Another Financial Train Wreck

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The biggest news last month was the massive failure of two large U.S. chartered banks, one on the east coast and one on the west, with several others still hanging in the balance in between. A lot of ink has been spilled in the popular press as to how this might have happened, who should bear the blame, and what it might mean for the U.S. banking system overall. I have a very strong opinion of what this means for my investors, which I will share herein. I thought long and hard over the past few weeks whether this most recent crisis should even be a topic of conversation because the issues surrounding it are complex. These issues, some of which are more technical in nature, would need a lot of pages to cover in their entirety, but I only have four pages. Therefore, I have decided to narrow the scope of my letter to this*: How might these recent bank failures affect our investments, and what should we be doing in the aftermath?* The very first thing I want to say is, “Don’t panic!” Markets rarely, if ever, go straight down. Bear markets take a long time to work through their entire cycle irrespective of the causes.

Those who have been reading my letters for any length of time (even if only occasionally) know that I have been a vocal critic of the policy responses from our Federal Reserve (Fed) and Treasury to past financial crises. In my opinion, every subsequent financial crisis since the late 1990s resulted from the fiscal policy initiatives that preceded it. When leadership fails to punish those most responsible for financial panics by delivering the hard medicine that is deserved, they effectively become complicit in resetting the system to fail again in the future. Backstops and rescues only serve to encourage more bravado and bad behavior in the future by those most likely to abuse leverage, and rely on excess risk-taking, all in an effort to chase extraordinary returns. Some speculators and leveraged players may even operate under the belief that when the next crisis hits, they will be among the elites who get the bailouts, as this behavior has been rewarded repeatedly for several decades now. It’s the rest of us who have had to absorb their losses either through higher taxes, a higher cost of doing business, or both.

I believe there is every appearance history is repeating itself as the root cause of the current crisis is seemingly going unresolved. There is more than one way to get through a financial crisis. I believe the Fed's actions have been predictable and the same; a financial "rescue" using other people's money (ours …the taxpayers!). Can't they ever just let a financial panic come to its own natural conclusion, even if that results in some (or many) taking a significant loss on their investments? This could teach the hard lesson of prudence, but more importantly, it would also allow the financial system to clear itself of the root cause of the problem. Isn't this how "free markets" are supposed to work?

The alternative option, the one that I believe fails to teach lessons and that further amplifies future risk-taking, has been the chosen method for over two decades now. The "solution" has been to intervene after every financial crisis has already broken out with a response that bails out the rich and powerful while sparing indignity to highly favored banks and other favored institutions. It has been a consistent pattern of easy money responses that are also experimental in nature. The current crisis started with "runs on the banks," and so the Fed response is two-fold. One, a sudden announcement that they would back-stop the wealthy depositors beyond the established limits of coverage, $250,000 per depositor per bank. Two, they created a new lending program by the name of "Bank Term Funding Program" (BTFP) that allows all banks to "swap" long-term bonds and mortgages that are on the bank balance sheets (and are underwater at current market prices) in exchange for "cash" equal to the <u>full value</u> ("face value") of those same securities at their maturity. Effectively, the Fed is printing more money out of "thin air" to supply this so-called remedy. What bank would not want to take advantage of that, and what could possibly go wrong?

Here is what goes wrong. Lessons do not get learned, bad behavior is rewarded, and the seeds of the next bubble are sown. Past is prologue. Rewarding those who stand to suffer losses due to their investment misdeeds or miscalculations has proven in the past to do nothing more than create an even bigger problem down the road. "Proactive" de-risking, and pushing back against high levels of speculation is one way to clean up the root causes of mismanagement, mal-intent, and outright fraud, but that always seems to be absent until trouble actually shows up. Once markets become over bullish, overbought, and overvalued, all you are left with is a “reactive” response that seems to always come too late to matter. The most important lesson that can be taught to highly leveraged risk-seeking participants who find themselves caught in an unexpected negative trend is to give them their medicine, force them out of the positions that got them into trouble to start with (regardless of the liquidity available to them), and allow the natural unwinding of what caused the negative condition to foment in the first place. Allowing speculators to fail, and letting the system reset, is the formula that allows the system to come back even stronger in the next iteration. The failures of the weakest players is the gift that rewards the strongest and the most prudent. Survival of the fittest.

Here is where we stand today. As investors, we must prepare ourselves for what could be a very uneven 2023 economy. The consensus analyst estimate from FactSet currently is for a net profit margin of 12.3% for the S&P 500 in 2023. [1] I see a problem with this forecast, and I am doubtful it will be fulfilled. We have much higher input costs than in recent prior years, a continuing disrupted supply chain, and higher wages almost across the board. Then there is the wild card regarding the wild swings with the U.S. Dollar against other foreign currencies, and whether that will help or hurt large companies that do a lot of exporting or importing. If things are seemingly so good, why are we still getting so many layoff announcements by the largest of publicly traded companies, something that started in late 2022? Why are so many companies (particularly in the tech sector) delaying orders for new equipment while watching their own inventories grow, particularly in the microchip manufacturing industry, which tends to be a leading indicator? I’m not saying all companies, but this has certainly been the case quite recently among the largest and most visible of them.

I am prepared to see even higher interest rates in 2023 than we have today. One of the biggest problems of money printing and excessive spending bills by the current administration, complimented by easy money policies of the Fed, is that this can stoke future inflation. The current banking crisis has caused the Fed to do a U-turn on their efforts to decrease the assets on their own balance sheet. In just one week (March 13-19) that balance sheet increased by more than $165 billion![2] It is my expectation that the current instability in the banking system will not be fully resolved with this current Fed/Treasury intervention program of backstopping depositors and supplying ready excess liquidity to more banks. The root causes are still there. Too many banks have too many assets on their balance sheets that are still below their acquisition costs, in part, I believe, a result of interest rates being pushed too high and too fast by the Fed. Potential problems may still be simmering under the surface.

Therefore, I am making a decisive change in my recommended asset allocation. We've had a slow and steady upward creep in the major stock market equity averages over the past six months now, but at this stage I would prioritize defensive measures over opportunistic risk-seeking behavior. At least for a few more quarters, potentially longer. As I weigh risk versus reward, it is hard to see where the upward thrust of reward might come from, but there is every appearance (to me) that the foundation of this economy is still getting weaker, not stronger. I recommend keeping equity exposures much lower than previously, increasing the holdings of short-term high quality fixed income (one-, two-, and three-year), holding exposure to the precious metals in the event future inflation remains stubbornly high, and to continue keeping some emerging market exposure to benefit from potential weakness in the U.S. Dollar. Lastly, keep some cash available for unexpected opportunity as the market volatility indicators are still running hotter than usual, indicating big money players are still willing to "pay up" for hedged protections.

One last note. Playing defense isn't the way to get rich; rather, it is designed to protect what you have. There are times when that is the better trade. I believe that this too shall pass, and that there will be ample opportunity to more aggressively seek out more favorable future market returns and from a much more appealing base valuation (from a historic perspective). No one said making money was easy! If it was, everyone would be rich. We are here to assist, and we welcome all calls to (715) 362-1719, or e-mail us at holperind@stifel.com.

David Holperin
Senior Vice President/Investments
Branch Manager

1 https://www.investors.com/news/stock-market-forecast-2023-challenges-abound-for-sp500-dow-jones-stock-pickers-can-shine/

2 schiffgold.com, 3/27/23, *"Fed Adds Another $94 Billion to its Balance Sheet in Week Two of Bailout,"* by Michael Maharrey.

Past performance is not indicative of future results.

The Standard & Poor's 500 Index is a capitalization-weighted index that is generally considered representative of the U.S. large capitalization market.

Diversification and asset allocation do not ensure a profit or protect against loss.

There are special considerations associated with international investing, including the risk of currency fluctuations and political and economic events.

Investing in emerging markets may involve greater risk and volatility than investing in more developed countries.

The risk of loss in trading commodities and futures can be substantial. You should therefore carefully consider whether such trading is suitable for you in light of your financial condition. The high degree of leverage that is often obtainable in commodity trading can work against you as well as for you. The use of leverage can lead to large losses as well as gains.