# Another Bites the Dust

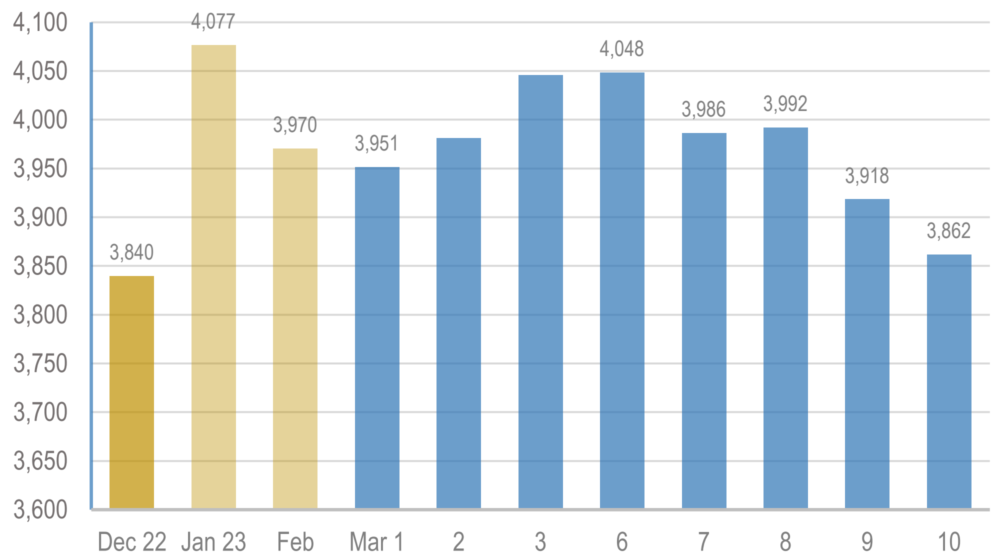
*Weekender*

March 11, 2023

Good morning and welcome to the *Weekender* for Saturday, March 11, 2023. It was a very eventful week, but not for the reasons we expected last week. US equity markets were lower by -4.5%.

**S&P 500 Index Levels and Price-to-Earnings Ratios**

*(Source: Bloomberg)*




For the year, the S&P 500 has given up almost all of its previously stellar 2023 gains. It's now higher by only 0.58%. The Dow is now lower by -3.7%. Globally, the best performing equity market is the Mexican Bolsa, higher by 14.8%.

Employment data released this week showed a perky labor market unwilling to be cajoled into layoffs by higher interest rates. Even so, the failure of Silicon Valley Bank on Friday pushed market interest rates and stocks lower.

Rates fell on what was, for some, a reasonable assumption that if Silicon Valley Bank's issues were generalizable, the Fed would halt, or at least slow, its aggressive rate stance in deference to providing stability to bank balance sheets, generally, by keeping rates lower. Stocks fell as economic data continue to support the view that inflation is not coming to heel while corporate profits are.

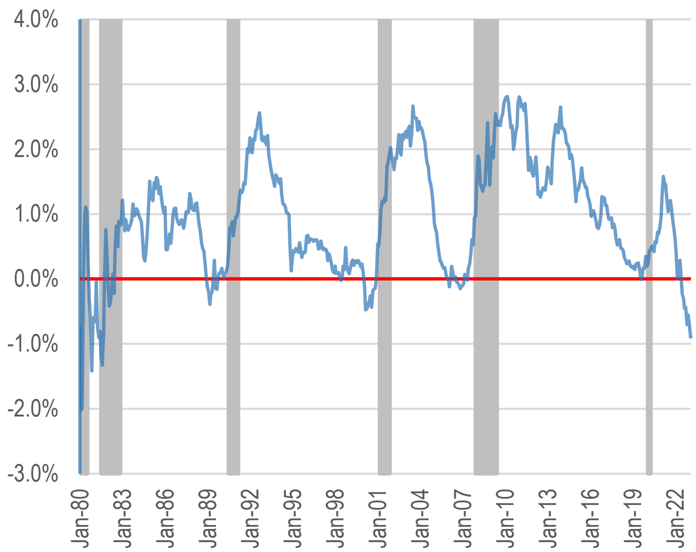
The dueling trinity of economic narratives—hard landing, soft landing, and never landing—continue to hold their own, as each was able to pick among economic data points that best support their story. One of the data points not up for interpretation is the yield curve. An inverted yield curve, a condition that exists when the yield on the US government 10-year bond is lower than the yield on the 2-year bond, is generally a reliable indicator of approaching recession.

As the graph illustrates, the yield curve has been inverted since July of 2022 and continues to be inverted at the lowest level since the early 1980s. There are some unique market dynamics that add to the level of inversion in today's bond market. However, it is clear that fixed income markets are predicting a recession within the next 12-18 months.

**Yield Curve Inversion**

*January 1980 - March 10, 2023*

*(Source: Bloomberg)*

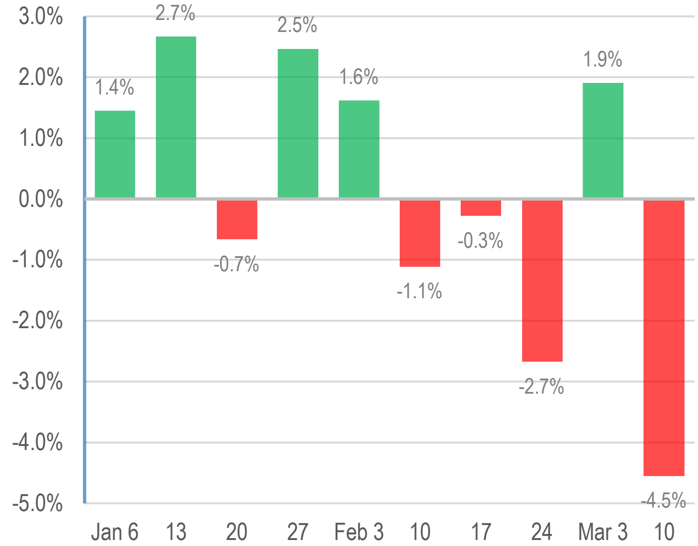



This year's weekly returns are equally split between gains and losses. But since the second week of February, the S&P 500 has been possessed by a noticeably negative tone.

**S&P 500 Weekly Returns**

*January 1, 2023 - March 10, 2023*

*(Source: Bloomberg)*




This *Weekender* was supposed to focus on the consumer. Instead, we will drill into the failure of Silicon Valley Bank and parse a general view of recent employment data. We will also discuss market moves in countries, instruments, sectors, and themes. Next week we will return to looking at the strength of the US consumer.

Please be sure to discuss any financial decisions with a qualified financial advisor.

## Market Narrative

At a gathering of bankers last Monday, the head of the Federal Deposit Insurance Corporation, or FDIC, warned of an enormous emerging risk in the banking system. The size? $620 billion. The risk? Bank balance sheets were full of low interest rate bonds, the value of which were cratering in the face of the Fed's rapid interest rate increases. Lower asset values cause an erosion in bank liquidity. By the weekend, two financial institutions succumbed to the risk. One a pet rock. The other a storied financial institution.

Silvergate Capital Corp. caters to the crypto industry. They began teetering at the beginning of March. Silicon Valley Bank, the 16th-largest bank in the United States, measured by deposits, fell into receivership on Friday. Silicon Valley Bank (SVB) fell victim to their regulator's demand that mark-to-market accounting be used to measure the value of bank assets, even those they plan to hold until they mature.

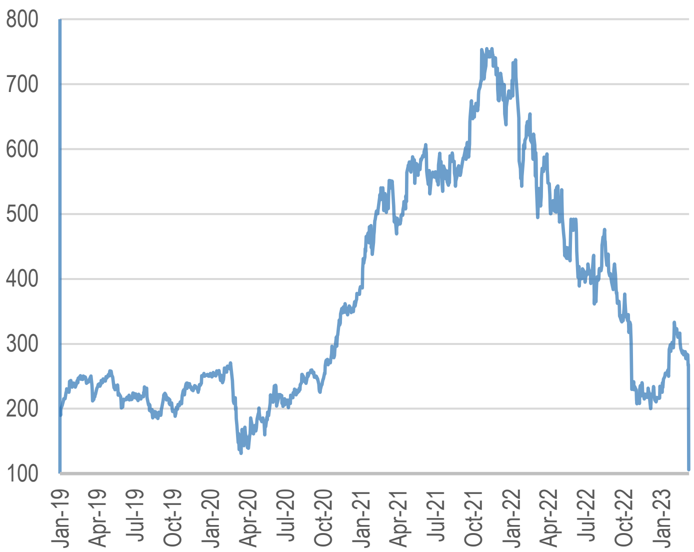
Silvergate's fall from grace was largely due to the blind spot cryptocurrencies still evoke in the view of regulators. On March 1, it was clear Silvergate was illiquid. Instead of taking it over immediately, it was allowed to limp through the weekend only to die mid-week in full view of a nervous financial market.

Below is a graph of Silicon Valley Bank's stock price, which was halted on Friday at $106.04 per share.

**Silicon Valley Bank Stock Price**

*January 2, 2019 - March 10, 2023*

*(Source: Bloomberg)*




SVB was a staple among the venture community. Their failure was due to five primary factors. First, mark to market accounting accentuated the bank's asset values. Second, rising interest rates lowered the value of their bond portfolio. Third, high interest rates made it difficult to raise equity capital for the bank as well as for its primary venture and private equity customers. Fourth, venture fund managers advised their portfolio companies to withdraw their money from the bank causing a run on deposits. Fifth, SVB caters to a risker class of client than most banks.

Silicon Valley Bank (SVB) is a pioneer. During the internet boom, they were an active lender and investor in dotcom startups. Such risky behavior made them the "go to" source for entrepreneurs. But as the Fed increased interest rates, discount rates for venture investors also rose, making it difficult for start-ups to find money. Running low, they drew on their letters of credit and pulled their money out so they could save for a rainy day. For Silicon Valley Bank it has been drizzling since the Fed began raising and the deluge started on Thursday when its stock fell by 60%.

Deposit outflows spooked a number of notable Silicon Valley founders who prompted their portfolio companies to pull their money out of the bank. Greg Becker, SVB's Chief Executive Officer, tried to reassure depositors and investors while at the same time trying to raise $2.25 billion through a last-minute equity raise. There were no buyers and depositors were running for the doors.

The failure of Silicon Valley Bank is the second largest bank failure in the last decade and one of the largest twenty banks in the United States. Approximately half of startups bank with SVB. Its fall comes on the back of the abrupt shut down of crypto company, Silvergate Capital Corp over last weekend. The point. Financial company failures come, part and parcel, with changes in interest rate regimes. Rarely do they have systemic ramifications.

However, looking at SVB's annual report (10-K) from February 24, 2023, the bank was insolvent. Its bond portfolio, which amounted to 57% of its total assets, had to be marked down in value due to higher interest rates. As of the end of 2022, the bank had mark-to-market losses on securities it planned to hold to maturity in excess of $15 billion. Almost equal to its total equity of $16.2 billion.

While most banks hold a significant amount of low interest rate bonds as part of their capital base, few banks have the combination of the five factors which pushed Silicon Valley Bank into receivership. We believe the financial industry, generally, has been penalized for the sins of Silicon Valley Bank, presenting some incredible buying opportunities. That said, prudence dictates that the Fed and the FDIC assess the risk management strategy of all banks to ensure they are not over-exposed to rising interest rates.

## Labor Market Summary

Over the past month, data suggest a fairly broad-based deceleration across most areas of the US economy. To some degree, bad news is good news for the Fed. If the economy begins to look like it will roll over soon, smaller rate increases will be the soup de jour, followed by the much anticipated, pause.

The one area not rolling over is the labor market. Unemployment rose from 3.4% to 3.6% during the month of February. But the reason wasn't a weak labor market. It was more labor. The labor participation rate showed more workers came off the sidelines and entered the working class.

US payroll data for the month of February came in hotter than expected. In total, 311,000 jobs were created. Most of the job growth came from the lowest paying areas of the economy like travel, tourism, and retail. Manufacturing employment fell in February. Other employment data were also released this week showing the number of job openings exceeding the number of unemployed by almost a two-to-one margin. However, some positive labor market news was released. Average hourly earnings rose by 4.6% compared to last year, a slightly lower figure than expected.

We reiterate our position stressed in many previous Weekenders. Conjuring up a severe recession requires a soft labor market. We have not seen any such signs in the offing.

## Countries

Hong Kong was the worst performing country as international investors beat a path for the safety and security of US bond markets. Continued saber rattling between the US and China has international investors on edge. Meanwhile, Japan outperformed other countries as the Japan Central Bank chose to keep its short-term interest rates unchanged at -0.1%.

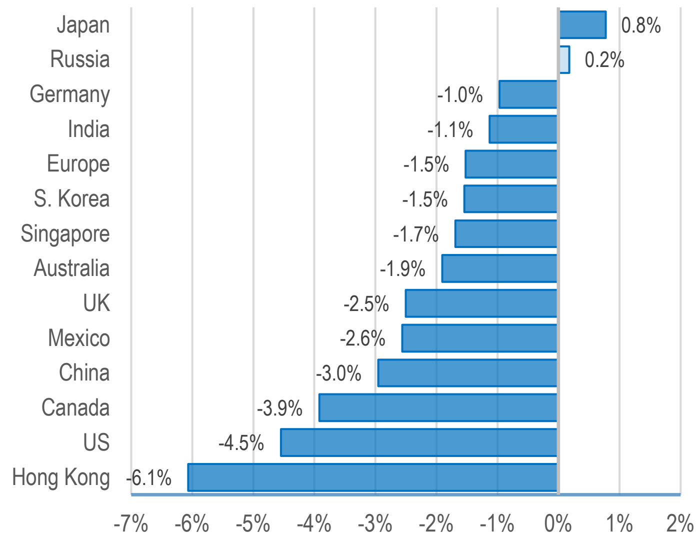
Looking back, fourth quarter earnings were softer than we expected. Earnings per share fell by -2.3%. Projections for the first two quarters of 2023 are relatively bleak. The US booked it's first quarter of what we believe will be an earnings recession lasting through the third quarter of 2023.

By contrast, European stocks have been outperforming all year. European earnings are also outperforming their US peers. Earnings revisions in the UK and Europe are showing positive moves while those in the US and emerging markets are falling.

### Country Returns

*March 6 - 10, 2023*

*(Source: Bloomberg)*



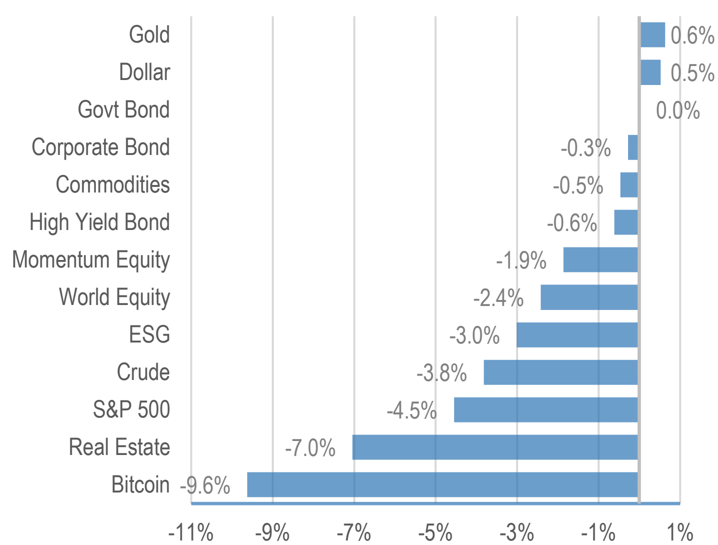

## Instruments

The failure of another crypto bank, Silvergate lifted the volatility and lowered the prices of most crypto assets. On the week, bitcoin was the worst investment instrument. As a pseudo-safe haven, gold was the best performer.

### Instrument Returns

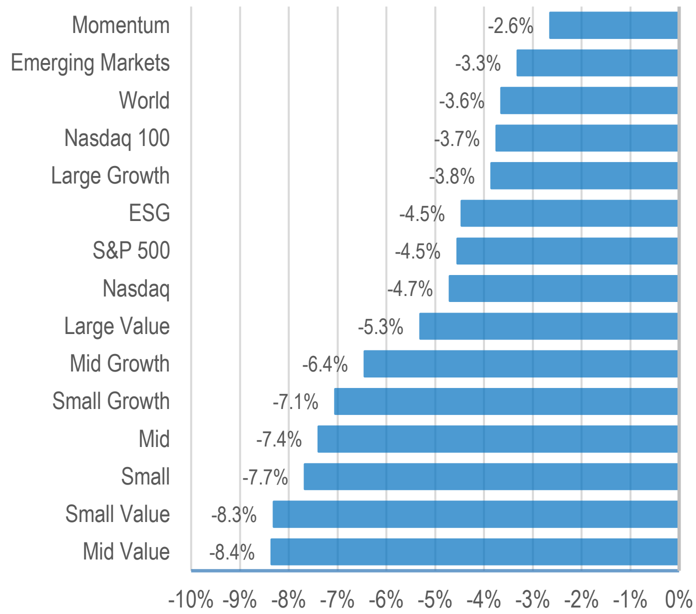
*March 6 - 10, 2023*

*(Source: Bloomberg)*




Considering equity investment instruments exclusively, everything was lower but smaller companies fared worse than their larger peers. Again, a general trade toward safety was the primary culprit.

### Equity Instrument Returns
*March 6 - 10, 2023*
*(Source: Bloomberg)*

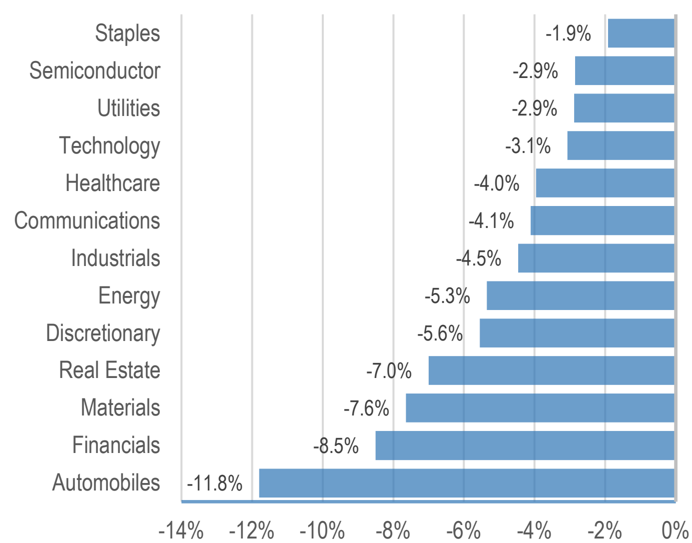



## Sectors

Among sectors, automobiles were the worst performing. Most of the underperformance came from Tesla which was lower on the week by -12.3%. General Motors was lower by -10.9% and Ford fell by -7.5%.

Financials fell early as interest rates strengthened. The failure of Silvergate and Silicon Valley Bank didn't help.

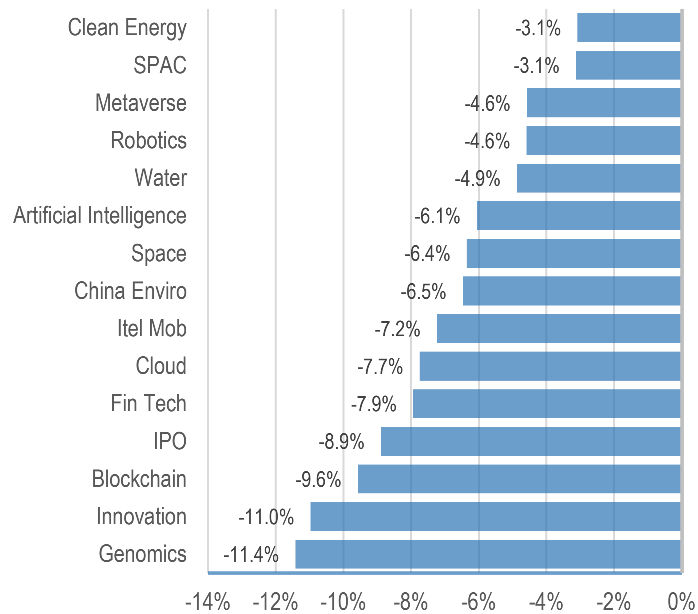
### Sector Instrument Returns
*March 6 - 10, 2023*
*(Source: Bloomberg)*




## Themes

All themes were lower. None of them make money. Consequently, themes are generally considered a very high-risk asset. Higher interest rates and financial system instability are both dangerous for high-risk equities.

### Theme Instrument Returns
*March 6 - 10, 2023*
*(Source: Bloomberg)*




## Conclusion

That's it for this *Weekender.* Have a wonderful week.

### *Disclosure Statement*

Index performance does not reflect the deduction of any fees and expenses, and if deducted, performance would be reduced. Indexes are unmanaged and investors cannot invest directly in an index. Past performance does not guarantee future results. Investing involves risk, including loss of principal.

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