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"Power Slap"

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Power Slap

A relatively new combat sport was sanctioned by the Nevada State Athletic Commission called "Slap Fighting." In these absurd and nonsensical events, two competitors take turns slapping each other. One lunatic (competitor) waits to absorb an unprotected open-palmed slap to the face, while standing motionlessly with his hands behind his back. After he gets smacked, it is his turn to strike back, with the slaps persisting until a contestant is so disoriented that he is unable to continue.

In a manner of speaking, Federal Reserve Chairman Powell is also engaging in the madness of slap fighting. For the last year, Powell and his committee members have embarked on a series of unrelenting interest rate hikes to knock the spirit out of their opponent, shocking inflation. With an apparent lack of appreciation or indifference that their policies work with a long lag time, they just kept slapping away.

Tapped Out

The collapse of Silicon Valley Bank (SVB) on March 10th, the second largest bank failure in U.S. history, was the first entity to break under the force of Federal Reserve policy. Contributing to their downfall was the decision by SVB's managers to invest more than half of the institution's assets in long-maturity U.S. Treasury bonds. As market rates soared and the principal value of the banks' bond holdings plunged, depositors became concerned about the safety of their savings. As panic ensued, depositors rapidly withdrew their cash causing a "run on the bank." Signature Bank (third largest bank failure in U.S. history) and First Republic Bank were also pressured by the same catalysts.

Citing systemic risk to the financial system, the Federal Reserve, FDIC, and the Treasury announced that all depositors of Silicon Valley Bank (SVB) and Signature Bank (SB) will incur no losses. This unprecedented decree upends a 90-year-old policy whereby each depositor is only insured up to $250,000. With 93% of the funds on deposit at SVB exceeding that limit (source: Bloomberg), this change amounted to a massive bailout for those customers.

Despite the government claiming that the smaller institutions were safe, depositors of other regional banks feared that a government backstop may not be provided for their assets. Thus, as the banking debacle unfolded, a substantial number of customers shifted their monies from local banks to the largest institutions. With these behemoths now stuffed with cash, a consortium of 11 banks that included JP Morgan and Bank of America devised a plan to recycle $30 billion of those newly received funds back into the troubled First Republic Bank. In essence, this arrangement could be a blueprint of how the largest banks can re-liquify the smaller institutions in the form of new deposits without direct government intervention.

Then there's the saga of Credit Suisse (CS), a 167-year-old firm that has been struggling financially for well over a decade. During 2022, Credit Suisse became starved for cash as fears mushroomed that the firm was on a path to collapse. Akin to the instances above, customers lost confidence and withdrew billions of dollars making it impossible for the bank to continue normal operations. To restore confidence in the Swiss banking system, regulators pressured UBS to acquire CS. With taxpayers potentially on the hook for over $9 billion (source: WSJ)

and a $100 billion line of credit offered by the state, UBS has agreed to purchase CS for what appears to be pennies on the dollar.

Heavy Hands

The point of this chronology is to highlight the fact that as is typical, the Fed went toe to toe with the financial system and once again caused something to break. Now, to instill confidence, heavy-handed tactics are being employed to flood the financial system with cash and it is happening at a break-neck pace. Since March 8th, 2023, the Federal Reserve's emergency bank lending (restart of Quantitative Easing) has already topped $400 billion (source: FRED). While this maneuver is being hailed as a "fix" by some, the problem remains that it may only be serving to mask the insolvency of those entities highlighted above and those not yet known.

On March 22nd, Federal Reserve Chair Jerome Powell commented about the current banking crisis. He said, "These are not weaknesses that are running broadly through the banking system" (source: WSJ). He knows this how? Thus far the messaging by officials has been analogous to the events leading up to the Global Financial Crisis (GFC). In RSW's second quarter 2007 commentary we said, "The Fed has either been incorrect or they have been consistently downplaying the looming crisis, perhaps to instill a sense of calm to the markets…we find that this particular type of financial stress is highly contagious and like none we have seen before."

Exhausted

Today, the Fed is somewhat hamstrung as to the level of financial shenanigans they could employ when compared to the period prior to the GFC. A few reasons are as follows:

- In 2007, to inject cash into the financial system, the Fed went on a buying spree to purchase distressed debt from the broker/dealer community. Before that flood of Quantitative Easing, the Fed's balance sheet stood at less than $1 trillion. In comparison, this current crisis had started when the federal reserve balance sheet was already at $8.3 trillion (source: FRED), roughly eight times larger than the amount recorded at the beginning of the GFC.
- Likewise, our nation's outstanding debt since 2007 has skyrocketed from 49% of GDP (Gross Domestic Product) to 100% as of year-end 2022 (source: FRED).
- It is important to note that although the yield curve was inverted (two-year and ten-year U.S. Treasury bonds) during the period preceding the GFC, the average inversion was only (-4) basis points. This compares to the current 2022-2023 episode, where the average inversion to date, has been over ten times greater, at (-48) basis points.

Believing that the impact of the Fed's disorienting blow was in the offering, RSW's 2023 Outlook says, "At this juncture, Chairman Powell remains on a collision course with the financial system." Powell's extreme interest rate policies caused the yield curve to invert massively with short-term rates climbing to historic levels above those offered on longer-dated bonds.

For the better part of the last year, RSW was warning about the awful consequences of an inverted yield curve and right on cue, the pundits were dismissive of its importance. The more looming problem is that the yield curve appears to be in the process of "un-inverting." Specifically, at the height of the "upside down", the yield

on the two-year U.S. Treasury bond exceeded bonds maturing in 10 years by 110 basis points (1.10%). Today that differential has collapsed to 55 basis points, a roughly 50% reduction.

Should short-maturity rates once again fall beneath long-term bond yields, it would likely signal the start of an imminent emergency. Think about it, when is it probable that the Fed will start slashing rates? After it is plainly obvious that they “broke something.” With the bond market typically acting ahead of the Fed, market participants will sense trouble and quickly snap-up shorter-dated bonds in anticipation that the Fed will begin to slash rates. It is important to note that in these situations, short-term rates fall quicker than long-term and hence a return to an upward sloping curve emerges.

That’s all You’ve Got!

As is typical, during periods of economic and/or financial stress, access to capital becomes constrained. While the bank failures are catching today’s headlines and could be classified as the “smoke”, the contraction of available credit should be considered the “fire”. In fact, according to the January 2023 Senior Loan Officer Opinion Survey (SLOOS), “Loan standards will soon hit the tightest on record.”

At this pace it won’t be long before only the most credit-worthy U.S. households will have access to credit and everyone else could be shut out. It is therefore likely that the next phase of the economic/financial turbulence will have more to do with insolvency rather than today’s issues surrounding liquidity. Some may breathe a sigh of relief as they cling to a belief that the Fed will save the day and economic activity and asset prices will remain resilient.

Unfortunately, the U.S. is likely to experience a deep recession. Historically absurd fiscal and monetary policies have rendered the path for a “soft landing” (inflation falling toward 2% and no recession) as likely as both opponents in a Slap Fighting contest forfeiting before the first slap is ever delivered.

Therefore, RSW reiterates a forecast for 10-year U.S. Treasury bond yields to reach 2.25%-2.50% range by year end.

Municipal Bond Market

During the first quarter, municipal bonds turned in solid performance. Against the backdrop outlined above, you may have anticipated that the changes in tax-exempt market rates were somewhat subdued prior to the banking crisis that emerged during March. However, yields continued to fluctuate rapidly as expectations for a “Fed Pivot” (rate cuts) were on full display during January, with those hopes being dashed during February, resulting in higher market rates. For the quarter, however, prices of municipal securities continued to take their directional cues from the U.S. Treasury bond market where yields declined markedly.

By adhering to our plan and discipline during the back half of last year, we were able to capitalize on the rising rate period by converting it into an asset for our clients. Specifically, we entered the year with a relatively high level of shorter-maturity bonds, which served to lessen the degree of principal erosion experienced as interest rates soared. In the back half of 2022, we seized the rise in rates as an opportune time to exchange a portion of

our clients' lower yielding shorter-maturity positions for longer-maturity holdings. In essence, this reversal of strategy served to enhance the portfolios' overall level of tax-exempt cash flow and allowed the market value of the holdings to snap-back at a quicker pace.

Given today's above average level of cross currents, as you would expect, we are concentrating a bit more on defense by reducing the average portfolios' level of interest rate risk. Although not our base case, it remains possible that during these periods of "flight to quality", assets other than U.S. Treasury securities can decline in value. Historically, should this occur, such a phenomenon should be short lived. Nonetheless, lower probability events must also be considered in executing our game plan.

Aside from interest rate risk, it is our chief responsibility to manage credit risk. Neither can be accomplished by following the herd and pinning clients' portfolio attributes to an index. While some may be relaxing their credit quality standards believing that the Fed has saved the day, these periods of uncertainty can result in the market's perception of an issuer's claims paying ability to shift more rapidly. We remain prepared for such an environment as we could be rewarded to modestly relax our very stringent issuer standards, to lock in even higher market yields.

Thank you as always for your trust and confidence and we look forward to reporting back to you next quarter, or sooner should market conditions warrant.

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