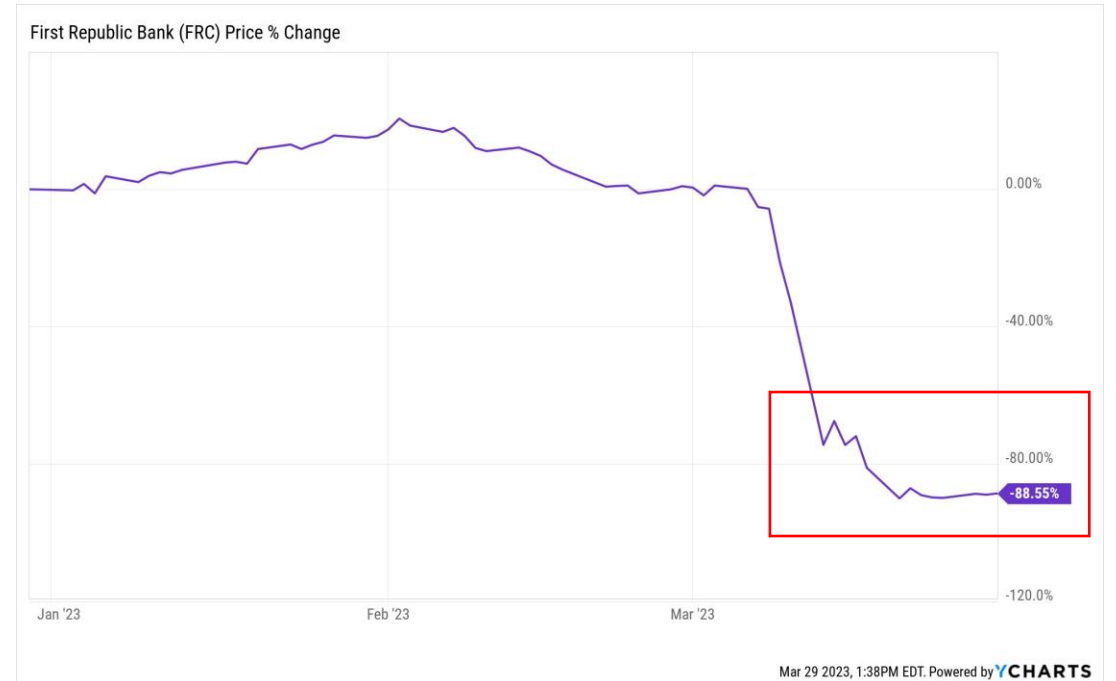
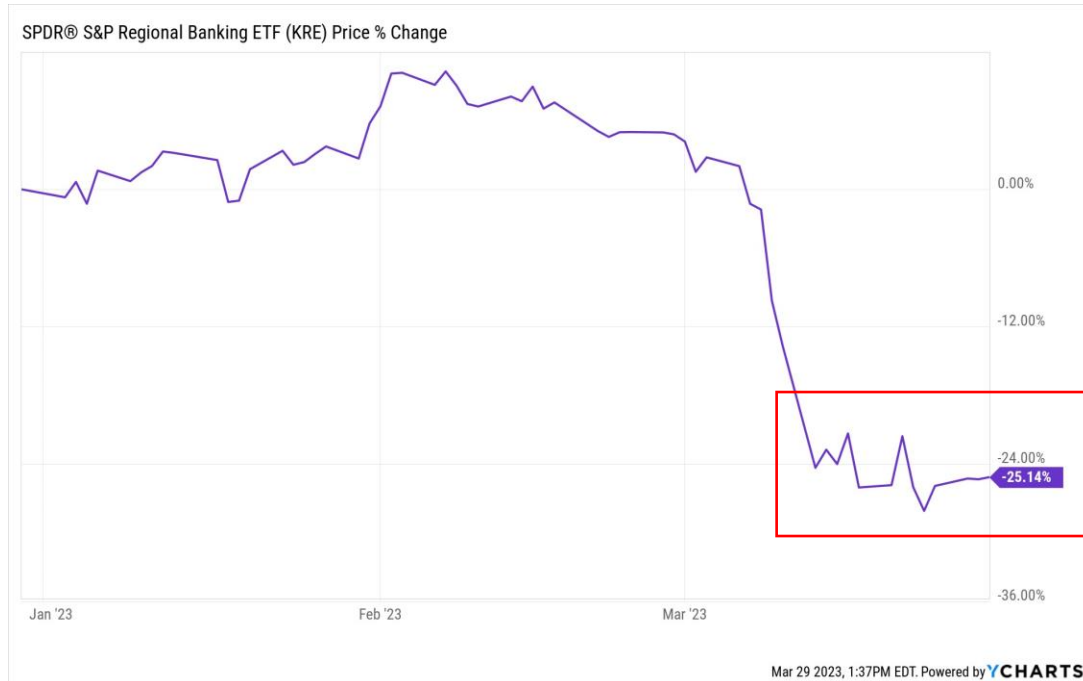


## **Sevens Report Alpha Webinar – Is the Banking Crisis Over?**

**March 30<sup>th</sup>, 2023**

**Tom Essaye, President Sevens Report Research**

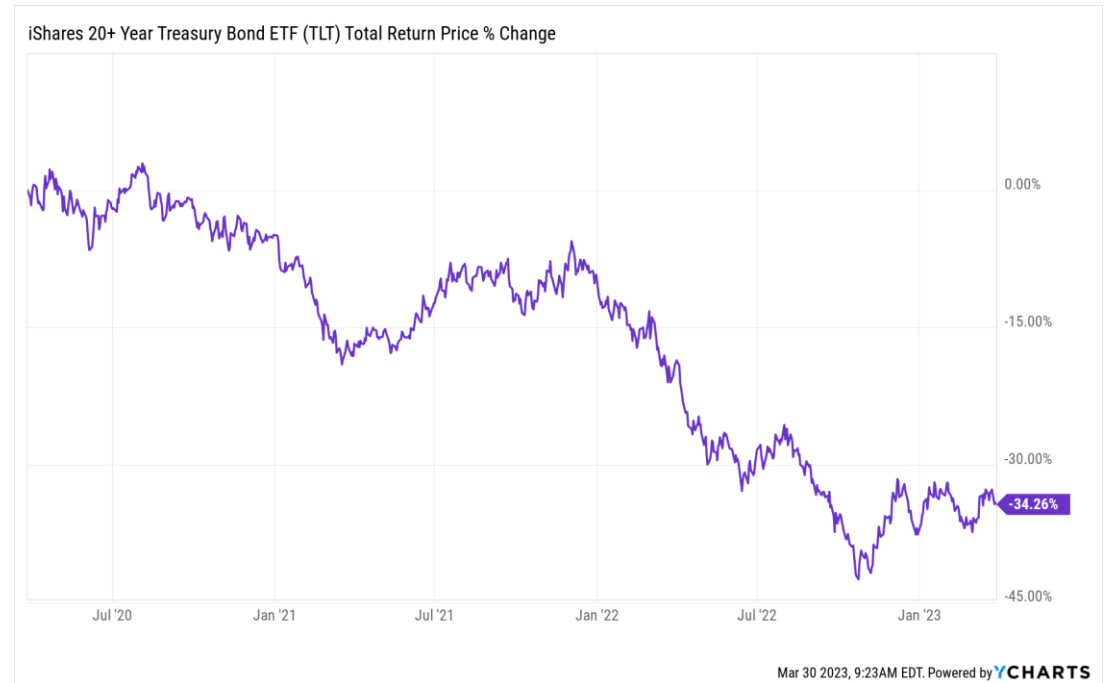
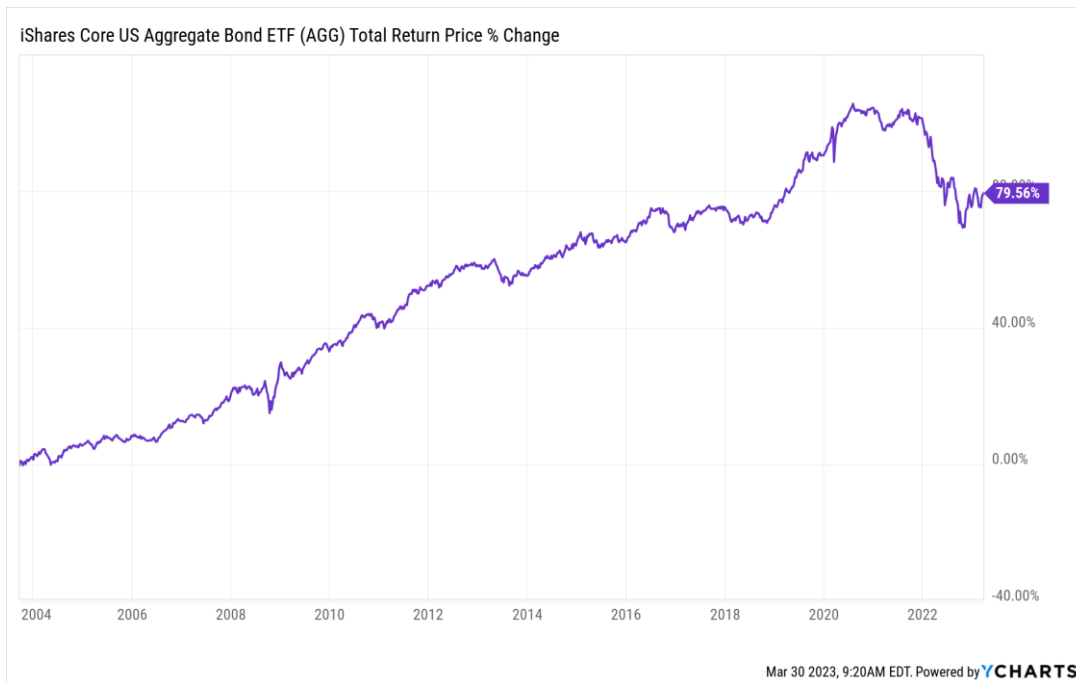
## Status of the Banking Crisis – Calm, for now.



## But, the underlying issue has not been fixed.

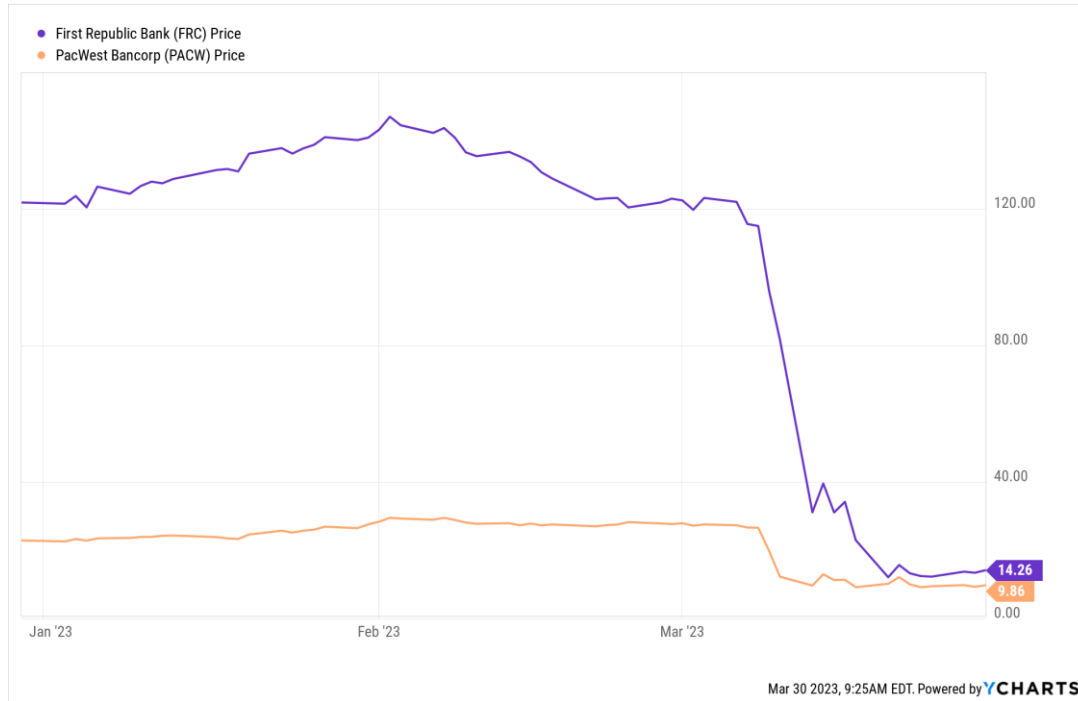
**The declines in the bond market following Fed rate hikes are generational.**

**That's especially true in the long end of the yield curve, where bond holders are sitting on massive losses.**



## Indicators to watch moving forward.

First Republic and Pac West are some of the most “at risk” banks right now.



A decline in discount window and BTFP usage will be a clear signal the crisis is truly easing.



## Financial Crisis and Now: Similarities

- How does the current banking crisis remind me of the financial crisis?
  - They both followed massive appreciation in value in core assets held by banks, investors, and other financial institutions.
    - In the financial crisis, it was housing.
    - Now, it's U.S. Treasuries (and bonds more broadly).
  - These assets (homes and Treasuries) were counted on to be stable, and the idea of a rapid decline in price was quasi-inconceivable, prior to it occurring.
    - The bursting of the sub-prime bubble caused massive drops in housing prices that no one modeled in.
    - The massive rate hikes from the Fed led to declines in bond funds that no one modeled in.
  - There appears to have been some regulatory gaps, and how deep and how far they go is unclear.
    - There were multiple and numerous regulatory failures in the housing crisis.
    - So far, oversight of Silvergate and SVB was poor if not utterly incompetent.
  - The underlying assets represent a massive part of the economy (the bond market and housing market).
  - The first “shoe to drop” in this banking crisis were overly exposed to some of the riskiest parts of the market.
    - In 2007, it was Northern Rock and Countrywide, both heavy into sub-prime mortgages.
    - So far, it's been Silvergate, SVB, and SBNY, all heavy into crypto.
  - After an initial shock, markets have looked past the incidents as isolated and contained.

## Financial Crisis and Now: Differences

- The most important difference: The underlying assets causing the stress will not lose value, as long as they are held to maturity.
  - In 2007, the mortgages on the homes were hopelessly underwater, so there were massive losses that had to be realized.
  - Now, U.S. Treasury bonds will redeem at par, so as long as they don't have to be sold, there's no solvency problem for the banks.
- The Fed and Treasury understand the price of inaction.
  - In 2007, everyone was learning on the fly. Regulators and policy makers were hesitant to get involved for fear of moral hazard or political ramifications. But, when we came dangerously close to massive bank insolvency, they stepped in and the situation was fixed.
  - The creation of the BTFP demonstrates that the Fed and Treasury understand the price of inaction, and that makes this a much more manageable crisis.
- There does not appear to be the rampant leverage that contributed to the financial crisis.

## Similarities and Differences

- You'll notice there are a lot more similarities between now and the start of the financial crisis than there are differences.
- Put simply, this easily could *become* the next financial crisis, but the fact that 1) It's Treasuries and not housing and 2) Policy makers have been through this before, makes it unlikely that this becomes a repeat of the financial crisis.
- Instead, this looks a lot more like the S&L crisis of the 1980's.

## The S&L Crisis

- The Savings and Loan Crisis of the 1980's was born out of the same problem we have today: A rapid increase in interest rates in response to inflation.
- S&L's borrowed short and lent long, but in the late 1970's (like now) that was a recipe for insolvency: Paying more on deposits than they were receiving in interest from mortgages.
- However, what made it so much worse was the policy response: To try and keep S&L's afloat, Congress de-regulated them and allowed them to engage in risky lending to try and "grow" their way out of the problem (mostly by lending to the energy industry).
- Eventually, the damn broke and the Federal government did what it should have done about 10 years earlier: Bail out the industry. The Resolution Trust Corporation closed 747 Savings and Loans and it cost the taxpayer around \$125 billion (in the late 1980's/early 1990's dollars!).
- But, it did not cause a broader financial crisis.



## What could be next?

- Here are some signs the crisis is starting to spread.
  - First Republic, Pac West, and other regional banks (Comerica) fail or are forced to merge with the systemically important banks (JPM/BAC/WFC, etc.).
  - Commercial real estate becomes stressed.
    - 70% of outstanding commercial real estate loans are linked to small banks. Small banks could tighten lending standards, negatively impacting the commercial real estate market.
    - This year, \$270 billion in commercial mortgages are set to expire with \$1.4 trillion expiring within the next five years. Most of this debt will need to be re-financed at higher rates.
    - Columbia Property Trust defaulted on a \$1.7 billion floating CRE loan, and Brookfield AM defaulted on a \$750 million CRE loan.
    - Stocks/REITs to watch: EQIX, APLE, PLD, SPG.