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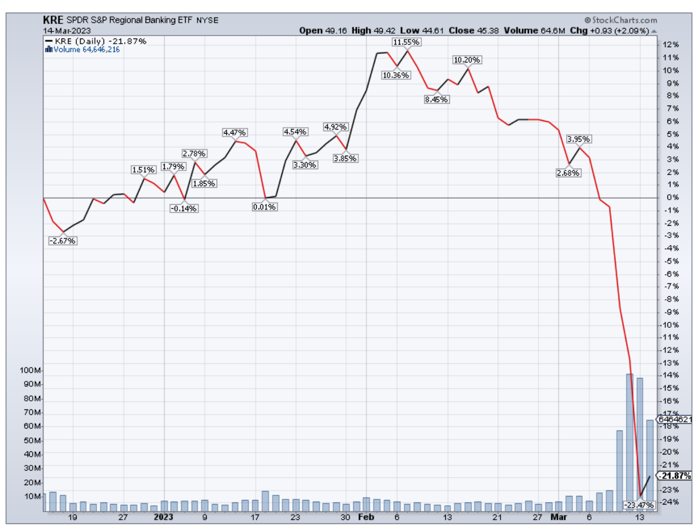
There is an old Wall Street maxim that "the Fed raises rates until they break something". The past week's headlines confirm that it is an adage that continues to stand the test of time.

After all, in the twelve months since the Fed started tightening monetary policy, we have witnessed one of the worst global bear markets in bond market history, a global bear market in equities, and a sharp trend reversal in residential and commercial real estate from a roaring bull market (particularly in residential real estate) to an environment of falling prices and decelerating rents.

That is not even to mention the impact that higher interest rates and reduced monetary liquidity have had on more speculative and/or less liquid asset classes like crypto currencies, SPACS, digital tokens and even private equity and private debt.

All along, investors, economists and policy-makers seem to have taken some comfort from the fact that the damage was being limited to the financial markets only, and had not yet impacted the efficient operation of the financial system itself.

If the failure of several regional banks, including Silicon Valley Bank, Signature Bank and Silvergate Capital (the last two largely being so-called cryptobanks) prove to be the canary in the coalmine that some believe them to be, it would suggest that the aftershocks of the Fed's uber aggressive policies are no longer being confined to the financial markets, and that they may now be starting to impede the smooth functioning of the financial system itself.

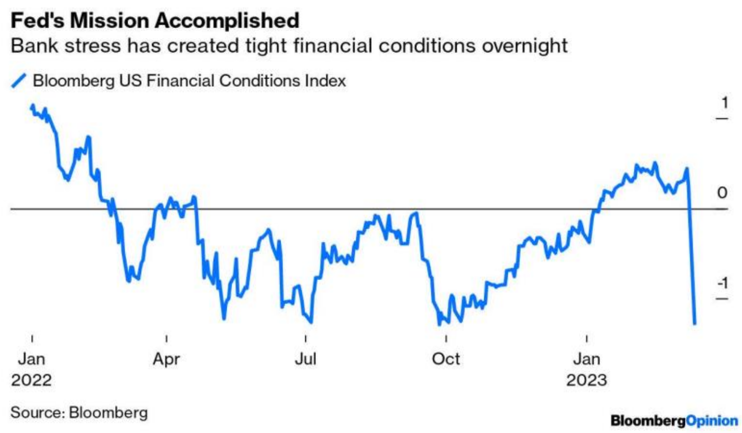


If so, this would likely be a game-changer for the Fed and its outlook for monetary policy, as it has among its primary objectives to promote "the safety and soundness of individual financial institutions, and their impact on the financial system as a whole".

The above chart of the regional bank ETF provides a tangible measure of just how much angst has been taking place in the banking system, particularly outside of the major money center banks. It is important to note that this greater than 30%

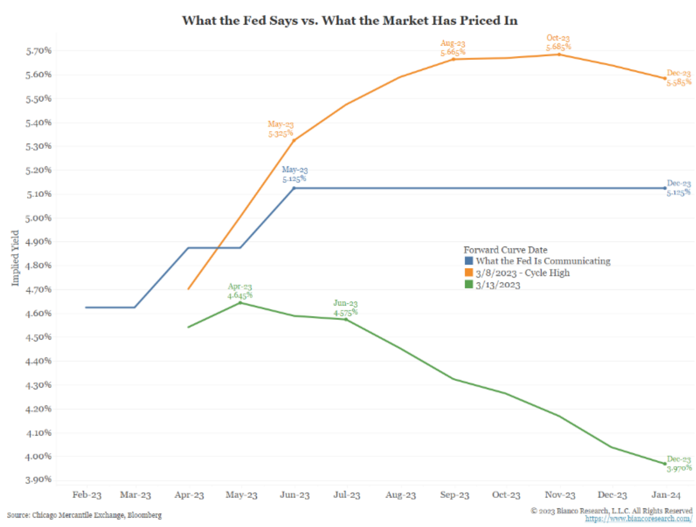
decline in the value of regional bank stocks started almost three weeks ago, well before the average American had ever even heard of Silicon Valley Bank.

Over the past several decades, chaos like this would likely have motivated the Fed to step in and throw a lifeline to investors, even if the turmoil was confined to the markets. Those were the days of the so-called "Fed put", when the Fed would respond to market turmoil by lowering rates, buying financial assets or "jawboning" (i.e. talking) the markets higher. These interventionist Fed policies have been a mainstay of Fed policy since the days after the 1987 stock market crash.



However, the advent of high inflation changed all of that, as the various tools at the Fed's disposal to support the capital markets would have simultaneously exacerbated inflation if they had been employed. Indeed, one can argue that the role of the Fed seems to have gone from providing a "Fed put" to providing a "Fed call", as their battle against inflation is enhanced if they can keep investor portfolios and home values under pressure, and keep the so-called "wealth effect" well contained.

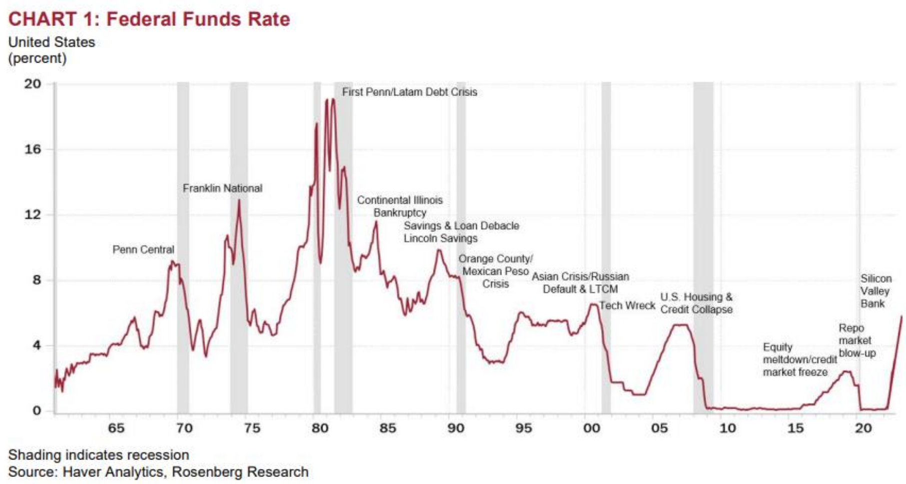
Ironically, this incipient banking crisis may have made the Fed's job much easier, as the Fed has been battling to offset the significant improvement in financial liquidity (a source of inflation) that had taken place since last October (see above), due to what had been improving stock prices, falling interest rates, a falling dollar, and narrowing credit spreads (the difference in yield between low-quality and high-quality debt [bonds, bills and notes]). In less than a week, the turmoil in the banking sector reversed financial liquidity from being stimulative to being restrictive.



Moreover, the banking crisis has changed entirely the markets' expectations for monetary policy. As of the week prior to the failure of Silicon Valley Bank, the markets were pricing in a peak in the Fed Funds Rate of 5.685% in October of this year, with the first potential rate cut taking place in December. Only one week later, expectations are for one final ¼ percent rate hike to take place in April (a terminal rate of only 4.645%, almost a full percentage point lower), and for the Fed to actually cut the Fed Funds Rate by about ¾ of a percent (to below 4%) by the end of this year.

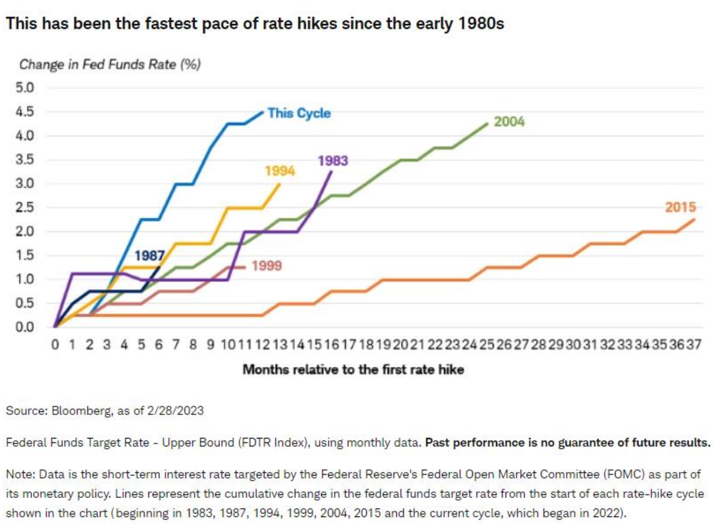
As counterintuitive as it surely seems, it may actually be a good thing for markets over the intermediate term, if the Fed's current policies are finally impacting the functionality of the financial system itself, as that may be the one thing that could cause a fairly immediate pivot in Fed policy, or at least an end to their policy of raising interest rates at every meeting.

This is a remarkable turn of events, when you consider that, at his most recent press conference, Fed Chairman Powell was preparing investors for the potential of a ½ percent rate increase at the next meeting, with at least several more to follow. It will be interesting to see if the markets' dovish expectations persist once the angst in the banking system becomes less acute.



So, how did we get here?

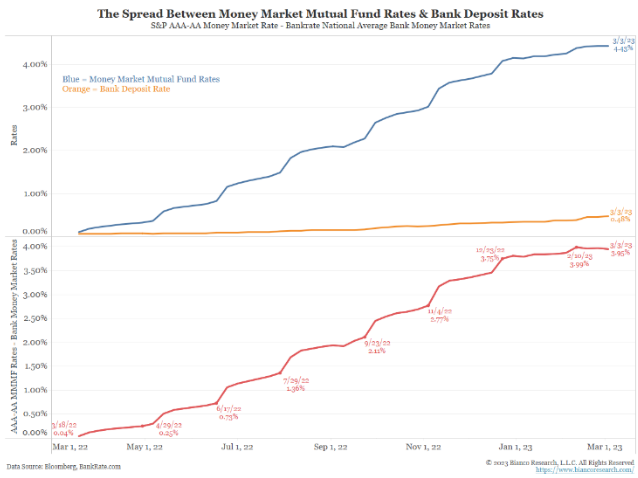
The best answer may actually be something that Herb Kelleher, who is best known as the iconic founder of Southwest Airlines, reportedly said to Fed Chairman Ben Bernanke in a phone call about fifteen years ago, when equity markets were in the midst of a sharp decline that was being driven by an aggressive tightening of monetary policy. Sound familiar? At the time, Kelleher was the chairman of the Dallas Fed board (and an avid consumer of Wild Turkey Bourbon). His advice to Chairman Bernanke was that "you can't go from Wild Turkey to cold turkey overnight". [1]



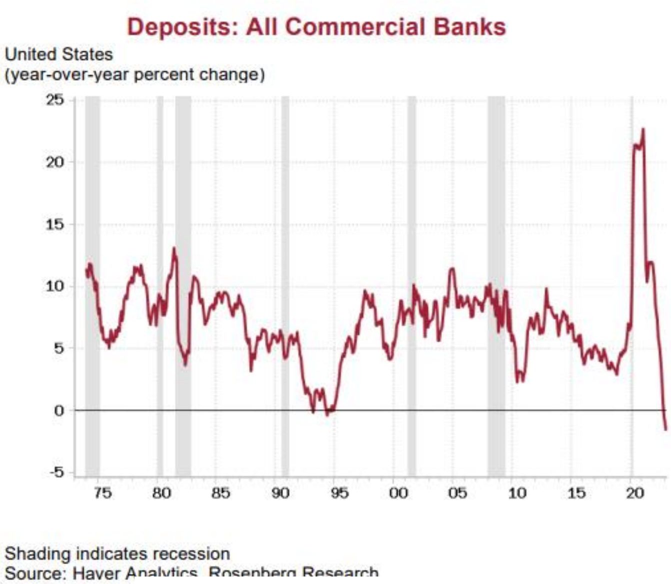
Whether it is done through higher interest rates, reduced money supply, quantitative tightening, providing forward guidance or, as is the case today, all four methods at the same time, the simple fact is that an aggressive tightening of monetary policy almost inevitably "breaks something". In its simplest form, this is exactly what is playing out in the markets.

Arguably, the problems in the banking system are largely of the Fed's own making. It was the Fed that drove yields down to essentially 0%, and then created an environment that encouraged banks to invest heavily in Treasuries, only to then drive interest rates dramatically higher in response to inflation, thus devaluating all of the Treasuries that the banks had been encouraged to hold. In many instances these securities were bought by institutions to be held until maturity (thus presumably eliminating interest rate risk), but now need to be sold at a loss to accommodate massive withdrawals, as money flows out of the banking system and directly into today's higher yielding Treasuries and mutual fund money markets, which offer much more attractive yields with reasonably similar levels of safety.

Our elected officials are also very much to blame, as Congress passed legislation in 2018 that allowed small and mid-sized banks to avoid the regulations and stress tests that had been put in place by the Dodd-Frank Act to help prevent a repeat of the Global Financial Crisis.

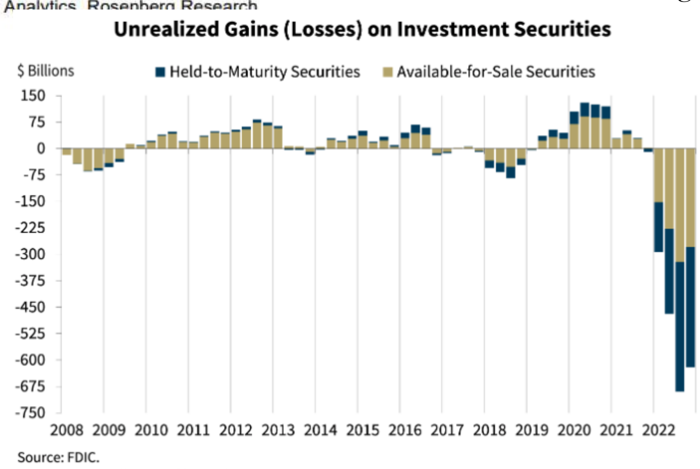


Many institutions are also to blame, as they never raised their deposit rates high enough to keep bank deposits competitive with short-term Treasuries and mutual fund money markets. The difference in available yields has reached almost 4%, and this has catalyzed a massive outflow of deposits from banking institutions, and has forced the banks to sell the securities on their balance sheets that are now worth considerably less than face value, as a result of the Fed's historically aggressive tightening of monetary policy. Remember that higher rates depress bond prices.

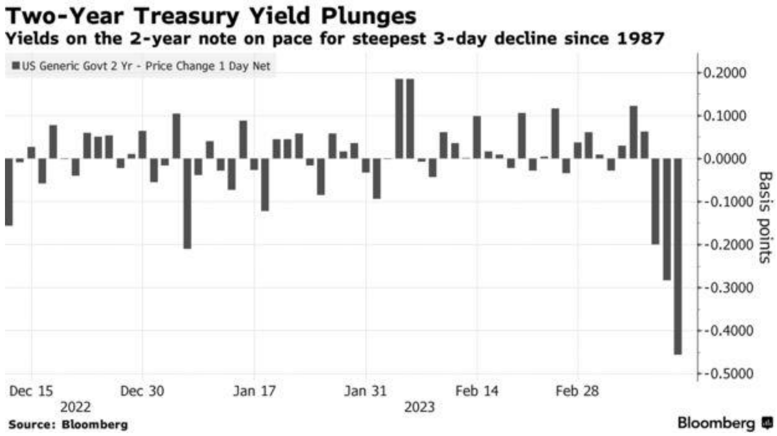


This is clearly an oversimplification, as there are many other contributors to the current banking system dysfunction. Further, and very importantly, the three failed banks had unique and highly idiosyncratic risks that do not appear to be common to most other banking institutions.

However, this is not to dismiss the importance of or the risks associated with the current banking crisis. According to Bianco Research, banks are sitting with $652 billion in unrealized losses, compared to just $3 billion a year ago [2], and Moody's just cut its rating on the entire banking system from "stable" to "negative", due to what it considers a "rapidly deteriorating operating environment" [3]. It is noteworthy that the two-year Treasury yield, which tends to fall when risks are perceived as high, just experienced its largest three-day drop since October of 1987.



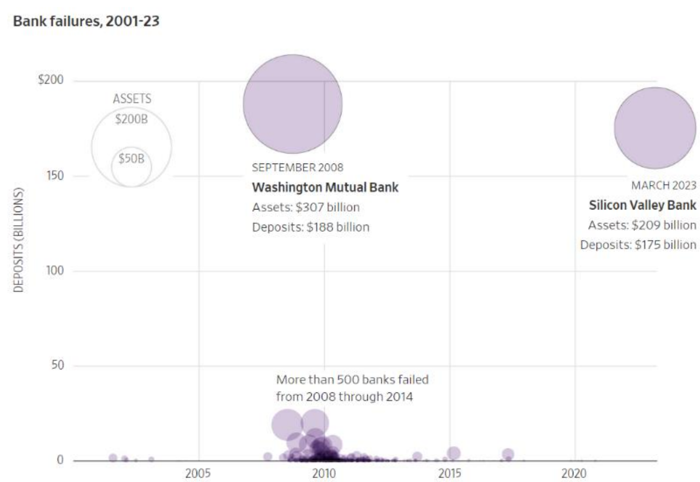
As we consider the potential negative ramifications of this banking crisis, there are three that come immediately to mind. One we consider unlikely. One we consider probable, but suspect that it will remain relatively contained in scope. One, we consider likely, and expect for it to have fairly broad implications.



The one that we consider unlikely is a continuation of the traditional run on the banks based on a fear that one's deposits are at risk (such as we saw with Silicon Valley Bank).

We would have even listed this as extremely improbable, based on the "whatever it takes" approach taken by the Fed, the F.D.I.C., the White House and the state banking regulators. However, over recent days, the promise to guarantee the funds of every customer at every bank, without regard to insurance limits, has been described as implicit instead of absolute, and the prior assurance has now been attributed to "an unnamed government official". We still believe that the government will do whatever is necessary to stop any run on the banks in its tracks. However, the lack of an absolute guarantee, as was made on a temporary basis during the Global Financial Crisis, means that it cannot be entirely eliminated as a possibility.

The probable, but hopefully contained outcome is contagion, not just from bank-to-bank, but also because almost all banks are currently somewhat compromised by their weakened balance sheet (because of the sharp surge in interest rates), and the inversion of the yield curve, which is just another way of saying that short-term rates are higher than longer-term rates. This is a real problem for banks, because much of their profits come from borrowing from depositors at short rates and lending at long rates.

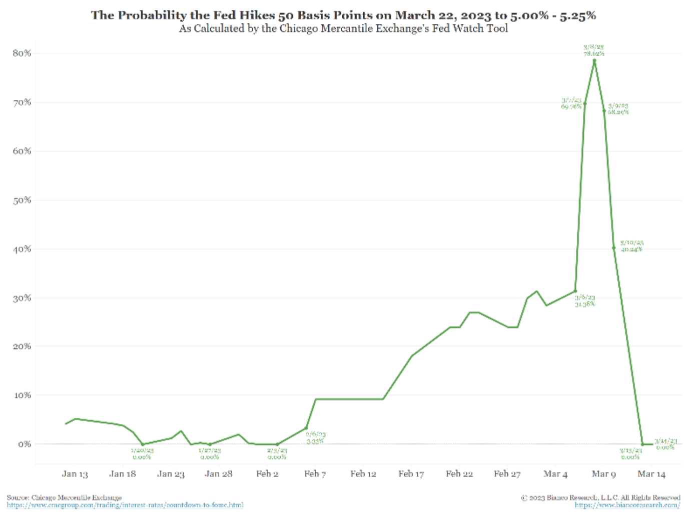


Note: Figures for assets and deposits are estimates.
Source: Federal Deposit Insurance Corp.

From our perspective, the most likely and most far-reaching ramification is likely to be a credit crunch, which will make it harder for individuals and businesses to get loans, as banks become more and more stringent in their underwriting standards. Indeed, there is evidence that this is already underway as, according the Fed's March 8th Beige Book, the summary of lending conditions across the country was described as: "On balance, loan demand declined, credit standards tightened, and delinquency rates edged up." [4]

This is the sort of thing that can turn a modest "soft landing" recession, which we have been anticipating, to something more severe and more long-lasting.

Fortunately, it is also the sort of thing that is likely to crush inflation and create a more balanced labor market, where the number of available jobs and the number of available workers is in better alignment, which should help to make sure that, once brought under control, inflation is not coming back anytime soon.

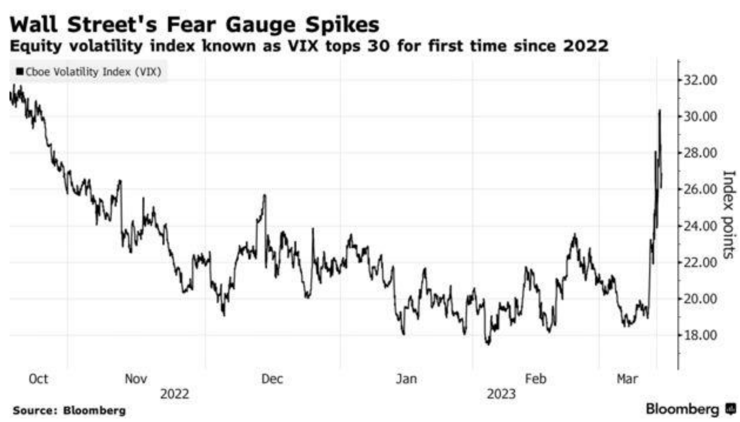


This is in sharp contrast to the 1970s and 1980s, when hyper-inflation kept roaring back every time that the Fed took their foot off of the brake.

It is likely also an outcome that would change monetary policy from today's increasingly restrictive policies of rising interest rates, plummeting money supply, and quantitative tightening, to a much more market-friendly policy of lower rates and increasing liquidity. We further believe that it would finish the job that the Fed started a year ago

The other potential benefit to longer-term investors of the current banking crisis (aside from the increasingly attractive valuations that it is creating) is that it is a classic example of the type of environment that may finally bring about investor capitulation (a point of maximum bearishness and despair) which, as all of our regular readers know, we believe is almost essential to the creation of a sustainable bear market bottom.

You can already see some emerging evidence of capitulation, as shown by the VIX "fear index" breaking above 30. While our experience is that it normally takes a break above 40 to hit real capitulation, this increase in fear is something that we are excited to see, as bear markets normally only end at the aforementioned point of maximum bearishness, when all potential sellers have already sold.



We look at it somewhat like knee or hip surgery. The patient is likely to experience rather acute pain in the immediate term, but will be much better off in the longer term once the surgery is done. We believe that the current banking crisis is likely to produce a greatly accelerated end to this current bear market in equities, and a return to a much healthier economy and capital markets, once inflation is brought back under control.

Remember the words of Mr. Kelleher, when you "go from Wild Turkey to cold turkey overnight", there are going to be some withdrawal pains. [1] We suspect that the banking crisis is just serving to accelerate the inevitable. Fortunately, that should also include the start of the next bull market.

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Past performance is no guarantee of future results. The investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than the performance quoted.

Definitions

The Standard & Poor's 500 (S&P 500) is a market-capitalization-weighted index of the 500 largest publicly-traded companies in the U.S with each stock's weight in the index proportionate to its market. It is not an exact list of the top 500 U.S. companies by market capitalization because there are other criteria to be included in the index.

The Bloomberg U.S. Financial Conditions Index is a Z-score tracking the overall level of financial stress in the U.S. money, bond, and equity markets to help assess the availability and cost of credit.

The Federal Funds Rate (FFR) is the average interest rate that banks pay for overnight borrowing in the federal funds market.

The VIX Index is a calculation designed to produce a measure of constant, 30-day expected volatility of the U.S. stock market, derived from real-time, mid-quote prices of S&P 500® Index (SPX℠) call and put options. On a global basis, it is one of the most recognized measures of volatility -- widely reported by financial media and closely followed by a variety of market participants as a daily market indicator.

Citations

(1) "Southwest Airlines' legendary co-founder Herb Kelleher dies at 87", Conor Shine, Posted 1/3/2019 https://www.dallasnews.com/business/local-companies/2019/01/03/southwest-airlines-legendary-co-founder-herb-kelleher-dies-at-87/
(2) "Do Banks Need To Raise Deposit Rates", Jim Bianco, Posted 03/10/2023, https://www.biancoresearch.com/tag/markets/
(3) "Moody's cuts outlook on U.S. banking system to negative, citing 'rapidly deteriorating operating environment'", Jeff Cox, Posted 03/15/2023, https://www.cnbc.com/2023/03/14/moodys-cuts-outlook-on-us-banking-system-to-negative-citing-rapidly-deteriorating-operating-environment.html
(4) "Early Morning with Dave", David Roseberg, Posted 03/10/2023

Image 1 "Broken Relection", RM Images, Taken 11/23/2007, https://www.flickr.com/photos/shinealight/2249017849