

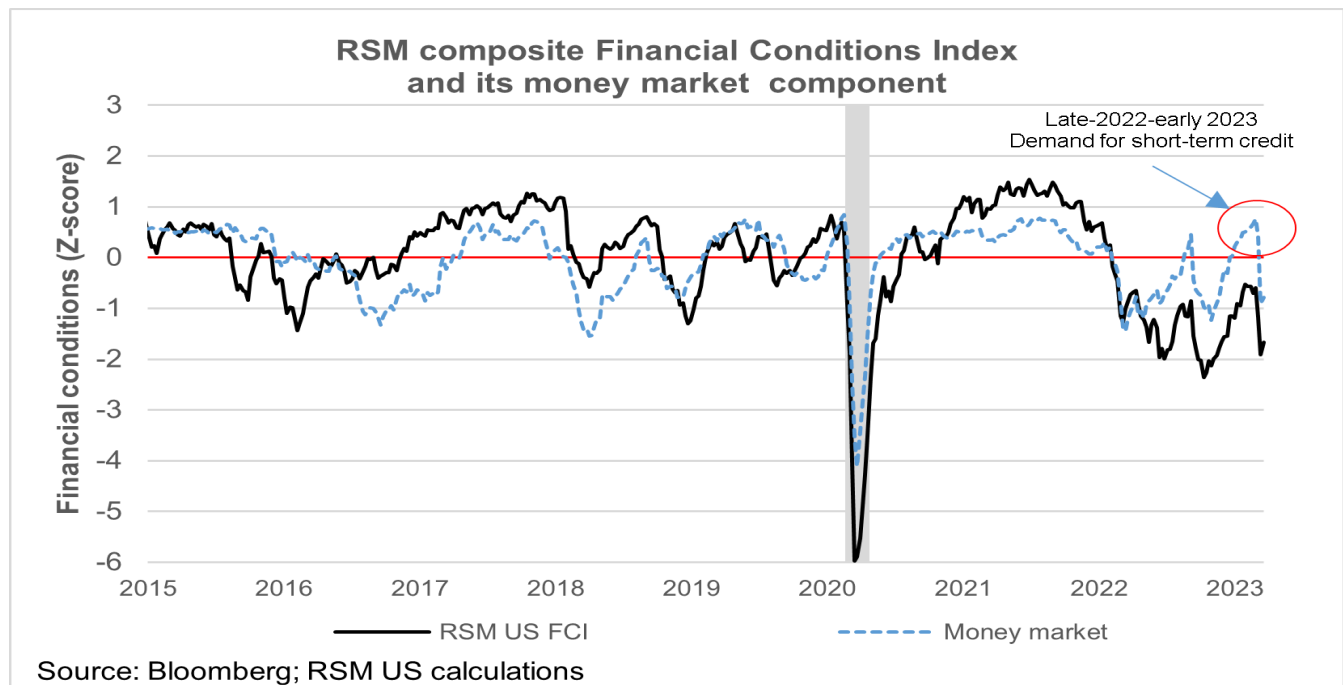
I Know What You Did Last Winter

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While not quite a horror story yet, we've had at least a few deaths (or near-death experiences) depending on your perspective and what you own.

Much of the current situation can be tied to events that occurred a year or so ago. **Yes Virginia, there are long and variable lags to monetary policy.** These recent events can be traced back to the start of the hiking cycle last winter, but also back to last summer (which would have been a catchier title) when the Fed doubled down on hiking to fight inflation at all costs.

In theory, there should be a lesson for central bankers in all of this. However, both the ECB and FOMC missed that possible lesson as they chose to hike rates at their recent meetings despite **significant changes in financial conditions.**



I've chosen the RSM Financials Conditions Index as it tries to track business sentiment and the demand for credit. In the past few weeks, we've seen an almost 2 standard deviation move, which RSM associates with a **higher risk of financial dislocation that will impact the real economy!** We all see how the stock and bond markets react instantaneously to news. One fear is that the events of recent weeks (which were triggered by the events of "last summer") won't show up in the economic data immediately. However, they have begun to cause inexorable damage to the real economy. Not just through tighter lending standards, but through an impetus for everyone (from savers to companies) to act more fiscally conservative.

I Still Know What You Did Last Summer

I didn't choose this for a title, but I could easily have done so since we are living in a sequel (if not a trilogy). Before going further into today's main topics, I want to highlight **that the events of last winter were a direct result of the summer before that!**

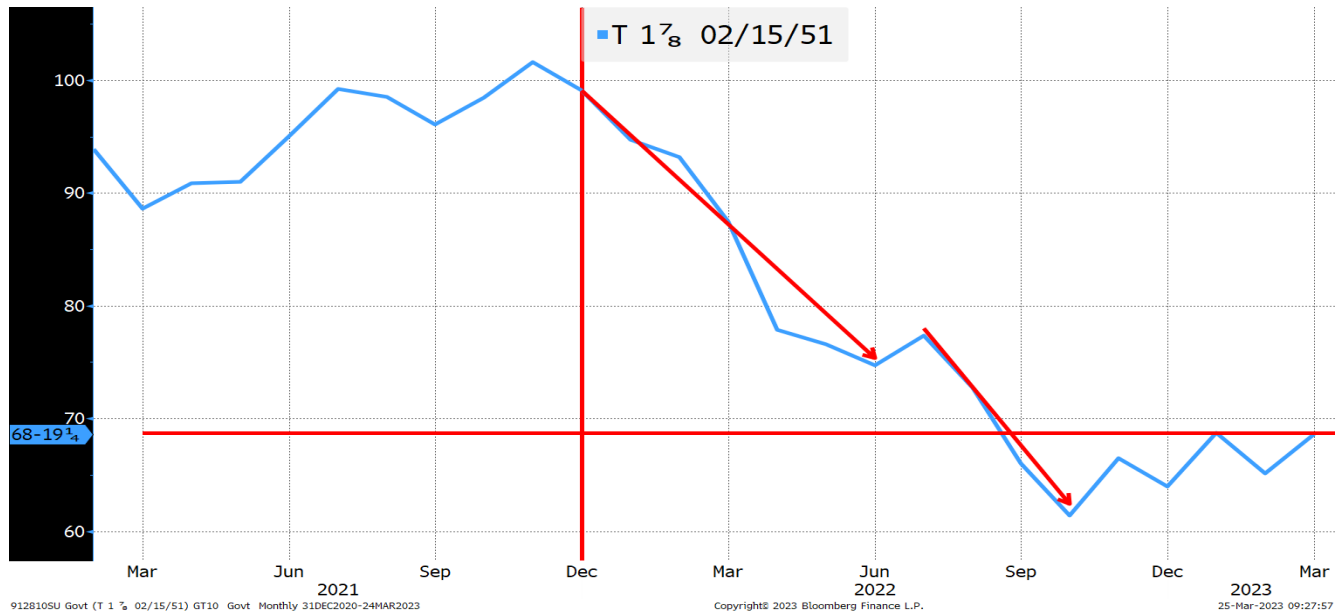
The events of last summer (hiking, Jackson Hole, QT, and high inflation) were a **direct result of the previous summer when we left ZIRP (0% rates, large scale asset purchases, etc.) on for too long!** We don't have the time to harp on this subject. It was really important, but reliving those actions (or

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inactions) won't change anything about where we are today. However, looking at last summer may help us figure out what is next. **It isn't too late to fix things, but I'm increasingly worried that we are heading in this direction.**

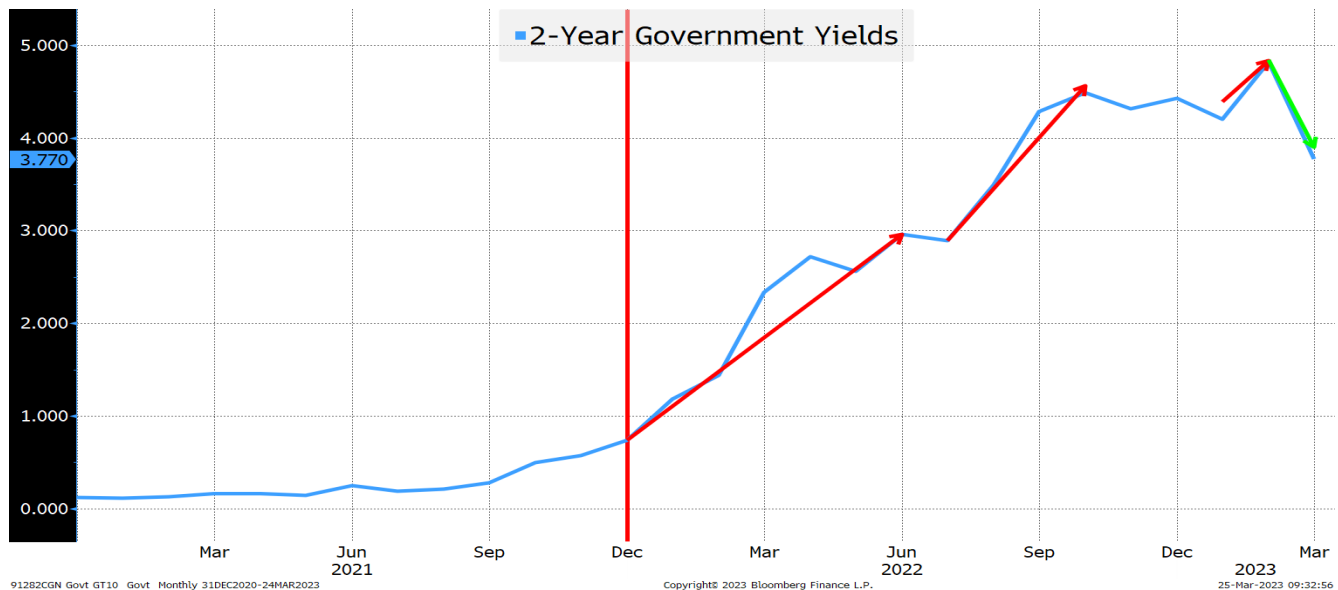
Bonds - Texas Chain Massacre

A recurring theme in today's T-report, unfortunately, will be the "steaming pile of unrealized bond losses".



This long bond began its life in February 2021 when 1.875% was a "good" yield (even for a 30-year bond). It was so good that the bond even traded above par in December 2021. While the massacre started well before the summer of 2022, the theme applies. Any attempts to bounce at a price near 80 were thwarted. Currently, we still languish in the 60s.

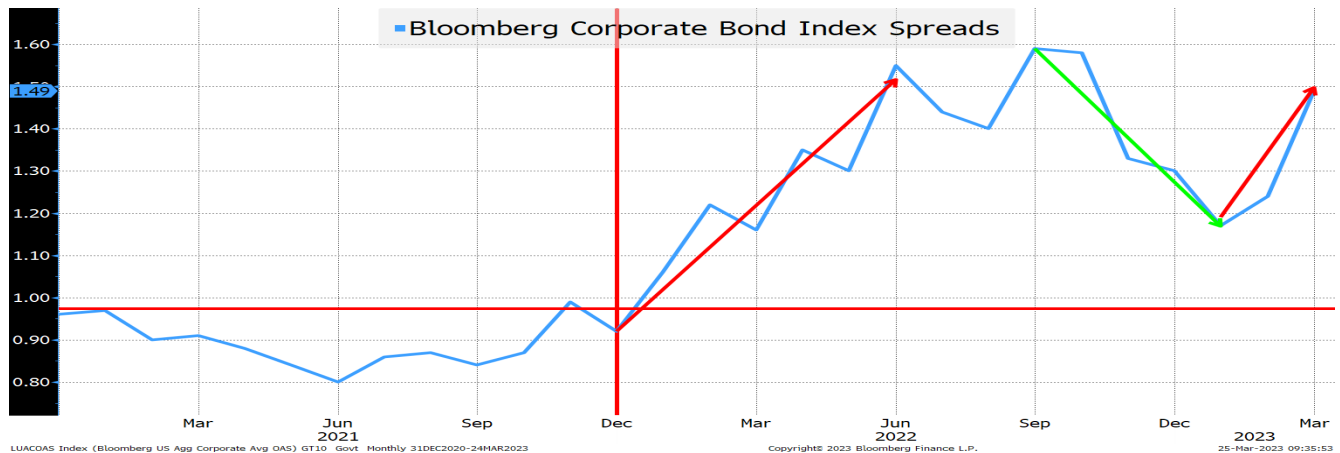
No part of the curve was spared!



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As inversion got worse, there was no place in the yield curve to hide.

Credit spreads weren't helping anything for the corporate bond investor (or the issuer).



At least corporate spreads are below their widest levels (seen in June 2022). However, they've started to widen again recently as concerns about a possible recession get put back on the table. These concerns should never have been removed from the table as thoroughly as they were. In addition, more people are starting to worry about credit conditions.

One positive is that very little, if any, of the pressure on the banking sector can be linked to corporate credit quality concerns and I don't see that changing!

The Ring – Deposit Rates

I remember being creeped out by “The Ring”. However, I still don't understand it (which brings me to deposit rates). They are starting to creep me out as well and I don't fully understand them either.

The only interest rates on the entire planet that have barely budged are the rates paid on deposits.

I can only find “reliable” data on [FRED](#) going back to April 2021. The data here is the FDIC rate on savings and it only moved above 0.1% in the summer of 2022 and was reported as 0.37% today (which is astonishing). We discussed this topic on Friday in [Discretion is the Better Part of Valor](#) and it is potentially the lynchpin for what happens next for banks.

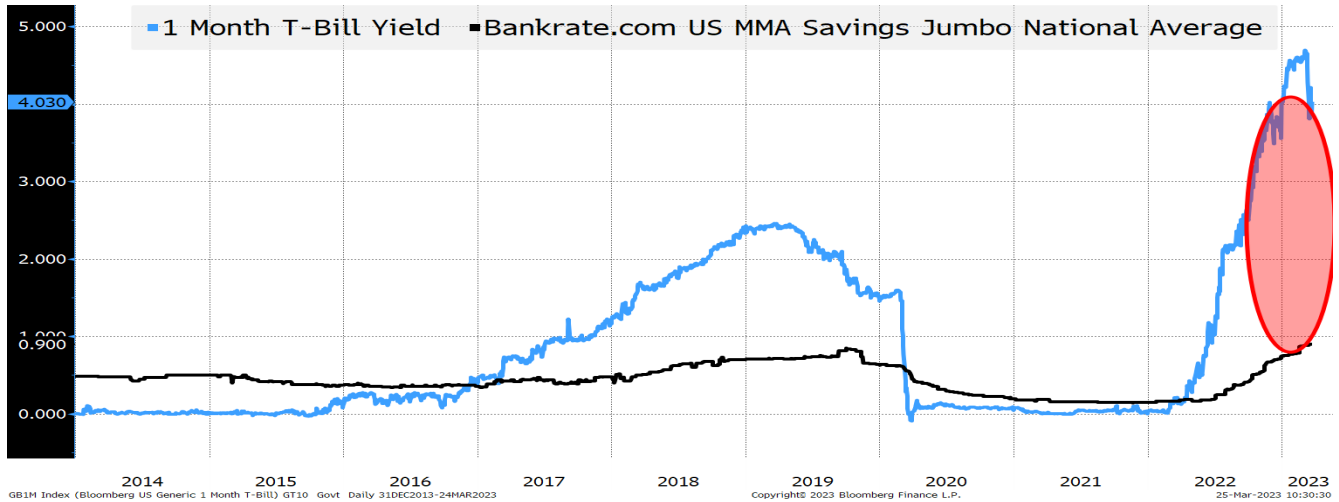
- **I'm 99.9999% confident that depositors in any bank will be fully protected.** However, the policy makers could have been more explicit (rather than Powell's “wink, wink, nudge, nudge” approach of hinting that they would step in when needed). This is hard to do except in the case of an “emergency”.

If I'm not worried about credit risk as a depositor, why am I still worried about bank deposits?

- Having money in a bank deposit account serves many purposes (getting cash, paying bills, and easily moving money around). **There are a lot of services that banks provide and part of the “payment” is accepting a lower interest rate than you could otherwise receive.**
- That is how it has always been done and is likely how it will continue. However, it seems like it has become much easier to move money seamlessly back and forth (quite cheaply), which could cause many to question how much one should keep in a bank.
- What started as people re-thinking their credit risk may morph into people re-thinking the cost (in terms of yield give up).

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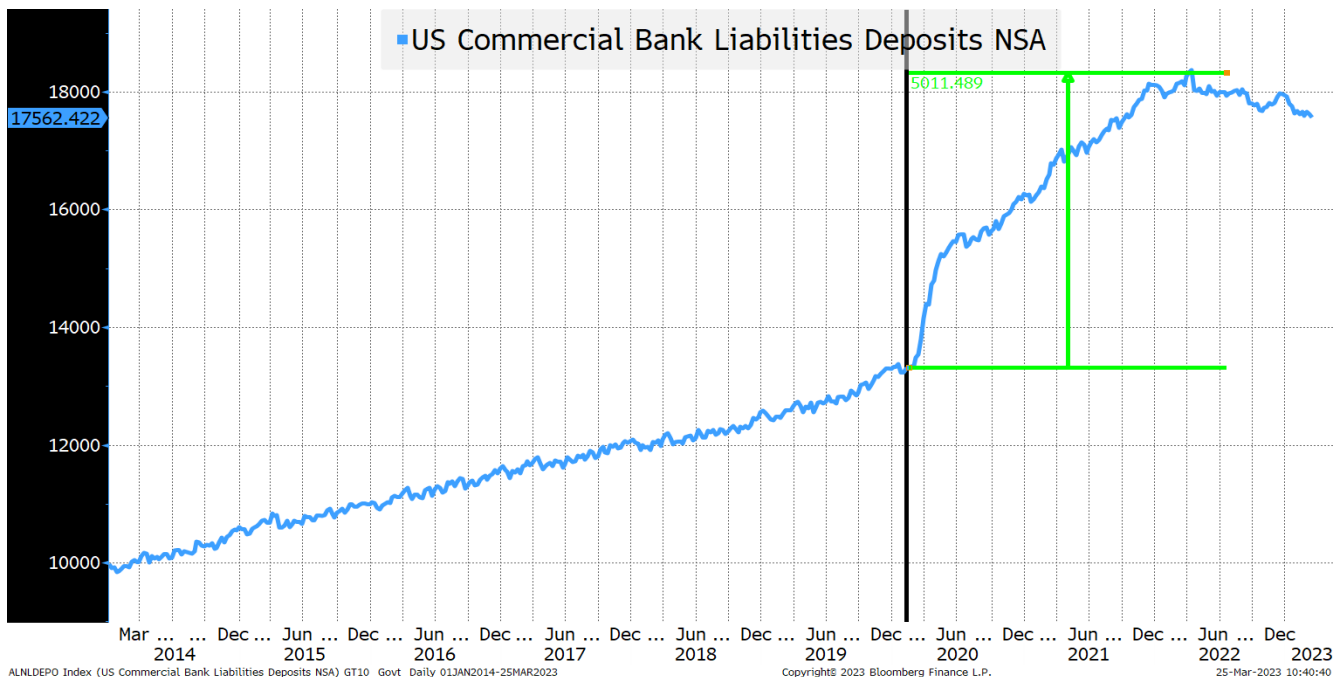
A “preliminary chart”. As mentioned earlier, I have had some difficulty finding a good estimate of the average interest rate paid on bank deposits. I found this bankrate.com index that seems to include rates paid on jumbo savings accounts. This might be why (at 0.9%) it is higher than the FDIC rate I mentioned earlier. I need to do more work to find some better information on this, but it is at least indicative of the spreads between something as safe as bank accounts and 1-month T-bills.



On Friday, I had an interesting discussion with a banker that offers clients the ability diversify up to \$50 million in deposits at the touch of a button. It would be distributed to enough different banks (and bank accounts) that the entire \$50 million would be covered by the FDIC. This is impressive (both the technology and anyone who has \$50 million lying around), but I am wondering if someone will ask the question – why?

Low rates paid on deposits and the ease of moving money around will be the next important point of discussion around banks. They can raise the rate they pay (should stem deposit flow), but this may hit earnings.

The timing of the “deposit boom” is also important!



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It took about 7 years for deposits to grow from \$10 trillion to just over \$13 trillion. Then, between stimulus and ZIRP, deposits grew by \$5 trillion in 2 years!

A system that basically was growing around \$0.5 trillion per annum for an extended period of time grew by \$2.5 trillion for 2 years in a row!

Remember (and this is crucial) that from early 2020 until somewhere in 2022, there was virtually no difference between what you could get in 1-month T-bills (and other super safe/low duration assets) and bank deposits. **You had all the benefits/features of a bank account and were paying next to nothing (in terms of yield give-up).**

That has all changed. It is not a coincidence that the level of bank deposits started to shrink early in 2022. This was all before bank deposits were part of the headlines on the nightly news.

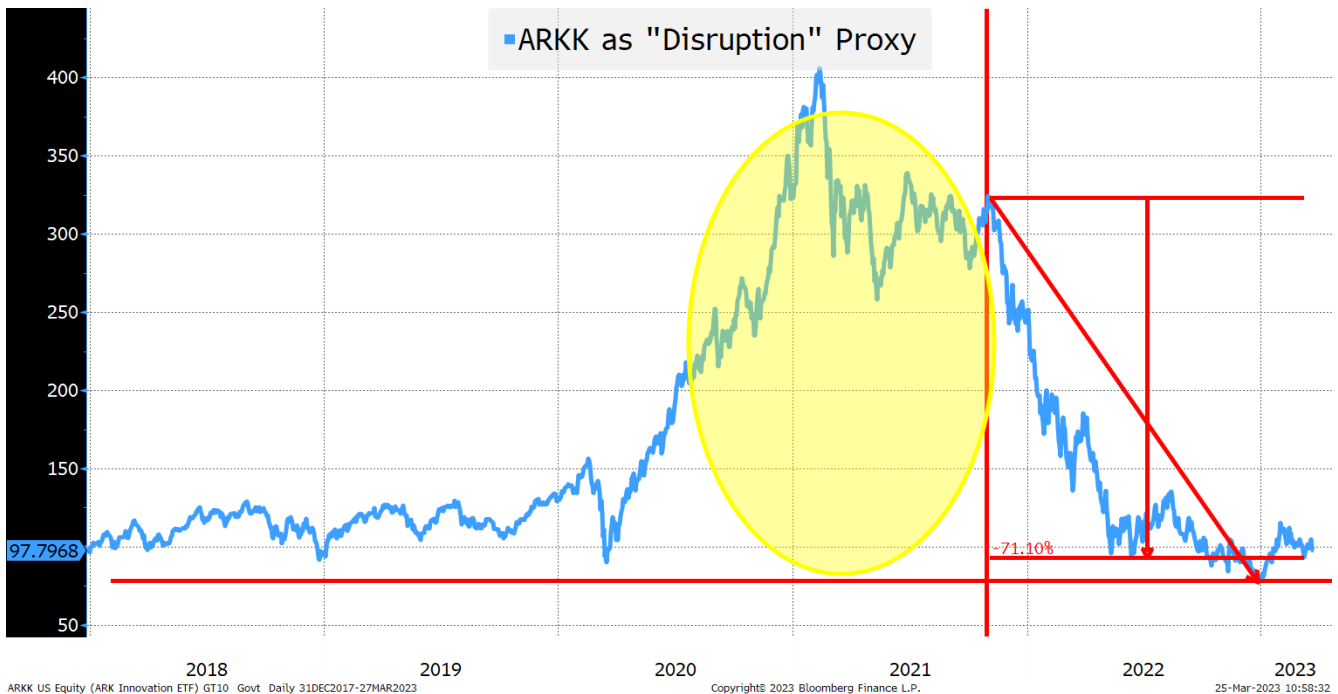
Maybe I'm wrong and this is sustainable, but something has to give in the coming weeks and months.

What concerns me is how much money came into the banking system during ZIRP when there were few ways to earn net interest margin without taking more risk than was needed in the past. Yes, remember that the seeds of inflation (and other issues) were sown when we kept ZIRP going far longer than many thought was necessary.

Scream – Disruption

The wealth destruction in disruption has been nothing short of epic – hence the “scream”.

What has happened to cryptocurrencies (even as bitcoin is climbing), private equity (not immune to what has happened in public markets), and so many companies (investors and their employees) has been awful.



I use ARKK as a proxy for disruptive since everyone knows it. Its problems started earlier, but it is still down 70% from late 2021 (and even more compared to the early 2021 highs). There are some issues with using this as a proxy because the portfolio is traded actively (which may overstate the problems in disruption) and it is only a subset of “disruption”. However, it also tended to have TSLA as a large

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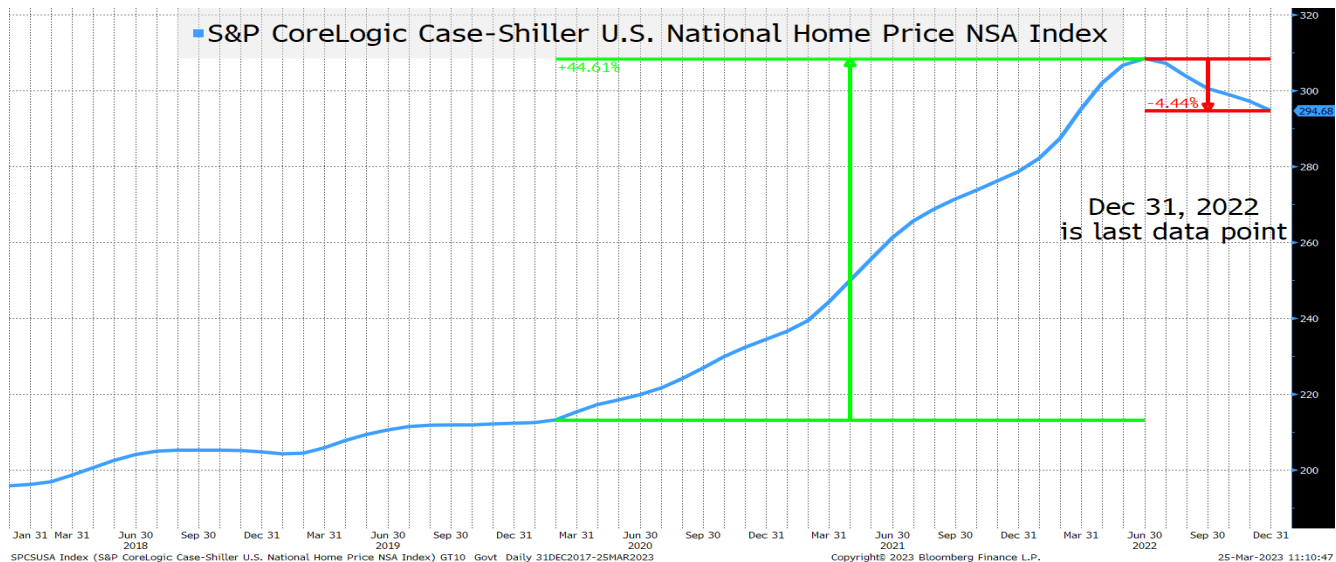
investment, which is still up more than 500% during this time period. In any case, I still cannot believe that I failed to tie the importance of the “disruptive economy” and the “disruptive portfolio” to Silicon Valley Bank. It literally personified my theory and I failed to see it.

If you get a chance, go back to [Inflation Factors](#) for why I think that disruption is so important.

I still believe in the importance of the wealth effect and think that **disruption is at the epicenter of the problem that the market and economy are facing.** The more your economy or business depends on the disruptive community, the more at risk you are.

Silence of the Lambs – Commercial Real Estate

The housing market, so far, has sustained much higher mortgage rates reasonably well.



I suspect that we will see declines continue, but so long as job losses remain minimal (so far, so good), many individuals who refinanced during ZIRP will not be in any rush to sell.

However, what isn't so positive is what is happening in relative silence.

[Limiting at least some withdrawals](#) on at least one real estate focused fund is hardly an endorsement for that type of investment. That was reported late last year, but it is an ongoing issue (I haven't seen stories that it has been re-opened to full withdrawals, but I could be wrong).

There are some publicly traded REITs that are at least 50% down since the start of 2022. Again, this is occurring in relative silence.

As I'm talking to people, CRE or commercial real estate is becoming the “topic de jour”. Small banks, which rely on local lending opportunities, could be exposed.

In any case, I encourage you to reach out to **Stav Gaon at Academy** who is our resident expert (and an II ranked analyst in the space). He has published many [reports on structured products and real estate](#).

Bottom Line - Caution

If I had to pick one “crazy” idea right now, it would be an emergency rate cut of 100 bps or more sometime before the summer is over.

One thing that fixes the “cost of funds” issue for everyone (even if the curve steepens) is much lower short-term rates.

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But the Fed and ECB both just hiked and are convinced that inflation is rebounding so I see more pain ahead. Inflation had improved steadily from last summer into January (disinflation was a risk at the second to last Fed meeting) and even wage inflation pressures eased in the most recent data, but let's not let facts get in the way of hyping the return of inflation. They've also chosen to ignore a potential serious tightening of **financial conditions**. So long as deposits remain at risk of being taken elsewhere, banks will be more cautious on their lending than they were even a month or two ago.

I haven't even touched on European banks today despite Friday morning's spread widening. I think that the SNB could have handled CS much better from an overall market perspective. They did a lot to ensure that it got taken over by UBS, but did little to give confidence to the broader market. European banks face a different set of issues. These issues include the ability to retain deposits and to address questions about that "steaming pile" of unrealized (or unrecognized/unknown) losses in their portfolios.

[Lehman was NOT a Moment](#). In no way am I comparing recent events to Lehman, but it is worth pointing out that the S&P 500 finished higher the week after Lehman filed. **Yeah, stocks bounced off of the lows Friday, all is good! Hmmmm...**

I like lower yields.

I'm mildly nervous about credit spreads here, including structured products.

- **I am NOT worried about credit risk increasing materially.** Companies are doing well and will likely weather any economic slowdown (which is by no means a foregone conclusion even in a cautious state).
- I am worried about the cost of credit risk increasing. Investors will demand more premium for any given level of credit risk. The price of credit is always influenced by liquidity and if selling pressure mounts, pricing will deteriorate. I cannot remember how low AAA CLO paper got during the GFC, but it was absurdly cheap for an asset class that still hasn't experienced losses due to credit. **Even after this year's bracket busting NCAA tournament, I still think that it is easier to pick a perfect bracket than to create credit losses in a AAA CLO tranche** (but that doesn't mean that the prices can't get worse).
- One positive development next week (I think it is positive) is that we may see more institutions use the new Fed facility after March 31st. They wouldn't have to report accessing the facility until the following quarter (small, but could help).

Equities, I see greater downside.

- Equities have been trying to re-ignite the ZIRP framework of 2020 (though conditions are so different compared to back then). This has created bullish positioning that is susceptible to a pullback.
- The system is "saved" mentality has helped markets too. Just watch how well stocks did after the FSOC meeting was announced (which so far has only produced a generic statement of "all is well").
- You get any geopolitical risk for "free" being underweight equities. Maybe Putin is making peace overtures, but I'm still leaning towards China deciding to sell weapons to Russia before then.
- I saw people mocking "volmageddon" early last week. While I didn't fully agree with the "volmageddon" idea, I do think that ODTE options can push markets. While I'm convinced that

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there is “always a seller”, I’m not as convinced that there is “always a buyer”. The risk of a big move here is heavily skewed to the downside rather than a face-ripping rally!

- In addition, the debt ceiling debate is also looming and there are concerns that the situation could be even more contentious this time around, which would hurt risk assets.

The narrative is shifting and one thing that I learned from 2007-2009 (and again during the European Debt Crisis) is that by the time central bankers and policy makers solve the “current” issue, the market has started to move on to the “next” issue.

There won’t be as many “green dots” on Bloomberg this Sunday night as there were last Sunday so enjoy your weekend!

I’m going to remain cautious into next week until I see things evolving in a sustainable way (rather than just knee-jerk reactions and short covering).

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