WARNER'S CORNER: MACRO FLASH

Jim Warner, Director of Research / Co-Portfolio Manager

3/21/23

Crisis Averted but Economic Questions Increase

Before discussing recent developments in the global banking industry and their potential impacts to the economy, we want to emphasis that **your assets are safe**. Your brokerage accounts at Charles Schwab or for that matter any other brokerage firm are safe:

- Assets held at brokerage firms are held in investor's names at the Broker Dealer and not comingled with assets from Schwab's bank;
- Schwab does not have any direct business relationship with Silicon Valley Bank or Signature Bank; we don't have exposure to any credit risk from either.

The link below is to an informative interview Schwab CEO Walt Bettinger conducted early last week on CNBC.

Walt Bettinger on financial stability | About Schwab

Second, we have evaluated our holdings in all of our strategies to eliminate as best we can any negative impact from the regional bank difficulties that we read about daily. In fact, we identified the "duration" risk regional banks face last year and exited our only regional bank position long ago. We continue to monitor the global financial system very closely and will act as needed. That said, our strategies have been tactically positioned toward the conservative ends of their risk spectrums for months, which has insulated client portfolios to a large extent.

****

There are two major obstacles facing the global financial system that we continue to monitor closely. The first is the deposit run on specific regional banks and the second is the failure of Credit Suisse and its implications.

The Run on the Regional Banks Explained

Last week, the deposit run experienced by Silicon Valley Bank spread to First Republic Bank. We discussed Silicon Valley Bank's unique issues in our note last week. First Republic is similar to Silicon Valley Bank. Both cater to Silicon Valley venture capitalists, entrepreneurs and their companies so it can be inferred that there may have been an overlap in their deposit customers or at the very least First Republic depositors saw what happened to Silicon Valley Bank depositors and did not want to wait around to find out their fate. So, a run began.

First Republic ended the year with $176.4 billion of deposits. Between the failure of Silicon Valley Bank on March 10th to March 15th, First Republic borrowed up to $119bn (from the Fed window and the Federal Home Loan Bank) to meet withdrawals. Then a consortium of big banks, including Bank of America, Citigroup, JPMorgan Chase, Wells Fargo, Goldman Sachs, Morgan Stanley, PNC Banks, State Street, Truist and US Bank agreed to deposit $30 billion into First Republic in a coordinated show of support. Including the $34 billion of cash on the balance sheet, First Republic has thus far survived the withdrawal of likely over half of their deposits. Today, Treasury Secretary Yellen reiterated her stance that uninsured depositors would be protected and so we are seeing a significant recovery in First Republic's share price today.

That said, we do not know how this specific situation will get resolved. The reality of deposit runs is that they are driven as much by depositor psychology as they are actual fundamentals. By definition, banks operate under the idea that not all of their depositors are going to want their money at the same time. So, when a sufficiently large number of depositors lose faith in their bank's ability to safely hold their deposits, that bank faces a liquidity problem (i.e., they do not have enough cash to meet all the withdrawals). There are a few sources of liquidity – I noted the Fed window and the Federal Home Loan Bank and also the new Fed facility – but if the demand for withdrawals are too great, the Federal Deposit Insurance Corporation will step in and seize the bank as is their responsibility.

This turmoil is thus an idiosyncratic issue definitionally and not one where one-by-one banks start failing all around the country.

So, will this issue spread to other banks? The analogy I would use is that the banking industry is facing a full moon low tide. Full moon low tides are extreme and not all boats float in those conditions. Similarly, the extreme increase and pace at which interest rates rose over the last year put to test all banks' ability to manage their interest rate risk. For banks like Silicon Valley who bought lots of low yielding long duration securities last year without proper hedging, their boat hit rock bottom as liquidity dried up. Many banks did not make this egregious error. Importantly, it is how each individual bank reacted to a common problem (i.e., higher interest rates) that matters. Therefore, the crisis of confidence depositors face at one bank does not necessarily translate to another bank's depositors. This turmoil is thus an idiosyncratic issue definitionally and not one where one-by-one banks start failing all around the country.

Having concluded that the run on banks will be contained to a few and not systemic, this moment does raise additional risks to economic growth. Specifically, we would expect additional regulatory burdens to be placed on banks that could restrict lending capacity. Even in the absence of increased regulations, we believe that banks are likely to tighten their lending standards in the wake of these runs that could also restrict economic growth. Our view is that the likelihood of a deeper recession for the economy is now greater than just two weeks ago. Time will tell.

And Then There was One Swiss Bank

Credit Suisse's distress was driven by nearly a decade of mismanagement and was clearly reflected in its consistently falling stock price. On Sunday, UBS acquired Credit Suisse effectively putting it out of its misery. The risk associated with global systemically important banks, like Credit Suisse, failing does raise the prospect of contagion as it has various financial relationships with many other banks. As concerns increased last week these relationships were being paused, so the Swiss regulators stepped in and orchestrated the UBS tie up thus ensuring an orderly unwind of Credit Suisse. This was a good result for the underpinnings of the global financial system.

In connection with this acquisition and to ensure ample liquidity in global US dollar swap lines, the Fed in coordination with the European Central Bank, the Bank of England, the Bank of Japan, the Bank of Canada and the Swiss National Bank announced an increase in the frequency of US dollar swap operations to daily from weekly. This step provides an important expansion of liquidity for global funding markets. The bottom line is that central banks are taking aggressive, pre-emptive actions to prevent a global financial crisis. We do not have any direct exposure to this situation but ensuring the global financial system can function effectively has direct implications on economic growth that could have had a broader effect. At this time, we believe that a conservative stance remains appropriate as we scan for any further developments, but we are cautiously optimistic that this any potential crisis has been averted.

The bottom line is that central banks are taking aggressive, pre-emptive actions to prevent a global financial crisis.

An important aspect of both the regional bank deposit runs and Credit Suisse's demise is that neither had anything to do with credit losses. This is not 2008 with bank and broker balance sheets chock full of defaulted mortgages. Today's problems arise from poor management that we expect are idiosyncratic issues not systematic ones.

Protecting Your Irreplaceable Wealth

The events of the last few weeks underscores our core philosophies as a firm. To always protect the irreplaceable wealth entrusted to us. And, to actively manage the risk in portfolios to reflect current market conditions. Our investment process is based on extensive research that guides us on whether to take more or less risk and which risks to take. Our dedication to transparent and frequent communication is an effort to empower, inform and provide peace of mind, particularly during times of market stress.

Let us help you. Please call anytime.

Disclosures

LIM is a Registered Investment Advisor based in Dallas, Texas and registered with the Securities and Exchange Commission. Registration does not imply a certain level of skills or training. LIM is a company with purpose, dedicated to creative and unique thinking. We focus on portfolio valuation and research, along with a superior client experience. We seek to identify investment opportunities by looking at economic factors, security valuation and human behavior. We start with the fundamentals of portfolio management and valuation. Then we build on these fundamentals with unique thinking and creative intelligence gathering to form a viable investment thesis. We believe this approach leads to dynamic global portfolios with increased return and managed risk. LIM utilizes Charles Schwab & Co. Inc. ("Schwab"), a FINRA-registered broker-dealer, member SIPC, as its custodian of assets. LIM is independently owned and operated and not affiliated with Schwab.
Additional disclosures:

This document may contain forward-looking statements based on LIM's expectations and projections about the methods by which it expects to invest. Those statements are sometimes indicated by words such as "expects," "believes," "will" and similar expressions. In addition, any statements that refer to expectations, projections or characterizations of future events or circumstances, including any underlying assumptions, are forward-looking statements. Such statements are not guaranties of future performance and are subject to certain risks, uncertainties and assumptions that are difficult to predict. Therefore, actual returns could differ materially and adversely from those expressed or implied in any forward-looking statements as a result of various factors.
This material represents an assessment of the market and economic environment at a specific point in time and is not intended to be a forecast of future events or a guarantee of future results.

Information is based on data gathered from what we believe are reliable sources. It is not guaranteed as to accuracy, does not purport to be complete and is not intended to be used as a primary basis for investment decisions.

This document is a general communication being provided to you for information purposes only. The communication is educational in nature and not designed to be a recommendation for any specific investment product, strategy, plan design feature or any other purpose. By receiving this communication you agree with the intended purpose described above. Any examples used in this material are completely hypothetical and for illustration only. The document is for the sole use of the person to whom it is addressed and is privileged and confidential. Use by anyone other than the addressee is strictly prohibited.

Investing in **alternative assets** involves higher risks than traditional investments and is suitable only for sophisticated investors. Alternative investments involve greater risks than traditional investments and should not be deemed a complete investment program. They are not tax efficient and an investor should consult with his/her tax advisor prior to investing. Alternative investments have higher fees than traditional investments and they may also be highly leveraged and engage in speculative investment techniques, which can magnify the potential for investment loss or gain. The value of the investment may fall as well as rise and investors may get back less than they invested.

Bonds are subject to interest rate risks. Bond prices generally fall when interest rates rise.

Investment in **commodities** may have greater volatility than investments in traditional securities, particularly if the instruments involve leverage. The value of commodity-linked derivative instruments may be affected by changes in overall market movements, commodity index volatility, changes in interest rates, or factors affecting a particular industry or commodity, such as drought, floods, weather, livestock disease, embargoes, tariffs and international economic, political and regulatory developments. Use of leveraged commodity-linked derivatives creates an opportunity for increased return but, at the same time, creates the possibility for greater loss.

International investing involves a greater degree of risk and increased volatility. Changes in currency exchange rates and differences in accounting and taxation policies outside the U.S. can raise or lower returns. Some overseas markets may not be as politically and economically stable as the United States and other nations.
Asset allocation or diversification does not guarantee investment returns and does not eliminate the risk of loss.
Data Sources: BlackDiamond, Bloomberg, Lear Investment Management and various other sources as cited herein.
LIM does not guarantee any minimum level of investment performance or the success of any portfolio or investment strategy. All investments involve risk, including the loss of principal, and investment recommendations will not always be profitable.

Definitions

The **S&P 500 Index** consists of 500 stocks chosen for market size, liquidity, and industry group representation. It is a market-value weighted index (stock price times number of shares outstanding), with each stock's weight in the Index proportionate to it market value.

The **Nasdaq Composite Index** is a market cap-weighted index, representing the value of all stocks listed on the Nasdaq Stock Market. The composition of the Nasdaq Composite is a mix of long-established companies that have been on the exchange since inception, to IPO newcomers, companies that grew from OTC exchanges or switched from other exchanges.

The **Dow Jones Industrial Average** is a price-weighted average of 30 blue-chip stocks that are generally the leaders in their industry. It has been a widely followed indicator of the stock market since October 1, 1928.

U.S. Treasury securities are guaranteed as to the timely payment of principal and interest if held to maturity. Investment options are neither issued nor guaranteed by the U.S. government.

The **Bloomberg Aggregate Bond Index** represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities.

The **Bloomberg U.S. Investment Grade Corporate Bond Index** covers U.S. dollar denominated, investment-grade, fixed ratee or step up, taxable securities sold by industrial, utility and financial issuers. It includes publicly issued U.S. corporate and foreign debentures and secured notes that meet specified maturity, liquidity and quality requirements. Securities included in the index must have at lease 1 year until final maturity and be rated investment-grade (Baa3/BBB-/BBB+) or better using the middle rating of Moody's, S&P, and Fitch.

The **Bloomberg US High Yield Index** covers the USD-denominated, non-investment grade, fixed-rate, taxable corporate bond market. Securities are classified as high-yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below. A small number of unrated bonds are included in the index. The index excludes emerging markets debt.

The **Bloomberg Commodity Index** is comprised of futures contracts and is designed to be a highly liquid and diversified benchmark for commodity as an asset class.

The **Bloomberg U.S. Mortgage-Backed Securities Index** tracks fixed-rate agency mortgage-backed pass-through securities guaranteed by Ginnie Mae, Fannie Mae and Freddie Mac.

The The **ISM Report on Business – Manufacturing and Services** – are two of the most reliable economic indicators available, providing a monthly gauge of the level of economic activity. A PMI reading above 50 indicates the economy is generally expanding; below 50% indicates that it is generally declining.