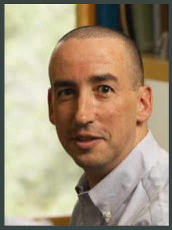

MARKET UPDATE

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March 27, 2023 – Market Update

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I. The Past Week

A. The Big Issues

1. There are still **concerns in the banking system**. UBS acquired CS and the AT1 bondholders were wiped out. FRC is down ~90% from its 2023 high. Deutsche Bank's stock dropped at the end of the week. Schwab is down ~35% from its 2023 high.
2. Despite fears about the banking system, the **FOMC raised rates 25 bps**. Fed Chair Powell and Treasury Sec'y Yellen sounded like they were on different pages concerning bailing out depositors in the future.
3. **Investors are on a different page from the Fed**. The Summary of Economic Projections predicts that the Fed funds rate will end the year at 5.1% while the Fed funds futures market shows is predicting less than 4%. (Barron's)
4. With all of this uncertainty about the banking system and the Fed, it's not surprising that there's also a lot of uncertainty in the stock market. The **gap between the highest and lowest year-end target for the S&P 500 is 47%** -- the widest at this time of the year in two decades. (Bloomberg)

B. Market Activity

1. **Positive week**: DJIA +1.18%; **S&P 500 +1.39%**; Nasdaq +1.66%
   a. Since March 10: Nasdaq + 6.15%; S&P 500 + 2.83%; DJIA +1.03%
2. Rates: 3-month 4.74% (+22 bps); 2-yr 3.76% (-5 bps); 10-yr **3.38%** (-1 bp)
   a. The Fed's dot-plot is inconsistent with the 2-yr yield.
3. 0DTE option contracts have accounted for 42% of S&P 500's total options trading volume in March. A year ago, it was 22%. Viewed through the lens of implied volatility, zero-day options aren't particularly cheap. The gap over the S&P 500's realized volatility (known as **volatility risk premium**) is typically 3X higher than longer-dated contacts. (Bloomberg)

C. Why are Stocks Doing Well?

1. Lower interest rates
   a. The **equity risk premium is still low** – but it has increased 68 bps since March 8 (Bloomberg)
2. Maybe the market is being helped by **extreme pessimism**. The BAC fund manager survey showed an 18-year low for allocation to stocks. (Bloomberg)
   a. Extreme pessimism can be bullish.
   b. Maybe you believe stock prices already reflect all of the fears we've discussed
3. Maybe hedge funds were already **positioned defensively**.
4. Maybe there is **fear of missing out** if the market bottomed. (Bloomberg) (Bloomberg)
5. Belief that the banking **crisis is temporary** or exaggerated or even that it is a positive in that it **lowers rates**.
6. **Trend-following** – the market has been doing well since October.

D. Concerns About Stocks

1. The **Fed is still fighting inflation**. With so much going on, there is greater risk of a **policy mistake**. Obviously, a **recession** would result in much lower earnings.
    a. **Treasury yields** seem to be pricing in a Fed pivot (due to recession)
        i. After inverting, the yield curve is normalizing again. If a yield curve inversion is indicative of a recession, the normalization is what happens as we move closer to the actual recession.
    b. The **expected three-month T-bill rate in 18 months' time dropped to 134 bps under the current rate**. Powell thinks of this as the best predictor of recession. (Bloomberg)
    c. The **gap between B-rated and CCC-rated debt has widened** since the end of February. It is now over 600 bps. (Bloomberg)
    d. **Distressed debt** (yields 10% higher than UST yields) rose from 7.8% to 10.6%. While this isn't a tremendously high number (median is 9.3% over the past 25 years), the increase is faster than late 2007. (Barron's)
2. There is a **mini-financial crisis** going on (concern about the banking system)
    a. Remember that financial crises **don't always end quickly**. In the week after Lehman declared bankruptcy on Monday, Sep. 15, 22008, stocks closed slightly higher. After that, the market dropped 46% before bottoming almost six months later. (Bloomberg)
    b. One of the greatest unknowns right now is whether the banking crisis will result in **tighter lending standards** (and if so, how much and for how long). Will there be fewer deposits (so lending will be reduced), will banks be less willing to lend or only willing to lend at higher rates?
        i. Senior Loan Officer Survey showed that the percentage of banks tightening lending standards had risen to 44.8%, the highest reading since July 2020.
    c. What will happen with **commercial real estate and private equity**? These are both leveraged bets in a rising-rate environment? (Barron's)
3. If the October-low marked the start of a new bull market, it's the **weakest** in recent history. Since 1974, the S&P 500 has gained an average of 32% in the six months following a previous low. (Barron's)
4. MS Michael Wilson's view: this is the **start of the end of the bear market**. We will see falling credit availability squeeze growth from the economy. The equity risk premium needs to climb. Correlations on the way down will be high. Declining credit availability may be what finally convinces investors that earnings estimates are too high. (Bloomberg)

II. The Fed

1. The Fed **raised rates for a ninth straight meeting**. The rate was increased 25 bps to **4.75% - 5%**. **QT will continue**. The vote was unanimous. (Bloomberg)
    a. By saying that they had **considered pausing**, Powell signaled that it was possible that the Fed was done raising rates. (WSJ)
        i. The question continues to be the persistence of inflation.
2. The Fed statement language changed from "The Committee anticipates that ongoing increases in the target range will be appropriate in order to attain…" to "The Committee anticipates **some additional policy firming may** be appropriate in order to attain…" (Bloomberg)
    a. Some saw the rate increase as a **dovish hike** – raising rates and **not committing to further hikes**. (Bloomberg)
        i. Yields moved lower. The equity risk premium increased 17 bps.
3. Almost all 18 Fed officials expected the Fed funds rate to rise to at least **5.1%.** Powell said that cutting rates this year is not part of the base case. (WSJ)
    a. St. Louis Fed Pres. Bullard said he raised his estimate of the peak Fed funds rate for the year to 5.5% - 5.75% because he believes that the banking-sector strains will prove temporary. (Bloomberg)
    b. Wall Street expects cuts consistent with a steep economic **slowdown or recession** that would batter corporate earnings. Lower rates should be seen as bearish. (Bloomberg)
        i. The **Atlanta Fed's GDPNow** is forecasting a 3.2% growth rate for Q1. If you combine that with the **SEP forecast of .4% growth for 2023**, it implies that we're going to be in **recession** later this year. (Bloomberg)
    c. There is a lot of variation in the dots for the medium term (2025). (Bloomberg)
4. Volker slayed **inflation** and Bernanke saved the **banks**. Powell needs to do both at the same time. (Bloomberg)
    a. There is a lot of debate as to whether the Fed can keep raising rates to fight inflation or whether they need to lower rates to prevent fear in the banking system. A more nuanced approach is that the Fed can raise rates to fight inflation and they can continue to provide liquidity to solvent banks. (WSJ)
    b. Powell said that **deposit outflows had stabilized** over the past week. He said that SVB was an outlier in terms of both its percentage of uninsured deposits and in terms of its holding of duration risk. He said that depositors should **assume that their deposits are safe**. (WSJ)
        i. In the week ending March 15th, $120B left small banks. (Bloomberg)

III. The Banking Crisis

A. Some Important Numbers – Deposits

1. In the first two years of the pandemic, banks received a massive influx of nearly **$5.2T in new deposits**. Loan demand was weak. As a result, banks bought a significant amount of USTs and MBS. (Guggenheim)
2. Only **$10T of the $19.2T in total bank deposits** are insured by the FDIC. (Note: FDIC says that there are $17.7T of deposits as of Dec. 2022.) (Guggenheim)
3. **Noninterest-bearing deposits** were ~15% of deposits in the early 1990s. They rose to 25% in 2011 and went past **30%** during the pandemic. Now, they are **dropping** and this could add to interest expense.
    a. Remember…even if you have funding that cost zero, if you invest that money in assets that drop in value, you lose. (WSJ)

B. Some Important Numbers – Bank Assets (Loans and Investments)

1. From 1990 through 2019, the **share of total US banking assets controlled by the 25 largest banks has doubled to 68%**. Over the same 30 years, the **five biggest** banks tripled their market share, controlling **45%** of all assets.
    a. A century ago, the 25 largest held a combined total of less than 16% of all bank assets, with the top five holding below 6%. (WSJ)
2. A recent paper (SSRN) argued that the value of loans and securities held by banks is **~$2.2T lower than the book value** on their balance sheets. That drop in value puts **186 banks at risk of failure** if half their uninsured depositors decide to pull their money. Real estate loans account for more than a quarter of the shortfall. (WSJ)
3. At the **median US bank**, **commercial real estate loans** account of **38% of loan holdings**. (WSJ)
4. **Agency MBS are an ~$8T market**. They are widely held by banks, insurers and bond funds. Banks that are holding a lot of these agencies may sell them, pushing prices down. (WSJ)
5. Between 2007 and 2022, banks boosted their holdings of **Treasurys and federally-backed mortgage securities from 12% to 20% of total assets**, while the **uninsured share of domestic deposits rose from 38% to 45%**. (WSJ)
    a. In order to calculate the risky assets (in order to determine how much capital a bank must hold), Treasury bonds count as zero risk. (WSJ)

C. Some Important Numbers – Smaller Banks

1. Banks outside of the top 25 largest account for **~38% of all loans and 67% of commercial real estate lending**. (WSJ)
    a. Smaller banks hold **~$2.3T in commercial real estate debt**, including rental-apartment mortgages.
2. **Banks outside of the top 25** largest represent **~70% of construction and land development loans and more than 90% of all loans secured by farmland**.
    a. Nearly **80%** of banks with **less than $10B in assets** characterized “largely all” of their commercial and industrial loans as going to **small-business** borrowers.(WSJ)

D. How Much Will the Banking Crisis Slow the Economy

1. The regional banks may offer some of their small-business clients **stricter terms, smaller amounts, or no financing at all**. In addition, if deposits flee, banks may have **less capital** available to loan. (WSJ)
2. Powell said that the banking turmoil is likely to result in **tighter credit conditions**. He said that it was equivalent to at least a **25-bp rate increase**. The reality is that we don't know how significant the effect will be. (Bloomberg)
3. Former NY Fed Pres. Dudley says that **larger banks are more resilient** with larger capital buffers. Households are in better shape than during the GFC. So, if we can restore confidence in the banking system, there won't be much damage to the economy. (Bloomberg)
4. After the collapse of SVB, **no companies with investment-grade ratings sold bonds over the next six business days** (first time since 2013). This month, we've seen \$59.9B in issuance of IG debt vs. March's five-year average of \$179B.
   a. Companies have raised ~\$5B of money through **junk issuance** this month vs. a five-year average of \$24B. (WSJ)
5. As **leveraged loans** come due, companies have to pay higher rates while the economy and their earnings are headed down. (WSJ)

E. Guarantee All Deposits?

1. The goal of federal insurance is to **boost confidence** in the US banking system without guaranteeing every deposit – almost \$18T currently. It was first implemented in 1934 in response to a bank panic the prior year. This really has to be done by Congress, unless the Treasury Dep't uses its emergency authority. (Bloomberg)
2. When asked about a broad increase in deposit insurance, **Yellen** said that it was not something that they had looked at and that it wasn't something that they were considering. **Powell** said that the banking system was sound and that all depositors' savings were safe. (Bloomberg)

F. Deutsche Bank

1. DB's shares were down 15% at one point on Friday but ended down just more than 3%. With that said, DB is **down ~30% since late January**.
   a. On Friday, their **AT1 bond issued in 2014 declined to 70 cents on the dollar**. It had been trading at 95 cents at the start of the month.
   b. The premium on their credit default swaps (CDS) is increasing.
2. There was no clear trigger for the stock drop, but some investors are saying that DB **resembles CS**. They have suffered from low net interest margins and they've been involved in some scandals (money laundering in Russia, accounts for Jeffrey Epstein, allegedly overstating sustainability claims on its investments). (Bloomberg) (WSJ)

G. Schwab

1. At the end of last year, SCHW was the **10th largest bank** in the US
2. The firm had more than **$11B in unrealized losses** on its hold-to-maturity bond portfolio at the end of 2022, exceeding its **tangible common equity of just over $6B**.
    a. Most of the holdings were government-backed mortgage bonds.
    b. They also own Treasurys, ABS, corporate debt and CDs.
3. Schwab executives **expected the Fed would raise rates 75 bps** in 2022. Instead, they raised them 4.25%.
4. SCHW had **$366B in deposits** at the end of 2022, **down 17% YoY**.
    a. SCHW says that these deposits just went to **money-market funds** and other high-yielding investments in their SCHW accounts
    b. Most of SCHW's deposits are gathered by its brokerage arm where the firm sweeps investors' cash into its banking unit. Its lending arm is relatively small, so they put **80% of deposits to work by buying debt**. This means that their bond portfolio is huge compared to its overall balance sheet
    c. Many of Schwab's deposit customers are individuals who come to Schwab largely for its investing platforms (**less likely to run**). **Only 20% of deposits are above the insurance cap**.
5. SCHW says it has **sufficient liquidity** even if 100% of their bank's deposits left. They say that they wouldn't have to sell a single security.
    a. $100B of cash on hand
    b. Interest on bond portfolio
    c. Borrow from Federal Home Loan Bank + BTFP ($300B)
    d. Issue certificates of deposit ($8B / month)
6. SCHW will still pay for its choice to hold the long-term bonds b/c they'll end up with more expensive funding. Earnings estimates for this year have dropped from $4.88 in Dec. to $4.07 now.
7. Short interest is not high. (WSJ)

H. Credit Suisse and AT1 Bonds

1. When UBS acquired CS, $17B of **Additional Tier 1 bonds** (**contingent convertibles**, also known as **co-cos**) were declared worthless. Many people were surprised because the shareholders received $3B. People are thinking about the **absolute priority rule** in bankruptcy and that's not what's going on here.
2. Contingent convertible debt is a special form of debt. If a particular contingency occurs, the bonds change.
    a. Normally, this debt is set up so that if a bank's **capital falls below a particular level**, this debt converts to equity so that the bank has the ability to absorb more losses in the future.
    b. Sometimes, this debt has terms that allow it to be wiped out if any government money has to be used to aid a firm (a "**viability event**").
3. The size of the co-co market is **~$275B**.

(Bloomberg) (Bloomberg) (Bloomberg) (Bloomberg) (Bloomberg) (Bloomberg) (WSJ) (WSJ) (WSJ) (Bloomberg) (WSJ) (WSJ)