that have more leveraged and poorly run businesses run into solvency issues. Once solvency issues hit, corporations and consumers are forced into liquidating investments/assets at whatever price they can get. In these events, broader markets participants end up going to higher quality assets relative lower quality assets as they want to minimize solvency/default risk. That makes higher quality bonds the most attractive options available. That demand results in higher prices/lower yields for high quality bonds.

If investors try to time investing in higher quality taxable and tax-exempt bonds, they will miss the income/yield opportunities and positions at lower yields in the future. We believe this asset class will likely see capital inflows from a risk-off liquidity event, and on a relative basis, provide an attractive risk/reward trade off across other asset classes today. We believe investors should evaluate their financial plan and explore the decision to ladder into high quality intermediate bonds

Disclosures

Investment Commentary Sources: Bloomberg and https://www.federalreserve.gov/newsevents/pressreleases/monetary20230312b.htm