
Polar Vortex and Bank “Crisis”**Polar Vortex and Bank “Crisis”**

We used to have winter storms, sometimes even nor’easters, but now we get events like a polar vortex or other more ominous sounding things.

Maybe this current banking “crisis” is behind us? At least for now.

Europe Responding Well

European bank stocks are on firm footing. Monday’s price action was mixed and erratic. However, today, banks across the board are doing well and UBS is trading like a company that got a good deal! UBS’s stock (trading in Switzerland in CHF) closed Friday at just over 17, it traded as low as 14.50 yesterday, and is above 18 right now – encouraging! Even CS stock (on the Swiss exchange) is trading at a slight premium to the announced deal price. Maybe people are hoping that as the dust settles, the deal terms could improve, like they did with Bear Stearns.

U.S. – Implicit vs Explicit and FRC Share Price

The FDIC has more power in an “emergency” situation than they do in normal times to protect depositors (Silicon Valley Bank and Signature Bank). I’m told (and it seems reasonable) that extending deposit insurance to all banks (for unlimited amounts) would require Congress. Unfortunately, that help is not likely to come, certainly not separate from the debt ceiling debate, unless things get much worse.

So, we are in limbo, and there is a high degree of certainty that depositors will be protected (but only if things look bleak). Tough way to keep deposits, but periods of calm do help. However, analysts rightfully demanding to know details on the “cash and cash equivalent” line item doesn’t help this calm.

Watching FRC stock break \$14 (down from \$147 on February 2nd) is difficult to watch. It seems staggering and unbelievable to me as an outside observer, but there it is. It looks like it is trading higher pre-market today, **which would be encouraging for the sector as a whole.**

As a reminder, and sometimes we all need this, we published about the unique nature of Silicon Valley Bank and Silvergate Capital less than two weeks ago (it seems so much longer than that) in [I Like Mid Banks, I Cannot Lie](#).

The Pit of Unrealized Bond Losses

We are all walking by this deep pit of “unrealized bond losses.” Something we walked by every day for months, but really didn’t notice. SVB made us focus on this. Wow, that is one big pile of unrealized bond losses! Without a doubt there is a massive hole created by unrealized bond losses. It is spread across the system (not just banks, but insurance companies as well). But, certainly in the case of insurance companies, the people who agreed to long-dated products at low rates (a 2021 annuity for example) are bearing losses to offset that from an insurance perspective. This is just one simplistic case showing how individuals are also sitting on these “unrealized” losses.

The questions are:

- How bad are the unrealized losses at any one place?
- Is there any need to sell and realize those losses? This is a bit circular with the first question because any bank that has eye-catchingly large potential losses may have to sell or raise capital.

Polar Vortex and Bank “Crisis”

- Can these losses get much worse? Sure, if interest rates move higher or credit conditions deteriorate, bond prices will drop (but they could also get better).
- **Is there something that could lead to contagion?** Could forced selling by some institutions lead to lower prices and cause more forced selling? This is what keeps me awake at night as an extremely dangerous situation and I’m watching for any sign of this, but **I’m not seeing it at all right now.**

The bank situation here continues to be rife with risk, but I like the risk reward and think that we will avert anything that can morph into systemic risk for now.

Yes, we have seen how quickly markets move (so maybe we are playing with fire here), but I like this risk right now.

The Fed – Where is the Inflation?

I am in the camp that the Fed should pause, as we just saw some upheaval in banks directly tied to interest rate policy. I see no harm in pausing while we establish what damage may or may not have been done to the “system” of “financial conditions” by the events of the past two weeks.

There are many who argue that the Fed must hike 25 bps to show that they are serious about inflation. To counter that point, **remember when the inflation data was pointing to 50 bps, and then wage pressure dropped?**

ADP, JOLTS, and NFP all pointed to wage inflation coming back under control.

Yes, there was inflationary pressure on other things. However, oil was at \$80 on March 6th and is \$68 right now – we have some breathing room.

While the “wonky finance” side of me can grasp the concept that balance sheet expansion (which is happening at a rapid pace) and rate hikes can go hand in hand, I find it difficult to believe that will play out well in the mainstream media - which should be a concern for all involved.

Just imagine a headline like, **“Banks Brought to their Knees By Rate Hikes Face an Unrepentant Fed which has Hiked Again”!** Mainstream media and social media love simple themes. Complex interactions don’t generate the buzz. The above take, wrong for those who understand, may be the message that gets out – which is another reason to pause.

Bottom Line

I like financials, with two caveats:

- Get ready for selling pressure if the Fed hikes because the story will not play out well in the media, and the knee-jerk reaction will be to sell.
- Keep an incredibly vigilant eye on that pile of unrealized bond losses to see if it is growing or getting even more scrutiny.

I don’t like rate risk, but I do like spread risk.

- While I don’t think that the Fed should hike, I do think that they will be incredibly reticent to cut rates and far too many rate cuts are priced in. The last two weeks of trading have destroyed the signal to noise ratio in the Treasury market (this is far more about technicals and stop

Polar Vortex and Bank “Crisis”

losses/fear, than about rational thoughts on Fed policy).

- With bond yields stabilizing and the “polar vortex extreme” of bank issues calming down, credit spreads as a whole should do well.

Fade disruption unless the Fed is super dovish.

- Look for a rally in disruption and stocks that benefitted the most from ZIRP. This isn’t ZIRP and while there is upside here, there is better risk reward elsewhere.

Nibble at commodities.

- Remember the “China re-opening” overreaction in the commodity market? We just got the same in reverse.

Bottom line is that **I’m looking for a “risk on” type of trade, but keeping one eye on that pile of unrealized bond losses** to make sure that it’s not growing rapidly (or that a bunch of new people have taken notice and are going to react to it).

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