1Q 2023
Market Commentary

The collapse of Silicon Valley Bank (SVB) in March cast a pall over all financial stocks and stock markets in the first quarter of 2023. Bank stocks plunged in response, particularly regional banks that are highly dependent upon customer deposits for lending and bond purchases. The overall U.S. economic growth will likely weaken as a consequence of the expected tightening of lending standards as banks attempt to protect their capital cushions for such events.

Our "Fractional Reserves Banking" system requires only a small portion of a depositor's balance to be maintained as bank reserves, with the remainder being lent to other customers. A bank run, with deposits fleeing at a record pace through internet and wireless connections, can happen to any bank. The holiday classic *It's a Wonderful Life* illustrates this phenomenon well. As customers panic and rush to withdraw their cash, Jimmy Stewart's character George Bailey says to the effect, *Mr. John, we don't have your money here. Why, your savings balance was invested in Joe's mortgage, and Henry's savings in Mr. James' mortgage…but your money is still safe if you keep your head*. The protagonist saved Bailey Building and Loan from bankruptcy by the skin of his teeth; closing the bank doors at the end of the day with just a few bucks remaining in cash. Bank runs doomed many banks in the Great Depression that had neither sufficient reserves nor FDIC deposit insurance protection (which didn't exist in the 1930s) to maintain the confidence of savers.

Other than the bank runs on SVB and Signature Bank in the U.S., we are not suggesting the examples from the 1930s are really the crux of today's crisis. The insolvency of savings & loan institutions starting in 1981 is perhaps a better comparison. Fed Chairman Volcker's actions to drive the prime rate to 20% created huge unrealized losses in the banking and savings & loan industry's balance sheets (individually and collectively) that were invested in fixed rate mortgages and Treasury bonds. Back then, it took over a decade and more than one S&L crisis to resolve the solvency and other credit quality problems that resulted in the closure of nearly one quarter of the 4,000 S&Ls that existed in 1980.

Albeit with a smaller magnitude of change than in the early 1980s, this most recent instance has occurred again in the last two years as the Federal Reserve Board has shocked a surprisingly unprepared banking system with 450 basis points of increase on the Fed Fund Rate. We think moving away from the 0% Fed Funds Rate has been a significant positive for bank net interest margins, but when banks borrow short and lend long, the maturity mismatch leaves poorly-managed banks with a huge vulnerability to rising interest rates. As depositors at SVB realized that the bank's mark-to-market loan losses vastly exceeded its equity and cash reserves, rumors turned to reality when depositors panicked.

One year-end measure of imbedded losses on bond and loan portfolios “Held To Maturity” by the U.S. banking industry amounts to $620 billion! We expect returns on capital for smaller banks may remain depressed for a number of years, but as investors and depositors anticipate that these bonds and loans will mature at par value (with no imbedded losses remaining), today’s fears will likely fade away. For SVB and Signature, however, it became an insurmountable problem. Huge deposit inflows during the boom years from Silicon Valley tech IPOs and entrepreneurs were rashly invested in the longer end of the Treasury yield curve.

While the vulnerability of other mid-sized banks to such deposit runs exists, the confidence in the overall system appears to have remained intact. The U.S. Treasury has so far succeeded in walking the fine line between avoiding moral hazard and providing necessary lifelines. For savers, there is good news in that savings accounts finally pay a more reasonable yield. For high-yield, or “junk bond” investors, however, the weakening economy could lead to loan losses not seen in years.

But who’s to blame for these chaotic conditions at banks and in financial markets? Certainly, we believe the Federal Reserve Board and various chairmen hold responsibility for the more than decade-long period characterized by the Fed’s ignominious pursuit of Modern Monetary Theory (MMT) with ZIRP (Zero Interest Rate Policy). Investors and savers were compelled to take unnecessary risks to find hoped-for returns, followed by serious price inflation. Fighting the inflation threat forced the Fed to belatedly institute massive hikes in short-term interest rates. At the same time, the federal government, supported by both parties and presidents, desired low rates that funded a massive expansion in federal spending well beyond what was necessary to accommodate the severe impact of COVID-19 on economic activity. The Treasury borrowed to finance massive deficit spending and the Fed monetized the debt—not an example of good fiscal or monetary policy management in our opinion.

Yet with just the hint of lower CPI growth and the end of tax loss selling pressure at the end of 2022, we saw the mega-cap stock losers of 2022 turned into the winners in the first quarter. This rally was further boosted by the plunge in Treasury yields that followed the run on SVB bank deposits which all but convinced bond investors that the Fed would have to lower interest rates later in 2023. A pause in raising the Fed Funds Rate seems likely to us, but rate cut assumptions imbedded in today’s interest rate levels seem too optimistic.

Our expectation remains that the first quarter stock market rally, which left a large number of economically sensitive and financial stocks behind, will not be sustained for long. We predict price inflation may remain uncomfortably high and economic growth mediocre at best. This is exactly our definition of a stagflationary environment over the next couple of years, which is generally a negative for stocks and profit margins except for those few companies able to maintain revenue growth with price increases.

As this unfolds, the risk of two or three quarters of recession also looms large in the immediate future as tighter credit standards constrict bank lending to small and mid-sized businesses. In addition, commercial real estate remains under pressure, energy prices remain high with constrained U.S. supplies, and tech and media company layoffs may finally raise the unemployment rate. We believe all should lead to weakening real incomes. As businesses become more cautious regarding investing in capital expenditures for future growth or seek to liquidate inventories, this will add to the potential for a decline in real Gross Domestic Product (GDP).

In all our strategies, we seek to manage prudently through these challenging times, just as was the case in 2022. We always keep a keen eye on under-appreciated risks in the marketplace and attempt to maximize downside protection while remaining invested in a sensible fashion.

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