



LLOYD TEVIS
INVESTMENTS, LLC

Securing your future through Precision Investing™



Round Up The Usual Suspects

Market Commentary

April 2023



Another Banking Crisis

Shortly before mid-month payrolls were due to be paid Silicon Valley Bank was taken over by the FDIC raising momentary terror that its customers – a broad selection of the United States's technical heartland - would be forced to shutdown due to inability to meet payroll. Fortunately, the government stepped in to guarantee all depositors and so this disaster was avoided. We issued a preliminary assessment of this situation on March 15 as the Research Note “Comments on the Banking Industry.” Subsequent events have not required any changes to that preliminary assessment, but some additional information has become available.

A paper by academic researchers addresses the solvency of the US banks and of the banking system[1]. Its major findings are

- 1) Silicon Valley Bank was an outlier in terms of funding long bonds with uninsured deposits. Only a few banks, most of them small, are in such extreme positions. Under moderate assumptions, the banking system as a whole is solvent with only 1.25% of assets held by banks in a weak position.
- 2) However there is significant asset impairment spread through the system. Unrecognized losses on long dated assets amount to \$2 Trillion dollars, or about 9% of assets on a mark-to-market basis. By implication, the system is in no state to further risk up by creating additional credit.
- 3) Under less moderate assumptions, there are more weak banks some of which are medium or even large. In this case the percentage of assets held by weak banks increases to 3.75%.

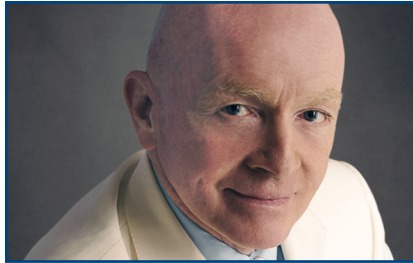
This paper did not address credit concerns, but credit issues certainly exist. Reportage by the Wall St Journal notes that 80% of commercial property mortgages are held by regional (i. e. smaller) banks. Approximately \$270 billion of such loans mature this year and a healthy percentage are believed to require rollover rather than payoff.

Overall we can say that the banking system is poised for a significant credit contraction which is likely already underway. Mishandled, this contraction has the latent capacity to snow ball into a painful economic recession. The Federal Reserve's policy has, of course, been to create exactly these circumstances. However their goal is simply to cool rather than contract the economy. Prior to SVB's collapse, the Federal Reserve had set expectations for an increase of short term interest rates by 0.50%. After the collapse, they actually made a 0.25% increase. We would have favored no increase at this juncture, which pause would have given the economy time to respond to SVB's collapse and would have allowed the additional information in first quarter company reporting time to come out. However, the Federal Reserve evidently felt that a slowing in their rate increase program was an adequate response to the SVB event. In any case, it would seem we are at or near peak rate for this tightening cycle. As credit creation slows, economic activity and inflation will both come down. Eventually the Federal Reserve will find that it either must reduce short rates to arrest economic contraction or that it may reduce rates since inflation is trending down. Cautiously, we are not expecting the Federal Reserve to achieve its target 2% inflation rate in this tightening cycle. We are expecting something closer to a 3% rate to be achieved before halting economic contraction becomes the dominant policy concern. It may take two tightening cycles to achieve the stable low inflation rate that the Federal Reserve seeks.

Meanwhile clients have been asking for advice on keeping their cash safe. In the resources section of our website we have created a section titled Advice and Guidance. The essays there address basic principles of financial management which do not depend on personal circumstances or the state of the economy. In particular the essay "Management of

Liquid Reserves” addresses the question of keeping cash safe in bad times as well as good. It is available at

https://www.lloydtevis.com/web/advice/management_liquid_reserves.pdf



Capital Controls

Mark Mobius is a distinguished investment advisor. For many years he headed up emerging market investment at Franklin Templeton. More recently he has headed the Mobius group. Recently he announced that barriers were being thrown in the way of his withdrawing capital from China. These barriers took the form of bureaucratic procedures, rather than formal capital controls. As a result Mobius issued a public caution regarding investment in China. We have been urging investors to shed their China investments for two years. China is a highly nationalistic society much given to group think and highly aware of government guidance. It is also troubled by a financial crisis in its real estate sector, massive disruptions from the pandemic and a seizure of power by one wing of its ruling Communist party which has been career ending or worse for other factions of the party. In this troubled environment the government is putting out the message that the United States stands in China's way and is determined to prevent the country returning to its historic greatness. The government announced a 7.5% hike to the official military budget even though the economy is only expected to grow 5%. Its recently promoted foreign minister stated that the United States must correct its errors or face the consequences. While we think the comment more an expression of the minister's inexperience than a deliberate war warning, the comment is troubling even on that basis. In such an environment, foreign investors cannot expect to be treated fairly. We are also hard pressed to think of a country which has proved a good

investment when it turned to stirring up international tensions as a distraction from its internal discontents. Our advice on China is affirmed.



The Russo-Ukraine War

February and March have seen a substantial pickup in initiative on the Russian side. The commander Valerie Gerasimov is known for his doctrine that all tools should be utilized in support of the offensive. That is exactly what we have seen occur, with plays in Moldavia and Belarus creating distractions, pushes along multiple fronts in the Ukraine and busy diplomacy backing up the troops. We attribute the new found activity mostly to Gerasimov's assumption of direct responsibility for the war. Forward progress has mostly been limited to the central front, however, with the Russian's having taken the greater part of Bakhmut after a bloody ten month assault. Stories floating back from the front lines have been wild: Russian troops armed with shovels charging entrenched positions, the Russians bearing a 7-1 casualty ratio, a Russian unit of 1200 men being reconstituted 8 times and bearing a cumulative 6500 casualties before being taken out of the line. This pressure cooker is producing other stories as well: POWs being executed, special force units troubled by desertion, airborne units refusing commands, politically out of favor units being sent on suicide missions, much higher casualty rates among Russia's ethnic minorities, mounting protest from military families appalled by the wastage of troops. Although the offensive has moved the front line incrementally forward, the cost in terms of men and morale has been high.

The war was begun with the explicit goal of reconstituting the Russia/Soviet empire. This is a direct threat to NATO and NATO needs this war to end with a Russian defeat so profound that the country ceases dreaming of imperial restoration. Russia has made it clear it does not accept the

existence of a Ukrainian nation and it has abducted an estimated 140,000 Ukrainian children from the occupied territories for eventual adoption by Russian families. During the month the International Criminal Court issued an indictment of Putin for this war crime. Ukraine needs its territory, children and POWs back and membership in the EU and NATO to guarantee its future. None of these seem possible absent a deep Russian defeat. This war falls into a familiar type of war in which a storied military power gets into a scrap with a feisty upstart and over a long campaign discovers that the power balance is different than it had perceived. Famous examples include the British fighting in the American colonies and the French fighting in Indochina. Often such wars end when an eye catching tactical defeat (e.g. Yorktown or Dien Ben Phu) forces the historic military power to recognize that its long campaign has built no assets and that it must doubly recommit even to stay in the game. Such a defeat is what Ukraine and its NATO partners will hope to serve up in a counteroffensive this summer. Even as he presses forward in Bakhmut, Gerasimov is ordering layers of entrenchment to be constructed behind the front lines. The strategic lack of depth in the Russian position is a point he is likely acutely aware of. Trenches can hold infantry and slow tanks, but they are ineffective against air forces. So far, however, NATO has not been building a Ukrainian air force.

President Xi of China paid a call on his strategic partner Putin in Moscow. Putin offered trade concessions and, we assume, sought military and political aid. Xi accepted the concessions, but limited his support to air kisses. Perhaps secret protocols are more substantive. However, Xi well realizes that the “Collective West” is his key trade partner – not Russia – and he is not going to give Putin enough aid to rescue him from the mess he has gotten himself into.

Putin's economic concessions to China will further China's penetration of Russia's trans-Ural territories. It will be interesting to see if this engagement falls into the US/Canadian pattern with Chinese capital furthering the development of a sparsely populated natural resource rich region. Or will the engagement follow the pattern we have

seen play out in Tibet and Xinjiang, where Chinese economic dominance leads to Chinese political control and then an influx of Han Chinese that threatens to submerge the original population. China has to a degree already signaled its intentions. Chinese schoolbooks refer to Russia's far east as Chinese territories lost through unequal treaties. China has indicated that it feels it has interests in the Arctic.



Iran

For a month a nationwide conspiracy in Iran engaged in poisoning school girls and to a lesser extent schoolboys and teachers. The government held aloof to the point of appearing to be colluding with the poisoners. Finally it arrested 100 alleged perpetrators, who – however – do not at this juncture appear to be anything more than the “usual suspects.” The regime's concern for school girls is unpersuasive given the allegation that it is torturing child detainees in special camps.

Reza Pahlavi, the son of the last Shah, has put himself forward as a rallying point for the Iranian opposition, but he has met with a lukewarm response. The late Shah and the Ayatollah Khomeini both thought that Iran should be a Persian led unified state. Much of the opposition, however, is made up of minority groups who – after enduring decades of Persian misgovernment – would prefer a less centralized state. Any would be leader of the opposition must somehow reconcile the aspirations of the minorities and the desires of secular minded Persian nationalists.

While Iran continues to seethe internally, the diplomatic front remains active. The UN nuclear watchdog agency reported finding traces of bomb grade enriched uranium at Iran's nuclear fuel facilities. The regime professed it was utterly bewildered about how it could have got there. Iran has been supplying Russia with drones and other munitions. In return Russia will sell it advanced warplanes. Russia and

Iran both labor under western sanctions and appear to be leaning on Belarus to serve as a front end to their smuggling operations. China has recently negotiated something of a reconciliation between Iran and Saudi Arabia. This will come as a severe disappointment to Israel and should be a warning to the US that its Mideast policy is failing.



Domestic Politics

President Biden will probably stand for re-election, but his age will mean a great deal of scrutiny attaches to his choice of a running mate. His current vice president, Kamala Harris, has not established herself as a natural successor in the two years since her election. A campaign to replace her in favor of a more consensus successor seems inevitable, but will open a significant power struggle within the Democratic party.

The President and Republican opposition hold diametrically opposed visions for the country which they have expressed in the form of budget proposals. As there is little possibility of compromise, we expect that after much ventilation of opinions a “stopgap” budget will be enacted which looks remarkably like the current budget.

The first of what looks to be several criminal indictments has been filed against former President Trump. Anticipating his political demise, several additional candidates have come forward for the Republican presidential nomination. With De Santis having positioned himself as an alternate leader for the MAGA wing of the Republican party, rival candidates are trying to build momentum among traditional but non-radical Republicans.



The Economy

Normally we focus on the big picture in this section. This month we focus in on how credit conditions have responded to this month's banking turmoil. We look at 4 dates in particular, the start of month when there was as yet no news, march 10 – the day Silicon Valley Bank failed, march 20 – the first trading day after the Credit Suisse rescue and the end of the month. The data we shall discuss is various indicators of credit conditions (table 1.)

Table 1: Credit Conditions over March 2023

Date	03/01/23	03/10/23	03/20/23	03/31/23	Change over Month
Treasury Yields					
3 month bill	4.73	4.83	4.65	4.57	-0.16
2 year note	4.89	4.6	3.92	3.94	-0.95
10 year bond	4.01	3.7	3.47	3.53	-0.48
bond – note	-0.88	-0.9	-0.45	-0.41	0.47
Short Rates					
Federal Funds	4.57	4.56	4.58	4.83	0.26
Call Money	6.34	6.38	6.41	6.75	0.41
Call minus Federal Funds	1.77	1.82	1.83	1.92	0.15
AA Commercial Paper					
1 month nonfinancial	4.57	4.7	4.69	4.82	0.25
spread over Treasury bill	-0.16	-0.13	0.04	0.25	0.41
Eurodollar Rates					
3 mo Libor	4.98	5.14	4.95	5.14	0.16
TED spread (Libor minus Treasury bill)	0.25	0.31	0.3	0.57	0.32
Medium Grade Bond Yield					
domestic	8.51	8.69	8.86	8.65	0.14
emerging markets	10.19	10.25	10.69	10.57	0.38
domestic minus 10 year treasury	4.5	4.99	5.39	5.12	0.62
international minus domestic	1.68	1.56	1.83	1.92	0.24
Market Price / Book Value					
4 Large US banks	1.05	0.95	0.88	0.90	-0.15
6 Large European banks	0.6	0.56	0.51	0.51	-0.09
3 US Office REIT	0.56	0.47	0.41	0.4	-0.16

Three month Treasury bill rates were rising before the banking crisis began on March 8. As a flight to safety took place, rates reversed course and dropped. A modest rebound took place near month end and rates ended up about where they began. The two year note and ten year bond made much larger moves as the market anticipated that the Federal Reserve tightening program had about run its course. The move was larger for two year notes and so the yield curve became less inverted than previously. The downward move in rates implies an upward move in prices and so these developments relieved some of the pressure on banks carrying bonds currently below purchase price.

The Federal Funds rate is the overnight interbank loan rate for banking reserves. It is the rate most reflective of Federal Reserve policy. It rose a quarter point at month end as the Federal Reserve continued its tightening program, albeit at a slowed pace. Call money is the rate at which banks loan funds overnight to brokers to carry security inventories. The rate widened over the month but only modestly, indicating no particular liquidity demands in the security business.

Commercial paper reflects the rate charged on one month unsecured loans to major nonfinancial corporations with top credit ratings. Here rates rose by a quarter point over the month and the spread over 3 month Treasury bill widened as a combination of the paper rate increasing and the bill rate decreasing. Changes occurred in a two step fashion but were in total not dramatic.

The three month Libor rate is the rate for three month deposits in leading European banks. The spread between Libor and the Treasury bill gives a measure of the credit concerns regarding European banks. The spread was initially little effected by the collapse of Silicon Valley Bank but it rose after the Credit Suisse rescue and closed the month up a third of a point.

Medium grade bond yields are the average yield on outstanding bonds issued by corporations with credit ratings below investment grade. Domestically these yields were little changed, but on foreign issued dollar bonds yields rose by a third of a point – similar to eurodollar deposits. Again most of the change was in the second part of the month. As medium

grade yields did not participate in the declining rates experienced by the Treasury market, spreads over Treasury widened by more than a half point.

Finally we look at the ratio of market price to book value for several financial businesses. In general banks will trade close to book value unless there are concerns about potential losses in their portfolios. We see for both US and European banks a modest decrease in this ratio over the month, indicating some increased concern about the quality of bank assets. The most notable point, however, is the substantial discounts on European banks as compared to US banks. For Real Estate Investment Trusts the ratio is between current market price and the historic cost of acquiring the buildings held. Here the ratio is substantially below one, indicating that the income generation power of the buildings has declined substantially. The ratio worsened considerably over the month as market prices dropped by nearly 28%. Most of the decline was in the first half of the month.

We can summarize this data by saying that the month's banking turmoil occurred in two parts. The first part was domestically focused and had its major impact on Treasury rates. The collapse of Silicon Valley Bank had little impact on domestic credit conditions but altered market views on the course of US interest rates and economic activity. In the second part of the month, the turmoil shifted to Europe and modest increases in credit spreads were observed as concerns about the general health of European banks developed. Some of these bank and REIT assets are now selling at wide enough discounts to offer attractive returns to those able to spot the ones which make a good ultimate recovery. Assuming this banking turmoil subsides without further drama, the episode may ultimately build confidence in the banking system. The measures put in place after 2008 will have to a degree been tested and while room for further improvement was uncovered, a systemic collapse did not result from this test.



The Markets

This month we update the 6 month trend for most asset classes from range trading to rising. Progress has for most asset classes had the choppy rising pattern aptly described as “climbing a wall of worry.” In other words, the core trend is upward but episodically it is interrupted by bursts of

Table 2: Recent Market Performance

Category	Asset Class	6 month trend	3 month return	1 month return
Equity	US Large Cap	rising	6.99%	3.29%
	US Large Cap Growth	rising	9.21%	5.31%
	US Large Cap Value	rising	4.61%	0.70%
	Growth – Value	falling	4.60%	4.60%
	US Mid/Small Cap	rising	3.22%	-3.08%
	Intl Developed	rising	8.96%	3.14%
	Intl Emerging	rising	4.12%	3.30%
	Fixed Income	3-7 Year Treasury	rising	2.40%
7-10 Year Treasury		rising	3.49%	3.50%
TIPS		rising	3.58%	2.87%
Muni		rising	2.10%	2.16%
Investment Grade		rising	2.73%	2.38%
Medium Grade		rising	2.61%	1.40%
Preferred		range trading	2.26%	-4.53%
Commodity	REIT	range trading	1.28%	-1.72%
	Euro	rising	1.26%	1.99%
	Gold	rising	8.57%	6.67%
	Oil	falling	-5.97%	-5.20%

anxiety. The collapse of SVB fits into and affirms this basic pattern – although mid-month many asset classes had dipped in response to the banking turmoil, by month end they had recovered and were moving ahead. A notably strong performance was turned in by US Large Cap Growth, which handily outperformed US Large Cap Value. In the three month picture also, Growth appears to have snapped out of the pattern of under performing Value which has been in place for most of the past two years. It remains to be seen whether this trend will be confirmed in the six month picture,

however. Gold also turned in a strong performance this month as it played its natural role of a haven of safety for funds fleeing banking turmoil. But it is also rising in the longer term picture as it benefits from the inflationary environment. Most equity classes and high quality bond asset classes turned in steady unspectacular gains. There was by contrast weakness in the equity income area: medium grade bonds, preferreds and REITs. Income oriented investors seemed to feel this was a moment to emphasize stability over stretching for yield. Oil continues its falling pattern as the market seems to anticipate tepid world economic growth being insufficient to sustain war driven premiums in oil prices.



Advice

Our view remains that these are normal times and that investment portfolios should be at or near their normal positions formed from a long range consideration of the investor's personal circumstances. Trends currently in place point to the collapse of greater Russia. This is a major historic event which is generally favorable to the US and Europe, but its direct impact on the capital markets is limited and declining. China is probably the most immediate beneficiary of Russia's weakness, but Beijing is most likely sufficiently focused on its rivalry with the US that is confused and uncertain how to respond to the crisis in its leading ally. Banking turmoil is, to this point at least, a purely business cycle scale event and likely to have limited impact beyond the bank industry and commercial real estate. The US is likely to continue enjoying peace, modest prosperity, continuing recovery from Covid and a gravitational pull back to its political center.



About Us

Lloyd Tevis Investments LLC is a registered investment advisor offering its services over the internet to US individual investors and their families. We believe the strategic asset allocation decision is the key decision faced by our investors. Accordingly, our monthly commentary focuses on matters which can shape the longer term performance of asset classes. We do not time market swings or pick individual stocks. Discussion at this level of detail is made for the light which it throws on relative valuations and such discussion should not be read as an investment recommendation. Indeed we strongly recommend a highly personalized approach to investment decision making which would make a general publication an inappropriate setting for an investment recommendation. In evaluating political and social developments our perspective is that of long term investors. We believe the investor's interest is best served by a stable environment in which change occurs incrementally as broadly supported policies rather than by an environment of abrupt changes and frequent U-turns driven by transient partisan advantages. Finally, our assessments should always be read as what we consider likely to occur and not as expressions of what we would like to see come about. To learn more about our firm visit us at <https://www.lloydtevis.com>.

Cover Photo

The cover is a frame from the movie “Casablanca.” It shows Captain Louis Renault (played by Claude Rains) informing his subordinate that Major Strasser has been killed and that the police should “round up the usual suspects.” While sending his staff on this mission, Captain Renault is perfectly aware that Major Strasser was killed by the American bar owner Rick Blaine (played by Humphrey Bogart) who is standing out of frame but directly in front of him. However, Renault is disinterested in avenging the death of the overbearing Nazi Major. The phrase “round up the usual suspects” has entered the lexicon as a description of official activity where the authorities need to appear busy but know the mission to be pointless. Iranian police, American bank regulators and Russian generals are all busy rounding up the usual suspects at present.

References

[1] “Monetary Tightening and US Bank Fragility in 2023: Mark-to-Market Losses and Uninsured Depositor Runs?” Erica Jiang, Gregor Matvos, Tomasz Piskorski and Amit Seru, published at <https://ssrn.com/abstract=4387676>.