Knightsbridge
WEALTH MANAGEMENT

April 12th, 2023

Spring Quarterly Commentary

"You only find out who is swimming naked when the tide goes out."

Warren Buffett
Investor, born 1930

Per the quote above, the financial tide has been receding because interest rates have been rising. The big economic news of the first quarter was a banking crisis which revealed that a few financial institutions were swimming naked – or at least wholly unprepared for the change in water levels.

To the casual market observer, the crisis unfolded at a dizzying pace. Equity and bond holders in Silicon Valley and Signature Banks were wiped out when those institutions were seized by regulators, who then broke their own rules to make all depositors whole. Many were surprised, such as the stock analyst who suspended coverage on these banks with an "Overweight" rating[1].


J.P.Morgan
North America Equity Research

U.S. Mid and Small Cap Banks

Coverage Update

Click here for the full Note and disclaimers

With SIVB and SBNY entering FDIC receivership, we are terminating equity research coverage of both. Our final rating for both stocks is Overweight. The last research for these companies should no longer be relied upon.

Click here for the full Note and disclaimers

U.S. Mid and Small Cap Banks

[1] One happy headline that emerged from all this was "First Citizen Buys the Assets of Silicon Valley Bank". The stock of First Citizens, which we own in

Fleeing customers also lost faith in the long-suffering but globally-important investment bank Credit Suisse. The Swiss Government was forced to step in and arrange a marriage to its more stable countryman, UBS. Skittish depositors and weary investors eyed all regional banks skeptically, preparing for the next domino to fall.

The headlines have been reminiscent of the punishing Global Financial Crisis of 2008. Yet, these events just might turn out to be exactly what the economy needed. Yes, you read us correctly. So far, the crisis has been contained, it has likely helped convince the Fed to stop raising rates (which we think is a good idea), and it is inherently disinflationary. All in all, it is entirely possible the banking crisis could help engineer a soft landing for the economy, where inflation comes down without too much economic interruption.

The question we receive most often goes something like this: What's going on with the banks? Are they safe? Our answer, *for now,*[2] is that by and large the banking system is safe because this crisis is an interest rate problem, and it has a straightforward interest rate solution if things get worse. Thus, we aren't worried about a repeat of 2008. We explain below.

The business model for banks is to borrow money short-term[3] and then turn around and lend those funds out long-term. This long-term lending can take the form of buying long-term securities (bonds) or making long-term loans. When interest rates rise, the value of these long-term assets declines. The sharper the rise in rates, the steeper the decline in value. Though the severity of this problem varies from bank to bank, this is the central issue of the current banking crisis. The decline in the value of long-term assets is an industry-wide problem and an obvious challenge for any bank attempting to remain solvent.

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our Opportunistic Value Equity Strategy, soared nearly 60% that day to become a rare winner in the embattled banking sector.

[2] Things could of course evolve. Thus, we are only saying *for now* this is a very solvable, and perhaps healthy, "crisis".

[3] When you put your money in a bank, you are lending money to them. This is a short-term loan because you are allowed to take it out at any time. If you leave your money in the bank for a long time, then that represents a series of short-term loans.

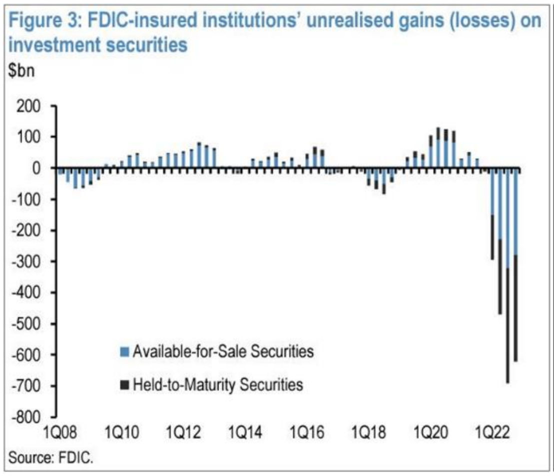
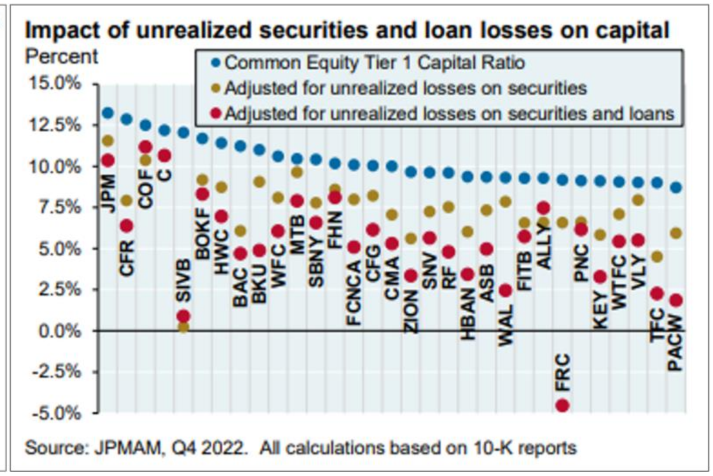


Figure 3: FDIC-insured institutions' unrealised gains (losses) on investment securities

Source: FDIC.



Impact of unrealized securities and loan losses on capital

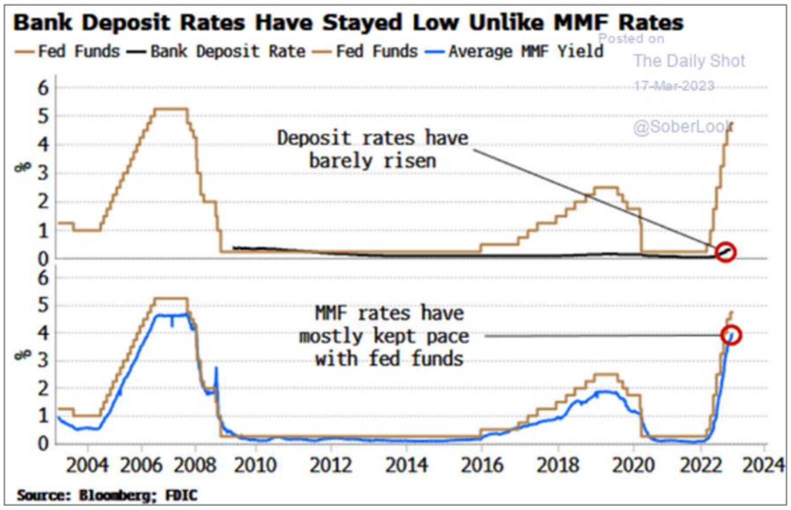
Source: JPMAM, Q4 2022. All calculations based on 10-K reports

Well, we suppose the problem isn't always obvious. While these long-term assets decline in value in the real world, by and large their values don't need to be marked down in the accounting world nor in the more important regulatory capital world. Thus, even a bank that would be insolvent if its declining assets were marked-to-market can continue conducting business as usual, so long as no one pays much attention to the declining real-world value of its assets. The excellent chart above at right shows various bank regulatory capital levels as reported (blue dots). It also shows where these capital levels would be if they marked these assets to market[4] (red dots). If everyone pays attention to regulatory capital (blue dots) and ignores the real-world values (red dots), and no one withdraws their money, then maybe the loans all end up paying off (many years hence) and the bank is fine in the end. However, if people instead withdraw their money, then banks must sell assets to generate the cash to return to depositors... and the real-world values start to matter in a big way.

That brings us to the second problem caused by rising interest rates: it becomes more attractive for depositors to place their money outside of their bank. This issue was perfectly illustrated in this very letter last quarter when we exhorted you to take your money out of your bank (where it was probably earning near 0%) and place it in a money market fund at your brokerage where it was likely to earn above 4%[5].

[4] According to information supplied in the banks' own annual reports filed with the SEC.

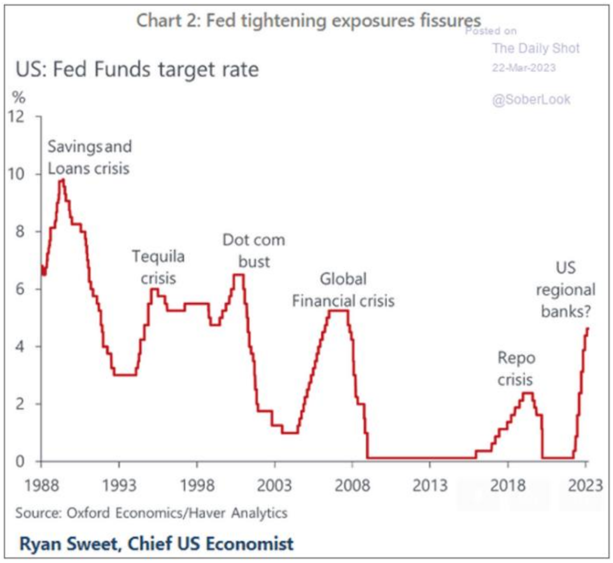
[5] This is still the case and something you ought to do. Call us, we can help you.



The classic bank run is a straightforward problem. No bank, no matter how careful or well-run, can survive all its depositors withdrawing simultaneously without outside help. This is why confidence is so crucial to a bank[6]. However, it's also a problem – albeit a smaller one – when depositors pull their money to seek yield elsewhere. Call it a bank power walk that has been pressuring the entire industry.

This is a system-wide issue caused by higher interest rates, which have simultaneously pushed down the value of banks' long-term assets and sent their deposits fleeing. So, why we are not overly worried? Because an interest rate problem has an interest rate solution: lower rates.

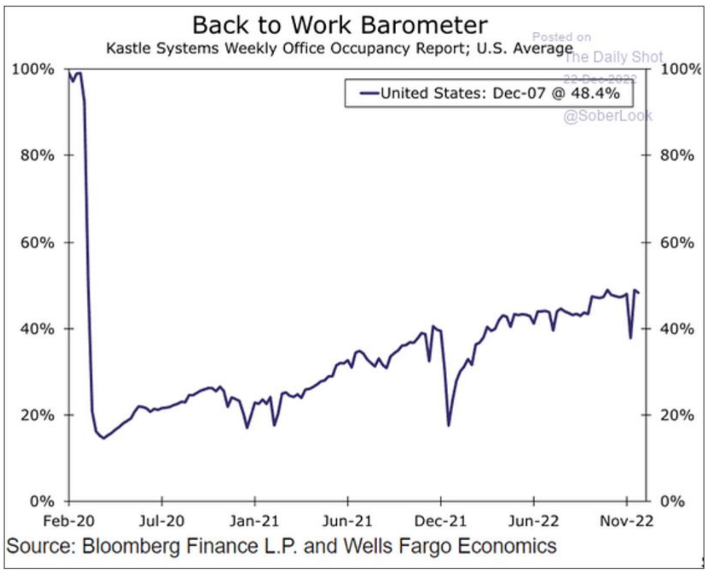
The Federal Reserve could solve the underlying problem with the stroke of a key by lowering interest rates. This is something they could not do during the mortgage crisis, when the value of banks' long-term assets plunged as it became clear that borrowers were unable to pay them back. In fact, the fear induced from this most recent bank crisis has already prompted a bit of self-healing: Investor fear prompted a flight to quality (i.e. to U.S. Treasuries), which lowered long-term interest rates, thereby increasing the value of banks' long-term assets. A real fix, however, would require the Federal Reserve to lower rates, which they are hesitant to do because inflation is still a problem.

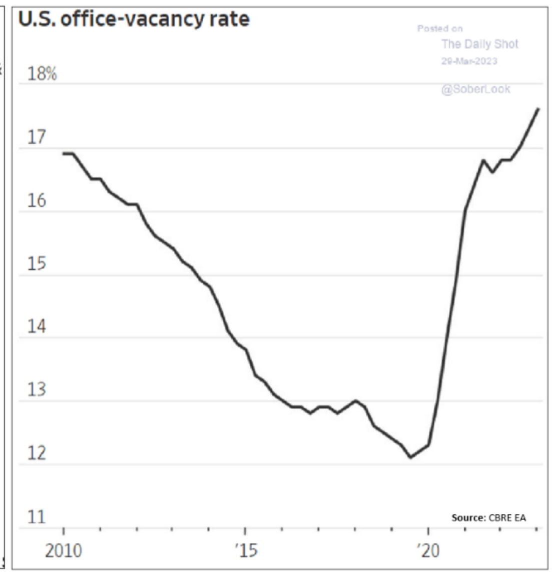


[6] Credit Suisse was mainly sunk by a loss of confidence. It had made so many missteps in recent years, that in the current crisis environment, customers became fearful and started to flee in such large numbers that the bank couldn't survive.

This is not to say that things couldn't get worse. Today, rising interest rates are the proverbial tide going out as mentioned in the opening. We found out a few banks were swimming naked. But what else will we uncover?

We have been wondering whether the next important financial issue will be caused by vacant office space. While the pandemic upended society in many ways, much of our daily life has returned to normal. But not all. The longest-lasting consequence of the pandemic may turn out to be work-from-home in white-collar jobs. A huge number of people have still not returned to work in the office. Perhaps some never will.

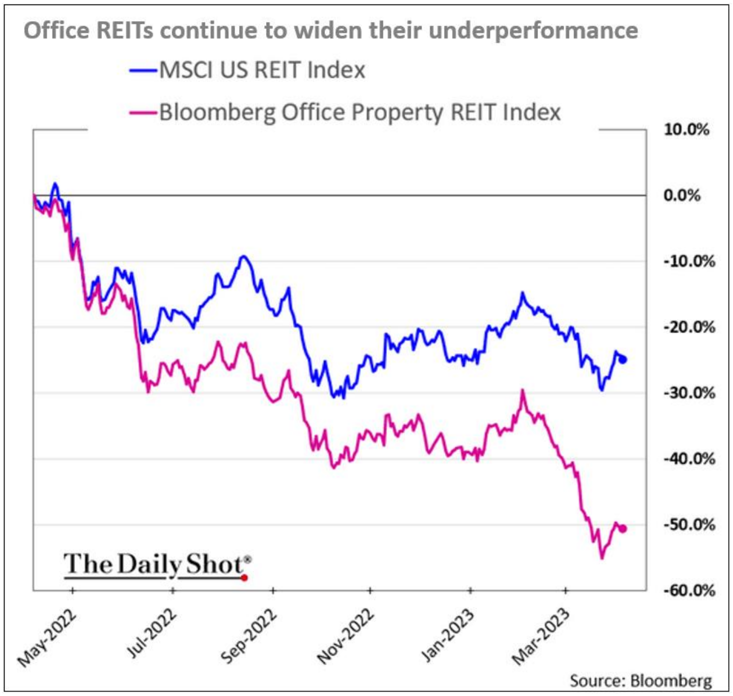


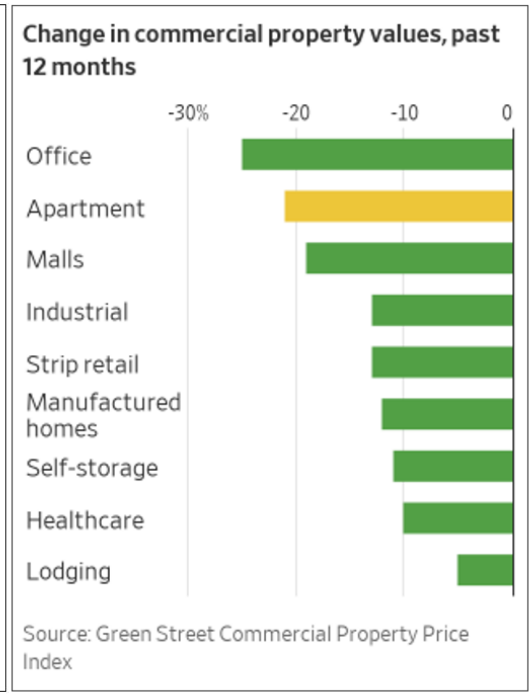


Note the huge difference in the charts above between the back-to-work barometer at 50% and the office space vacancy rate at 18%. The need for space has gone down but many companies are still locked into the long-term office leases they signed pre-pandemic. Empty or sparsely populated office buildings are not considered vacant so long as the tenant is still paying the lease. What happens as those leases expire over the next few years?

While publicly traded office REITs are down 50% since May 2022 alone, in the private markets this crisis will play out much slower as these leases roll off and companies don't renew for as much space. It is going to be tough times for the owners of office buildings and for the banks that gave those owners mortgages[7].One prominent investment bank has already suggested that office values might decline another 40% from here over the next 2-3 years.

[7] Mortgage REITS, or publicly traded companies that issue debt against property, have also been beat up in the market. We think that this is an interesting place to look for value, as long as said REIT isn't dominated by office-related investments.





With all this cheery talk about bank risk and people worried about their bank deposits, this might be a good time to discuss the safety of your brokerage accounts. (Spoiler alert: they are by their nature inherently much safer.)

First, default cash left in your brokerage account is often just like cash at a bank because many brokerages have banks inside them. This cash earns little interest and is used by the bank inside your brokerage to buy securities and make loans. It is protected by the FDIC up to the amount of $250,000 per depositor. (Though in the recent cases of failed Silicon Valley and Signature Banks, the Federal Reserve decided to protect the funds of all depositors no matter how large, and they might be expected to do so again in the future.)

For your accounts managed by Knightsbridge, we do not leave your cash in the default option but instead buy money market mutual funds[8]. When we buy a money market mutual fund for you, you still have daily access to your cash, but you earn more interest. In addition, the money market fund is not like a bank account, but rather is a security (like a stock, bond, or regular mutual fund).

Securities held in a brokerage account are different from cash held at a bank and are protected in a very important way that has little do to

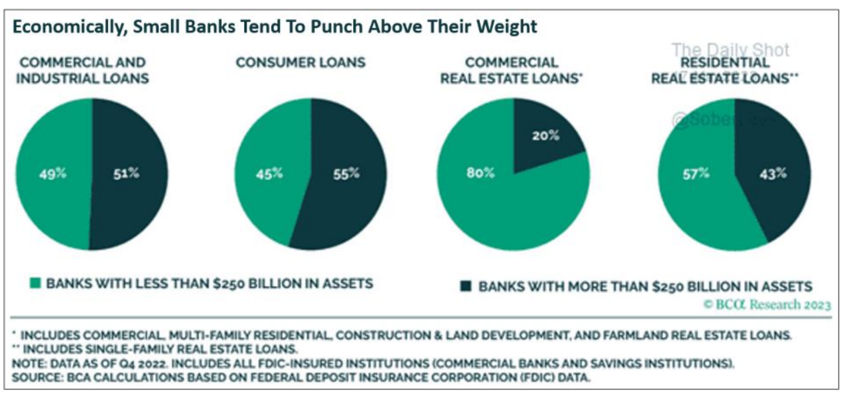
[8] We have a monthly process by which we look across the various money market fund options available to you, and after taking your state of domicile and estimated tax bracket into account, we choose the best one and put your money there. During the banking crisis, out of an abundance of caution we moved to a money market fund only investing in the safest government securities, a process we are now about to reverse as it appears unnecessary.

with insurance. When you put money in a bank, the bank typically lends it out or does something else with it. When you buy a security in a brokerage account – the security just sits there. The most important implication is that if your bank goes bust, your money may not be there for you. However, in the extremely unlikely scenario where your brokerage goes bankrupt, your securities *will* be there[9]. Any creditor of said brokerage is not allowed to claim your securities, they must be delivered to you.

The fact that a brokerage must keep your securities on-hand has another important implication: there's no such thing as a brokerage run. The securities are always there for you to take out if you want to and it's not a problem if you do.

Back to the banking crisis, there is a silver lining that we alluded to in the beginning - it will reduce inflation. Here's how that works:

Banks are now scared. Particularly the smaller regional banks who are more at risk and will need to appear strong so no one gets nervous and starts a bank run. In response, they will pull back on lending so they have as much cash on hand as possible to meet potential withdrawal requests. Indeed, the week ending March 29th saw the largest decline in U.S. banking system loans ever. Pulling back on lending lowers spending in the economy[10]. Recalling that inflation is the ratio of spending to production capacity, this will lower inflation. The banking crisis, limited as it was, will have the economy-slowing power of a few rate hikes.



The Federal Reserve knows this and will likely curtail their interest rate hikes sooner than was previously expected. The reverberation of

[9] If for some crazy reason the securities aren't there, then there is a government insurance program called SIPC which will be there to reimburse you. This insurance covers up to $500,000 in securities value per investor and account type. Do not worry if your account is larger than $500,000. This SIPC protection is completely secondary to structural protection provided as described above. It is unlikely that SIPC will ever be used by anyone reading these words.

[10] In a large financial crisis, as in 2008, the banks pull back so much that the economy falls into recession.

Silicon Valley Bank's lightning failure has been felt throughout the interest rate world, as illustrated in the four charts below.

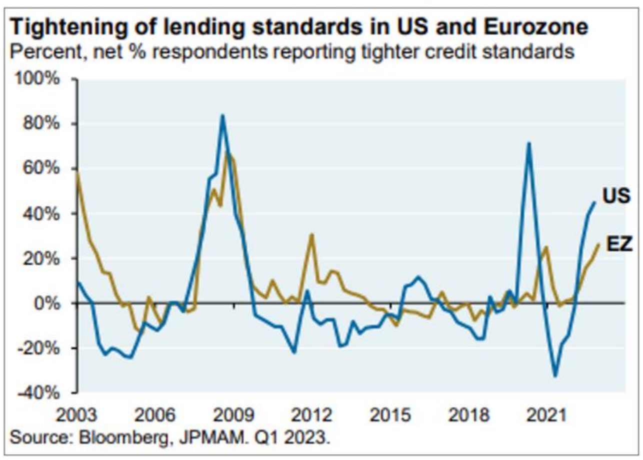
Going clockwise from the top left:

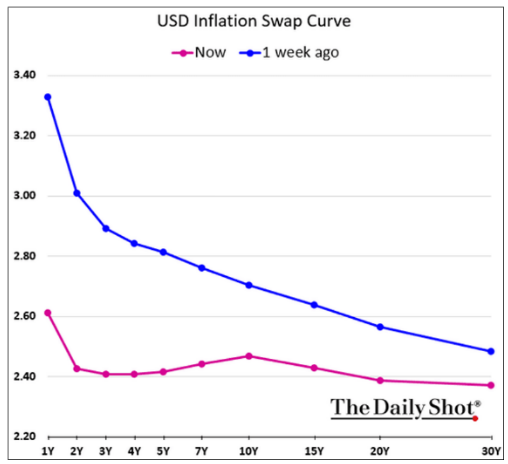
1. The banking crisis has already acted to tighten bank lending standards meaning fewer future loans.

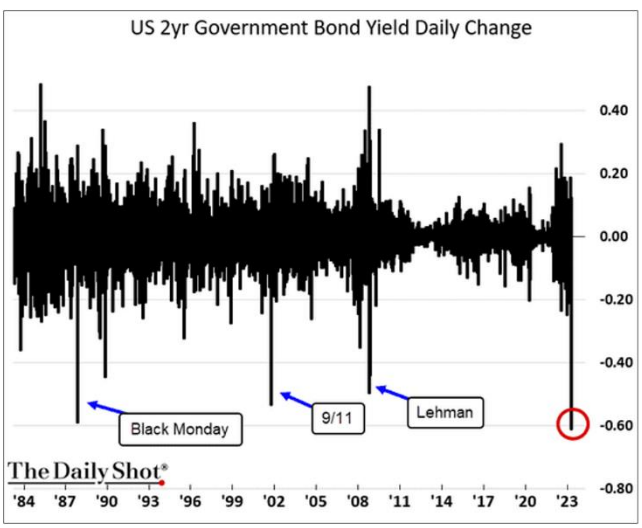
2. The banks pulling back will lower inflation going forward. This is reflected by massive changes in inflation swaps, which is the market's estimate of what inflation will be going forward.

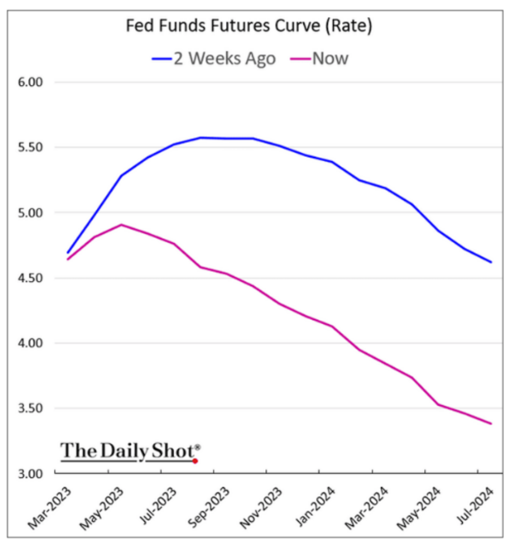
3. Because less inflation is likely going forward, there is less need for the Fed to further tighten things by raising interest rates. Shown here are the market's recalibrated expectations for inflation over the next few years[11].

4. This seismic recalibration of rate expectations was reflected in a massive one day drop in the two-year government bond yield. A change this large hasn't been seen since Black Monday in 1987.









[11] This new path is more in line with what we wrote last quarter that we expect the Federal Reserve to potentially be lowering interest rates by the end of 2023.

It has been a jarring quarter, but not a terrible one. As we have written, plunging stock market values last year have already set the foundation for reasonable returns going forward. Despite the banking turmoil, the S&P 500 had a positive return in the first quarter. The economy is waking up from its 10-year fever dream of near-zero interest rates and is expected to have some aches and pains to work through on its much-needed path to sobriety[12]. Though the path forward may continue to be choppy, we think it quite possible that the stock market won't drop beneath its 2022 low again this cycle.

Thank you for the continued trust you place in us.

Sincerely,

John Prichard

John G. Prichard

Miles E. Yourman

Miles E. Yourman

Kurt Beimfohr

Jeff Vieth

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[12] To stick with our metaphor, we think a mild hangover in the form of a recession is likely in 2023.