ACCESS FINANCIAL SERVICES, INC.

Quarterly Review and Outlook

April 10, 2023
First Quarter, 2023

Index Returns as of March 31, 2023	3 Mo.	6 Mo.	12 Mo.
US STOCKS			
S&P 500 Index TR (large-cap stocks)	7.50	15.63	(7.73)
Dow Jones Select Dividend Index TR	(1.82)	11.69	(4.58)
NASDAQ Composite Index TR	16.77	15.57	(14.05)
Russell 2000 Index TR (small-cap stocks)	2.74	9.14	(11.61)
FOREIGN STOCKS			
MSCI EAFE Net Total Return Index (US$)	8.47	27.27	(1.38)
S&P Europe 350 Index Net TR Index (US$)	10.35	32.33	1.88
MSCI Japan Net Total Return Index (US$)	6.19	20.23	(5.23)
MSCI Emerging Markets Net TR Index (US$)	3.96	14.04	(10.70)
COMMODITIES & CURRENCIES			
US Dollar	(0.98)	(8.57)	4.23
Euro	1.13	10.58	(2.06)
Gold	7.96	18.59	1.64
Oil (West Texas Intermediate)	(6.36)	(2.79)	(17.07)
Bloomberg Galaxy Crypto Index	59.67	28.18	(48.19)
BONDS			
Bloomberg US Aggregate Bond (inv. grade)	2.96	4.89	(4.78)
Bloomberg US Treasury 20+ Year	6.56	5.12	(17.48)
Bloomberg US Treasury Inflation Notes: 1-10 Yr	2.94	4.63	(2.93)
Bloomberg Municipal Bond	2.78	7.00	0.26
Bloomberg US Corporate	3.45	7.01	(5.31)
BBgBarc US Corp. High Yield Bond	3.57	7.89	(3.34)
Bloomberg Global Aggregate Treasuries	3.08	8.05	(9.29)

Source: Bloomberg and Morningstar

On the heels of a recovery during the fourth quarter of last year, the financial markets started 2023 on solid footing even as measures of economic sentiment and business activity had fallen into contractionary territory (Charts 1 - 3), estimates of corporate earnings growth continued to contract and the Federal Reserve Bank (Fed) maintained its emphasis on the need for ongoing hikes in interest rates as the financial markets continued to price the federal funds rate (short term interest rates – the FFR) meaningfully lower than where Federal Open Market Committee (FOMC) members believe it will be during 2023 according to minutes of its December 13 - 14 FOMC interest rate policy setting meeting.

The Fed's December summary of economic projections had the FFR at 5.2% at the end of 2023 whereas the consensus expectation based on FFR futures was 4.5% despite Fed chair Powell's remarks following the meeting that "no FOMC members anticipated that it would be appropriate to begin reducing the federal funds rate target in 2023" even as markets were priced for just such an outcome. The minutes suggested that we would need some significant downside surprises on either inflation or growth to get the Fed to change course. They were pretty forthright in pushing back on the market's obsession with a Fed pivot that we've been writing about over the last few quarters.

Chart 1: Weakening Manager Surveys

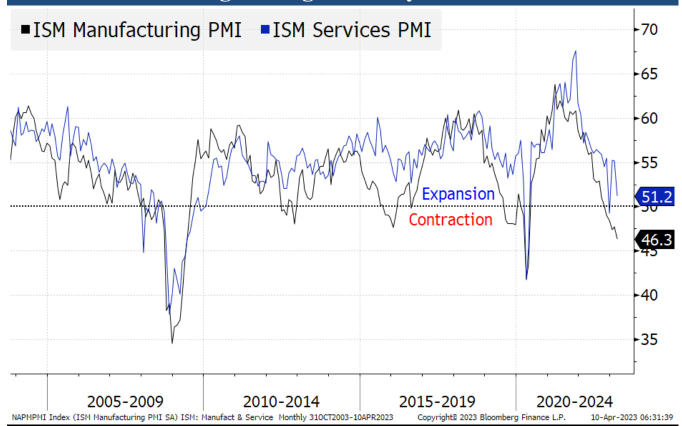

Chart source: Access Financial Services using Bloomberg Software & Data

Chart 2: New Orders Lead Industrial Production

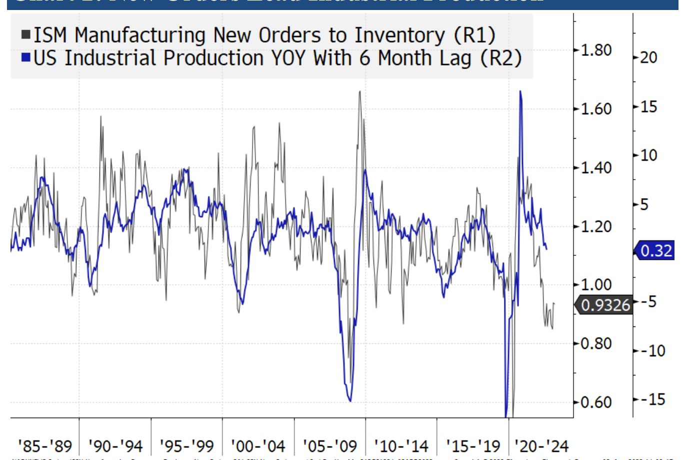

Chart source: Access Financial Services using Bloomberg Software & Data

Chart 3: NFIB Small Business Optimism Index

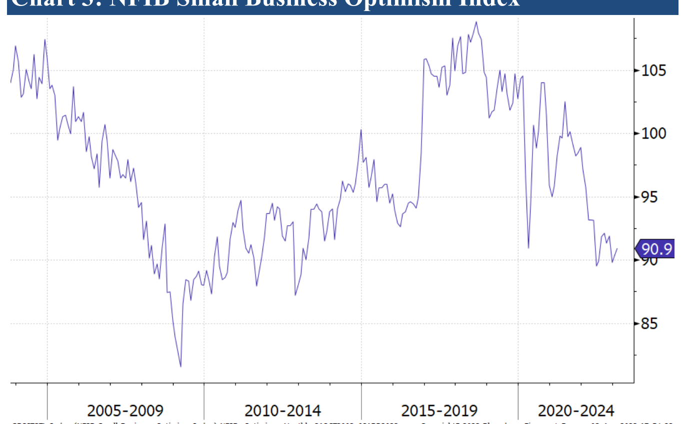

Chart source: Access Financial Services using Bloomberg Software & Data

Inflation and monetary policy have been the main headwinds facing the financial markets since around the third quarter of 2021 and the strength in financial asset prices during January was mostly the result of generally weak economic data and easing inflation pressure that led to a decline in longer term interest rates (Chart 4) as the market's "soft landing" (i.e., no recession) narrative became increasingly consensus. By the end of January, the S&P 500 index (SPX) had advanced almost 8.9% Y-T-D and 16.7% since its October 2022 lows with investors embracing a belief in an "immaculate disinflation" that will return the economy to a low inflation regime with minimal turbulence. January's rally also pushed the SPX above a well watched chart trendline drawn from the index's high point on January 3, 2022 (Chart 5).

Chart 4: Term Structure of Interest Rates (Yield Curve)

Chart source: Access Financial Services using Bloomberg Software & Data

Chart 5: S&P 500 Downtrend Broken

Chart source: Access Financial Services using Bloomberg Software & Data

Market based interest rates (as opposed to the FFR, which is set by the Fed), started rising in late 2021 and became one of the strongest headwinds to risk assets during 2022, stabilized around the time the SPX made its lows in October 2022. Rates then drifted sideways through January 2023 as the financial markets (as observed in the interest rate futures markets) continued to wager that the interest rate hiking cycle was coming to an end and that the FFR would peak in June or July at around 4.9% and end the year at around 4.55% (i.e., a monetary easing cycle – a ‘pivot’ to easier policy would start as early as this summer).

The market’s resolve in frontrunning a pivot to easier monetary policy has complicated the process of tightening for central banks. The Fed has repeatedly emphasized it would hold rates higher for longer, but to no avail as the market has maintained its view of interest rate cuts soon after the FFR’s expected peak this summer with headline consumer price inflation having dropped to 6.5% in December from its peak of 9.1%.

Then, in early February, the January payrolls report was released showing a 517,000 increase in the number of payrolls which was quite literally off the charts (the highest forecast by economists tracked by Bloomberg was 320,000). This, combined with stronger than expected business surveys, housing, retail sales and inflation data stoked concerns of a reacceleration in inflation and led to the market – once again – coming around to the notion that the higher interest rates the Fed has been consistently telling the markets to expect should be respected. Moreover, the Fed's new favored services ex-housing (supercore) inflation measure is over 6% - at least double the Fed's target (Chart 6).

Chart 6: “Supercore” Inflation

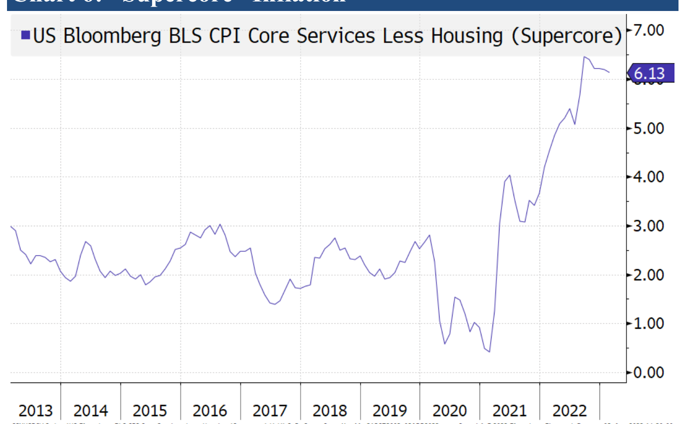

Chart source: Access Financial Services using Bloomberg Software & Data

By mid-month, the expected maximum FFR of 4.9% in June or July had increased to 5.25% in August, and by month's end it had increased to 5.40% in August with a year-end projected value of 5.30%. The two year Treasury interest rate had risen from 4.1% to 4.8% (the highest level since before the global financial crisis started in August 2007) and ten year treasury yields had risen from 3.4% to 3.9%.

What was clear by month end is that the market’s optimistic view of the Fed’s policy trajectory in January had quickly turned into a pessimistic one. Interest rates continued to rise into early March with the two year Treasury yield exceeding 5%. All of this pressured risk assets and translated to a decline of 5% for the SPX and 3.5% for the Bloomberg Aggregate Bond Index (a commonly used benchmark for intermediate term high quality bonds).

"So, of course, monetary policy does, famously, work with long and variable lags…. changes in financial conditions begin to affect economic activity fairly quickly, within a few months. But it's likely to take some time to see the full effects of changing financial conditions on inflation. So we are very much mindful for that."

- Fed Chair Jerome Powell
post-FOMC decision press conference,
September 2022

Long and variable lags – for sure…

On March 8, Silicon Valley Bank (SVB) announced it was taking "strategic actions to strengthen our financial position" by selling its available for sale securities portfolio (consisting of US Treasury and agency bonds valued at $21 billion) at a realized loss of $1.8 billion and had "commenced an underwritten public offering, seeking to raise approximately $2.25 billion" because "we expect continued higher interest rates, pressured public and private markets, and elevated cash burn levels from our clients as they invest in their businesses." Their presentation also stated that: "We are experienced at navigating market cycles and are well positioned to serve our clients through market volatility, with a high-quality, liquid balance sheet and strong capital ratios."[1]

SVB's stock price closed at $267.83 on Wednesday, March 8 (after having declined from $754.65 on November 16, 2022). On Thursday, March 9, the stock's price target was cut at several brokerage firms but wasn't actually downgraded in most cases (Table 1) and closed at $106.04 after which trading was halted. Trading in SVB resumed on March 28 and closed the day at $0.40. Today it is trading around $1.00. The news on SVB sent non "systemically important" bank stocks tumbling (Chart 7).

Table 1: SVB Analyst Price Targets

Broker	Initial Price Target	New Price Target	Initial Rating	Rating Change
Piper Sandler	$250	$195	Buy	None
Wells Fargo	$350	$300	Overweight	None
Wedbush	$250	$200	Neutral	None
JP Morgan	$300	$270	Overweight	None
Truist Securities	$269	$174	Hold	Downgraded

Source: Bloomberg

The Federal Deposit Insurance Corp. (FDIC) shut down Silicon Valley Bank that Friday, March 10 after a run on deposits following a desperate 44 hours in which its long established customer base of tech startups yanked deposits. SVB investors and depositors tried to pull $42 billion from Silicon Valley Bank on Thursday in the run up to the Bank becoming the largest US lender to fail in more than a decade.

Chart 7: Regional Bank Stock Prices

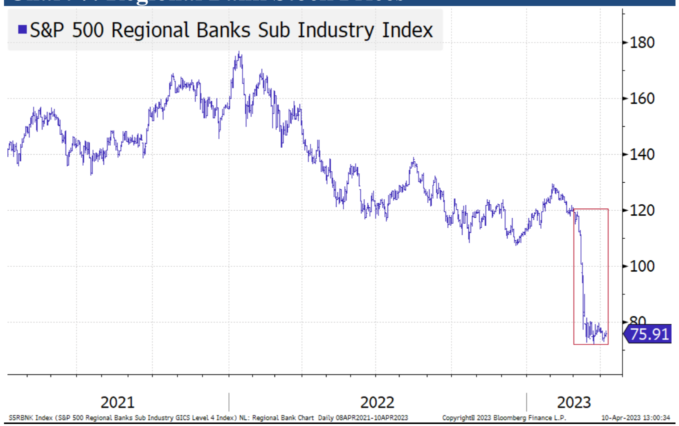

Chart source: Access Financial Services using Bloomberg Software & Data

The FDIC issued a statement saying depositors would have access to their *insured* deposits by Monday, March 13. The problem this created to SVB's depositors is that retail deposit accounts below the FDIC insurance threshold of $250,000 represented only 2.7% of SVB's customer deposit accounts. The rest of its depositors had accounts at the bank that (in many cases, massively) exceeded FDIC coverage levels. This led to large scale transfers out of other regional banks by depositors in a similar situation.

On Sunday, March 12, US authorities took "extraordinary measures" to shore up confidence in the financial system by introducing a new backstop for banks that Federal Reserve officials said was large enough to protect the entire nation's bank deposits. Regulators acted on a number of fronts to contain the potential fallout:

› The FDIC said it will resolve SVB in a way that "fully protects all depositors." Similarly, "all depositors" at Signature Bank (another bank that went down during this time period) will be made whole.
› The Fed also announced a new Bank Term Funding Program that offers one year loans to banks under easier terms than it typically provides.
› The central bank relaxed terms for lending through its discount window, its main direct lending facility that loans money to banks against a wide set of collateral for a maximum of 90 days.

On Monday and in the weeks that followed, we were subjected to all the media hype and political finger pointing, grandstanding and rhetoric we have come to expect from our outstanding political leadership.
In last quarter's letter, I wrote the following:

[1] Let us know if you would like a copy of the Bank's March 8 pitchbook.

As they say, stability breeds complacency. And as Artemis Capital Management has said, volatility is an instrument of the truth, the more you deny the truth, the more the truth will find you through volatility. Volatility is often the mechanism for closing the gap between the world as we imagine it and the world that actually exists.

This is a fitting description of what happened at SVB.

Stepping back a bit, many banks - to one degree or another - find themselves in a similar situation.

As we have spelled out in the past, under normal circumstances the term structure of interest rates - better known as the yield curve - is such that interest rates are lower for shorter maturity debt obligations and higher for longer maturity obligations.

In very simplistic terms, banks borrow at the short end of the yield curve and lend at the long end of the curve thereby making money on the spread between the interest they pay depositors (short term interest rates) and interest they receive from the longer term loans they make. This spread is the net interest margin (NIM).

Using three month Treasury yields as a proxy for banks short term borrowing costs (banks generally pay depositors less than three month Treasury rates) and ten year Treasury yields as a proxy for bank lending rates (banks almost always make longer term loans at rates that exceed the yield of similar maturity Treasury rates), we can see that NIMs are almost always positive (Chart 8).

Chart 8: Short and Long Term Yields

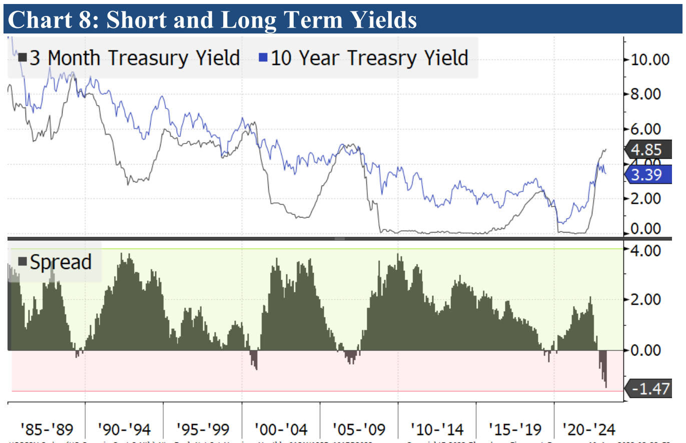

Chart source: Access Financial Services using Bloomberg Software & Data

One of the (many) risks of the borrow short/lend long model is that interest rates change over time. Banks that pay depositors based on short term interest rates have unknown future funding costs (the interest rate paid to depositors) while the rates they make longer term loans at are normally fixed for the duration of the loan. This all works well as long as the rate they pay depositors is less than the overall interest rate on their loan book. However, if short term rates rise above their loan portfolio's average interest rate, their NIM goes negative.

Banks also have investment portfolios invested mostly in bonds. After the Great Recession of 2008 - 2009, regulators forced large banks (known as systemically important financial institutions – SIFIs – banks with assets greater than $50 billion at that time) to own an amount of high quality liquid assets (HQLA) that is at least large enough to meet a stressed outflow of deposits for 30 days (a liquidity coverage ratio – LCR – greater 100%; see formula below). Investments that qualify as HQLAs are shown in Table 2 below. As a result of LCR regulation, banks all over the world have accumulated trillions of dollars of bonds.

$$\text{Liquidity Coverage Ratio} = \frac{\text{Stock of High Quality Liquid Assets}}{\text{Net Cash Outflow Over 30 Days}} > 100\%$$

Table 2: High Quality Liquid Assets

A. Level 1 assets:
- > Coins and bank notes
- > Qualifying marketable securities from soveriegns, central banks, PSEs, and multilateral development banks
- > Qualifying central bank reserves
- > Domestic sovereign or central bank debt for non-0% risk-weighted sovereigns

B. Level 2 assets (maximum of 40% of HQLA):

Level 2A assets (15% discount applied)
- > Sovereign, central bank, multilateral development banks, and PSE assets qualifying for 20% risk-weighting
- > Qualifying corporate debt securities rated AA- or higher
- > Qualifying covered bonds rated AA- or higher

Level 2B assets (maximum of 15% of HQLA - 25% to 50% discount applied)
- > Qualifying residential mortgage backed securities (RMBS)
- > Qualifying corporate debt securities rated between AA- and BBB-
- > Qualifying common equity shares

Source: The Macro Compass and Bank for International Settlements

Further, these HQLAs can be booked as either available for sale (AFS) or held to maturity (HTM) assets on bank balance sheets. The current market value AFS investments do not impact a bank's profit/loss position, but they do show up in its capital position and banks with prudent risk management policies hedge the interest rate risk (the risk of the value of their bonds declining when interest rates rise) of their AFS book. (SVB's AFS book was unhedged.)

Booking securities as HTM prevents changes in the portfolio's market value from showing up at all. Regardless of their market value, securities held in a bank's HTM book are basically reported at their amortized cost until they mature – their value is never marked-to-market on the bank's balance sheet (other than being buried in the footnotes of its financial statements). SVB's February 24 10-K filing showed the Bank had losses in excess of $15 billion on its HTM book if they were marked-to-market.

These losses were crystalized as depositors fled and the bank needed to sell its HTM assets to meet withdrawals. Chart 9 shows that the unrealized losses of US commercial banks' AFS portfolios alone is over $88 billion.

Chart 9: Unrealized Losses on Available for Sale Securities

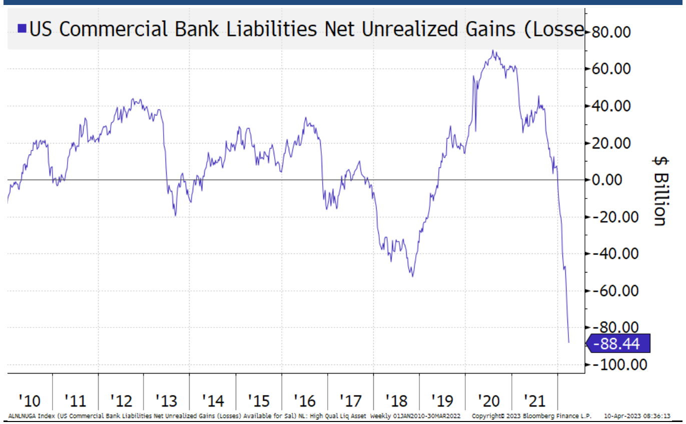

Chart source: Access Financial Services using Bloomberg Software & Data

In 2018, following a wave of complaints from smaller banks struggling with the costs of complying with enhanced regulation, Donald Trump signed into law a partial rollback of the SIFI requirements. The bill increased the SIFI threshold to $100 billion and then to $250 billion 18 months later.[2] This is important because banks with assets below the $250 billion threshold are not subject to the tighter regulatory scrutiny of SIFIs: no LCRs, no net stable funding requirements that force SIFI banks to diversify their funding base, and lighter stress tests.[3]

Further complicating matters for banks is that as short term interest rates have risen sharply as the Fed has raised interest rates, banks have not passed these increases along to depositors in any meaningful way. Depositors have responded by migrating their balances to money market funds that pay interest at much higher rates than bank deposit accounts (Chart 10). And when banks must sell assets in their investment portfolio at a loss to meet withdrawals, these realized losses *do* flow to the banks' profit/loss statement.

The failure of SVB has highlighted these issues for investors and depositors with account values that exceed FDIC coverage and uninsured deposits continue flowing to money market funds and SIFI banks that are 'too big to fail' which is stressing the solvency of non SIFI banks.

To insulate the banking system from having to realize losses in order to meet withdrawal requests (which many could not do), the Fed announced a new Bank Term Funding Program (BTFP) that offers loans to banks under easier terms than are typically provided by the central bank and would be large enough to protect uninsured deposits in the wider US banking system. It was invoked under the Fed's emergency authority allowing for the establishment of a broad based program under "unusual and exigent circumstances," which requires Treasury approval.

Chart 10: Money Market Fund Assets

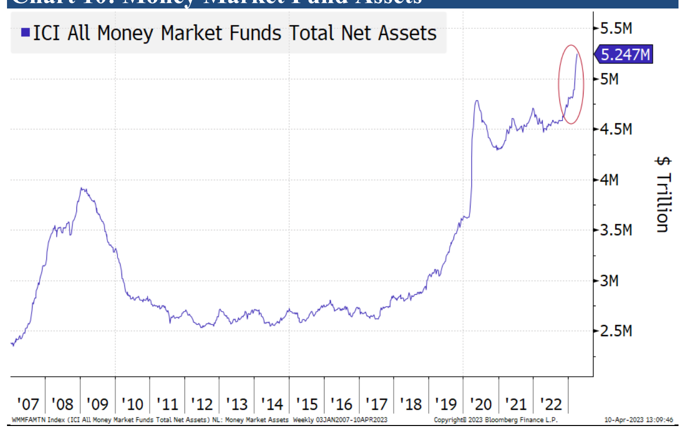

Chart source: Access Financial Services using Bloomberg Software & Data

More specifically, the BTFP allows banks to pledge qualifying assets – assets that they are carrying at cost on their balance sheets, but have declined in value on a marked-to-market basis – as collateral for loans at favorable interest rates. These underwater securities will be valued at par (full maturity value) from a loan collateral perspective. So, SVB is gone, but the *next* bank with bonds purchased at $100 and are now worth $80 can go to the Fed and borrow $100 against them. All this is possible because the Fed *can* hold assets to maturity and it *can't* lose its funding and be forced to sell everything in a panic, a fact that is easy enough to observe by looking at the Fed's own balance sheet. It, too, bought TONS of bonds via quantitative easing between March 2020 and March 2023 during the pandemic (Chart 11) which are now worth significantly less than what it paid.[4]

For the week ending March 15, banks borrowed a combined $164.8 billion from two Federal Reserve backstop facilities - $152.9 from the Fed's discount window (the traditional liquidity backstop for banks, up from $4.6 billion the previous week) and $11.9 billion from the BTFP.

Actions by the authorities were enough to calm financial markets (mostly). The SPX only declined -3.41% after March 8 and had recovered its post SVB failure losses by March 21 (nine trading days). Fortunately for the SPX, 1)

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[2] For reference, the third largest bank in Germany has a balance sheet of *less* than $200 billion.

[3] SVB managed to stay just below the $250 billion limit while repeatedly lobbying to increase the threshold above $250 billion.

[4] According to the Fed's Quarterly Financial Report, the US central bank had an unrealized loss of $1,125,302,000,000 on its $8,632,599,000,000 (amortized cost) portfolio as of 09/30/22. Source: https://www.federalreserve.gov/publications/files/quarterly-report-20221129.pdf

there are only nine regional bank stocks in the index (the group was down -28.67% between March 8 and March 21) and 2) Technology related sectors – information technology, consumer discretionary and communication services – which make up a combined 43.8% of the index posted gains ranging from 2% to 6% during the period. The SPX ended the month of March up 3.5% even as the S&P Regional Bank index posted a decline of -35.6%.

Chart 11: Fed Securities Portfolio

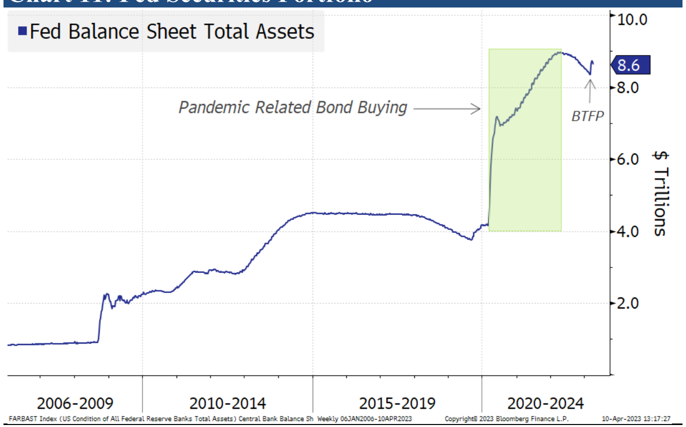


Chart source: Access Financial Services using Bloomberg Software & Data

SVB wasn't alone in planning to keep its Treasury and agency debt on the books and accounting for them as HTM from the outset. In fact, other individual financial institutions have balance sheets with greater mark-to-market losses than SVB had when it went to the wall. A recent paper by four economists[5] outlines the magnitude of the problem, saying "the US banking system's market value of assets is $2 trillion lower than suggested by their book value of assets accounting for loan portfolios held to maturity." This suggests there may be a systemic problem, not an idiosyncratic one that can be chalked up to poor risk management alone. As long as interest rates remain at current levels, holding lower yielding long term assets until maturity is likely to be a consistent drag because it bleeds away banks' NIM.

Weak or negative NIMs, erosion in deposits, a drop in the value of their equity and increased regulatory scrutiny will most likely result in banks being forced to restrict credit availability which ends up pressuring households, property prices and midsize companies that make up the backbone of the economy as banks try to rebuild capital buffers. This in turn, could feed a vicious cycle as deposits bleed away from banks to higher interest paying money market funds and/or SIFI banks (of which there are eight in the US[6]) (Chart 12).

The seeds of the deposit account exodus out of bank deposit accounts were planted during the pandemic, when banks were flooded with deposits after the massive liquidity injections from the Federal Reserve and fiscal stimulus measures of the federal government. On the eve of the national lockdowns in 2020, there were $13.5 trillion of deposits in all commercial banks. By June, after the initial burst of economic support, that number grew to $15.5 trillion. Deposits peaked at over $18 trillion in early 2022 ahead of the Fed's first rate hike.

Chart 12: Deposit and Money Market Fund Flows

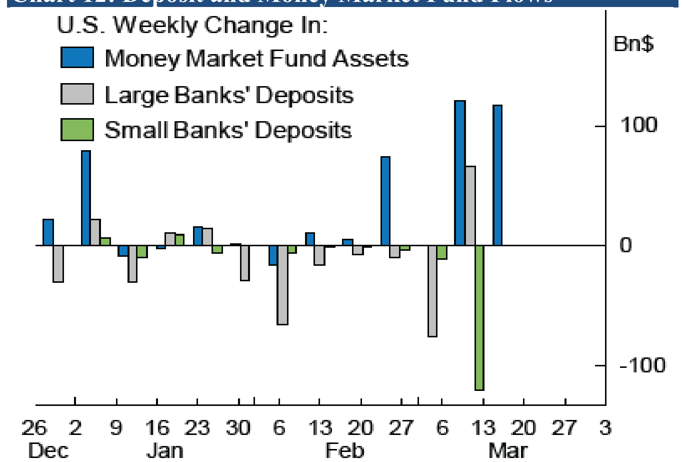


Chart source: Alpine Macro

As it stands today, financial markets seem to have put the fear of systemic risks in the banking system behind them as a result of swift government intervention to backstop depositors and the government's role as 'lender of last resort' has prevented a rapid tightening of financial conditions. The number of stories hitting the wires related to the banking 'crises' has evolved from a tsunami to a trickle in just a few weeks.

However, alternative metrics like bank lending surveys point to a more challenging credit and bank lending outlook. In the first quarter, 2023 Federal Reserve Board Senior Loan Officer Survey, for example, banks reported tighter credit standards, weaker demand for loans, and deteriorating credit quality, especially for corporate and commercial real estate loans (Chart 13). Tighter standards like greater collateral requirements or higher premiums on riskier loans stall credit growth, in turn denting the spending outlook. Besides an uncertain economic backdrop, banks cited a reduced risk tolerance and a deteriorated liquidity position as key reasons for their reduced willingness to lend.

For the US to undergo a 2008 type crisis, banks would have to experience a sharp deterioration in collateral values. Unlike the early 2000s, US banks have limited exposure to subprime mortgages, household debt remains low (although revolving debt is growing – Chart 14), and

[5] *Monetary Tightening and U.S. Bank Fragility in 2023: Mark-to-Market Losses and Uninsured Depositor Runs?* Available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4387676

[6] JP Morgan Chase, Citigroup, Bank of Amer., Goldman Sachs, Morgan Stanley, Wells Fargo, Bank of NY Mellon & State Street

capital ratios for SIFI banks are well above regulatory minimums. Thus, even if residential housing prices fell sharply, a lengthy debt deleveraging episode remains much less likely than in 2008.

Chart 13: Senior Loan Officer Survey Results

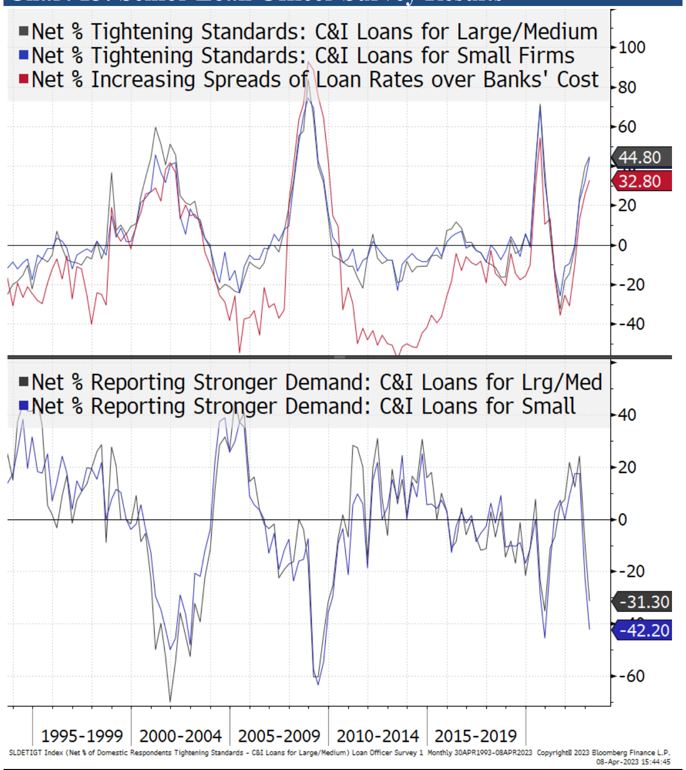


Chart source: Access Financial Services using Bloomberg Software & Data

Chart 14: Revolving Debt and Personal Savings

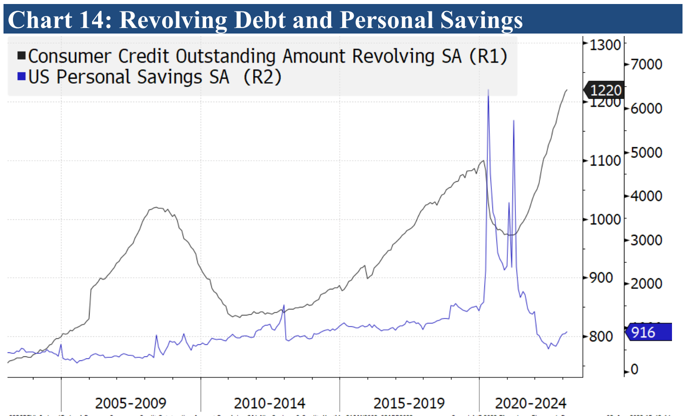


Chart source: Access Financial Services using Bloomberg Software & Data

Even so, smaller regional banks face other risks. Arguably, the key source of vulnerability is not their investment decisions (the trigger behind the SVB and Signature bank collapses), but their lending portfolios. In particular, regional banks account for 67% of all commercial real estate (CRE) loans, a sector which is facing real headwinds amid low office occupancy rates and a high interest rate environment.

US office properties are up against something of a perfect storm of falling cash flow and asset values, higher interest rates, and a lack of liquidity in lending and transaction markets. Office owners facing debt maturities may find it increasingly difficult to refinance or sell, triggering default risk.

Loans on office properties make up about 25% of the $728 billion of 2023 commercial mortgage debt maturities, according to Mortgage Bankers Association data. Banks are the largest lenders for commercial property loans, and therefore face the most refinancing risk. There have already been several high profile office loan defaults including entities controlled by Brookfield Asset Management, Blackstone and PIMCO, and large real estate investment funds managed by Blackstone, Starwood and KKR (among others) have put limits on investor redemptions to slow the bleeding – if investors cannot get their money out, the funds will not be forced to raise money by selling properties.

Small banks have increasingly taken over the share of total bank lending as tighter regulation of large banks forced them to strengthen their liability and capital positions. These smaller banks became more competitive in the lending arena and particularly so in the CRE space (Chart 15).

Chart 15: Growth in Loans Made by Small Banks

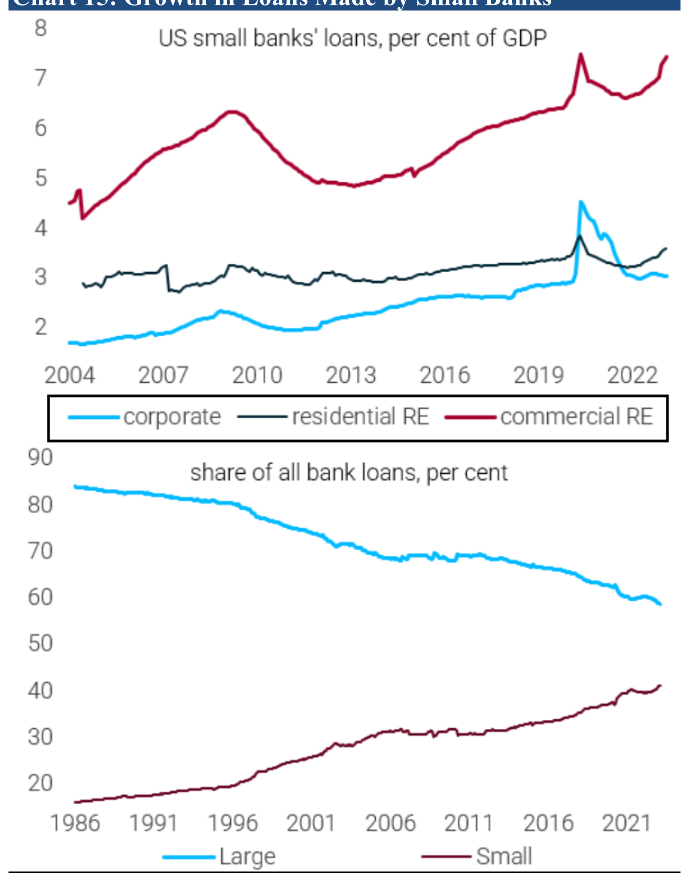


Chart source: Dario Perkins

Table 3 shows the loans held on the balance sheets of domestically chartered commercial banks, with the amounts denominated in billions (yes, add nine zeros to the numbers). Real estate loans (combined residential and commercial) make up the largest cohort, followed by commercial and industrial loans, and then other various components, including credit card/revolving debt.

Table 3: Commercial Bank Loans

25.4%	Commercial Real Estate	$2,820
22.7%	Residential Mortgages	$2,519
20.8%	Commercial & Industrial Loans	$2,312
8.7%	Credit Card	$968
4.7%	Auto	$519
3.4%	Other Consumer Loans	$379
14.4%	Other Loans	$1,604
		$11,121

Source: Bloomberg

While it is not clear that the recent banking mess can do much more damage to residential mortgage lending than we have already seen – the surge in mortgage rates last year took care of that. In any event, most of the largest originators of residential mortgages these days are not even banks, and the stocks of many of these lenders make even the regional bank index look pretty good by way of comparison (Chart 16).

Chart 16: Loan Originator & Regional Bank Stock Prices

Chart source: Access Financial Services using Bloomberg Software & Data

CRE loans are mostly structured using amortization schedules that exceed the term of the loan. A lender, for example, might make a CRE loan for a term of five years with an amortization period of 30 years. In this situation, the borrower would make payments for five years of an amount based on the loan being paid off over 30 years, followed by one final "balloon" payment of the remaining balance on the loan. In most cases, the balloon payment is then refinanced with a new loan.

Refinancing debt presents the next in a seemingly endless wave of challenges for US office properties. Debt maturing this year and next (Chart 17) is a particular source of potential stress. The approximately $20 trillion CRE market is financed with $5.5 trillion of debt, roughly half of which comes from commercial banks according to a recent Real Estate Roundtable letter to regulators. Excluding multifamily CRE, over $900 billion of that is maturing in 2023 and 2024 and was mostly originated during an era of extremely low interest rates according to the group.

Chart 17: CRE Debt Maturities

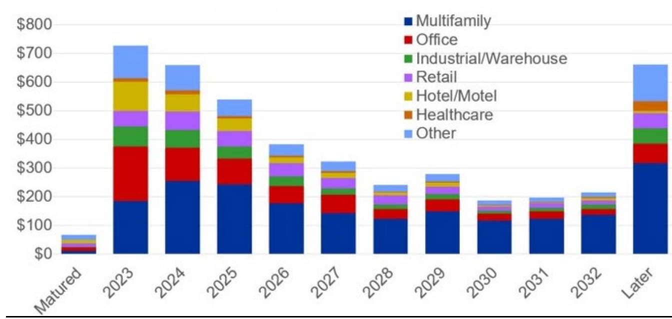


Chart source: Mortgage Bankers Association

While loans held in commercial mortgage-backed securities (CMBS) – as opposed to CRE loans made by banks – make up a small part of overall commercial property debt, we can get a sense of the interest rate environment CRE borrowers with loans coming due are facing today versus those five to ten years ago from a refinancing perspective (Chart 18).

Chart 18: CMBS Bond Yields

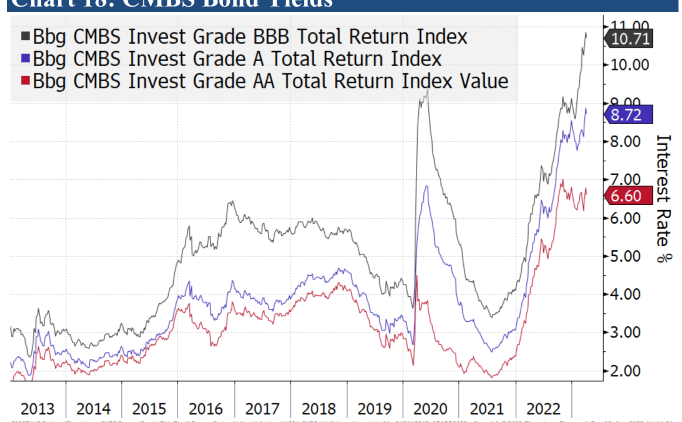


Chart source: Access Financial Services using Bloomberg Software & Data

Borrowers will need to negotiate new terms or find new lenders in an environment of emptier office buildings and weaker cash flows. Cracks in commercial property markets had been widening for months and efforts along those lines had already begun, with office building defaults on the rise well before the recent series of bank failures. Bank balance sheet weakness, along with impending tighter rules, likely means lenders may be even less willing to extend credit and will likely seek more onerous terms when making new loans. The situation is not unique to the US, with properties and lenders in Europe facing similar circumstances.

While office building values have begun to decline, a lack of transactions (total office transaction volume is down

76% YOY) make it difficult to ascertain a true market clearing price for CRE (Chart 19).

Banks and thrifts hold 39% of outstanding commercial real estate debt, or 45% if multifamily is excluded, making it the largest category and therefore most exposed to refinancing risk. Mortgage Bankers Association data show banks and thrifts hold $1.1 trillion of commercial-property debt, excluding multifamily-backed loans. This may amount to a small portion of most banks' loan books, with exposure to office-backed mortgages even less, and reserves might be sufficient. But if distress mounts, banks stand to face pressure of potential foreclosures.

Chart 19: CRE Office Fundamentals

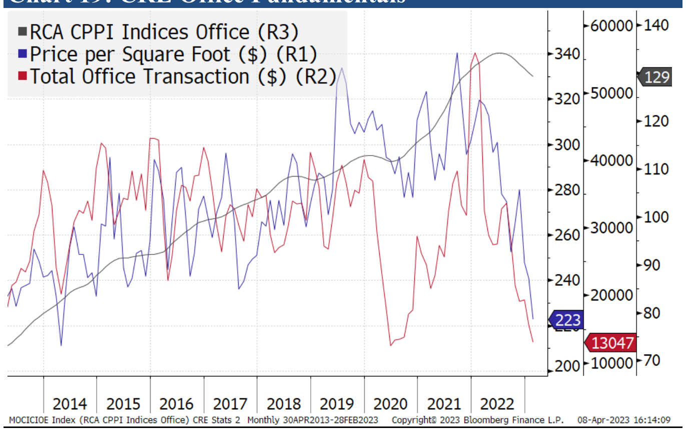


Chart source: Access Financial Services using Bloomberg Software & Data

Most banks' business model cannot compete in an environment where money market funds are offering yields in the 4% - 5% range, so deposit flight is set to continue. More importantly, though, is that their loan books are less profitable with the front end of the yield curve this steeply inverted. Neither of these two issues will be resolved until the Fed reduces the FFR and the yield curve normalizes. The contraction in lending is set to accelerate until then.

As it stands, US bank lending contracted by the most on record in the last two weeks of March. Commercial bank lending dropped nearly $105 billion in the two weeks ended March 29, the most in Federal Reserve data back to 1973. The more than $45 billion decrease in the latest week was primarily due to a drop in loans by small banks. The pullback in total lending in the second half of March was broad and included fewer real estate loans, as well as commercial and industrial loans.

The report released on Friday, April 7 also showed commercial bank deposits dropped $64.7 billion in the latest week, marking the tenth straight decrease.

On April 6, the American Bankers Association index of credit conditions[7] fell to the lowest level since the onset of the pandemic, indicating bank economists see credit conditions weakening over the next six months. As a result, banks are likely to become more cautious about extending credit.

The Fed began its tightening campaign on March 15, 2022, and has lifted short term interest rates by between 0.25% and 0.75% at each of its policy setting meetings (eight per year) since then. Over this time period, the effective FFR climbed from 0.07% to 4.33%. Longer term interest rates have also risen, but not to the same extent (Chart 20).

Chart 20: The Impact of Fed Rate Hikes on Interest Rates

Chart source: Access Financial Services using Bloomberg Software & Data

On a quarterly basis, the FOMC publishes its Summary of Economic Projections which includes its outlook for real gross domestic product (GDP), the unemployment rate, inflation and what is sees as the likely future path for the FFR. This gives the public some insight into the projections members of the Federal Reserve Bank are basing their interest rate policy on.[8]

There are a number of methods we can use to get a sense of what market participants believe the Fed will actually end up doing with monetary policy in the future which, in turn, impacts asset flows into various asset classes. For example, when market participants believe the Fed will ease monetary policy relative to its projections, riskier assets have a tenancy to outperform safer assets and vice versa. Liquidity – which is a function of monetary policy – is an important driver of risk assets because the fundamental value of assets become moot as in extremis – with no liquidity, there can be no transactions. So, identifying turns in liquidity is important for investment strategy.

As we have discussed in the past, market participants in aggregate have consistently underestimated the extent to

[7] Available at: www.ABA.com

[8] The most recent report is available at: https://www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20230322.pdf

which the Fed will lift interest rates during this cycle and have positioned their investments accordingly. Chart 21 illustrates the history of the of the FFR (white line) along with the market's expectation of the path of the FFR in the future (orange lines) and Chart 22 shows the market implied level of the FFR set by the Fed at their Federal Open Market Committee meetings in the future.

Chart 21: Market Implied Fed Rate Path vs. Actual

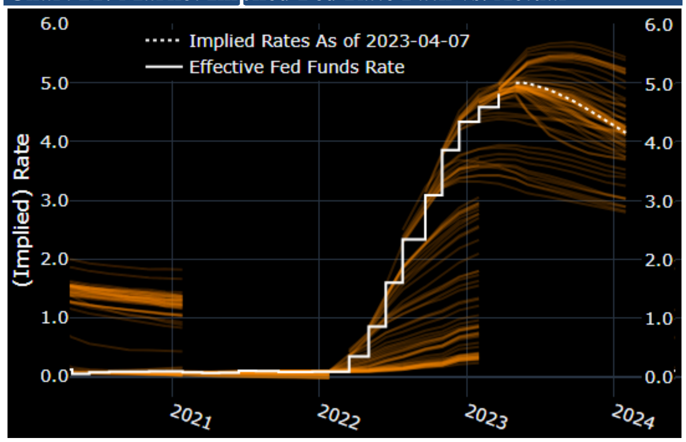
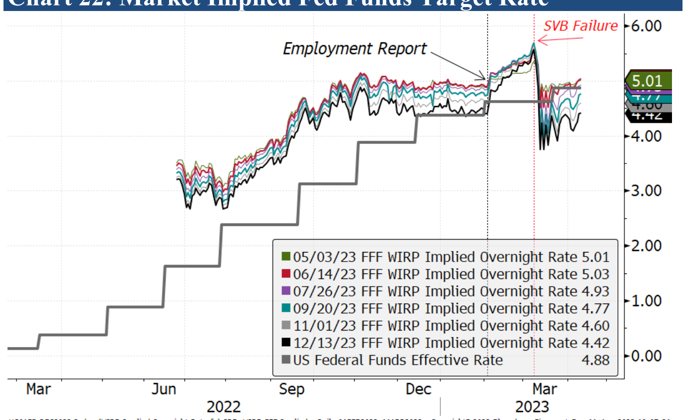


Chart source: Access Financial Services using Bloomberg Software & Data

Chart 22: Market Implied Fed Funds Target Rate



Note: WIRP is Bloomberg's world interest rate probability function
Chart source: Access Financial Services using Bloomberg Software & Data

As you can see, prior to the blowout employment report in February (dotted vertical black line) mentioned earlier, the max FFR implied by market pricing was 4.90% in June (red line) with the rate dropping to 4.40% at the December meeting (black line). After the stronger than expected employment report was released, the market repriced the max FFR at 5.70% at the September meeting and 5.56% at the December meeting (dotted vertical red line) – a pretty significant move that pressured stock and bond prices lower – until the banking issues surfaced. Initially, this pushed the December meeting projection all the way down to 3.75%. The year end level now sits at 4.25% which implies two 0.25% rate cuts between now and year end.

Chart 23 illustrates the evolution of Fed policy expectations a bit differently. Each line represents the market's view of where the FFR is expected to be at various points in the future as of February 2, March 8 and today (April 6). Today's rate expectations are almost identical to where they were on February 2 with the expected maximum FFR being hit at the May 3 FOMC meeting and declining steadily through early 2025.

Chart 23: Market Implied Federal Funds Rate

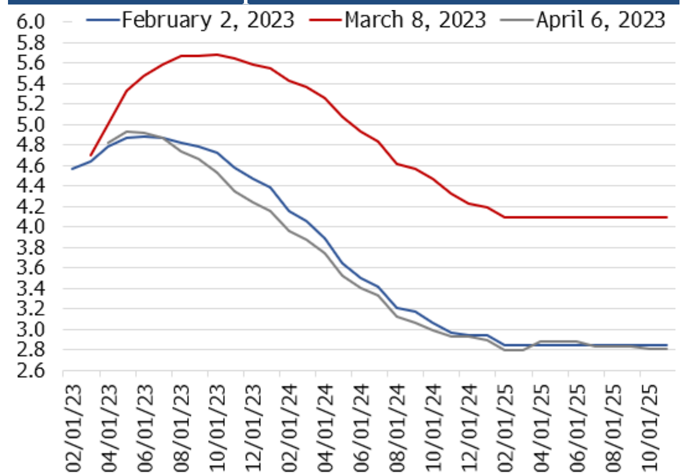


Chart source: Access Financial Services using data from Bloomberg

Pulling it all together, if the 10 year Treasury bond yield stays at its current level of 3.4% and the FFF market is correct in its projections, the yield curve will only be approaching normal (short term interest rates lower than long term interest rates) around June 2024. However, if short term interest rates are moving lower, it is likely that longer term rates will be doing the same implying that a normalization is even further out. This, too, can be observed in the futures markets by looking at the pricing of interest rates today (spot), in six months, one year and two years as shown in Chart 24.

Chart 24: Treasury Overnight Index Swap Curves

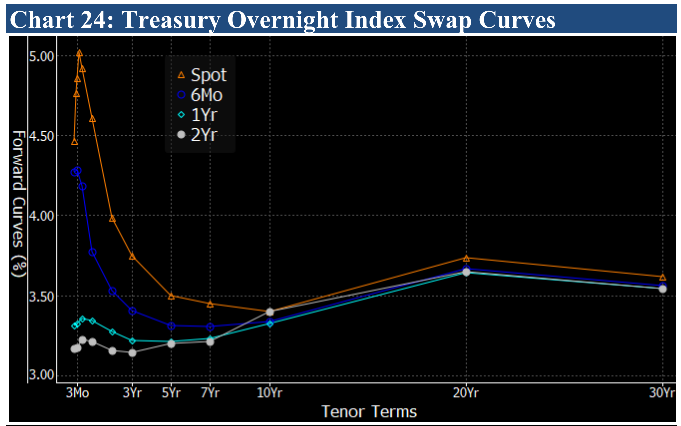


Chart source: Access Financial Services using Bloomberg Software & Data

Unfortunately, there is nothing about this outlook that spells fast relief for the non SIFI banking sector or the CRE debt space.

The financial markets have been fixated on inflation and interest rates since the SPX reached its all-time high on January 2, 2022. This is understandable given that most of the gains up to that point were the result of the cheap (low interest rates) and easy (low lending standards) money regime of the last 13 years combined with low inflation (green box in Chart 25), plenty of fiscal stimulus and rising government social benefits (Chart 26). The liquidity environment could hardly have been more supportive of risk assets.

Chart 25: Inflation and Interest Rates

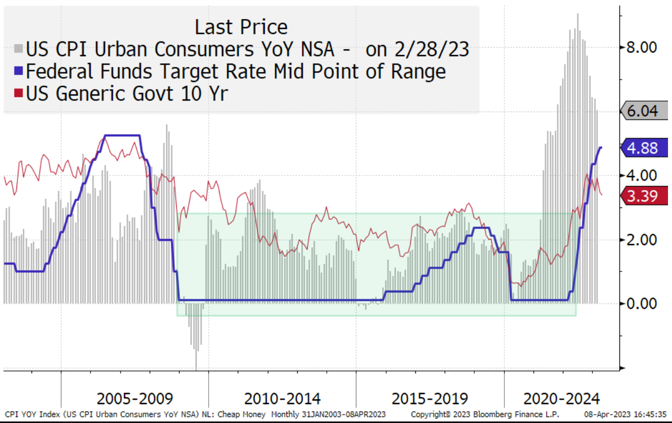


Chart source: Access Financial Services using Bloomberg Software & Data

Chart 26: Growth of Fed's Balance and Social Benefits

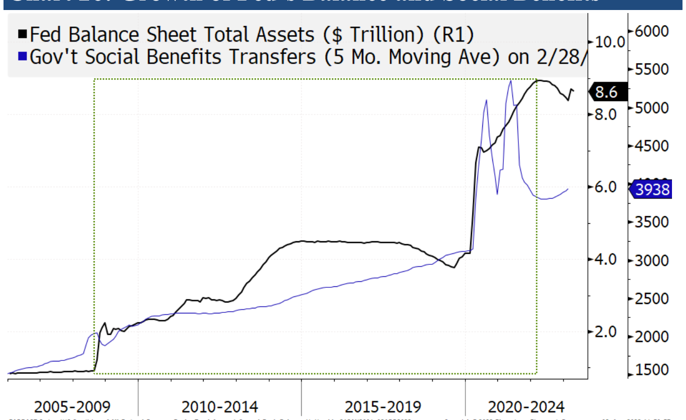


Chart source: Access Financial Services using Bloomberg Software & Data

When interest rates are low and things are going well, the natural response is for investors to invest more of their own liquidity in increasingly riskier assets. As more and more liquidity flows into riskier assets, asset price appreciation takes on a life of its own, ultimately resulting in high valuations and speculative excess. Maintaining price levels becomes dependent on at least maintaining the status quo from a liquidity perspective. This has been further underwritten by regulators, central banks and politicians that have proven to be reliable backstops when 'accidents' happen. Talk about moral hazard.

I am still of the view that inflation is coming down for many of the reasons outlined in last quarter's *Review and Outlook*[9], but that it will be a gradual process. The ongoing tightening of lending standards in the banking system should further constrain liquidity and serve to accelerate the process, all else being equal.

I also maintain that it is unlikely that the Fed will begin reducing the FFR as quickly as the market is pricing unless the banking system becomes much more stressed or we experience some other 'accident' or 'extraordinary event' where the Fed, regulators and/or politicians are compelled to implement yet another rescue package.

In addition to the tightening liquidity environment, the trend in forecasted corporate earnings growth has continued moving lower as shown in Chart 27 and models that rely on macro factors such as money supply, the US Treasury yields, the US dollar, corporate bond spreads and data from purchasing managers continue to imply that a year over year change in earnings will reach -10% to -20% (Charts 28 and 29).

Chart 27: S&P 500 YoY% Earnings Growth Estimates

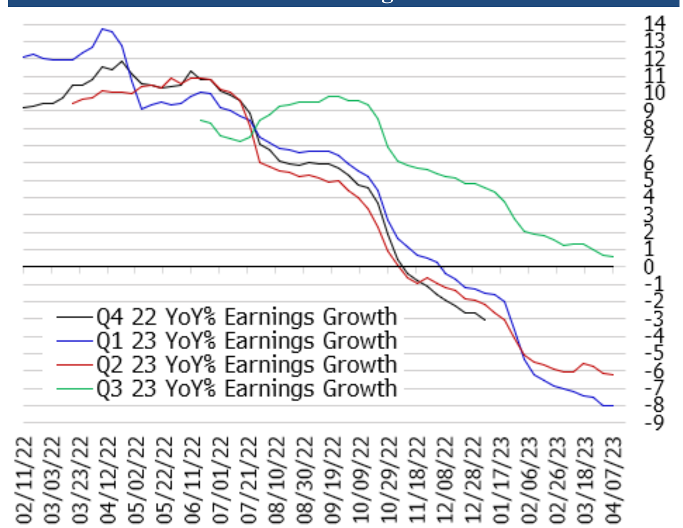


Chart source: Access Financial Services using data from Bloomberg

Chart 28: Alpine Macro EPS Growth Model (YoY%)

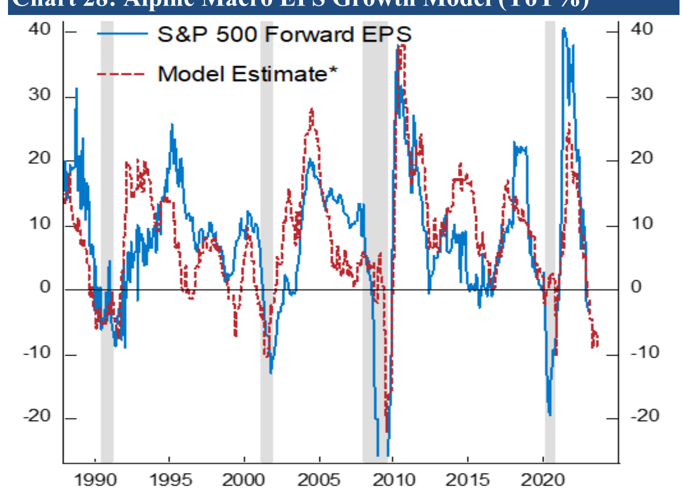


Chart source: Alpine Macro (shaded areas are recessions)

[9] Prior commentary is available at: http://accessafs.com/useful-info/newsletter/

Chart 29: BCA Research EPS Growth Model (YoY%)

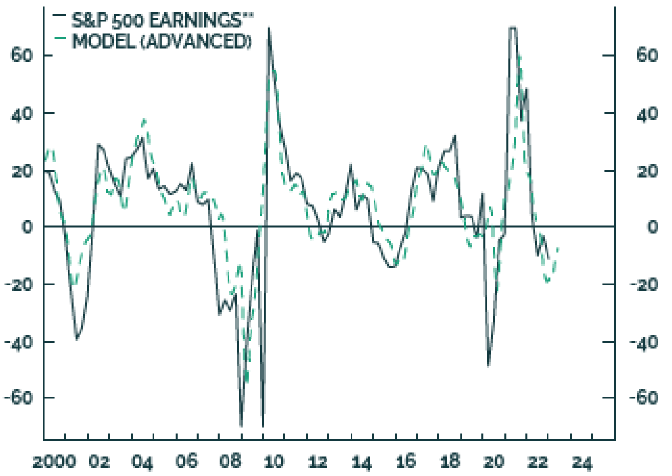


Chart source: BCA Research

The deteriorating earnings outlook continues to be supported by Citigroup's Earnings Revisions Index, which tracks the relative number of corporate earnings upgrades versus downgrades. It has been in negative territory for over a year now. The index has a history of leading actual earnings per share (EPS) growth by about one year (Chart 30).

Chart 30: Citigroup Earnings Revisions Index

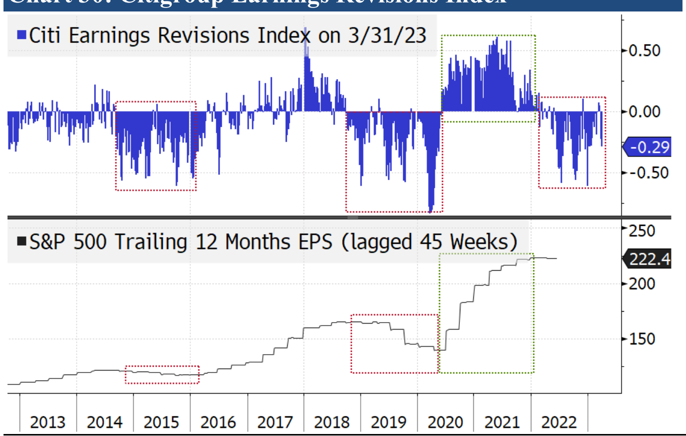


Chart source: Access Financial Services using Bloomberg Software & Data

Stock valuations are often measured as the ratio of a company's stock price relative to something else (i.e., price/earnings, price/sales, price/book value, price/cash flow, etc.) with the price/earnings (P/E) ratio being the most common. As valuations increase, the attractiveness of an asset from an investment perspective declines. And when corporate earnings decline, valuations increase even if stock prices do not.

Valuations surged on the back of massive fiscal and monetary stimulus in response to the Covid pandemic and have since receded as stocks declined during 2022 (Chart 31). The SPX's P/E ratio – based on earnings that have already been reported (the trailing P/E ratio) has now returned to its average going back to the mid-1990s after reaching levels that exceeded even those achieved prior to the late-1990s dot-com mania.

Chart 31: US Stock Market Measures of Valuation

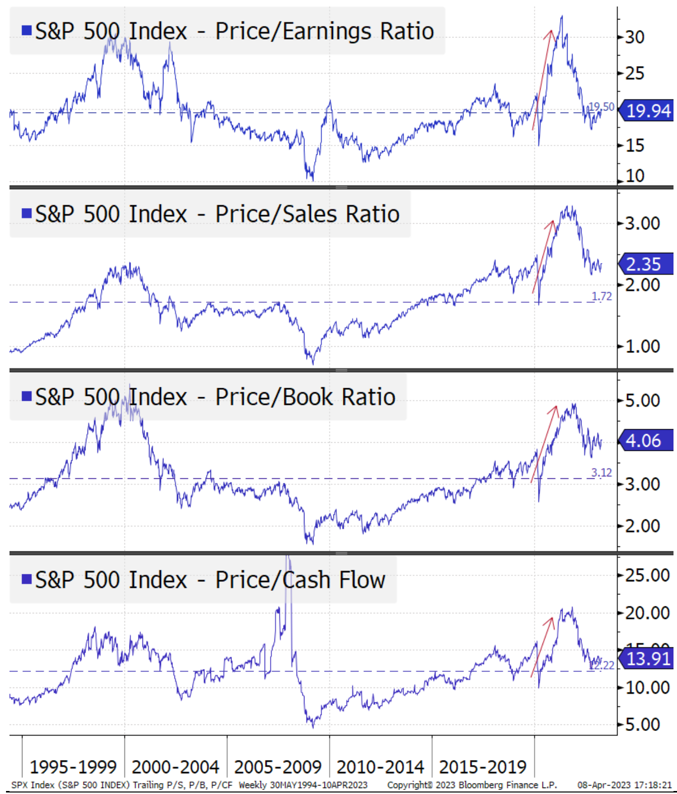


Chart source: Access Financial Services using Bloomberg Software & Data

Chart source: Access Financial Services using Bloomberg Software & Data

One lens that takes account of the increasingly anemic growth expected in corporate earnings illustrated in Chart 27 shows stocks as richly valued as they have been in almost three decades of data. The model, a tool of Fidelity Investments legend Peter Lynch a generation ago, is the price/earnings growth (PEG) ratio, the market's P/E multiple divided by its forecast earnings growth rate. The higher it is, the more expensive shares are – and right now, at about 1.8 based on longer-term estimates, the indicator's message looks a bit ominous. As it stands now, based on long-term profit forecasts, the SPX is roughly 20% more expensive than it ever was during the internet bubble (Chart 32).

Early recession indicators that have a solid track record such as the yield curve (Chart 33), the Conference Board's Leading Economic Indicator and bank lending standards (Chart 34) continue to warn that a recession is to be expected while investors continue to cling to a soft landing (no recession) scenario. This is not the most likely scenario in my opinion.

Chart 32: S&P 500 Price Earnings Growth Ratio

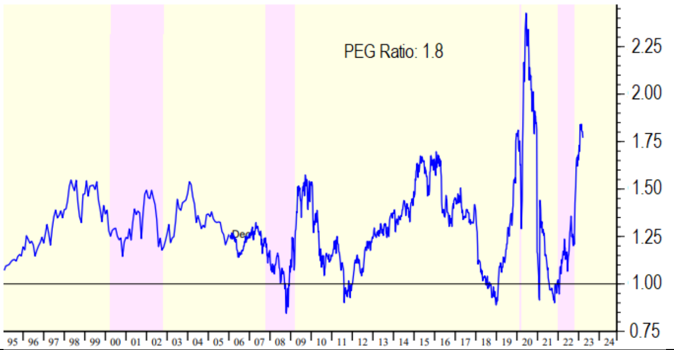


Chart source: Access Financial Services using Bloomberg Software & Data

Chart 33: Yield Curve Inversions Have Signaled Recessions

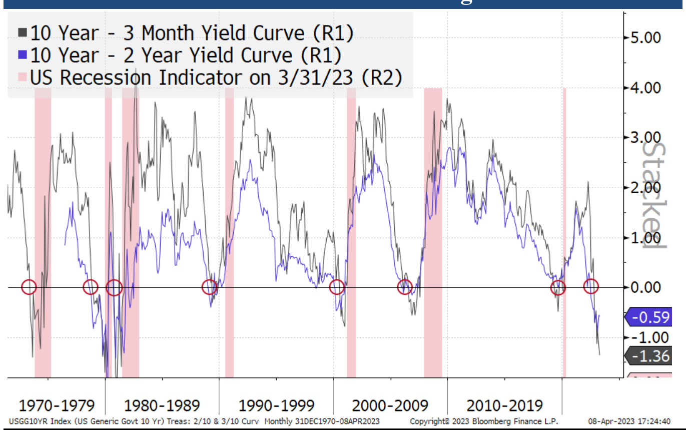
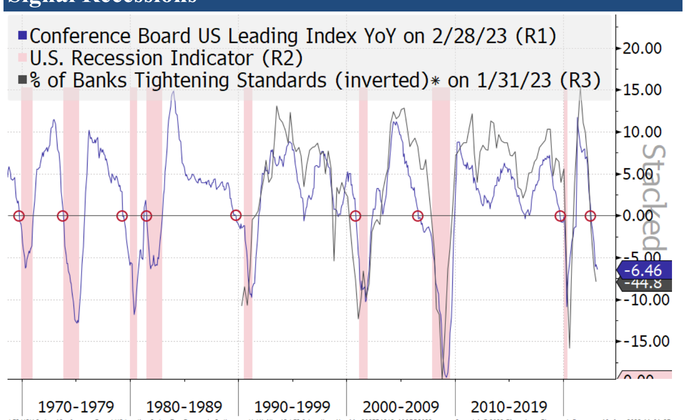


Chart source: Access Financial Services using Bloomberg Software & Data
Red Shaded areas are recessions

Chart 34: Negative LEI & Tight Lending Standards Usually Signal Recessions



* *C&I Loans for large/medium firms*
Red Shaded areas are recessions
Chart source: Access Financial Services using Bloomberg Software & Data

Throughout the Fed's tightening campaign, bad economic news has generally been good news for the financial markets because it supports investors' hopes that the Fed will pivot to easing monetary policy. We may now be entering an environment where bad economic news is actually bad for the financial markets because it confirms that there will not be a soft landing and that when the Fed does pivot to easier monetary policy, it will be because economic growth is faltering, unemployment is rising, credit and lending have declined, and inflation is moving to the downside because demand for goods and services is no longer supportive of economic and earnings growth. In other words, a recession which, as we explained last quarter, is somewhat arbitrary and defined as a significant decline in economic activity that goes on for more than a few months that is visible in industrial production, employment, real (inflation adjusted) income and wholesale-retail trade. We also noted that recessions tend to happen quickly and that they are only labeled as recessions after there is enough negative data to affix the "recession" label. That is one reason why economists often miss them.

At this point, our outlook can be summarized as follows:

- The Fed is approaching the end of its rate hiking cycle, but it is not likely to start cutting the FFR at the pace implied by the interest rate futures markets. It will eventually ease but risk assets will probably be at lower levels than they are today.
- A monetary policy reversal is a necessary but not sufficient condition to turn bullish on risk asserts. A discernable bottom in corporate profits, however, is probably a necessary requirement.
- The combination of tightening bank lending standards and high borrowing costs will likely lead to a contraction in demand.
- Stock valuations overall are not low enough to justify looking through the valley of shrinking profits and loading up on risk assets.

During a volatile 2022, the stock market as measured by the SPX bottomed in October. While volatility has remained elevated since then (Chart 35), the SPX has been making a series of higher highs and higher lows. This is generally viewed as a bullish price trend.

Chart 35: S&P 500 Major Market Swings Since Jan. 2022

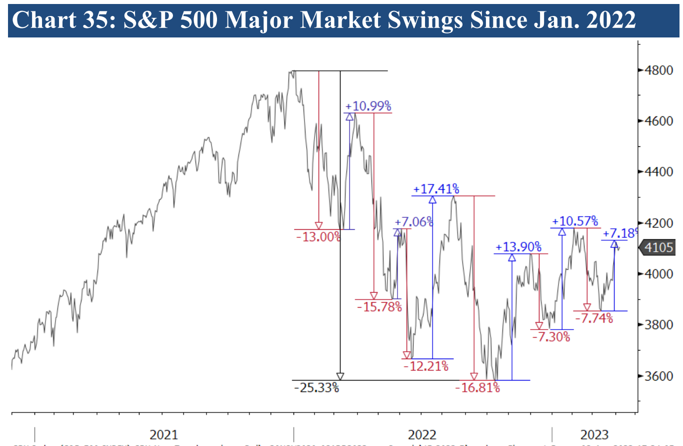


Chart source: Access Financial Services using Bloomberg Software & Data

Given our less than constructive outlook, and the message being sent by indicators that have a solid track record of frontrunning recessions, it is hard to embrace the soft landing/new bull market narrative. This is reflected in our clients' portfolios.

Broadly speaking, our clients' portfolios are positioned as follows:

Stocks: 25% underweight

› Mostly large cap

Bonds:

› Neutral allocation
› Mostly high quality credit

Cash (money market):

› Overweight

In addition to our cautious outlook given the policy, earnings and recession outlook, we are increasingly concerned by the impasse in congress over raising the US debt ceiling. US Treasury Secretary Janet Yellen has said the government could face default as soon as June if a deal in Congress to raise the debt ceiling is not reached before then.

Financial markets have also become increasingly concerned as can be seen in the credit default swap markets. Chart 36 below illustrates that the cost of insuring government bonds against default over the next six and twelve months has surged this year.

Chart 36: US Government Bond Credit Default Swap Prices

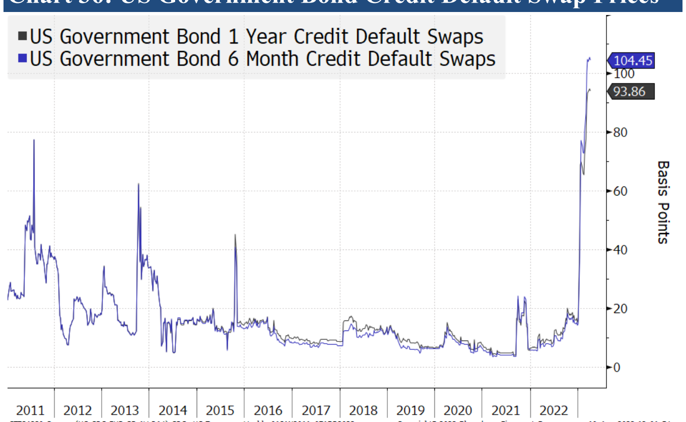


Chart source: Access Financial Services using Bloomberg Software & Data

With the so called X-date – the day when the government won't be able to pay all of its bills – just months away, the recent bank drama might complicate things further as the FDIC withdraws money from its account at the Fed to pay claims. Since it first bumped up against the debt limit in January, the Treasury has been relying on a combination of extraordinary measures and its cash pile to avoid breaching the cap. It only had about $54 billion of special measures remaining at the end of February and outflows increase the risk that the government has less time until it exhausts its remaining cash.

While we continue to expect the debt ceiling to be raised, the new Congress is more partisan than during the 2011 and 2013 battles, which increases the risk of a disastrous situation further reinforcing the risk asset underweight in our clients' portfolios.

Thank you for your continued confidence. It means a great deal to all of us. Please do not hesitate to contact me if you would like to discuss any of this in more detail.

Brant Kairies
952-885-2732