First Quarter 2023 Quarterly Letter

The first quarter of 2023 saw the S&P500 rise by 7.5% and long-term bonds measured by the 7-10 Year Treasury Index rise by 3.5%. At face value, these robust returns masked a tumultuous quarter featuring a near banking crisis. Following Silicon Valley Bank's bankruptcy, investors wondered whether Silicon Valley Bank was a unicorn or a canary in the coal mine for a reprise of the Global Financial Crisis of 2008.

What happened at Silicon Valley Bank? What we understand at this point is that two primary factors appear to have led to SVB's demise. First, their depositors were all concentrated in the tech/venture capital ecosystem. Many of these companies raised capital when rates were low and placed funds on deposit with SVB. Coinciding with the Fed tightening, the companies began drawing down on that the deposited funds for working capital and growth. Second, SVB invested the deposits in long term fixed income assets.

As the Fed raised interest rates, market-to-market losses were significant in SVB's "held-to-maturity" account. Held-to-maturity assets are typically held at cost, not market value, and do not draw much attention. However, when SVB was forced to sell some held-to-maturity assets as deposits were withdrawn, it shined a light on SVBs losses. The run to withdraw deposits from SVB began, and as more deposits were withdrawn, more bonds needed to be sold, making the problem worse. Some thought we were headed to worldwide contagion with the likes of Credit Suisse and more regional banks under pressure.

The Fed and the FDIC stepped in. The FDIC guaranteed all depositor funds. The Fed promised to lend against the banks' impaired capital at par value rather than the substantially lower market value to ensure that banks have the ability to meet the needs of all of their depositors. These actions quelled further panic. So now, SVB looks more like a unicorn, a one-off, or perhaps a four-off rather than a canary signaling the beginning of the next global financial crisis.

SVB's balance sheet did not have credit quality problems that large banks worldwide had in 2008. Credit impairment led to the failure of Lehman Brothers and the full-on Global Financial Crisis. There is not the same credit impairment today. Yes, SVBs balance sheet became impaired, but it was from prices falling on high-quality bonds as yields rose. Those high-quality bonds will continue to pay interest and principal when due. During the GFC, through financial engineering, banks were holding junk credit they did not understand. They thought it was high quality, and it was not. So, the challenge to contain any SVB-related contagion was much less severe than the Lehman case, and regulators acted quickly and forcefully enough to avoid contagion.

The Fed now has three risks to manage: Inflation, employment, and financial stability. While there will be ripple effects from the sinking of SVB, the Fed helped to save the "passengers." So long as there are no more passengers on sinking ships, the focus goes to inflation and recession. Given employment remains strong, the Fed remains focused on inflation first. The current Fed Funds target rate is 5.00%, with a 0.25% hike to 5.25% expected in May to be the last.

While the Fed expects the effective Fed Funds rate to remain above 5% through the rest of the year, the market has the Fed cutting rates at least four times in the second half to end the year with the Fed Funds rate below 4%. Clearly, there is a disconnect between the markets and the Fed. This disconnect has become more pronounced since the SVB collapse.

One explanation for the disconnect is that the markets are more concerned than the Fed that SVB ripple effects, specifically tightening lending standards, will cause a severe credit crunch. The Fed reduces demand by raising the price of borrowing. Tightening lending standards reduce demand by reducing the quantity of borrowing. In concept, the more lending standards are tightened, the less the Fed should have to raise rates to control inflation. It seems the market is pricing a true credit crunch rather than a modest tightening of lending standards, while the Fed is expecting the opposite. The next several months should guide us regarding the degree of tightening of lending standards.

Meanwhile, the disconnect has created what appears to be a significant underpricing of inflation-protected securities. Even if inflation falls to just 4.0% this year, at current pricing, 10-year Treasury Inflation Protected Securities (TIPS) will yield more than 5%, about 1.7% above the 10-year Treasury Note. TIPS are complicated in design, but they are simple in what they offer: CPI Inflation protection.

As always, please feel free to contact me anytime with any questions or concerns.

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