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INVESTMENT SERVICES

Weekly Relative Value

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WEEK OF MARCH 13, 2023

How I Long for Yesterday

Yesterday
All my troubles seemed so far away
Now it looks as though they're here to stay
Oh, I believe in yesterday

Suddenly
I'm not half the man I used to be
There's a shadow hanging over me
Oh, yesterday came suddenly
— The Beatles

Silicon Valley Bank (SVB) was the sixteenth largest bank in the U.S. with $210 billion in assets. SVB lost 75% of its equity valuation in a day and a half. Shortly thereafter, the Federal Deposit Insurance Corporation (FDIC) shuttered SVB and appointed a receiver. SVB was the biggest U.S. bank failure since 2008. This is akin to the failure of Washington Mutual in July 2008 or perhaps IndyMac at around the same time.

What is most incredulous is that SVB was actually up for an award on March 2, at a gala in London, to be named "Bank of the Year!" Can you believe that? As I like to say Truth is stranger than fiction.

Get this, last Thursday, as the chaos took on a head of steam, the CEO of SVB issued a memo (Bloomberg News) that stated the company had "ample liquidity and flexibility"

THIS WEEK

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(shades of Lehman saying in 2008 that its liquidity positions were "very strong"). This is how investor confidence can be shaken. And we saw first-hand that a collapse of a bank can happen in a matter of hours.

It was a bloody end of week as the Silicon Valley Bank sent shockwaves across every bank in America. The single-day performance of KRE on Thursday (-11%) rivalled performance last seen during the 2008 Great Financial Crisis. For the week, regional banks (KRE) took it on the chin plunging 17%!%. This moring the fall out continued with an additional 18% haircut! The total decline is 35%!!

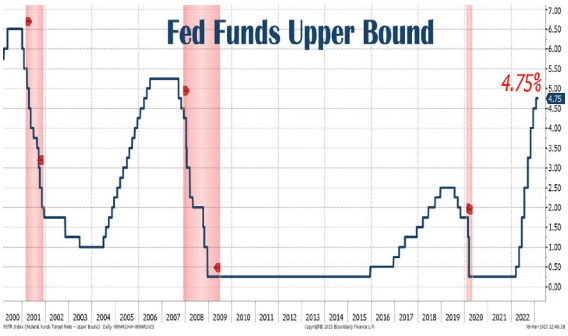
But it wasn't just the smaller regional banks. The four biggest U.S. banks, JPMorgan, Bank of America, Wells Fargo and Citigroup, lost $47 billion in market value in a day!

Investors are so nervous about the possible spillover that we also had the likes of Charles Schwab sliding 23.0% last week. Overall, the S&P 500, Nasdaq and Russell were down between -4% and -8%.

So what happened?

SVB's had became the go-to bank for start-ups from biotech to crypto. In 2020 and 2021, these startups once had a huge amount of cash on deposit at the bank (most of the deposits were uninsured) that they obtained from primarily venture capital funds, including tech startups and biotech companies. After receiving more than $120 billion in deposits in a relatively short period of time, SVB had to put that money to work, and it's loan book wasn't big enough to absorb the massive influx in cash. So, SVB purchased U.S. Treasury bonds and mortgage backed securities.

Fast forward to March 16, 2022, the Fed embarked on its first interest rate hike. In less than a year, interest rates have soared 1,600% from 0.25% to 4.50%.



**Shaded areas denote recessions*

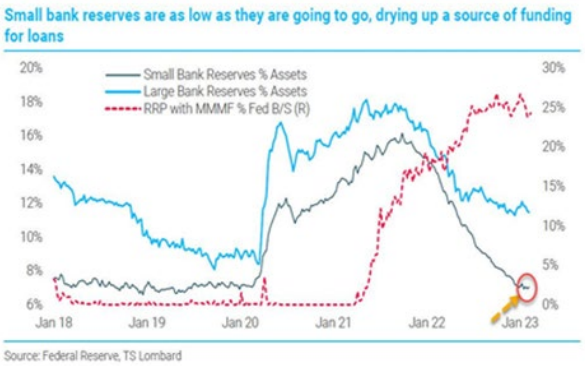
With market rates backing up sharply, courtesy of the Fed, SVB was slow to raise deposit rates in an attempt to preserve their income and margins. However, once short term, risk-free Treasurys started generating more attractive returns than what SVB was paying, people started withdrawing massive amounts of deposits.

To address the liquidity, SVB, publicly announced a $2.25 billion equity raise (but it failed). Its only option left was to sell all of its $21 billion in available-for-sale securities and book a staggering loss of $1.8 billion on those sales. As rumors spread and fear struck, SVB customers withdrew $42 billion from their accounts on Thursday. Doing the math, that's $4.2 billion an hour, or more than $1 million per second for ten hours straight. To put that into context, the previous largest bank run in modern U.S. history took place at Washington Mutual bank in 2008, and totaled $16.7 billion over the course of 10 days. This amounted to the largest bank run in history. Clearly, other banks do not have the same concentrated exposure to start ups as did SVB, however, they may potentially have the same problem.

This is why.

Most of the regional banks have relied on low cost deposits to fund their holdings of longer-term assets (Treasuries, MBS, etc). Like SVB, banks have been very slow to raise deposit rates to protect income and margins. However, as the Fed raised rates drastically over the past 12 months and expected to to stay "higher for longer," depositors have or will soon figure it out and switch their savings and transaction accounts (that pay 0%), to brokered CDs, Treasury bills and/or money market funds that offer between 4.5% and 5%. The result has been an epic contraction in bank deposits, especially with the small banks. The latest Beige Book highlighted this concern.

The solution is either the depository institution pays up via higher funding costs, gets a loan from the Federal Home Loan Banks (FHLB), issues brokered CDs or issues bonds, which are all expensive options that negatively impact earnings and margins. Or they could raise cash by selling securities to reduce or avoid those higher funding costs. According to the FDIC, the problem with selling securities is that the U.S. banks are sitting on unrealized security losses on their balance sheets to the tune of $620 billion! And banks take a hit to their earnings if they sell their bond at a loss (unless they have designated their assets in hold-to-maturity accounts). In a nutshell, there are no great options for depository institutions facing depositor withdrawals.



THE GOVERNMENT STEPS IN

"After receiving a recommendation from the boards of the FDIC and the Federal Reserve, and consulting with the President, Secretary Yellen approved actions enabling the FDIC to complete its resolution of Silicon Valley Bank, Santa Clara, California, in a manner that fully protects all depositors. Depositors will have access to all of their money starting Monday, March 13."

— The *Federal Reserve, the Treasury Department and the FDIC*

In the wake of the SVB debacle, the FDIC, Fed and Treasury announced the most extraordinary measures since early 2020, and before that, early 2009. All depositors, including uninsured depositors of Silicon Valley Bank, will be made whole. In addition to backstopping all uninsured deposits in the banking system, the Fed (along with the Treasury and FDIC) has widened access, improved terms at the discount window and established a new facility (a new acronym born — the BTFP or the Bank Term Funding Program) that will allow the banks to trade in their under-water securities in hold-to-maturity accounts at par value.

But investors in failed banks are on their own. They're given some tough love instead with stockholders and "certain debtholders," such as preferred stock holders, likely experiencing a total loss.

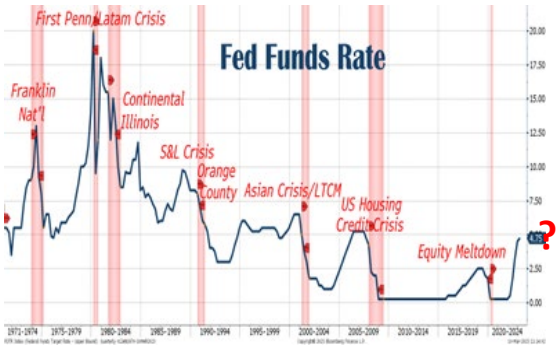
"Let me be clear that during the financial crisis, there were investors and owners of systemic large banks that were bailed out . . . and the reforms that have been put in place means we are not going to do that again."
— Janet Yellen, U.S. Secretary of the Treasury

Ironically, even as the Fed whispered words of reassurance, the question is why would depositors park their money at "suddenly" risky banks when they can just buy a 6 million Treasury bill and get the same return with zero risk?

There's a reason why banking is the ultimate confidence game. Go back and watch *It's a Wonderful Life* to see how one thing is critical to prevent bank failures when there is a loss of confidence — in one word or less: liquidity. Not just that, but outside the big bank community regulatory oversight was lacking.

Bottom Line: In a broader sense, three banks, that became symbols of the worst excesses of Free Money, collapsed within a few days. These failures attest to the fact that this is what happens after years of quantitative easing (QE), zero rates and central bank financial repression.

When you raise interest rates quickly, after 15 years of near-zero rates, and to think something will not break is naïve. Take a look at the folowing graph below (which I have highlighted numerous times), which shows various crises notated - from the Penn Cental Crisis, to the Savings and Loan crisis, to the Asian Crisis/Long-Term Capital Management, to the Housing Crisis and to the equity meltdown. All of these events popped out of nowhere during or after Fed tightening campaigns.



My Take: I need to stress that this will not be repeat of the 2008 to 2009 Global Financial Crisis. Ido not believe this is a systemic issue. The big banks are well managed and capitalized thanks to the Fed's massive post-COVID-19 QE. The big banks are still drowning in reserves and have trillions in excess liquidity. In fact, the big banks are likely to be the primary benefiaciaries should the SVB failure lead to financial contagion.

So far, the real problems are with the smaller regionals and the Fed and Treasury have stepped in with emergency measures to prevent contagion from spreading thoughout the financial sector. However, bailing out uninsured depositors is not a panacea. All the stresses on the regional banking system have not disappeared, (history does show that a crisis very rarely stops at just one firm) which is why the government, yet again, has been forced to step in with a backstop.

This isn't just about asset-liability mismatching, but also about deteriorating credit quality, underlined by the notable increases seen in 30-day past-due rates across a wide swath of loans, which is a feeder for future loan delinquencies.

Most importantly, I believe the biggest intermediate/long term economic implication is further credit contraction. Banks will be forced to raise deposit rates. Also, the regulatory backdrop is certainly going to become more stringent, the banks will tighten their lending guidelines and throttlle back on loan growth, which was already happening.

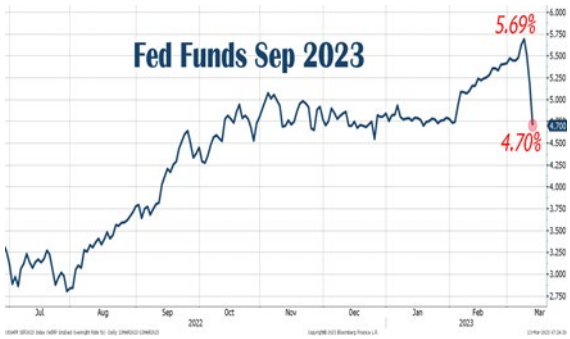
This is not good news for a credit-driven economy that requires lenders to take on risk, not shed risk.

The recession is now going to come into full view.

POWELL COMES OUT SWINGING

"We are seeing the effects of our policy actions on demand in the most interest-sensitive sectors of the economy. It will take time, however, for the full effects of monetary restraint to be realized, especially on inflation. In light of the cumulative tightening of monetary policy and the lags with which monetary policy affects economic activity and inflation, the Committee slowed the pace of interest rate increases over its past two meetings. We will continue to make our decisions meeting by meeting, taking into account the totality of incoming data and their implications for the outlook for economic activity and inflation." — Jerome Powell, Chair of the Federal Reserve of the U.S.

Before the SVB news hit the tapes, Jerome Powell's testimony before Congress was perceived as being more hawkish than the consensus expected. He stated that the economy is not slowing fast enough, the labor market is too tight and the Fed's preferred core service inflation measures are stubbornly high.
Powell strongly intimated that the Fed Funds rate will be heading above the previous estimate of the terminal (peak) level of 5.1%. For context, prior to the SVB event, the market was pricing an additional 100 basis points of tightening in Fed Funds before this cycle ends. The Fed's terminal rate was at 5.65% — up a stunning 300 basis points from July 2022 expectations.



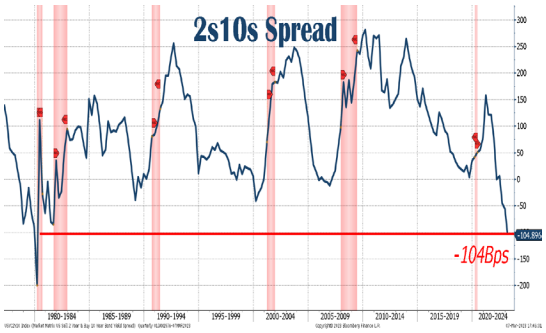
Bottom line: Again, most importantly all of this was before SVB collapsed. As shown above, the futures market has slashed the terminal Fed Funds rate by 100 basis points from 5.69% to 4.70%. Should financial contagion occur, there is

one way to short-circuit the process and it, of course, involves the Fed. The Fed would need to step in the way it did in September 2019 when it was the big banks (namely JPMorgan) that were reserve-constrained.

YIELD CURVE SCREAMS RECESSION

The bond market has taken heed and is has been *screaming* that there is going to be a recession, and now it seems certain that the Fed is overtightening. This all started with last month's payroll report showing the economy added over 500,000 jobs in the month of January. A lot of people (including yours truly) questioned the credibility of that data saying that the seasonality calculations might have been wonky, or it could have been due to warm weather.

While yields on the front end have risen sharply, it's quite telling that the 10-year Treasury yield is the same today as it was in mid-October when the Fed Funds rate was sitting just above 3%. So, after the Fed has raised rates nearly 200 basis points, there has been no change to longer term bond yields. This is the bond market's way of signaling a recession.



**Shaded areas denote recessions*

The widely watched 2s/10s spread broke below -100 basis points for the first time since Sept 1981 (-104 basis points). Moreover, this curve has now been inverted for nine months. For perspective, the 2s/10s curve was over +150 two years ago (March 2021).

Now, consider the following: Over the past 50 years, the average time of peak inversion prior to a recession has been nine months. The the average "peak" inversion is -75 basis points. Thus, the yield curve is at or near peak inversion in both duration and magnitude. At no time in the past has the depth and duration of the yield curve inversion failed to presage a recession. Yet, all I hear and read is "where is the recession?" These are the same people, who don't know their economic history and how policy lags work, that were asking the same question in 2000 and 2007.

Bottom line: If you're Jerome Powell and you look at your Bloomberg Terminal to see the yield curve freaking out, you might want to reconsider what you're doing. The bond market talks. Everyone knows the yield curve has a nearly flawless track record in predicting recessions. If we don't have a recession after nearly nine months and a -102 basis point inversion, then I'll eat my hat!

WHAT COMES NEXT?

*"**On all the previous occasions** that the 2s/10s has been more than -100 basis points inverted from the early 1940s (there are just four of these — 1969, 1979, 1980 and 1981) **a recession has either been underway, or has occurred within a maximum of eight months.** And just to highlight how rare the current inversion truly is…there have only been seven month end closes lower than -100 basis points in 80 years of available data, so we are in rarefied air."*
— Jim Reid, Head of Global Fundamental Credit Strategy, Duetsche Bank

Many may not be aware that the best year of the economic cycle is, believe it or not, the year the Fed begins to tighten policy. Historically, in the initial year of the Fed tightening phase, real gross domestic product (GDP) growth averages +3.5%. This is because the economy has been benefitting from the lags of previous policy accommodation.

Let's review the past two years. In 2021, real GDP boomed 6% (the highest growth since 1984) due to the massive and unprcedented fiscal and monetary stimulus. Much of this stimulus and growth was front loaded.

In March 2022, the Fed started tightening and rasied rates by an epic 425 basis points. And as the cost of money rose combined with the end of the gobs of fiscal stimulus, the economy grew at a "stall" speed of less than 1%.

The more leveraged an economy, the more sensitive it is to interest rate changes. Think of higher interest rates as a tax on the economy. The Fed's juice of years past, low-interest rates, is being replaced with the highest interest rates in 15 years. High interest rates are stifling new debt creation and credit demand. A contraction in credit will slow the economy. More importantly, borrowing to repay old debt introduces a financial shock to the borrower and a tax on the economy.

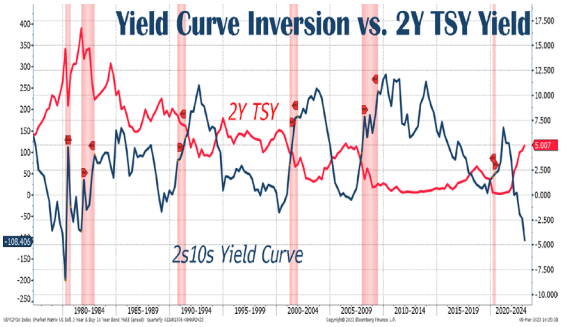
Here's a little factoid. Going back to 1959, in the year after the Fed has tightened, real GDP declined by an average -2.5%. With the U.S. economy currently running at 1%, there is little margin of error.

With every passing day, the effect of yesterday's interest rate hikes will weigh more on the economy. As we move further into 2023, the lags of the Fed actions in 2022 will become more evident to the economy in 2023. Moreover, whatever the Fed does going forward will impact the economy in the first half of 2024.

Understanding the time lag between monetary policy changes and full economic impact suggests that a no landing scenario is a pipe dream.

So if a recession does occur this is historically what has happened:

- The yield curve steepens. (Remember, it's the re-steepening from inversion that is the big recession signal).
- The 10-year Treasury yield declines 75 basis points.
- The 2-year Treasury yield plunges approximately 200 basis points.
- The Fed pivots from tightening to easing.



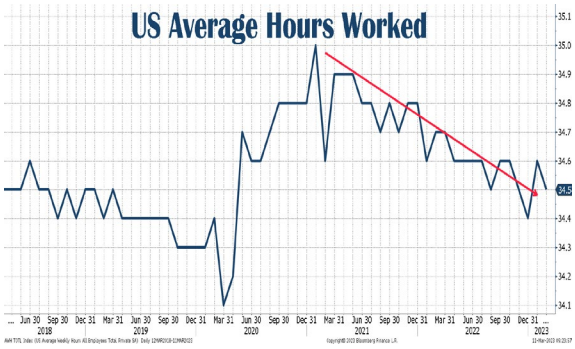
**Shaded areas denote recessions*

Bottom line: I respect data, history and probabilities. From my perch, the only debate is when the recession officially begins. The "no" or "soft" landing scenario assumes economic cycles no longer exist, and that interest rates, policy lags and the yield curve are irrelevant. In other words, "this time is different." I truly hope for a soft landing, but fear the more typical hard landing is the likely course.

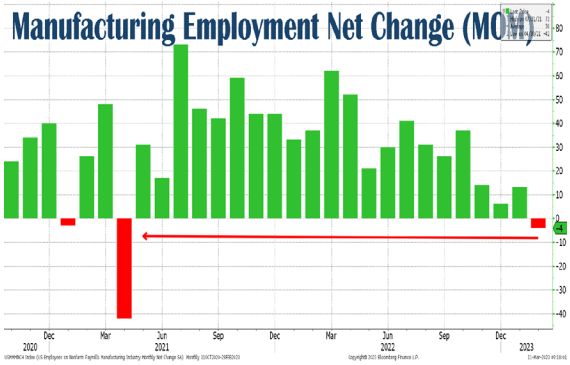
JOBS BEAT AGAIN

"February's extremely strong jobs report exceeded expectations — and, following January's blowout report, means the Fed will likely follow through with Powell's statement in his semiannual congressional testimony about accelerating the pace of rate hikes. That said, there are some signs of weakening in the print — Hours worked slowed, and average hourly earnings cooled faster than expected – that are consistent with our read that the labor market is softening. Still, with inflation elevated, the Fed will have to take the data in this report at face value. We have upgraded our baseline to a 50-basis-point hike at the March Federal Open Market Committee (FOMC) meeting."
— Anna Wang, Chief U.S. Economist, Bloomberg

Non-farm payrolls came in at +311,000, which once again topped the consensus forecast (+225,000) for a record tenth consecutive beat to consensus expectations. If all you do is look at the headline, you will draw one conclusion, which is that we are in for a 50 basis point hike at the coming FOMC meeting.



But beneath the headline, the workweek contracted 0.3%, the third decline in the past four months. And much of the employment gain was in the lower paying leisure/hospitality sector (+105,000) and retail sector (+54,000). Manufacturing, financial services and transports/warehousing all shed workers (a combined -27,000) so this was a highly uneven report.



The companion Household survey headline increase was a more modest +177,000. The number of folks working part-time because of "slack work or business conditions" jumped +105,000 and has risen +305,000 over the November to February period. This metric tells you a thing or two about the shape of the U.S. economy. Workers are working at part-time jobs because economic conditions are deteriorating.

On the postive side, people are getting off the couch and re-engaging in a job search. The labor force expanded +419,000. This caused a nice pop in the labor force participation rate to 62.5% from 62.4% in January, which is the best level since March 2020.

More importantly, the expansion in labor force entry in the key demographic segments. Prime-age working females (25-54 year olds) are up to a record-high of 77.2%! Likewise for males (25-54 year olds), the participation rate jumped to 88.9% from 88.5%, and is now at a post-COVID-19 high. One would have to assume that the bear market has unwound the Great Resignation theme.

LABOR MARKETS ARE ABOUT TO BE CHALLENGED

"Certainly, employers are paying attention to rate increase plans from the Fed. Many have been planning for a downturn for months, cutting costs elsewhere. If things continue to cool, layoffs are typically the last piece in company cost-cutting strategies… Right now, the overwhelming bulk of cuts are occurring in Technology. Retail and Financial are also cutting right now, as consumer spending matches economic conditions. ***In February, job cuts occurred in all 30 industries Challenger tracks****." — Andrew Challenger, Senior Vice President of Challenger, Gray & Christmas, Inc.*

The non-farm payroll report is a "coincident" indicator and it is very common for payrolls to continue to rise into the early months of the recession.

Despite the jobs beat, Challenger Gray & Christmas, Inc reported that U.S. employers announced 77,770 job cuts in February — 410% higher than the 15,245 cuts announced in the same month last year. February's total is the highest for the month since 2009. At 77,770, pink-slip announcements are up an astounding +410% from year-ago levels, which is more than five times higher. And these haven't shown up yet in the official data.

So far in 2023, employers handed out pink slips to 180,713 jobs, up 427% from the 34,309 cuts announced in the first two months of 2022 — the highest January to February total since the Lehman crisis in 2009.

The two-month total is about on par with what we had on our hands in March 2020, May 2008 and December 2000. You may as well say "It's different this time." How well has that catchphrase worked in the past?

In addition, this is the first time since the Lehman crisis that layoffs occurred in all 30 industries followed by Challenger.

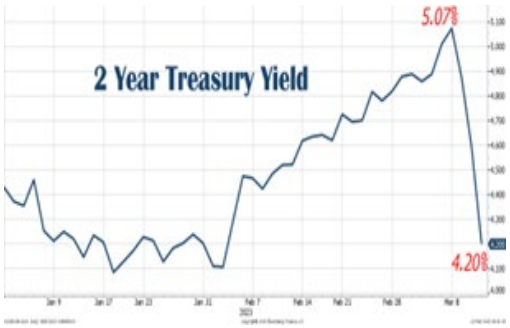
The "worst since Lehman" is never a good thing.

In terms of the reasons for the layoffs, cost-cutting, economic conditions, demand downturn and restructuring, financial losses totaled 65,512 and accounted for more than 100% of the year-over-year surge in layoff plans.

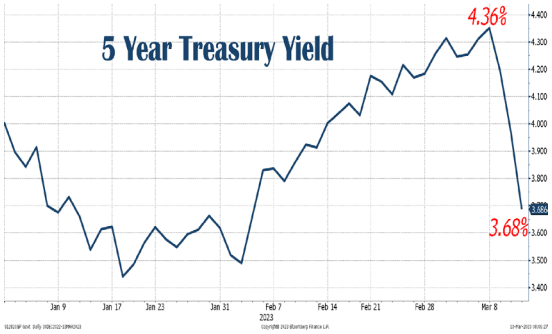
And it's not just the layoffs that are piling up, but also the hiring plans are hooking down in a major way. They sank 86.6% year-over-year in February. Hiring plans are about back to levels during the 2008 to 2009 Great Recession.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

The Treasury market rallied in the immediate aftermath of the SVB news. Front-end rates are seeing the biggest plunge with the 2-year Treasury yield tumbling a further -35 basis points to 4.20% as investors re-price the Fed. It was sitting at 5.07% just five days ago!



Likewise, the five-year Treasury yield has cascaded lower from 4.44% to 3.66%.



As I discussed last week I really believe that the next "BIG" long term cyclical move in inflation and bond yields is lower. That said, timing this is next to impossible. Last week highlighted how quickly rates can decline. After managing institutional fixed income funds for 40 years, I know that it is simply not possible to catch the exact bottom (or the peak) in rates, so it is best to invest regularly and consistently in a diciplined manner. This why we have steadily advocated building a risk appropriate ladder portfilo of high quality investments. Over a "full interest rate cycle," this prudent approach is likley to deliver consistent returns. Best of all, you will not need a crystal ball to predict what comes next.

MORE INFORMATION

For more information about credit union investment strategy, portfolio allocation and security selection, please contact the author at tom.slefinger@alloyacorp.org or (800) 782-2431, ext. 2753.

Tom Slefinger, Senior Vice President, Director of Institutional Fixed Income Sales, and Registered Representative of ISI has more than 40 years of fixed income portfolio management experience. He has developed and successfully managed various high profile domestic and global fixed income mutual funds. Tom has extensive expertise in trading and managing virtually all types of domestic and foreign fixed income securities, foreign exchange and derivatives in institutional environments.

At Alloya Investment Services, Tom is responsible for developing and managing operations associated with institutional fixed income sales. In addition to providing strategic direction, Tom is heavily involved in analyzing portfolios, developing investment portfolio strategies and identifying appropriate sectors and securities with the goal of optimizing investment portfolio performance at the credit union level.