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Monetary Tightening 101

The banking crisis of 2023—triggered by rising interest rates that caused unrealized long-term losses in bank bond and loan portfolios—revealed who was swimming naked as the Fed's free money tide washed out. Our resident financials specialist, Tim Piechowski, pointed out in an internal January 27th memo how one large bank, which we do not own, had unrealized losses totaling over half of its tangible equity capital. The biggest surprise to us was how poorly some banks managed their securities portfolios. The second biggest surprise was how Fed regulators failed to assess interest rate risk in their Comprehensive Capital Analysis and Review (CCAR) stress tests.

"Monetary Tightening 101" has historically played out as follows: the U.S. Federal Reserve increases interest rates to fight inflation (real or perceived), banks manage the dynamics of rising rates as best they can, and the economy rolls into recession due to higher rates and tighter credit. The difference today is that the current cycle started under perfect storm conditions: interest rates were near 40-year lows and inflation was spiking under supply constraints caused by a historic pandemic and fiscal stimulus.

The good news is that this perfect storm has so far led only to a contained liquidity crisis. This is very different from the insolvency crisis that ravaged the U.S. financial system and economy during the Great Financial Crisis (GFC). While no one knows for sure, we would expect a more pedestrian recession should one develop this year, not the whopper that we got in 2008-09. We also note that an S&P 500 earnings recession is well under way, having begun in the first quarter of last year. ACR had already factored these declines into our valuations by cyclically adjusting our earnings estimates.

Equally important for assessing the health of our portfolios, ACR believes that our significant financial sector investments are well positioned for rising rates. Our large banks and insurance companies are potential capital providers to weaker institutions rather than being the source of today's banking crisis. Additionally, analysis of our P&C insurance companies shows that they are unusually well-positioned with little exposure to long-term bonds, while also benefiting from a "hard market" with rising insurance premiums. Lastly, should rising rates cause a recession, we believe that our portfolio companies have the financial strength to weather a severe contraction.

Regarding opportunities, in our view, regional banks were not the best investment hunting grounds in the first place. Traditional lending is highly competitive, exposed to interest rate risk, and vulnerable to bank runs (which we address further below). Moreover, we are concerned that tighter regulation resulting from today's crisis will make the traditional lending business even tougher. Nevertheless, we are by nature opportunists and contrarians, and bank stock prices have declined.

For discussion purposes we place regional banks into two broad categories: (1) stronger, healthier banks whose prices have not declined enough yet to compensate for interest rate risk and potential future regulation; (2) distressed banks whose prices have declined significantly. Our credit team is finding

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190 Carondelet Plaza, Suite 1300 | St. Louis, MO 63105
t 314.932.7600 | **f** 314.932.1111 | 877.849.7733 | **acr-invest.com**

opportunities in this second group via select, fixed-income securities. Our equity team, on the other hand, has determined that the common equity of distressed banks is too risky. Additionally, while we would not rule out additions to our financial sector holdings, we are currently content with our overall exposures.

The events of the current quarter do not change what we consider to be the more important risks and opportunities facing ACR clients and investors generally. Recession or not, overall equity market prices remain relatively high. High prices do not guarantee declines, but they do establish lower future returns. We are 3¼ years into the 2020s, and the S&P 500 annualized total return is 9.7% (1/1/20-3/31/23). We believe that as the decade unfolds, this return will regress to the mid-single digits or lower. Conversely, portfolios of certain “value” stocks remain historically inexpensive. Our EQR strategy price/value remains a relatively low 0.73[1]. The comparative math remains compelling: the estimated cyclically adjusted P/E is 9.7x for our EQR strategy and 33.1x for the S&P 500[2]. Lastly, credit spreads are just barely above historical averages, a climate that is providing select opportunities, though fewer than we would find during a recession.

Our strategy has always been to go where the value is. In doing so, we must remain alert to general economic imbalances such as the financial fragility and housing market dynamics that precipitated the GFC of 2008. It is incumbent upon us to protect client assets from such imbalances. At the same time, we do not attempt to anticipate *when* a recession will strike. Rather, we forecast cash flows through full cycles in which we consider recession a certainty. ACR equity strategy cash balances are relatively low today, as they were at the market peak in 2000, because select values are compelling. Perhaps we will regret not having more dry powder in the coming months, but we have never been market timers. We remain confident that come what may in the short-term, paying the right price for the cash flows of sound companies bodes well for the long-term.

The banking crisis of 2023 has revealed problems in our financial system, which neither the financial nor government sector has yet to solve. The remainder of this quarter’s commentary will provide a brief overview of several key issues and our views on them for those with a deeper interest in finance and prudential regulation. Inherent duration mismatch, intermediary transparency, depositor flight, psychological contagion, moral hazard, and financial accounting are issues that continue to beguile modern economies and policymakers. A plethora of articles, research and even books have been written on these subjects. While off-topic for a typical ACR commentary, we think financial practitioners have a duty to weigh in on these issues.

Inherent duration mismatch refers to the fact that enterprises generally consist of long-term assets that produce cash flows over time, while investors prefer access to their cash immediately. We are not referring to the type of duration mismatch that caused the banking crisis of 2023. Silicon Valley Bank, First Republic, Signature, and others purchased low-yield long-term bonds (or made low-yielding loans) when their primary liabilities were in the form of short-duration deposits. While banks are certainly impacted by inherent duration mismatch, they can still match the short-term duration of their liabilities by maintaining a commensurately shorter duration portfolio of securities and loans. Inherent duration

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mismatch is a more intractable problem, the antidotes to which are intermediary transparency and investor understanding.

Intermediary transparency, depositor flight, and psychological contagion are related. Banks continue to labor under expansive regulatory requirements, yet balance sheets still remain too opaque. Financial intermediary transparency is essential for investor confidence. For example, mortgage-backed security prepayment assumptions, which form the basis for duration calculations, are often missing in financial statements. Without such disclosures, it is impossible to properly assess the duration of many bank bond portfolios. Asset detail and quality disclosures are sometimes (not always) worse. Lack of transparency is the basis for depositor flight. Once it is determined there may be distress, uninsured depositors have every reason to flee.

Psychological contagion may be the most pernicious danger in modern financial systems. The banking system came close to an all-out regional bank run in the first quarter as uninsured depositors became aware of potential interest rate risk. The fact is when everyone panics and wants their cash back, the financial system is practically guaranteed to melt down. This applies to banks as well as to financial intermediaries like ACR. The reason excellent communication is one of our five core principles is to ensure that our investors understand the fundamental *value* of their investments when a market panic causes severe price declines. We are proud to say that ACR clients are a competitive advantage—allowing us to buy at such times, rather than forcing us to sell.

Moral hazard is a more complex topic. Many depositors think of their bank as a safe place to keep cash. Why? It could be because they know that 96% of uninsured depositor losses have been covered by the FDIC since the GFC[3]. Additionally, they probably cannot recall reading anything about bank failures and depositor losses over the past 15 years. Lastly, they also probably know on some level that the government went into regulation overdrive because of the GFC. Why then would anyone think bank regulation since the GFC has not worked? Moral hazard results from a misplaced sense of safety. Today, bank depositors are getting a wake-up call. Some banks may not be so safe after all.

Why does moral hazard matter? The Fed has the ability to back all deposits. Why not just make the guarantee of all deposits explicit? The unintended consequences of backing all deposits are, in our view, difficult to assess. The first hurdle would be to get the regulation right on both quality and duration for qualifying assets. As the current crisis is revealing, this is easier said than done. We guess that if the assets of depository institutions are properly regulated, fewer loans and securities would qualify, and the market would shrink. In circular fashion then, a larger “shadow” financial system would develop, and the overall system may be no safer. We do believe that the Fed should serve as a lender of last resort, carefully considering the circumstances and ways in which such powers are executed, and lending against reasonably sound collateral.

Last but not least is financial accounting. There is controversy about whether securities should be marked to market or held at cost with seemingly cogent arguments on both sides. We do not believe that institutions should be able to arbitrarily shuffle securities between one accounting method and

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another. Yet we also think it is a mistake to call for mark-to-market accounting when more volatile securities do not have to be liquidated. This potentially forces financial institutions to impair capital when they remain solvent with positive long-term cash flows. Mark-to-market accounting can add unnecessary distress to the financial system. One thought is to allow historical cost accounting for long-term assets, while requiring a 10-year "run-off" *cash flow* disclosure based on current assets, liabilities, estimated durations, and under several interest rate regimes, to assess solvency while reducing noisier, market-induced capital adequacy volatility. Ideas such as these should be floated among thoughtful and knowledgeable practitioners and policymakers and turned into carefully crafted rules.

Nothing protects better than a deep understanding of the institutions and assets in which one is invested. One sign of progress is that such knowledge was nearly impossible across a broad array of financial institutions prior to the GFC of 2008. Our financial system today is stronger and more transparent, though we still have more work to do.

Nick Tompras
April 2023

End Notes

1. *The Price/Value is ACR's estimate of undervaluation based on market prices and fundamental value. EQR portfolio pricing data from CapIQ and Bloomberg. Estimates of fundamental value ("value") are generated internally by ACR Alpine Capital Research. ACR calculates a fundamental value estimate for each portfolio holding. The fundamental value of a business is the cash flows that the business generates over its life discounted by a risk-adjusted discount rate. ACR compares its estimate of fundamental value to the publicly quoted market price to determine if a security's valuation is satisfactory for investment. The security's market price divided by the fundamental value estimate yields the price-to-value or "P/V" statistic, which is also calculated at the portfolio level weighted by position size.*
2. *The Price/Earnings for EQR is the cyclically adjusted P/E, which is based on the weighted market value divided by the weighted average estimated normalized cash earnings for the investment holdings in ACR's Equity Quality Return Strategy. EQR portfolio normalized earnings is based on portfolio manager estimates of the sustainable cash earnings power of the individual companies in the portfolio. Portfolio manager estimates of sustainable earnings incorporate economic cycles and recessions. ACR S&P 500 CAPE (cyclically adjusted P/E ratio) is based on Real (inflation adjusted) S&P 500 Price Per Share (PPS) divided by the Ordinary Least-Squares Regression (OLS) trendline of S&P 500 Real Earnings Per Share (EPS) from 1926 to 2022. S&P 500 price as of April 26, 2023. Sources: S&P Dow Jones Indices; Robert Shiller; BLS-CPI Data; ACR Alpine Capital Research.*
3. *"Will FDIC keep protecting failed banks' uninsured deposits?" American Banker February 14, 2019*

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