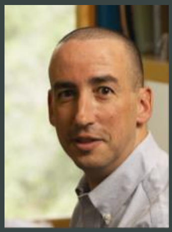

# MARKET UPDATE

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## April 3, 2023 – Market Update

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# I. Markets

## A. Stocks

1. Last week: DJIA +3.2%; **S&P 500 +3.5%**; Nasdaq +3.4%
    a. It was a relatively **uneventful week**. Market rallied on signs of **stabilization in the banking system**. Fed speakers continued to say that inflation is too high.
    b. **Core PCE** came in lower than expectations
    c. Jobs report comes out this Friday
2. **Nasdaq** was up 6.69% in March and **16.77% for Q1**
    a. **S&P 500** was up 3.51% for March and **7.03% for Q1**
3. S&P 500 **Growth** increased 9.24% for Q1 while Value was up 4.62%
    a. Financials kept Value down
    b. Tech, communication services and discretionary all helped Growth

## B. 2023 Earnings Estimates Must Decrease

1. Analysts predict **Q1** earnings will be **4.6% lower YoY**
    a. On Jan. 1, the estimate was for 1.4% growth; six months earlier, forecast +**9.9%**
    b. **Q4** earnings were **-3.2% YoY**
    c. **Revenue** is forecast to grow **1.7%** in Q1
        i. High inflation and a tight labor market are pushing up costs
2. **2023 Q4 EPS** is still projected to be **10.6% higher YoY**
    a. Doesn't fit with a second-half of year recession
3. S&P 500 trades at **17.5X 2023 consensus $221.40**
    a. Expecting **$247** next year (Barron's)

## C. Bonds

1. UST: 3-month 4.85% (+11 bps); 2-yr 4.06% (+30 bps); 10-yr **3.48%** (+10 bps)
    a. The 2/10 yield curve is inverted by **58 bps** (had been 107 bps on March 8)
    b. 3-month/10-yr is inverted by **137 bps**
2. Dec. 31 UST: 3-month 4.42%; 2-yr 4.41%; 10-yr 3.88%
    a. **High yield during Q1**: 3-month 4.83%; 2-yr 5.05%; 10-yr 4.08%
    b. There is fear that loss of deposits and tighter credit could cause recession
3. **Less credit** could mean **slower economic growth**
    a. DB's high-frequency financial conditions index has tightened to recession level
    b. Bond market appears shut to high-yield borrowers
    c. Leveraged loans and private lending are less available and more expensive
    d. Borrowing rates are higher, rules on loans are more onerous, terms are shorter
4. The current **real Fed funds rate** is **barely positive**
    a. **Core PCE** is 4.6% YoY and 4.9% for the last three months annualized
        i. Strip out housing and it's 4.6% and 4.8%

Sources: (Barron's) (Barron's)

## D. Money is Flowing into Money Market Mutual Funds

1. There is now more than **$5T** in money market mutual funds
    a. Fueled by higher rates and the collapse of SVB
    b. **$300B** were added in the three weeks to March 29
2. A **funding pinch for financial institutions** could impact willingness to lend
    a. Of course, part of this is what the Fed wants – to **curb inflation**
    b. At the same time, the risk is that we have a **hard landing**
    c. Largest banks have a combined $6.5T of loans outstanding vs. $4.5T for the rest
3. Money market funds invest in T-bills, repurchase agreements, commercial paper
    a. Right now, close to **$2.3T is in the Fed's reverse repo facility** – 4.80% yield
4. Tighter lending standards make the market more attuned to **risk of recession**
    a. Flows into money market funds make a normal process more **disorderly**
5. Some argue that the Fed needs to adjust the parameters on the reverse repo facility
    a. Lower the rate or limit the amount any fund can park there
        i. But this is how the Fed controls the Fed funds market
6. **Banks could** boost rates paid to depositors, borrow from FHLB, tighten lending standards
    a. They could also **sell securities** to fund loan growth – but that would hurt earnings and regulatory capital (Bloomberg)

## E. Emerging Markets

1. Over past 30 years, EM stocks down >20% during US recessions; 3% worse than US
2. **Arguments for emerging markets** (EMs)
    a. EMs may be less affected now. Demand supported by China.
    b. Fund managers are more optimistic about EM equities
    c. Dollar weakness could also help. Could happen as Fed tightening ends.
    d. EM stocks have been underperforming developed-market stocks YTD
        i. At the start of the year, investors had been hopeful about EM b/c of the weaker dollar and China's reopening
    e. Commodity prices remain at levels that are good for exporters (Bloomberg)

## F. The Dollar

1. **Arguments against the dollar**:
    a. The appeal of pandemic safe-haven and strongest economy are fading
    b. Fed may not keep raising rates
    c. Europe's likelihood of recession now seen as lower than US chance
    d. Banking system under stress (Bloomberg)
2. The dollar's role in the world economy has been hurt by:
    a. The confiscation of Russia's central bank reserves
    b. The US's increasing reliance on sanctions and weaponizing the dollar
    c. The banking failures in the US (possibility of destabilizing financial crises)
3. **Arguments in favor of the long-term status of the dollar:**
    a. No sign Saudi Arabia will price oil in yuan (despite China being biggest customer)
        i. Saudi riyal is pegged to the dollar
        ii. Chinese yuan is not convertible
            1. China's foreign exchange rate is closely managed
            2. The yuan's share of international reserves is ~2.75%
        iii. China even funds Belt and Road initiative with dollars
    b. The BIS estimates that the daily turnover in the foreign exchange market is $7.5T
        i. The dollar is on one side of 88% of currency trades
            1. Little changed from 1989 (90%)
    c. US capital markets have depth, breadth and transparency
        i. We also have military dominance and a good legal system (Barron's)

# II. Articles about Banking

## A. Thoughts on the Banking Crisis (John Authers)

1. Banks can have:
    a. **Liquidity** crisis – customers pull money out
    b. **Solvency** crisis – borrowers fail to repay (credit crisis)
    c. **Confidence** crisis – shareholders sell their shares
2. So far, this has been completely about liquidity
    a. And mostly from small banks
3. It seems like bond **yields hit** a **tipping point** and that's what started the run. Money flowed out to large banks and to money market funds. MMFs are not guaranteed, but losses are limited to any decline in the value of the securities owned. MMFs now have $5T. Some of these funds just hold s/t gov't paper (super-safe).
    a. The **speed** with which banks can be wiped out is **totally different today**. This is the result of social media plus the ability to withdraw money over the internet.
4. The outflow of money resulted in a **historic drop in the 2-yr UST yield**. This yield is now almost a **full percentage point below the 3-month yield**. That **only makes sense if rate cuts are coming**.
    a. The **Fed says** that they're **not cutting** rates this year
    b. **S&P is higher** for 2023 and 11% above its October low
    c. **Does it make sense** to have a banking crisis driving lower rates, yet stocks are higher? This is like an "**immaculate recession**" where output contracts so we have lower rates, but earnings aren't hurt.
5. If the government does end up guaranteeing all deposits in order to stop outflows, you can be confident that **regulation will increase**, there will be **less risk-taking**, and **lower profitability**.
    a. It becomes harder to justify investing in small banks, as s/hs can get wiped out
6. This **liquidity crisis could become a solvency crisis** with commercial real estate (CRE). Office vacancy in the 50 largest cities is now **18.8%.**
    a. Mid-size banks ($10B - $250B of assets) have a $1.3T CRE loan book
        i. So the banks under the most pressure lately are the most exposed
    b. The largest banks have $738B of the loans
    c. If you want to be scared about CRE, realize that NY subway traffic is ~30% below 2019 levels (Bloomberg)

## B. Will We Have a Slower Economy Because of the Banking Crisis

1. **No**
    a. **Large** commercial **banks** are **well capitalized** and don't have liquidity constraints
    b. The Fed's **Bank Term Funding Program** should provide liquidity to mid-tier banks
    c. **Market rates have dropped** and that should increase the demand for loans. The price of credit is the main rationing tool for credit. (Carson Report)
2. **Yes** (from the work of Torsten Slok)
    a. **$600B has left the banking system** since the Fed began raising rates
    b. Roughly half of money pulled **from small banks went to large banks** (different types of lending)
    c. **Capital markets** have **effectively** been **closed** since SVB

## C. The Fed's Role in the Bank Failures

1. **Four reasons why the banking problem may be more systemic**:
    a. **QE leads to more uninsured deposits** in the banking system. It's not just the Fed's balance sheet that grows.
        i. As the Fed did QE during the pandemic, uninsured bank deposits rose from ~$5.5T to $8T+ by 2022 Q1.
    b. **Many banks were trying to benefit from "carry"** – use this cheap funding to buy USTs and MBS. Normally, this would have been low risk, but this time there were a lot of uninsured deposits.
        i. Depositors became aware of the risk at the banks and the possibility of higher returns from money market funds.
        ii. "The road to hell is paved with positive carry."
    c. The risk is magnified today by the **faster/larger interest rate increases and** the **larger amount of interest-sensitive securities** held by banks.
        i. This meant larger losses and more bank runs.
    d. Supervisors either didn't realize interest rate risk or couldn't force banks to reduce it. Regulators also didn't subject smaller banks to the same level of scrutiny that they applied to the largest banks.
        i. These differential standards may have caused a migration of risky commercial real-estate loans to smaller banks.
2. The **Fed also contributed to the problem**:
    a. **QE has stuffed the banks' balance sheets with uninsured deposits** and made the banks increasingly **dependent on liquidity**.
        i. This dependency makes QT and raising rates more difficult.
        ii. The larger the scale of QE and the longer its duration, the more time the Fed should take when normalizing the balance sheet and raising rates.
            1. Unfortunately, this conflicts with the inflation mandate
3. **Markets** now **expect the Fed to cut rates** and **quit QT** despite high inflation
    a. The Fed is again providing liquidity (through discount window)
        i. This could make inflation fight more difficult (Project Syndicate)

## D. Policymakers Keep Solving the Wrong Banking Problem, by Andres Velasco

1. **Banks fail and everyone blames** speculators, greedy investors and bad regulators
    a. **But banks are peculiar institutions** – they engage in **maturity transformation**
        i. They take deposits that can be withdrawn in a moment's notice and invest in loans and bonds that cannot be redeemed at the same speed (without loss)
            1. This gives entrepreneurs access to cheaper long-term money
    b. So **banks are vulnerable by design, not by mistake**
        i. Banks aren't supposed to have enough deposits in the vault to satisfy all depositors
        ii. **Every bank** (regardless of how conservative or well-regulated) **would go under** if its depositors decided to withdraw funds simultaneously
            1. SVB didn't have to crash, absent a run
            2. The maturity mismatch is what banks do
2. **Imagine** a bank consisting of demand **deposits of $100**. Bank uses it to **buy a 2-yr bond yielding 1%**. If on the first day of the second year, **yields increase to 5%,** that bond is **worth $96**. The bank has an **unrealized loss**.
    a. But this is only a paper loss. The bank will still receive $101 at the end of the year.
    b. A crisis will only occur if depositors flee. So **banks depend on trust**.
3. It is often the **large, uninsured depositors that flee**.
4. In 2018, Congress changed the threshold for "**systemically important**" from $50B in assets to $250B. SVB was under the threshold ($209B) – yet we needed intervention.
    a. Because all banks are vulnerable by design, even a pin drop can trigger panic.
5. Increasing **capital buffers protects** depositors **from credit losses**.
    a. **Capital mitigates solvency problems**.
    b. A **run** is a **liquidity problem**. (Of course, more capital discourages runs.)
6. **Sticky deposits** make banks less susceptible to runs. But today, news travels instantaneously and depositors can withdraw funds with their smartphone.
7. **We don't want deposits to be like equity** (getting a share of profits) because that destroys the idea of stability of value. We **don't want deposits to be backed solely by riskless assets**, because that destroys the socially useful "maturity transformation."
    a. The result is that **we need**:
        i. Broad-based deposit insurance
        ii. Swift liquidity provision by central banks (lender of last resort)
        iii. Stringent regulation
8. But realize that **banks will sometimes get in trouble**. (Project Syndicate)

## E. Slow-Motion Banking Crisis

1. It's possible that **this could be a slow-moving banking crisis** as many factors affect several institutions. This **could cause many banks to shrink or be acquired** and this could **hamper the supply of credit**.
    a. From 2008 – 2021, the Fed kept rates near zero.
    b. Banks boosted their holdings of USTs and agency MBS
    c. Then, rates began to rise
2. One academic study argues that **~11% of US banks** (~500 in total) suffered larger percentage losses on their assets (as the result of higher rates) than SVB
3. On the **positive side**:
    a. Most banking crises happen as the result of **credit losses**
    b. **86% of banks' securities were federally-backed** in Q3 2022 (vs. 71% in 2008)
    c. If we have a **recession**, we'd likely have **falling rates** (lifting bond values)
4. **Banks' problem is on the liability side of the balance sheet**
    a. QE and stimulus resulted in **deposits** increasing significantly
    b. Banks **invested deposits in securities**
        i. Ratio of **bank loans to deposits fell to a 50-year low** of 60% in Sep. 2021
    c. A **growing share of deposits were uninsured**
        i. And mistakenly thought of as **sticky**
            1. But social media and smartphone banking meant that was wrong
            2. Share of customers using internet or mobile banking: 66% in 2021 (was 52% in 2017)
    d. **Fed started raising rates** and this led depositors to search for **higher yields**
    e. **Fed started QT** and this resulted in soaking up excess reserves and deposits
5. In July, we'll have **FedNow**, a real-time payments service and bank customers will be able to transfer funds instantly (instead of waiting for transactions to settle)
6. In the week ending March 15, **smaller banks lost $120B** in deposits and large banks gained $66B
    a. Banks with substantial **unrealized securities losses** and **non-retail and uninsured depositors** may be sensitive to depositor flight
        i. Will hurt funding, liquidity, earnings and capital
            1. Unless we extend insurance to all deposits (WSJ)

## F. Banks Did a Balance Sheet Switcheroo

1. **Six large banks** (including SCHW and PNC) **switched the classifications** on more than **$500B** of their bond investments last year from **available-for-sale to held-to-maturity**
   a. Allowed the banks to **report robust levels of capital**
   b. Available-for-sale is marked to market
2. These banks' **held-to-maturity bonds increased from $681B to $1.14T** in 2022
   a. The $1.14T was **$118B (12%) higher than FMV**
      i. This was equivalent to **18% of the banks' total equity**
3. **~48% of securities** held by US banks were classified as **HTM** at the end of 2022; **up from 34%** in 2021
   **a. Unrealized losses were $620B**
      i. $341B of unrealized losses were in HTM portfolios
   **b.** The **six banks' unrealized losses on HTM securities** account for **35% of industry total**
4. The **six banks and the amount of reclassification** were:
   a. Schwab $188.6B
   b. PNC $82.7B
   c. JPM $78.3B
   d. Truist $59.4B
   e. Wells Fargo $50.1B
   f. USB $45.1B
5. **SVB didn't reclassify** any securities last year
   a. Most were **labeled HTM from the start**
   b. Their **unrealized losses** were almost **as large as their equity**
6. **Amount of unrealized losses**:
   a. SCHW's HTM bonds were $14.1B less than balance sheet value
      i. Unrealized losses = 39% of total equity
         1. Exceeded SCHW's $6.2B of tangible common equity (which excludes preferred stock and intangible assets)
   b. WFC: HTM securities were $41.5B (23% of total equity)
   c. USB: $10.9B (21% of total equity)
   d. Truist: $9.9B (16% of total equity)
   e. JPM 13%
   f. PNC 11% (WSJ)

## III. The Coming Doom Loop, by Nouriel Roubini

### A. Higher Rates

1. We had **higher rates** in 2022
    a. Ten-year Treasuries lost more value (20%) than the S&P 500 (15%)
    b. US banks' **unrealized losses on securities** reached $620B
        i. ~28% of their total capital ($2.2T)
2. Realize that **higher rates have also decreased the value of banks' other assets**
    a. This would bring US banks' total unrealized losses to $1.75T
3. On the other hand, **rising inflation reduces the true value of banks' liabilities** (deposits) by increasing their "**deposit franchise**" – which isn't on the balance sheet
    a. Banks still pay near 0% on most deposits while the overnight rate is 4% or more
    b. The **deposit franchise value may have risen by $1.75T**
        i. But this asset only exists if the deposits stay
4. **Banks chased yield** (taking **duration risk** to fatten their **net interest margins**), knowing that they didn't have to mark these bonds to market and the **capital charge was zero**. They weren't even subject to **stress tests**.

### B. Consequences

1. The credit crunch caused by today's banking stress will create a **harder landing** for the real economy – b/c regional banks are important to small and medium-size enterprises and households.
2. Central banks raising rates doesn't just increase recession risks; it creates **financial instability**
3. **Creditors have great losses**. As a result, the economy is falling into a **debt trap** with high public deficits and debt causing **fiscal dominance** over monetary policy, and high private debts causing **financial dominance** over monetary and regulatory authorities
    a. In a **debt trap**, higher policy rates will fuel systemic debt crises that liquidity support will be insufficient to resolve
    b. When central banks respond to the recession with lower rates, **inflation expectations** will become unanchored
        i. The **separation principle** will not work – the Fed won't be able to achieve both price and financial stability
4. Even worse, the coming credit crunch **may not kill inflation**
    a. Negative aggregate supply shocks persist and labor markets are too tight
    b. A **severe recession** is the only thing that will temper price and wage inflation
        i. But it will make the debt crisis more severe
    c. Liquidity can't prevent this systemic doom loop
        i. Prepare for a **stagflationary debt crisis** (Project Syndicate)