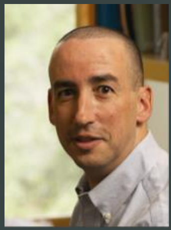

MARKET UPDATE

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March 20, 2023 – Market Update

Table of Contents

I. The Last Two Weeks

A. Timeline

1. **Mon. March 6th** – waiting for March 22 FOMC decision – 25 or 50 bps? Thought it would depend on inflation and employment reports.
2. **Tues. March 7th** – Powell hawkish warning before Senate – will fight inflation. Market starts pricing in 50-bp increase. Terminal rate 5.6%. 2/10 inversion to 104 bps (deepest inversion since 1981) – not good for banks.
3. **Weds. March 8th** – Powell speaks to House. After market closed, Silvergate Capital announced plans to shut down. Bank was tied to crypto industry. SVB announced a stock offering, sold substantially all of the available-for-sale securities in portfolio. Two-year UST yield remained above 5% (highest since 2007).
4. **Thurs. March 9th** – KBW Bank Index dropped 7.7%. SVIB dropped 60% (erasing $10B of market cap). VC funds told portfolio companies to pull money. Saw an increase in unemployment claims. Predictions for Fed rate hikes came down a little.
5. **Fri. March 10th** – BOJ did not change its intervention (keeping yields low). US payrolls rose but wage growth slowed. SVB was closed by regulators that morning. Second-biggest bank failure in U.S. history. US stocks wiped out all of 2023 gains. Two-year UST yield fell 28 bps to 4.59%.
6. **Mon. March 13th** – Fed and Treasury Dep't agreed to lend to banks and accept bonds at par value as collateral (so banks wouldn't have to sell at loss). SVB's depositors made whole, paid for by higher insurance premiums from other banks (and their depositors). Shareholders wiped out. Management fired. Regulators seized Signature Bank after customers withdrew 20% of deposits. First Republic Bank shares fell 62%. KBW index dropped another 12%. Two-year UST yield fell by more than 50-bps for biggest fall in 41 years. Dollar erased gains for year. GS predicted FOMC would not raise rates; Nomura predicted FOMC would get rates.
7. **Tues. March 14th** – CPI rose in Feb. by most in five months. Moody's downgraded its outlook for US banking system to negative from stable and placed six large regional banks on review for downgrade. Then, Credit Suisse said it had identified material weaknesses in its financial reporting.
8. **Weds. March 15th** – CS's largest investor, Saudi National Bank, said it would "absolutely" not provide more assistance to lender. Stock fell 24%. That evening, Swiss National Bank said it was ready to lend $54B.
9. **Thur. March 16th** – ECB announced 50-bp rate hike. First Republic Bank shares continued their slide at the open, bringing them down 83% in two weeks. From there, the shares regained 65% by the close as details of a rescue package emerged. The gov't persuaded 12 large banks to deposit a total of $30B in deposits at First Republic. S&P rallied above 200-day MA and erased all of losses for month. After the close, news came out that banks borrowed a record $152.85B from the discount window. (Bloomberg)
10. **Fri. March 17th** – Regional banks continued to drop. First Republic dropped 33%. In addition, CS dropped 8% (despite the lifeline from the Swiss National Bank).

B. Price Movement Over Past Two Weeks

1. The **S&P 500** is **down 3.19%;** DJIA is down 4.58% and Nasdaq is down .50%
   a. **KBW bank index** is down **28%** in the past ten days; **First Republic** down 70% for week
   b. **Nasdaq** was **up 4.41%** this past week: lower rates, recession fears, some rotation from financials to technology (Bloomberg)
   c. **Bitcoin** is **up ~33%** in the past week
2. The **Fed funds futures** contract is pricing in **~60% chance** that the Fed will raise rates **25 bps** (and 40% chance that the Fed won't raise rates)
   a. The market is pricing in that this will be the last rate hike
   b. The market is pricing in that the Fed funds rate will be **3.75% - 4% by the EOY**
      i. Short-term yields are now below the Fed funds rate – the market believes that the tightening cycle is over (Bloomberg)
3. **Yields dropped**: lower projected Fed funds rate + safe-haven assets
   a. The **2-yr** UST yield was 4.89% on March 6, **5.05%** on March 8 and is now **3.81%**
   b. The **10-yr** yield has dropped from **3.98%** to **3.39%**
   c. The **three-month** T-bill was **5.06%** on March 8 and is now **4.52%**
   d. The **re-steepening** of the yield curve indicates recession is imminent
   e. The **MOVE index** is approaching levels seen after Lehman failed (Bloomberg)
4. **Breakeven inflation rates** on March 3: 5-yr **2.71%;** 10-yr **2.52%;** 5-yr,5-yr forward **2.33%**
   a. March 17th: 5-yr **2.10%;** 10-yr **2.10%;** 5-yr,5-yr forward **2.10%**
5. Since March 8, the **dollar** has **dropped 2.11%** (and is up .1% YTD)
6. **Gold** is **up 8.43%** in the past eight days
7. **WTIC** is **down 13.73%** in the past eight days
8. **Bloomberg's US Financial Conditions index** returned to restrictive territory. (Bloomberg)

C. We're Not Seeing Signs of Distress (except MOVE)

1. **VIX** – at 25.51; hasn't closed above 30 during this period
2. Investment-grade and junk **spreads** – nowhere near past crises; still in normal range
3. **Ted spread** (LIBOR minus T-bill yield) is low – no fear about lending to banks
   a. Indicates this is a liquidity issue, not a solvency issue (Bloomberg)
4. **Cyclicals vs. staples** – staples have outperformed in last two months, but not extensively

D. General Stock Advice

1. Making negative comments allows you to gain attention. But it also results in great underperformance for those who listen. Morningstar's latest Mind the Gap report finds that **investors earned ~1.7% less** (per year) than the total returns their fund investments generated over 10 years through 2021. They lost ~1/6 of the return that they would have earned if they simply bought and held. (Bloomberg)
2. Be careful with **leveraged ETFs**. SQQQ is a -3X Nasdaq 100 ETF. In the past 12 months, the Nasdaq is down 15%. You might think that this means you should be up 45%. Instead, you'd be down 9.98%. This is the result of **variance drain**.
   a. Imagine losing 20%. You need to earn 25% to get back to even. When this happens repeatedly, you lose. These leveraged ETFs promise to give you that particular return for a day (not for the long-term). (Barron's)
3. If we remove Fed support for bonds, what is the appropriate stock market multiple? The price-to-sales multiple is still as high as the tech bubble peak (but remember that margins are higher now). Bank valuations are less than half their pre-crisis peak.

II. Banking

A. Silicon Valley Bank

1. SVB was very tied to the **startup community**. They did business with almost half of all US venture capital-backed startups.
2. SVB **grew with more startups getting funded**. In March 2021, SVB's deposits had grown to $124B (from $62B 12 months earlier). SVB thought these deposits were **sticky**.
3. By the end of 2022, the bank had **$212B of assets** and was 10% of the size of JPM. They were the **16th largest bank** in the U.S.
4. SVB used deposits (and other funding) to **buy securities and make loans**. SVB's **investment portfolio was 57% of its assets**; no other competitor among 74 major US banks had more than 42%. They owned a lot of bonds that were purchased at high prices (low yields). These were "safe" bonds, but there was a **duration mismatch**.
5. As rates increased, **customers (including start-ups) took their deposits elsewhere** (to earn more interest). In addition, deposits were being withdrawn b/c start-ups haven't been raising much money in the past year. As the bank's funding was reduced, the bank had to reduce their assets. This meant selling bonds (at a $1.8B loss). The bank also announced a $2.25B share sale.
    a. Banks often shift bonds from "**available-for-sale**" to "**held-to-maturity**."
    b. In a meeting late last week (the week of March 3), **Moody's told the bank that their unrealized losses meant that it was at serious risk of a credit downgrade**, potentially of more than one level. The bank needed to offload a large portion of its bond investments to increase its liquidity. They ultimately sold the portfolio and announced a $2.25B equity deal. Moody's downgraded the bank on Wednesday anyway.
6. This started a **run on the bank**. Several venture firms told their portfolio companies to withdraw their funds. The depositors were all connected.
7. The **bank failed** on Friday (a week ago). This was the second-largest bank failure ever ($200+B of assets). Washington Mutual was the largest ($300+B of assets).
8. As of Dec. 2022, **more than 93% of their domestic deposits were uninsured**. In past bank failures, uninsured investors often recover ~90%.
9. SVB helps handle payments for payroll service provider Rippling. Some paychecks were already "in flight" with SVB and have yet to be paid out. Companies may have to fire employees rather than not be able to pay them. Venture firms are likely to come up with some access to funding. It turned out that the gov't stepped in.
10. The bank also invested in these startup firms, so people are wondering if they will be liquidating their stakes.
11. This situation is very similar to what recently happened with Silvergate Capital. **Silvergate** served a lot of crypto-clients. Silvergate had $12B of zero-interest demand deposits. They invested it into securities that dropped in value when rates increased. At the same time, crypto firms were withdrawing money. (Interestingly, crypto may also be very interest rate sensitive.) Then, Silvergate had to sell their bonds at a loss.

(Bl.) (Bl.) (Bl.) (Bloomberg) (Bloomberg) (Bloomberg) (Bloomberg) (Bloomberg) (Barron's)

B. Bailout vs. Providing Liquidity?

1. The **Treasury Department, Fed and FDIC** announced:
    a. The FDIC will **fully protect all depositors** at SVB and Signature.
        i. Federal regulators invoked a "systemic-risk exception" allowing the FDIC to insure SVB's uninsured depositors. (Bloomberg)
        ii. In past resolutions, uninsured depositors got ~90% of their deposits. (Bl.)
    b. The Fed announced a new "**Bank Term Funding Program**" that offers one-year loans to banks under easier terms.
    c. The Fed is also relaxing terms for lending through its **discount window**. These are 90-day loans and the terms will be the same as the BTFP. **No haircuts**. (Bl.)
        i. The emergency lending program is an admission of **systemic risk**. (Bl.)
2. Key ideas:
    a. Alleviate depositor fears so **no more bank runs**
    b. **Taxpayers not on the hook** (directly). FDIC will charge banks more (and the banks will charge customers more). Lending standards will tighten.
        i. If the existence of the BTFP and the increased insurance calms the banks' clients down, no money will have to be committed. (Bloomberg)
    c. We've seen the **cost of aggressive tightening** (Bloomberg) (Bloomberg)
3. **Banks borrowed a combined $164.8B** from two Federal Reserve backstop facilities:
    a. **$152.85B** from the **discount window** – up from $4.58B the previous week; the all-time high (previously) was $111B during the 2008 financial crisis.
    b. **$11.9B** from the new **Bank Term Funding Program** (Bloomberg)
    c. Other credit extensions totaled $142.8B in lending by the FDIC to bridge banks for SVB and Signature Bank. (Bloomberg)
4. The "not a bailout" allows banks to place Treasuries, which have declined sharply in value of the past year, at the Fed and **receive face value back** in the form of a one-year loan. It was large **unrealized losses** on such securities, combined with unstable deposits, that doomed SVB. (Bloomberg)
5. Some commentators worry about **moral hazard**. Depositors are being bailed out from their sloppy cash management practices, but ultimately, that's what we want – depositors to not even question banks. Management lost their jobs and shareholders and bondholders were not protected. (Bloomberg)
    a. Remember that there was no bailout for shareholders or bondholders. We also do not know the difference in value between assets and liabilities. Caps on deposit insurance only hold until something bad happens. (Bloomberg)
6. Since the Fed is now backstopping anyone facing asset/rates pain, they are de facto allowing a **massive easing of financial conditions** as well as soaring moral hazard.
7. If banks have to offer higher rates to maintain deposits, **profits will decrease**. (Bl.)
    a. As regional banks compete for deposits, the riskiest banks have to offer the highest rates. (Bloomberg)

C. Credit Suisse

1. Credit Suisse's **stock fell to its lowest level on record** and its credit spreads surged. The cost of CDS surged. Clients pulled more than $100B of assets in the last three months of 2022. Once worth more than $100B, it's now worth **< $10B**. (Bloomberg) (Bloomberg)
2. Credit Suisse has a **long trail of problems**: a criminal conviction for allowing drug dealers to launder money in Bulgaria, entanglement in a Mozambique corruption case, a spying scandal involving a former employee and an executive and a massive leak of client data to the media. Their association with Archegos compounded the problem. Then, on March 9, the SEC forced the delay of their annual report. The largest shareholder, Saudi National Bank, ruled out further investment in the company. The Swiss central bank stepped in with a $54B loan. The price of CDS implies a 10% default likelihood. (Bl.)
3. Credit Suisse has very **healthy levels of liquid assets and access to the Swiss central bank**. More than half of their liquid assets are cash. The bank has 62B Swiss francs at central banks, which are part of its 118B francs in liquid assets. These are held against 233B francs of deposits and 12B francs of interbank loans.
    a. But investors are nervous about the huge outflows they had last year. Its deposit outflows for Q4 were 138B francs. **UBS** may acquire CS. (Bl.)
4. Investors are concerned about CS's investment banking and its franchise erosion. (Bl.)

D. First Republic

1. The biggest **US banks pledged $30B** of fresh cash for First Republic Bank. JPM, BAC, C, and WFC all contributed $5B of uninsured deposits. GS and MS added $2.5B each. First Republic said that no sector represents more than 9% of total business deposits. (Bloomberg)
    a. BAC, JPM, WFC and C have attracted billions of dollars of deposits. Depositors want too-big-to-fail. **Big banks were under fire** for soaking up deposits from smaller lenders. (Bl.)
        i. The idea was pitched by Janet Yellen to Jamie Dimon. First Republic does cater to wealthy tech executives.
    b. First Republic said its borrowings from the Fed varied from $20B to $109B from March 10 to March 15. (Bloomberg)

E. Commercial Real Estate is a Big Risk

1. We've moved **from low rates and low volatility to** a **higher-rate and more unstable environment**. So many investments can be thought of as a **carry trade** – including commercial real estate and private equity. When financing costs are rising, these carry trades are pressured to unwind. (Barron's)
2. Many **commercial properties** are at **risk of default** and this will become worse if we have a **recession**. Commercial real estate loans make up close to **24% of all bank loans**. It has become **tougher to offload** these to investors. The CMBS market went from $240B in annual issuance in 2007 to just $60B in 2020. (Bloomberg)
3. As BNY Mellon's strategist said, "In textbook monetary policy, **rate hikes are intended to tighten financial and credit conditions**, leading to lower economic activity. However, certain parts of the economy, in particular where significant leverage is present, can come under duress, often leading to financial-sector strains. We are keeping an eye on commercial real estate (CRE) loans as one area of the financial system where we see vulnerabilities present." (Bloomberg)
4. **Loan stress can feed on itself** quickly in commercial property as rates rise b/c loan **refinancing becomes more costly and harder to find** as banks look to reduce their exposure and this leads to more property sales at lower prices. (Bloomberg)

III. The Fed

A. Arguments to Continue to Raise Rates

1. **Inflation is still high.**
    a. The **core CPI** increased **.5% MoM** and **5.5% YoY**. The headline number increased .4% MoM (70% of this increase was due to shelter) and 6% YoY.
        i. Core goods were unchanged in February.
        ii. **Shelter costs**, which are the biggest services component and make up a third of CPI rose **.8% MoM**.
            1. Rent and OER were each up at least 8% YoY.
        iii. **Services ex housing** were up **.5% MoM**. (Bloomberg)
    b. On a **three-month** annualized basis, **core CPI was ~5.2%.** The core excluding shelter increased .5% MoM and 5.1% on a three-month annualized basis. (Bl.)
2. **Inflation is broad-based.**
    a. The Cleveland Fed's **trimmed mean** is barely below its January level and still **above 6%** and the **median** is **above 7%** for the first time.
3. **Inflation is sticky.**
    a. The Atlanta Fed's **sticky inflation is now higher than flexible**. The fear is that inflation is becoming ingrained.
4. **The real Fed funds rate remains negative.**
5. **Raising rates may offset recent accommodative policy.**
    a. While we're likely to see credit contraction, **the slowing of credit is not nearly as much as the amount of Fed tightening that has now been removed from market pricing.**
    b. Encouraging the use of the discount window as well as the implementation of the new BTFP could both be thought of as more QE – reserves will grow. (Bl.)
6. **Not raising rates will show fear.**
    a. If the FOMC doesn't raise rates when median inflation is above 7%, this would be a sign of panic. (Bloomberg)
        i. It would show tremendous fear about financial stability. (Bloomberg)
        ii. The ECB raised rates 50 bps, partly to show confidence in CS.
    b. Not raising rates will invite comparisons to Arthur Burns. In addition, the Fed rarely changes directions that quickly. In 2019, the rate hovered at its peak for seven months; in 2015, it was 15 months; in 1999, it was eight. The fastest was in 1995 when it was five months (but the cuts were just 75 bps over seven months). (Bloomberg)
7. **The "separation principle" – the idea that the role of banker of last resort can be carried out separately from monetary policy.**
    a. The Fed should not allow "**financial dominance**" – where a central bank doesn't tighten its policy because it would threaten the stability of the financial system.
        i. We need to move to a system in which basic cash deposits sit in T-bills. (Bloomberg)
    b. The problems are based on liquidity, not solvency. (This could change.)
    c. Leveraged institutions getting themselves in trouble with duration bets have traditionally been one channel through which Fed tightening has slowed aggregate demand. (Bl.)

B. The Argument to Pause Rate Increases

1. **There are signs that inflation is receding.**
    a. PPI dropped .1% MoM and is now 4.6% higher YoY. Core PPI was unchanged for the month. This could signal reduced cost pressure for companies. (Bloomberg)
2. **Short-term inflation expectations have fallen to the lowest level in nearly two years**. The Univ. of Michigan survey says that consumers expect 3.8% inflation over the next two years and 2.8% over the next five to ten years. (Bloomberg)
3. **The economy may be slowing.**
    a. Retail sales dropped .4% in February after increasing 3.2% in January. Excluding gas and autos, retail sales were flat. Sales at restaurants and bars fell 2.2% in Feb. (Bloomberg)
4. **The recent crisis is already like financial tightening – lending will slow**. Consumers are scared.
5. **Financial stability fears**. (Bloomberg)
    a. We knew that for the Fed to pivot, something has to break. Something has broken. (Bloomberg)
    b. All of the uncertainties in the market add to the possibility of a policy error.
        i. Add in the fact that they don't know what **R*** is. (Bloomberg)
    c. **Financial stability is more important than inflation**. It's hard to transmit monetary policy through a broken banking system. (Bloomberg)
    d. Small banks could be in trouble.
        i. Small banks have a larger concentration of loans in commercial real estate. Small banks had **28%** of their loans in nonfarm, nonresidential real estate compared with just 8% for large ones.
        ii. On the liability side, they're relying on expensive **time-deposits**. (Bar.)