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# The Damped Spring Report

"Shifts in growth, inflation, risk premium and positioning all lead to opportunities in markets"

3/12/2023

**The events at Silicon Valley Bank last week like the LDI crisis in the UK have once again placed the multiple mandates of the central banks in conflict. The NFP figures last Friday confirmed that the Fed's efforts to kill inflation are being met with a continued challenge of a strong labor market and kept the goal of full employment fulfilled. But simultaneously the FDIC closed one of the Country's largest regional banks. Like the LDI crisis and perhaps the LTCM bailout the role that policymakers should play in the resolution of the SVB situation and any role they should play if the run on SVB becomes a broader deposit run on a larger set of banks has placed in conflict the other two mandates of the FED.**

**The Fed has always considered financial stability as part of its mandate and financial stability may be able to be managed by the Fed without conflict with the price stability mandate. However, if the Fed responds to this small crack in financial stability by pulling the wrong levers or using too much force on the levers it pulls, inflation fighting goals will be directly impacted.**

Let's cut to the chase.

Markets moved dramatically as the SIVB situation unfolded. Equities fell over 3% led by regional banks falling over 10%. The front end of the rates curve bull steepened. Even the long end, rallied driving 30-year rates below 3.75%. The US Dollar weakened, and Gold rallied. All the market action was consistent with a financial crisis which would result in falling growth and credit tightening which would need to be countered by policymakers ending rate hikes and potentially cutting rates. What had been a steady march for six weeks toward Higherer for Longerer Island became a rush toward Recession Island and all hope for a soft landing evaporated.

We were well positioned for this abandonment of Soft-Landing Island as we were short NDX, SPX, and Eurostoxx. In addition, our short Twos position had been converted into a steepener. Nothing about the events last week has changed our primary view that a soft landing is highly unlikely. However, we also believe that the market has grossly overestimated the specific risk of the SIVB failure and has extrapolated the idiosyncratic case far too much. We unwound our SFRU3 Position and now are only short SFRZ4 only. We added a short in TLT and we covered a small portion of our SPX short.

Over the course of the next week, we expect the FDIC will fully resolve the SIVB closure and provide certainty for the uninsured depositors for the return of substantially all their deposits. In addition, we think the Fed will stick to its inflation fighting job while the FDIC and the Legislature deals with the potential bank runs on other banks with short term assurances and long-term restructuring of FDIC protections. However, we do not expect and would be very concerned if the FDIC stepped in to fully protect currently uninsured depositors in our nation's banking system.

We have estimated the asset values of the SIVB balance sheet and expect the disposition of assets to generate 80-100% of deposits. We do not expect a bailout but think that any uninsured deposit losses will have limited to no impact on the real economy and certainly not enough to warrant Fed easing.

We have evaluated the potential contagion risk to other banks and deem it to be modest. We also conclude that the deposit base of SIVB was unique as compared to its peer due to a tiny fraction, 2.7%, of its deposits were insured. The regional banks system has a difficult future, but its insured deposits are higher than the national average of about 55%. A run can happen even when deposits are insured. That may require FDIC action, but the solvency of the banking system remains extremely strong.

All this suggests that by next weekend assuming a CPI which is in line with expectations this little tempest in a teacup will have abated. The curve will have reinverted, and all interest rates will be higher. The economy will not skip a beat. Equities is a tougher question. A knee jerk rally on favorable resolution of SIVB is inevitable. But equities require a soft landing to make new highs and that hope may have finally been dashed.

## What happened at SIVB – chunky uninsured depositors and unhedged portfolio?

Silicon Valley Bank is a simple bank which makes loans to the Silicon Valley eco system. Like all US banks it saw a huge influx of deposits as the Covid Fiscal Stimulus flowed into people's banks accounts. The bank management did what all the US banks did. They bought US Treasuries and Agency Securities.

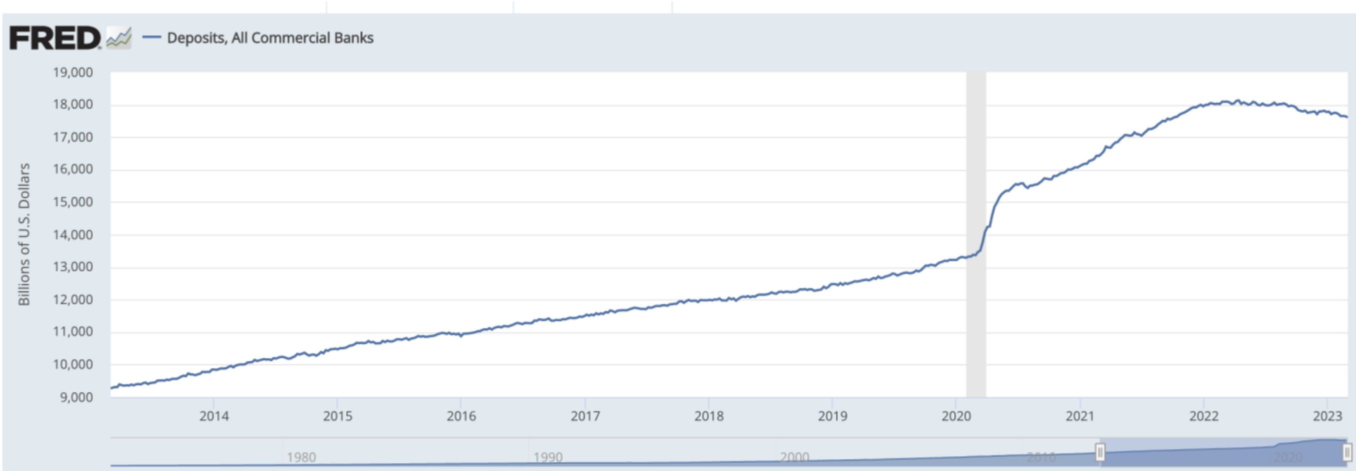

However, two extremely important differences between SIVB and most big banks.

1. SIVB depositors left large sums of money in their accounts. In fact, about 2.7% of the bank's deposits were below $250,000 and thus 97.3% of the deposit base was not FDIC insured. 2.7% of insured deposits as compared to overall US Banking system that has 55% of its deposits insured left SIVB uniquely at risk for a bank run.
2. But more importantly they didn't hedge any of their bond portfolio. They did the classic bank mistake of borrowing overnight to fund long term fixed rate bond purchases. This has generated large losses. These losses put into question the banks solvency and led to a run.

We have looked through the entire asset stack and valued each piece and we are confident that 85-100% of the depositor's money will be recovered without a government bailout payment. In aggregate that represents a hit to depositors of roughly 17BN. Not a small sum but in the context of the US economy a literal drop in the bucket.

## What about the rest of the banking system – do they hedge?

The US banking system has 18TN of deposits. Those deposits are held in large and small accounts. In total 10TN of deposits qualify for insurance.



Each banks composition of deposits is different, but SIVB was a multi standard deviation outlier at 2.7% vs a mean of 55%

While a bank run can happen at any bank it is important to understand whether the banks solvency is in question. In SIVB's case they had a 122BN portfolio of unhedged bonds. That position fell about 15% from peak and wiped out the equity and holding company creditors. We will see probably this evening what the depositors get. We are optimistic.

At this stage it is important to understand how banks account for their bond holdings and how that accounting drives realized and unrealized earnings and impacts hedging.

Banks have two ways to account for assets.

- Available For Sale (AFS). Bonds classified as AFS are marked to market. Gains and losses hit income and are accounted for in the accumulated other comprehensive income ledger item AOCI. Bonds in AFS can also be hedged explicitly and that eliminates the marked to market P/L.
- Held To Maturity (HTM) Bonds classified as HTM are not marked to market. They amortize to par but are not impacted by changes in bond prices. In addition, they cannot be hedged explicitly. This results in some confusion. However, a hedge can be in place on this portfolio but is accounted for in a marked to market way. Because the marking of the hedge and the bond aren't offset its possible that bank managers would choose to not hedge at all. This accounting incentive seems warped but that's another topic.
- In aggregate HTM and AFS classifications are used about equally by our financial institutions.

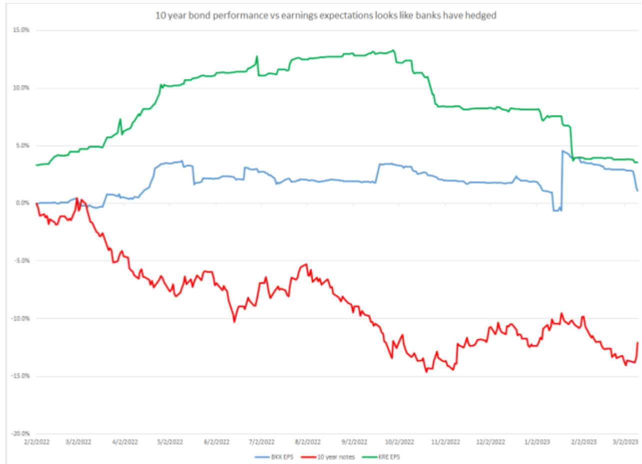
Systemically Important Financial Institutions. (SIFI)

The largest US banks have a more stringent risk management framework because they are too big to fail. SIFI have stress tests. These stress tests are far more important to regulators than accounting methods because they measure the true economic risk to the bank so classified. The result is a highly sophisticated asset liability management function exists at each of these banks. They hedge.

Regional and smaller banks.

These banks vary in level of sophistication and do have the accounting friction to deal with. It is possible that they do not hedge. However, if they do not hedge, they must have experienced sizable mark to market losses in their AFS book. In addition, they have unrealized losses in their HTM book as well. We aren't banking analysts and while we have begun to deep dive into bank balance sheet we are not through with our analysis.

On the surface earnings of both SIFI and Regional banks look like they have been hedging. We expected hedging from SIFI banks, Regionals look a little net long to us.




## How big is the problem?

The US banking system owns 4.4TN of US bonds and mortgage securities that has exposed the banking system to roughly 600BN in drawdowns at peak if the entire holdings were unhedged. During the GFC it is estimated that US Banks lost close to 1.0TN due to credit losses.  While 600BN is comparable it pays to break down the likely distribution of losses.

- SIFI banks own approximately 75% of these assets and are hedged.
- SIVB was a whale and owned 2.5% of these assets and was unhedged.
- The balance of the banking system owns roughly 1TN of assets and has an unhedged mark down of 150BN.
- We suspect the loss on duration risk for the entire banking system is less than 100BN.

Is 100BN a large number?  Sure, particularly because it is held by regional and smaller banks.  Does it represent an imminent threat to the US economy.  We do not think so. Does it represent an imminent threat to depositors.  Only if the concentration of those losses is with a small number of banks.  It is not likely that SIVB is the only bank with a solvency problem.

## Regional banks and the banking system have a bigger problem due to SIVB.

The insolvency of SIVB was on the asset side of the balance sheet.  The bank run was something else entirely.  As we mentioned 97.3% of the deposit balances were uninsured. This is very unusually and not likely to happen with other banks. However uninsured depositors are now looking for safer banks or safer non-bank alternatives like T-bills and Money Market Mutual Funds.

To the extent that deposits migrate from one bank to another the system liquidity will be unaffected but the delevering of one balance sheet will not be necessarily where the new bank will invest.  Particularly loan books will tighten credit in the regional bank eco system.  Furthermore, to the extent that a deposit loss results in a bond sale if the seller was unhedged that would generate net duration for sale.

Worse for the banking system and liquidity and overall asset prices and credit conditions would be a move from uninsured deposits to T-bills or money market funds. In that case we would expect a significant growth in the RRP and a significant shrinkage of Reserves. Currently the US banking systems has significantly more reserves than necessary even in an ample reserve regime so in aggregate a broad bank tightening and asset delevering is not an imminent threat to the economy. However, the total uninsured deposits in US banks are close to 8TN. The trend is very negative if the FDIC doesn't act.

## Full Insurance of banking deposits is a bad idea, but an adjustment makes sense.

The FDIC should consider changes to the bank deposit insurance regime.

- There are many valid reasons why individuals, small business, corporate and municipal governments need to have a safe place to hold cash. A small business with 50 employees needs more than $250K just to book revenue and pay expenses.
- We suggest creating non-interest bearing fully insured accounts for transactional convenience while segregating the investment assets banks use to offset that deposit from broader bank risk.
- Increase interest bearing account protection to $500K
- Above $500K bank depositors should expect risk for their return as they would any other investment.

The FDIC must have a framework that requires depositors above these limits to accept the risk of loss. If they protection to depositors was made unlimited it would distort financial markets significantly

- Other short term obligations including T-bills, Municipal Bonds, and corporate bonds see lower demand and the issuers experience higher costs.
- Banks would be confident that no bank run would occur. That would encourage risk taking.

## Synthesis

**The events of last week have resulted in quite a bit of instability. We believe inflation is still the most important problem and expect the Fed to continue to fight. We also recognize the potential for a few more banks who were underhedged to struggle with solvency. But most importantly we expect a large shift out of uninsured bank deposits at weaker banks toward stronger banks and money market funds. That shift will result in duration and loans for sale and demand for RRP. We expect bank reserves to fall and RRP to rise. That will tighten credit availability and add to duration supply. Those two factors will impact asset prices of all sorts. Eventually that will require the Fed to take its foot of the brake and ease. However, that time is not now. The financial stability threat is extremely low and can be handled by other policymakers without distracting the Fed. This tempest in a teacup isn't breaking anything. If the Fed reacts and pivots and abandons its inflation mandate, we will react by selling every**

**nominal bond short and buying gold, equites and tips.  But we don't expect that pivot and remain in our no soft-landing positions.**

## Current Portfolio and Performance

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| | Assumed Portfolio size | $ 100,000,000 | | | | | |
| | LTD P/L | $ 49,816,666 | | | | | |
| | Total Return | 49.82% | | YTD Return | | 4.52% | |
| | Today's Date | 3/12/2023 | | Portfolio Created | | 4/15/2019 | |

| Date | Position | Entry Price | Amount | Worst case los | MTM | P/L | Open/Close |
|---|---|---|---|---|---|---|---|
| 10/20/2022 | CLZ23 95/105 Call Spread | 2.1 | 476 | $ 1,000,000 | 1 | $ (523,810) | Open |
| 1/4/2023 | FXI ETF | 30.28 | 115,000 | $ 500,000 | 27.37 | $ (334,650) | Open |
| 2/24/2023 | SPX 3750/3350 April 21 2023 Puts Two's and Spoos | 42.50 | 235 | $ 1,000,000 | 49 | $ 152,941 | Open |
| 2/24/2023 | NDX 11500/10750 4/21/23 Put Spread Recession Isl | 165.00 | 61 | $ 1,000,000 | 165 | $ - | Open |
| 3/1/2023 | SX5e June 4000/3600 Put Spread Dax,Schatz trade | 65.00 | 154 | $ 1,000,000 | 64 | $ (15,385) | Open |
| 3/2/2023 | SPX 3750/3350 April 21 2023 Puts Two's and Spoos | 36.00 | 278 | $ 1,000,000 | 49 | $ 361,111 | Open |
| 3/7/2023 | SPX Iron Condor 3/31 3965/4065/4165 Legged JHEQX | 88.00 | -200 | $ 1,000,000 | 88 | $ - | Open |
| 3/10/2022 | SPX March 17 2023 3850/3800 put spread | 18.00 | -156 | $ 500,000 | 16 | $ 31,250 | Open |
| 2/1/2023 | Short SFRZ4 Twos and Spoos | 97.085 | -1600 | $ 2,000,000 | 96.46 | $ 2,500,000 | Open |
| 3/10/2023 | TLT Jun 16/2023 102/98 Put Spread | 1.25 | 8000 | $ 1,000,000 | 1.15 | $ (80,000) | Open |