Economic & Market Outlook

Executive Summary

~ Bonds and global stocks are off to a strong start for the year, appreciating 3.0% and 7.4% respectively.

~ During the quarter, we witnessed a bank panic following the closure of Silicon Valley Bank, a bank that seriously mismanaged its mix of assets and liabilities.

~ We find it ironic that the banking crisis stemmed from an asset/liability mismatch as opposed to growing concerns around the credit quality of loan books. Community and regional banks are one of the largest originators of commercial real estate credit, a sector that faces multiple headwinds.

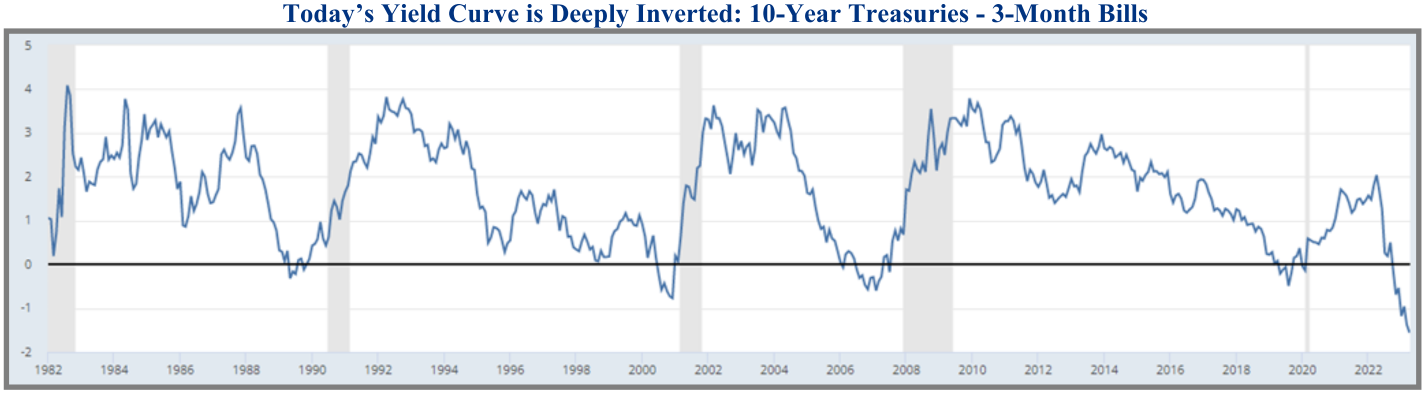
~ The combination of stress within the banking sector and tighter monetary policy from the Federal Reserve appears to be slowing the growth of credit in our economy.

~ The headwinds facing commercial real estate are beginning to unleash attractive investment opportunities.

Campbell Harvey

In 1986, Campbell Harvey, a graduate student at the University of Chicago, submitted his dissertation, *Recovering Expectations of Consumption Growth from an Equilibrium Model of the Term Structure of Interest Rates*. The premise of his paper was simpler than its title suggests. Harvey thought the relationship between interest rates for varying bond maturities might be useful for forecasting future economic growth (i.e. the spread between a 10-year Treasury and a shorter maturity, like a Treasury Bill, may contain information about our economy's prospects). The Treasury yield curve, a plot of Treasury yields relative to their tenure, is almost always positively sloping because investors demand greater compensation to lock up their money for longer periods. On rare occasions that relationship will flip, and short-term Treasuries will yield more than long-term Treasuries. This is known as a yield-curve inversion. Since 1968, the yield curve has inverted only eight times and we have seen a recession shortly after each instance. By historical standards, this indicator has a perfect track record with zero false positives, which is alarming given today's yield curve is deeply inverted.

Today's Yield Curve is Deeply Inverted: 10-Year Treasuries - 3-Month Bills



Source: Federal Reserve of St Louis

The problem is no one knows exactly why this indicator works or if it will continue to do so in the future. We have theories we will discuss later, but before you panic, consider the following. First, eight historical observations do not make for a robust dataset. Second, even if the indicator has strong predictive power, you should expect some number of false signals going forward. Third, in the past, inversions were not widely discussed, but today they make headlines. Since we know recessions have historically followed inversions then it is reasonable to expect investors and businesses to alter their behavior when such an event occurs. Said differently, our knowledge of this signal could alter its efficacy. Fourth, real yields (i.e., Treasury yields adjusted for expected inflation) are not inverted and that was the initial subject matter of Harvey's thesis. The economic backdrop this time around happens to be quite different. Lastly, even Campbell Harvey doesn't trust the signal this time around.

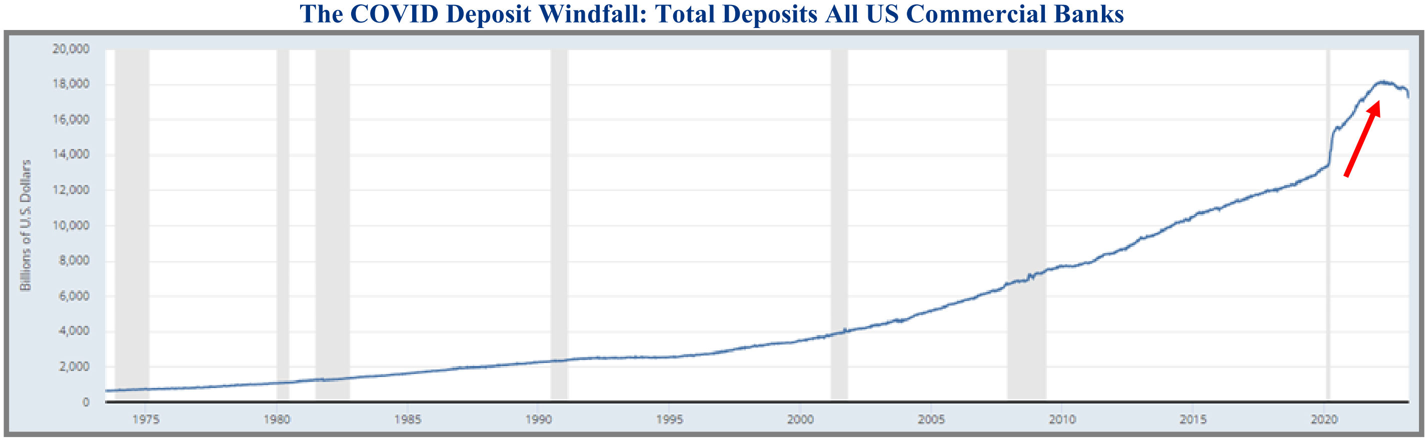
"In science, we use models all the time, and they're simplifications of reality… And part of the skill of the scientist is to know when to deploy the model and when not to or, in other words, to know the limitations of the model. And maybe I'm in a good position of knowing the limitations, given it's my model."

For Campbell Harvey, the one wildcard is the Federal Reserve. He thinks the US has a decent shot of avoiding recession, but that view is dependent on the Fed not pushing short-term rates too high. In his view, the time to stop tightening is now; a sentiment shared by many investors that think the Federal Reserve should stop hiking before something breaks.

Cracks in the Banking System

Silicon Valley Bank and Signature Bank are the first banking casualties of 2023. For bearish investors, they are evidence that the Federal Reserve has already gone too far, but for us, the case isn't clear cut. To understand what transpired, you must step back to the pandemic. When COVID hit, policymakers responded with a rush of stimulus that included PPP loans, enhanced unemployment benefits, and direct cash payments to individuals below a certain income threshold. The stimulus measures were so strong that real-per-capita income actually increased during the pandemic. Corporations and individuals became flush with excess savings that needed to find a home. Some of the money entered the financial markets, pushing valuations higher on startups and new-economy growth stocks (see our last letter), and the rest entered the banking system as deposits.

The COVID Deposit Windfall: Total Deposits All US Commercial Banks



Source: Federal Reserve of St Louis

The business of banking is to safely capture a spread between the cost of their deposits and the interest they can earn on loans (like a residential mortgage) and/or investment securities (like a longer-term Treasury or Agency RMBS). When deposits enter a bank, the banker can use them to make new loans, leave them in cash or equivalents, or invest in securities. Loans take time to originate and can only be made if sufficient demand for that loan product exists. Said differently, it would have been impossible for banks to quickly redeploy the COVID deposit windfall into loans even if they wanted to, so banks had to choose between holding cash and equivalents or buying investment securities.

The first option, parking deposits in cash and equivalents, came at an immediate cost. Cash and equivalents yielded little over their cost of deposits and would result in lower profitability. For example, on 9/30/20, $1 billion of deposits invested in 3-month Treasuries (a cash equivalent) would have produced only $985 thousand in interest income whereas an investment in 10-year Treasuries would have generated $7 million in annual interest income. Still, more conservative bankers, like Rene Jones at M&T Bank, chose the less profitable path. "*With a lack of loan demand during the year, many peers chose to invest a greater portion of their excess cash into investment securities. It is notable that during the year, we chose to avoid following suit given the historically low rates of interest that did not seem to compensate us for the risk that rates might rise in the future. In essence, we decided it was better to hold our fire.*" Rene Jones (and many others) willingly sacrificed near-term profits so that they might have the chance to redeploy that capital at higher rates in the future.

Silicon Valley Bank and others atop today's headlines chose the latter path. They decided to maximize their near-term profitability by purchasing investment securities (like Treasuries and Agency MBS). Unfortunately, those purchases coincided with generationally low-interest rates. When inflation reared its head, interest rates spiked, leading to massive mark-to-market losses on banks' securities portfolios. The losses in and of themselves were not the problem. Most banks can classify securities as "held-to-maturity," in which case mark-to-market losses don't punish their financials or regulatory requirements; the basic idea being that these securities are of the utmost credit quality and if held to maturity will return par. A problem only existed if a bank was forced to sell securities in the open market and crystallize those losses, which is exactly what happened to Silicon Valley Bank.

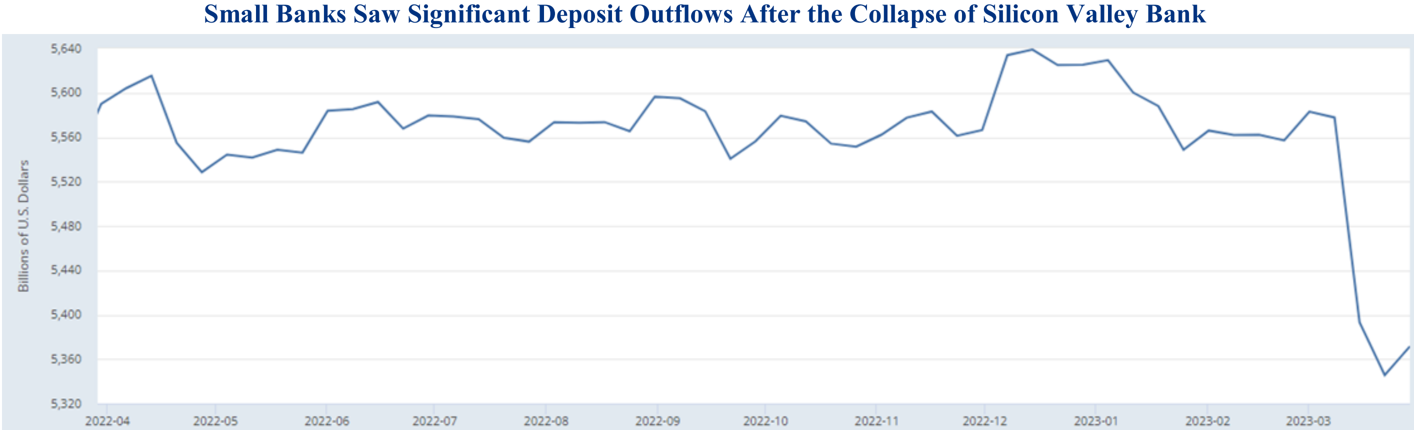
Mark-to-Market Losses are Significant

Source: FDIC

Silicon Valley Bank had a unique deposit base. The bank's success was the byproduct of the 2020-2021 venture capital bubble. It's customer base largely consisted of venture capital funds, their partners, and companies they invested in. During the boom times, Silicon Valley Bank had a steady inflow of deposits. New funds were being raised and portfolio companies were regularly raising new rounds of financing, the cash of which ended up on Silicon Valley Bank's balance sheet. When the venture capital bubble burst, this cycle reversed. Venture capital-backed portfolio companies could not raise new capital and as a result, burned through their cash hoards to fund operations. Venture capital funds found it hard to raise money. The implication being Silicon Valley Bank's deposit base turned into net consumers of cash. Silicon Valley Bank had made the mistake of investing in longer-term securities when it had a decaying deposit base. They had a mismatch between their assets and liabilities. To fund customer withdrawals, they were forced to sell securities marked at par, at deep discounts, eventually pushing the bank into insolvency.

After the FDIC stepped into Silicon Valley Bank, we witnessed a miniature bank run. Investors and deposit holders grew suspicious of banks, like First Republic, with large unrealized losses on securities and/or banks where customer balances far exceeded FDIC insurance. Fortunately, before the contagion could spread, the Federal Reserve announced the Bank Term Funding Program ("BTFP"), which gives banks liquidity, at a cost of 4.8%, to meet customer deposits in exchange for the par value of their underwater securities. In essence, the Federal Reserve provided a stopgap, so banks don't have to sell securities at a steep loss. Early data indicates the run on deposits has already ended and for the week ending March 29^{th,} we saw deposit inflows to small banks. To us, the banking panic of 2023 was not the proverbial canary in a coal mine, but rather an accident waiting to happen for banks who took undue interest rate risk to maximize short-term profits.

Small Banks Saw Significant Deposit Outflows After the Collapse of Silicon Valley Bank



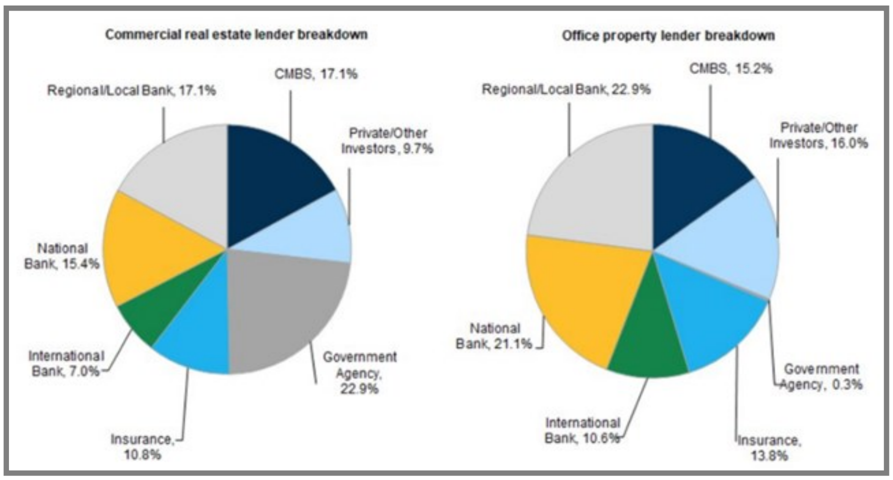
Source: Federal Reserve of St Louis

The Irony of Silicon Valley Bank's Demise

Many astute investors saw trouble coming for Silicon Valley Bank, but their focus was on the bank's credit risk not the mismatch between the bank's assets and liabilities. Silicon Valley Bank was famous for pioneering new loan types, like venture debt, where it would loan startups 25-30% of their latest financing round at extraordinarily low rates - a recipe destined for failure. Similarly, our concerns with the banking sector have little to do with interest rate risk and everything to do with their loan portfolios, specifically commercial real estate.

The potential headwind is most acute for smaller banks, which the Federal Reserve defines as all banks except the 25 largest. To put that into perspective, there are 4,844 insured commercial banks in the United States, and "small banks" control almost $6.9 trillion in assets. If you dig into their balance sheets, you will find a high concentration of loans (65% of assets) and about two-thirds of those loans are real-estate loans with an emphasis on commercial real estate. In fact, these banks are the largest financers of commercial real estate in the country, specifically office. And to be clear, looking at loan balances understates their exposure as these banks are also large holders of commercial mortgage -backed securities.

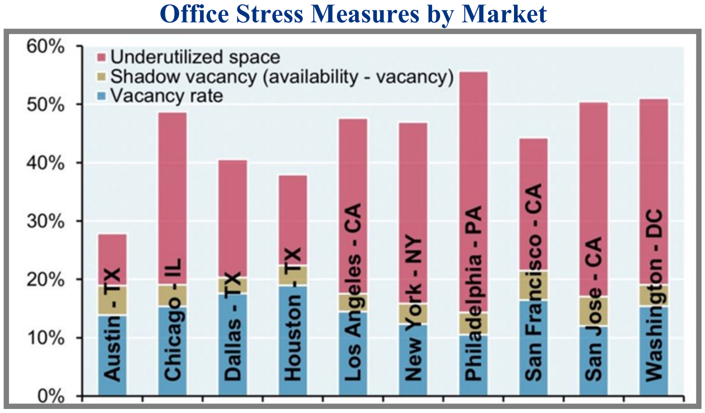
Breakdown of the Commercial Real Estate Loan Market



Source: Goldman Sachs

When it comes to office properties, our cause for concern should be obvious. The sector never recovered from the pandemic. The reported US office vacancy rate is pushing close to 19%, and we have reason to believe that the number is heading higher. A 2022 CBRE survey found that 52% of the 158 companies surveyed planned to shrink their office footprint in the coming years. Everyone knows that office vacancy rates are a problem, but nobody knows where they will settle and finding the answer will take time because you must wait for leases to roll off. Kastle Systems, a security provider for office space, has been tracking customer foot traffic since the pandemic, and the top 10 metro areas sit at 55% of their pre-pandemic levels. What is worse is the Kastle traffic barometers have stopped recovering. We don't know if nationwide occupancy rates will settle around today's levels or double, but we do know the economics of many office properties are already stressed.

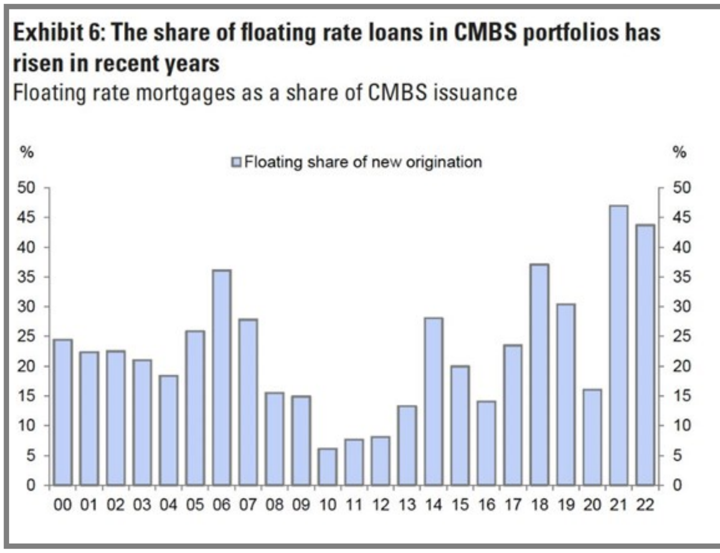
Office Stress Measures by Market

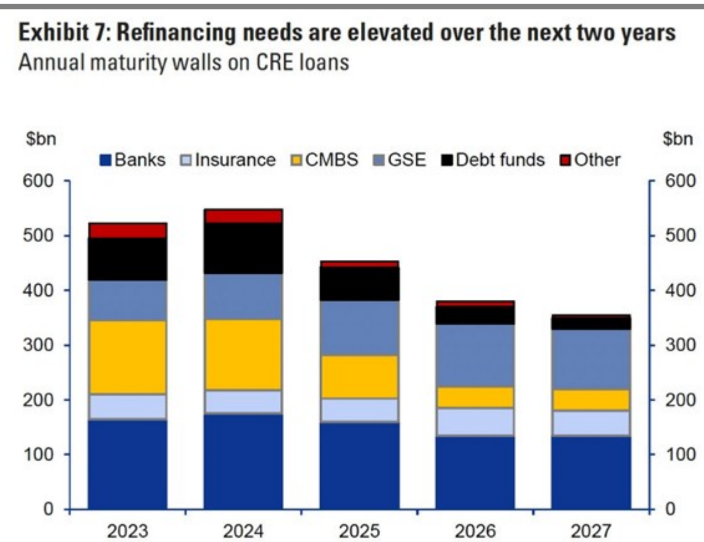


Source: Kastle Systems, CoStar, JP Morgan, First American

Our second cause for concern isn't limited to the office market. Interest rates are considerably higher today than they were at any other time in the recent past, which poses a problem for any property type that needs to refinance its debt and/or has variable-rate debt. We know that almost $1.5 trillion in commercial real estate debt comes due between now and 2025, of which banks are the largest funders followed by securitizations. This debt will have to be refinanced at higher capitalization rates (i.e. lower valuations) and carry higher financing costs, which will create refinancing gaps and put interest coverage ratios to the test. The largest real estate types behind that debt are multi-family and office properties. We also know that in the era of ultra-low interest rates, real estate acquirers increasingly utilized variable-rate debt to finance their purchases. Recently, the Wall Street Journal published an article on the foreclosure of a 3,200 -unit complex in Houston. Typical of multi-family deals following COVID, the buyer financed the purchase with 80% debt and a variable rate mortgage. Trepp, a real-estate data provider, estimated interest on that property's loan climbed from 3.4% in 2021 to around 8.0% and the property's cash flow could no longer service its debt. It is hard to quantify how much commercial real estate is at risk, but we know that special servicing rates, an indicator for loan defaults, are on the rise for all property types except hotels and industrial assets.

Floating Rate Loans Account for a Growing % of New Originations & The Looming Wall of Maturities



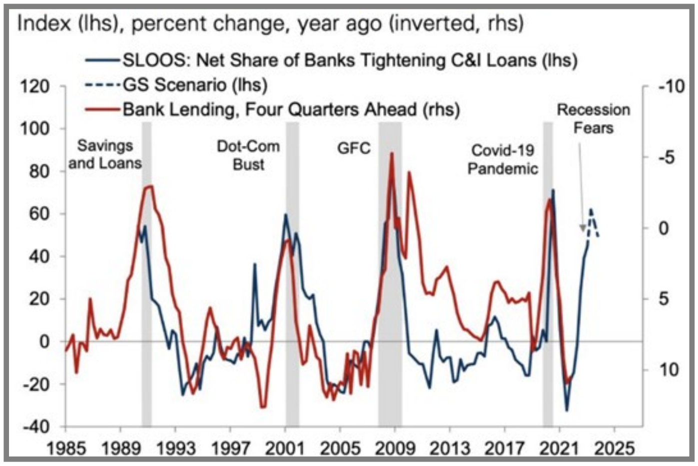


Source: Goldman Sachs

The Summation of it All

Consider the implications of what we have discussed so far. First, we witnessed a small banking panic driven by a mis-match of assets and liabilities. Regulators were caught off guard when this event occurred and are likely to keep a more watchful eye on banks going forward. And while the bank run appears to have subsided, we know that deposit rates remain well below what clients can earn in money markets, which means banks are unlikely to see significant deposit inflows unless they raise rates on checking and savings deposits. Long story short, banks are unlikely to have fresh capital from which they can make new loans, and even if they did, that capital would come at a higher cost. Sec-ond, most US regional and community banks are saddled with commercial real estate loans they issued at much lower rates. Unless interest rates fall and/or occupancy rates and rent climb, we would expect to see more trouble in the com-mercial real estate market. As this plays out, banks will be forced to set aside funds for potential problem loans in the form of loan loss reserves. Lastly, even if neither of the aforementioned problems existed, today's inverted yield curve isn't conducive to bank lending. Deposit costs are loosely tied to short-term interest rates and loans (like a 30-year mortgage) are tied to longer-term interest rates. When the yield curve is inverted, it becomes more difficult for banks to earn a profitable spread on their capital. The summation of it all is banks will be more reluctant to lend in the imme-diate future, which is a net negative for our economy and in particular the real estate markets. You can already see this playing out in the form of lower lending volumes and tighter lending standards.

Tighter Bank Lending Standards Ahead

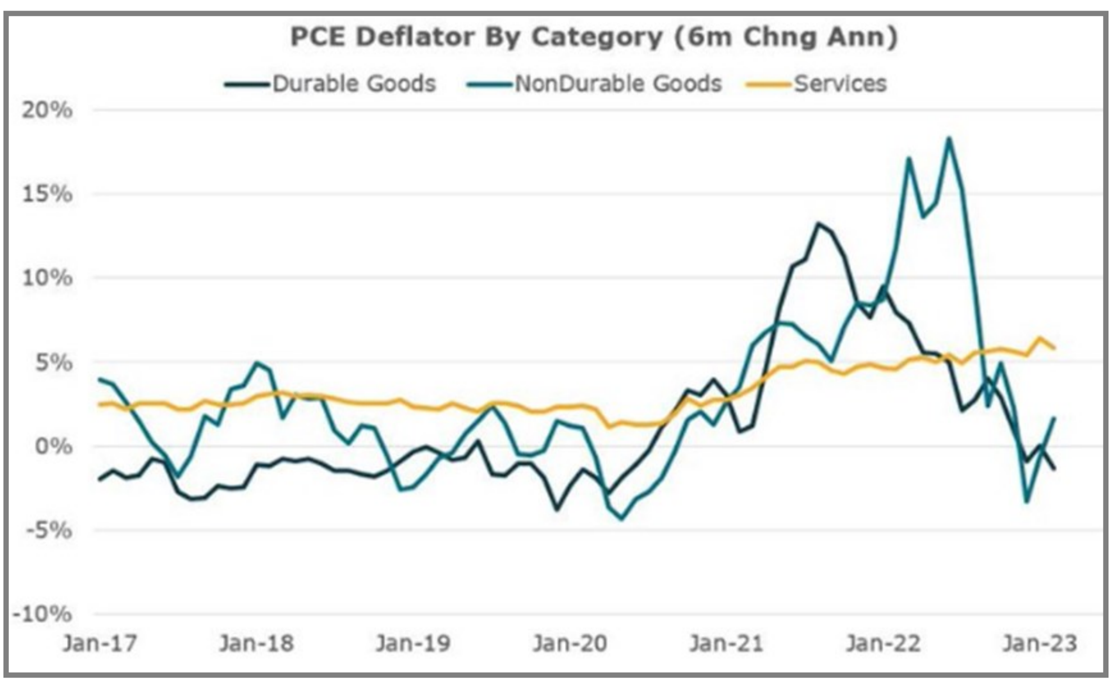


Source: Goldman Sachs

The Fed's Explicit Goal

The Fed has made it clear that fighting inflation is its number one goal, and to do so, it must use the monetary policy tools at its disposal to slow economic activity. The problem faced by the Fed is that monetary policy has "long and variable lags." In plain English, it will take time for us to know the true economic impact of past rate hikes. The aforementioned drop in lending volumes and tightening of lending standards is a result of tighter monetary policy, which are the early indicators the Fed wants to see. The Silicon Valley Bank debacle likely helped speed up matters. March CPI came in at 5.0% year-over-year, well below the June 2022 peak of 9.0%, but the question remains will inflation continue to fall, or will it begin to plateau from here? Can they get it back down to the Fed's goal of 2% inflation? These are tough questions to answer. The decline in CPI over the past few months has been driven by declines in the prices of goods, particularly durable goods like oil and used cars. These are volatile data series and more recent observations show their price stabilizing. In fact, the Cleveland Fed's inflation nowcast shows April inflation trending higher, not lower. What really matters is inflation in the service sector, about 78% of GDP, which appears to be more entrenched (see the chart below).

Services Inflation is Harder to Tame



Source: Bob Elliott, Unlimited Funds

Tight Labor Markets

To quell inflation in the service sector of our economy, we will likely need to see pressure on the labor market (i.e., lower wages). If you read the Fed's minutes you can see their particular focus on this matter. *"Participants agreed that the labor market remained very tight… participants assessed that labor demand continued to substantially exceed labor supply, and several participants pointed out that wage growth was still well above the rates that would be consistent over the longer run with 2 percent inflation… Participants commented that recent inflation data indicated slower-than-expected progress on disinflation… Participants generally judged that some more easing in labor market tightness and slowing in nominal wage growth would be necessary for sustained disinflation."* To date, we have seen only modest deterioration in the labor market. The unemployment rate sits at 3.5%, but this is a backward-looking barometer. Continuing jobless claims give us a better look into the state of the labor markets, as they are a signal of individuals who have lost work and are finding it difficult to land a new job. To that end, continuing claims have risen modestly from their late 2022 lows but are far from elevated, and our most recent data point showed a slight improvement in continuing claims. Other labor indicators, like initial unemployment claims and Challenger job cuts, paint the same picture - modest cooling in a labor market that is very strong by historical standards. As a side note, we suspect many of the layoffs over the past 12 months influencing data are specific to the technology industry, which has been focusing on efficiency after years of excess. Year to date, the state of California accounts for almost 40% of the layoffs that have taken place.

Conclusion

At present, our labor market and economy appear to be strong, but we acknowledge this could change in the coming months. The tightening of credit markets and other leading measures point to some level of cooling in our economy, but will it continue? Economic forecasting is a difficult act and one we strive not to participate in. We would stress that financial markets and the economy are related but they don't necessarily move in tandem.

We have already witnessed significant valuation declines in companies where economic stress is the most acute. Vornado Realty Trust, one of the largest holders of office real estate in Manhattan, has seen its share price fall from $70 pre-COVID to $15 a share. That is a 79% decline in valuation. And, after the Silicon Valley Bank implosion, the regional bank ETF fell 35%. We are not bullish on either of those securities, but we would be very hesitant to bet against them. The market is a discounting mechanism, and the prices of those two securities already reflect many of the economic stresses we have discussed in this commentary.

Vornado Has Fallen 79% Since COVID

Source: Bloomberg

Our job as asset managers is to thoughtfully build a portfolio that puts the odds in your favor. Our default portfolio is a diversified basket of stocks and high-credit quality bonds. We view stocks as the best, liquid, long-term store of wealth, historically accruing at 10-11% per annum. Our bonds help us manage liquidity, generate income, bring stability to portfolios, and provide us ammunition to play offense when markets are in disarray. We also have a long history of making less-liquid private investments. For a private opportunity to make it into our portfolios, it must be demonstrably better than our default portfolio of stocks and bonds, and we must have high conviction the investment carries a limited downside. To put things simply, we only stray from our default stance when it seems obvious to do so, whether investing in a private opportunity or altering our stance in public markets. Furthermore, we try not to alter our stance because of our explicit or implicit macro views, such as the trajectory of the economy, interest rates, or commodity prices, but instead, we strive to react to price. We want to layer investments into our portfolio when the bargain is such that the investment will work no matter the economic conditions ahead.

You have probably noticed a slower cadence to our private deal flow as of late. The issue hasn't been a lack of deals, but rather a lack of deals that meet our hurdle rates. The best opportunities are unearthed amid volatility and panic, but we have been operating in a sanguine market. This is beginning to change. The real estate sector has not capitulated, but it is under duress, particularly investments funded over the last few years, and banks, the largest holder of real estate debt, may become sellers. If these conditions persist, it will create an abundance of opportunities. To that end, we are busy looking for real estate partners with both equity and credit expertise. We have one existing investment, Emet, that is well-positioned to capitalize on stress in student housing, senior living, and affordable housing via the tax-free bond markets. The fund has closed on two transactions to date and has ample capital to deploy into fresh opportunities at attractive prices. We have another firm in the final stages of diligence, that can invest from both the equity and debt side but has a particular knack for finding clever ways to recreate real estate assets at heavily discounted valuations. They have direct relationships with the FDIC and many small banks, putting them in the perfect position to buy loans and/or real estate in foreclosure.

At the cost of being repetitive and cliché, we are looking for "heads I win, tails I win" transactions to deviate from our default portfolio. The stresses in today's real estate market appear to offer fertile hunting grounds. Being ready, whether the opportunity emerges, is how we gradually stack the investment odds in your favor. As always, we appreciate the trust you have placed in us, and we love what we do. We are grateful for the opportunity to steward your capital.