

The Weather Is Still a Bit Cloudy

April 17, 2023

Dear Clients,

Most people receiving this have seen quite a bit of rain and stormy weather. I hope this letter finds you well. I'm ready for some smooth sailing and sunshine, with spring coming I think I'll get it.

Financial markets are another matter and it's likely to be choppy for a bit longer. We've gone through a mild, so far, banking crisis. The financial press describes it as mild and contained to regional banks. I'm not sure about that but I don't think it will rise to levels of the 2008-2009 Great Financial Crisis. However, it does have investment and economic consequences. Also, it's in the "class" of crisis' mentioned in last quarters letter that could make a future recession something other than a mild recession.

Here's a few things to consider:

-The Federal Reserve has been raising rates trying to slow the economy. This bank crisis will also slow the economy. But by how much we don't know and neither does the Fed. So, Wall St expects the Fed to slow or stop rate hikes.

-On the other hand, if the crisis is contained, and mild, that could be a green light for the Fed to continue hiking at a faster pace. In not sure the market is prepared for that.

-There's a higher standard of regulation applied to large, national, banks that isn't applied to regional banks. That's likely to change and regionals will be held to higher standards and regulations. This will constrain their ability to lend. That, added to already higher interest rates, will have an adverse effect on the economy.

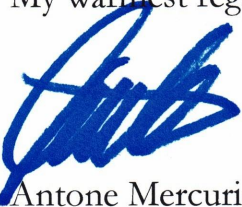
In discussions with research people the consensus hasn't changed much, a mild recession around the end of the year. Everyone's convinced inflation continues to come down and some are seeing CPI under 4% in 12 mos. I don't hear the same level of concern around supply lines and shipping as I did last year

Throughout all the unwelcome news the market continues “climbing a wall of worry” as they say on that street in lower Manhattan. At this writing, the S&P is up about 7% since the beginning of the year and about 14% since it’s October low.

I’m a little skeptical. Over the past year stocks have come down in price but never got cheap. In my opinion stock prices don’t reflect the possibility of a recession. Finally, I’ve learned to be suspicious of the consensus. I am investing accordingly.

Enclosed, a research piece by Ann Walsh of Guggenheim Partners. Put out early in banking crisis it does an excellent job of laying out some of the causes and possible ramifications. I’ve enjoyed reading Guggenheim’s research over the years and hope you do as well.

My warmest regards to all of you,



Antone Mercurio, CFP®
Investment Advisor

Enclosure

March 13, 2023

Portfolio Strategy

Silicon Valley Bank Replays the Ugly Consequences of Disintermediation



Anne Walsh, JD, CFA
Chief Investment Officer,
Guggenheim Partners
Investment Management

Financial market participants, including the Federal Reserve (Fed), can be forgiven if the Silicon Valley Bank (SVB) mess is bringing back PTSD flashbacks of the Global Financial Crisis (GFC). Even the rare Sunday announcement by regulators that its depositors (and Signature Bank's) would be made whole and have access to their cash felt eerily similar. As did the creation of another emergency facility, the Bank Term Funding Program (BTFP), which is the regulators' attempt to provide additional liquidity and stem contagion fears. I have also been around long enough to bear the scars of episodes where rising rates made many asset liability models go upside down, including the bank and insurance company funding crises of the 1980s and 1990s.

As we often say, history doesn't repeat but it does rhyme. On the surface, the sudden collapse of SVB shared some of the same symptoms of the 2008 meltdown—a financial institution forced by a funding disruption to crystallize crippling unrealized portfolio losses—but the catalyst, the funding model, and the assets are different. Understanding the similarities and differences in these events from financial history is an integral part of our analysis of current conditions and considering how they may play out.

One rhyming theme that runs through financial sector crises is the disintermediation of funding sources. Disintermediation refers to the process by which existing funding relationships that exist with intermediaries, such as banks, are broken. Another way to think about disintermediation is capital rationing, which I talked about in my [recent commentary](#). Recall that the early warning sign of the GFC was in March 2008 when Bear Stearns ran into trouble rolling over its wholesale funding facilities because the firm's lenders did not trust the asset quality of its mortgage book. This forced a Fed-directed fire-sale rescue by J.P. Morgan. At that moment in time a crisis was averted, but it was only temporary as similar situations with Lehman Brothers, Fannie Mae and Freddie Mac, and others popped up in September 2008.

In the specific case of SVB, disintermediation came from SVB's depositors—savers, investors, corporations, venture capital funds—who opted to move their deposits, first slowly and then all at once. While that choice may have initially been to seek higher cash yields or improve their liquidity position, it quickly turned into a bank run flight to safety.

Another common theme in financial accidents is bad management. For example, in the early 1990s in the savings and loan crisis it was poor asset-liability management. The GFC was caused by many parties failing to adequately perform their roles in the mortgage finance process—appraisers, rating agencies, mortgage underwriters, financial engineers, regulators. It is clear to everyone now that SVB's business strategy left it relying on a deposit base concentrated in a relatively homogeneous type of commercial customer. This lack of diversified funding sources was compounded by SVB's portfolio asset allocations. Treasuries and Agencies might not carry credit risk, but they are exposed to market risk that has hit like a sledgehammer during the Fed's aggressive 450 basis points of rate hikes over the past year.

This last point is where SVB changes from an idiosyncratic anecdote to a broader story. The possible systemic element of the SVB situation is the dramatic reshaping of the yield curve over the past year, which affects virtually every financial institution, every levered corporation and household, every bond portfolio. SVB is a mid-sized bank, and calculating exposures to the bank, and similar banks, is a straightforward exercise that every company, bank, and asset manager is doing now if they haven't already. In addition, larger Systemically Important Financial Institutions (SIFIs) are held to a much tighter regulatory capital standard, including capital testing on a portfolio mark-to-market basis. SVB might be the extreme case at the margin that gets exposed first and worst, but for everyone else their vulnerability to a dramatically swift and sharp rise in rates is just a matter of degree and management decisions—we will all see how resilient their funding models are, how matched their assets and liabilities are. We have been focused for some time on identifying and minimizing exposures to investments that are vulnerable to rising rates throughout our portfolios as part of our overall credit and risk surveillance.

The fallout from the SVB situation is still fluid, and we do not believe that this is a Lehman moment. It may, however, be a Bear Stearns moment. The risks in the market that catalyzed the SVB collapse are still out there. Regulators have given financial market participants a break by backstopping the SVB depositors and creating the BTFP. Investors must remain alert to the disintermediation risks that have been brought on by the Fed's unrelenting and ongoing quantitative tightening. Complacency is the investor's enemy.

Important Notices and Disclosures

Investing involves risk, including the possible loss of principal. Investments in fixed-income instruments are subject to the possibility that interest rates could rise, causing their values to decline. High yield and unrated debt securities are at a greater risk of default than investment grade bonds and may be less liquid, which may increase volatility.

This material is distributed or presented for informational or educational purposes only and should not be considered a recommendation of any particular security, strategy or investment product, or as investing advice of any kind. This material is not provided in a fiduciary capacity, may not be relied upon for or in connection with the making of investment decisions, and does not constitute a solicitation of an offer to buy or sell securities. The content contained herein is not intended to be and should not be construed as legal or tax advice and/or a legal opinion. Always consult a financial, tax and/or legal professional regarding your specific situation.

This material contains opinions of the author, but not necessarily those of Guggenheim Partners or its subsidiaries. The opinions contained herein are subject to change without notice. Forward-looking statements, estimates, and certain information contained herein are based upon proprietary and non-proprietary research and other sources. Information contained herein has been obtained from sources believed to be reliable, but are not assured as to accuracy. No part of this material may be reproduced or referred to in any form, without express written permission of Guggenheim Partners, LLC. There is neither representation nor warranty as to the current accuracy of, nor liability for, decisions based on such information. **Past performance does not guarantee future results.**

Guggenheim Investments represents the following affiliated investment management businesses of Guggenheim Partners, LLC: Guggenheim Partners Investment Management, LLC, Security Investors, LLC, Guggenheim Funds Distributors, LLC, Guggenheim Funds Investment Advisors, LLC, Guggenheim Partners Advisors, LLC, Guggenheim Corporate Funding, LLC, Guggenheim Partners Europe Limited, Guggenheim Partners Japan Limited, GS GAMMA Advisors, LLC, and Guggenheim Partners India Management.

© 2023 Guggenheim Partners, LLC. All rights reserved.

56514