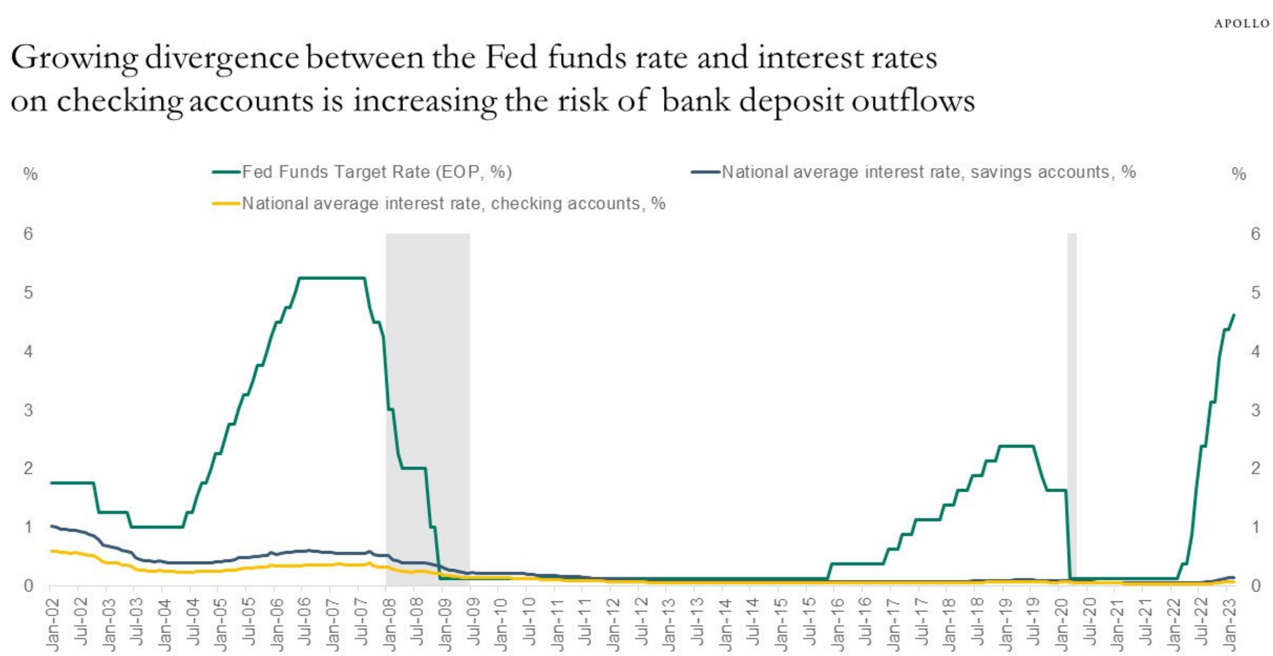
March Madness

As the sporting world gears up for the 2023 college men's basketball Final Four, we wanted to share an astounding statistic. From NCAA.com (emphasis added):[1]

> The Final Four is set and 2023 might be the maddest of any March Madness yet. Three teams are making their first Final Four appearance ever and no No. 1, No. 2 or No. 3 seeds made the Final Four. It's safe to say this year's Final Four was unpredictable, yet six brackets in our Men's Bracket Challenge Game defied the odds and picked all four Final Four teams correctly. **Only about 1 in every 600,000 brackets predicted the Final Four correctly** in the Men's Bracket Challenge Game.

Given the last few weeks of stress in the US and European banking systems and continued uncertainty as to the trajectory of monetary policy and the economy, about 1 in 600,000 also seems like the odds that the S&P 500 would be flat for the month (currently up 0.07% as of mid-day on March 28).[2] March Madness, indeed.

By now, we assume you are aware of the fall of several US banks – Silicon Valley Bank – being the most notable, and the subsequent federal intervention to solidify the banking system. Rather than detail the specifics, we thought it would be helpful to provide a broad overview of the main issue facing banks. Below is a chart depicting the average interest rates on bank checking and savings accounts relative to the Federal Reserve's policy rate (or Fed Funds Rate),[3] which has an outsized influence on money market fund rates and short-term Treasury rates. With banks offering close to 0% on deposits, a lot of money has migrated out of the banking system and into short-term cash-like holdings such as 0–1-year Treasuries and money market funds. Likewise, a number of clients transferred in bank deposits to us, which we can invest in Treasuries or FDIC-insured certificates of deposits (CDs) currently yielding 5%.



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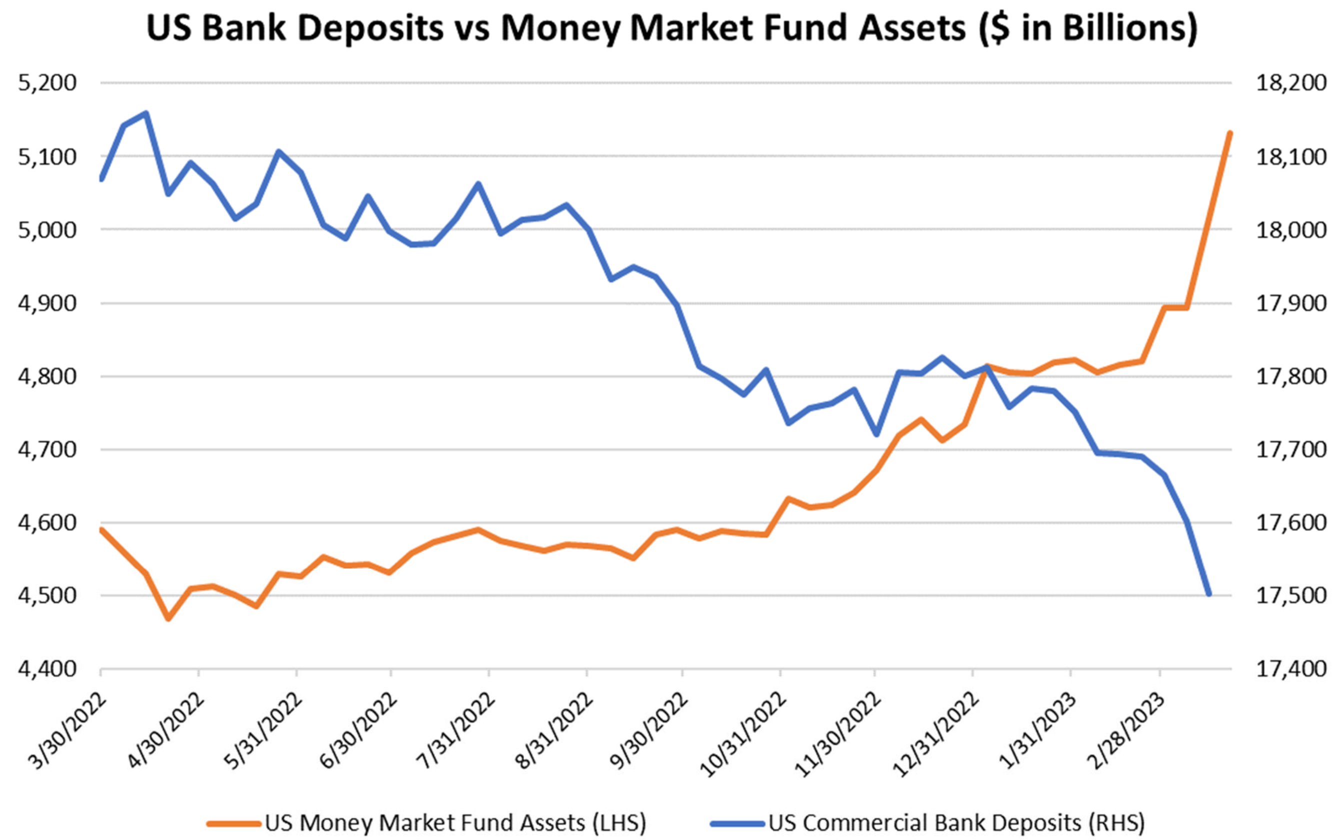
Considering this rate discrepancy, it's no wonder that hundreds of billions of dollars have flowed out of bank deposits and into holdings like money market funds. This was happening even prior to the banking system stress which started several weeks ago.



While we think most banks will ultimately be fine – especially the large ones that are deemed systemically important – bank profitability may decline as they need to raise the amount they pay depositors in order to retain assets. Further, if banks poorly managed their interest rate risk (like Silicon Valley Bank) by investing deposits in long-duration fixed income securities at low yields (and not hedging), then they may face additional pressure if they need to sell those securities at a loss in order to fund depositor withdrawals. Given the new federal lending program to backstop bank assets (under which banks can borrow against their fixed income holdings at par value, rather than market value), this risk is not as severe as a few weeks ago.

In any event, the banking system stress (while not permanent) is likely to lead to both more regulation and near-term hesitancy to take on additional risk – meaning that banks will tighten lending standards,[4] making credit less available on the margin. As the charts on the following page show, lending standards were already tightening just prior to the Silicon Valley Bank blowup.

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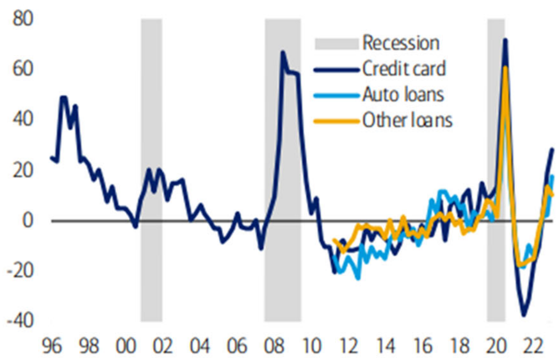
March 28, 2023

Exhibit 2: Net percent of banks reporting tighter standards for consumer loans (%)
Banks have also tightened standards on all forms of consumer lending



Source: Federal Reserve, Haver Analytics, BofA Global Research

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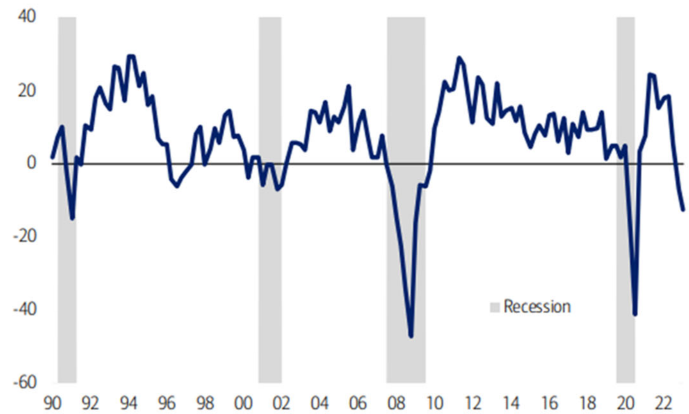
Exhibit 3: Banks willingness to lend to consumers (%)
Net percent of banks reporting increased willingness to lend to consumers



Source: Federal Reserve, Haver Analytics, BofA Global Research

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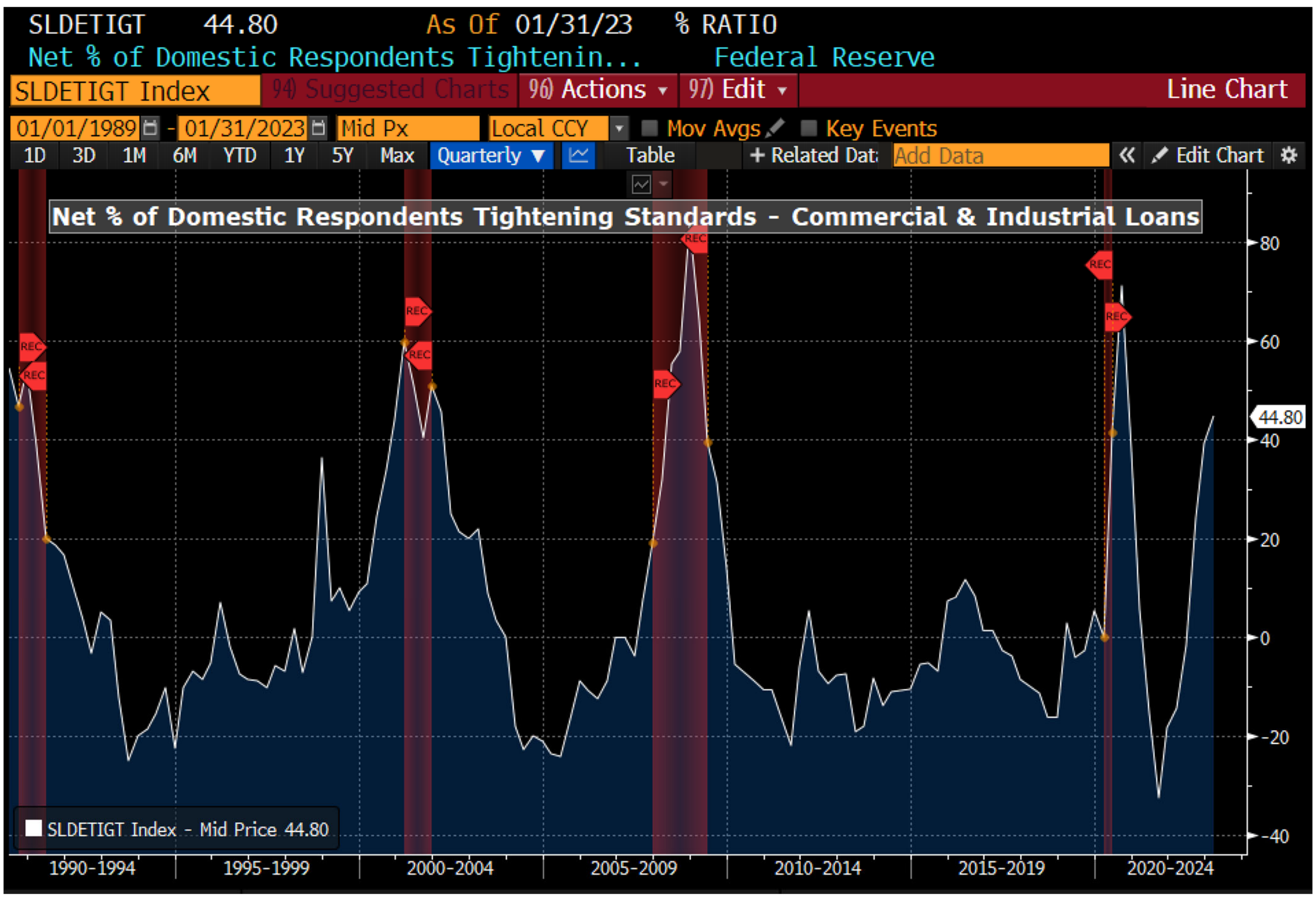
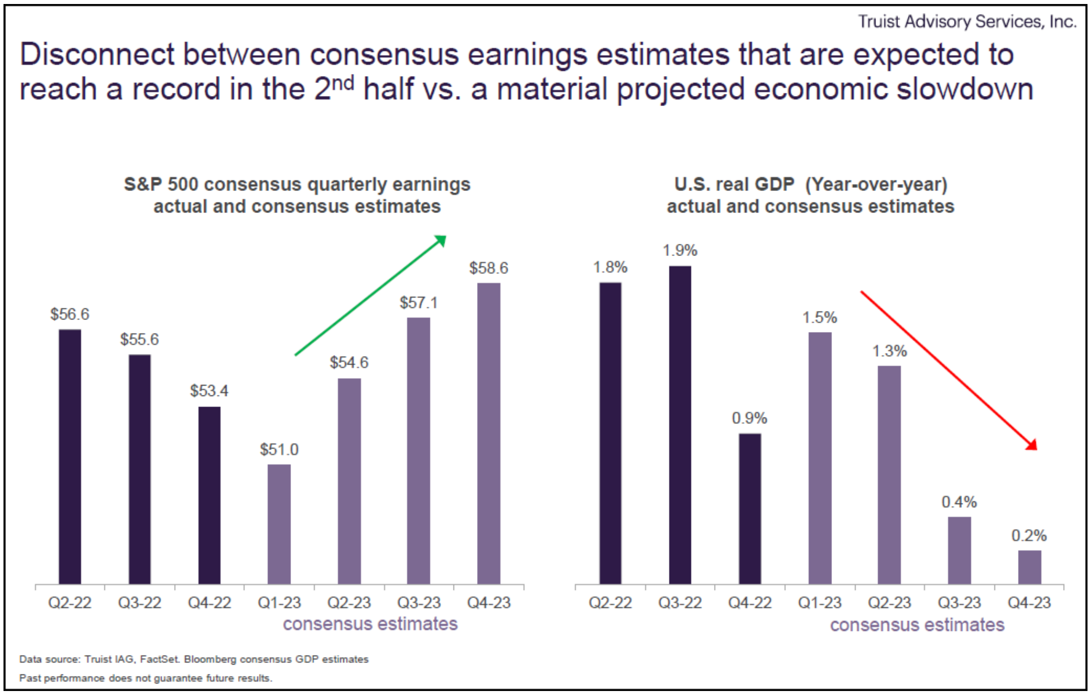
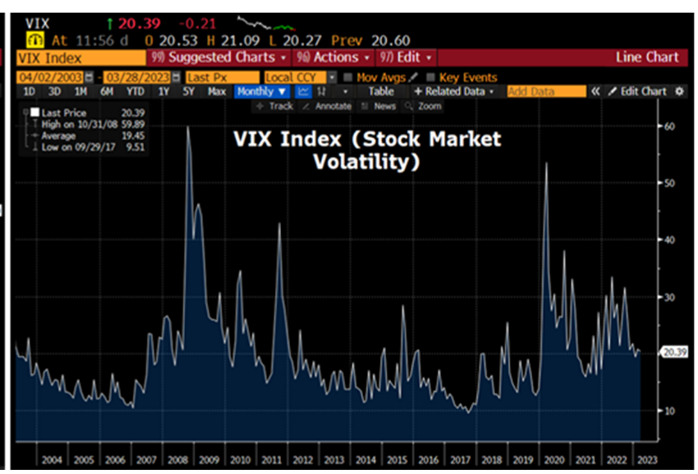


At some point, tightening lending standards are likely to slow the economy, as credit becomes harder to come by. We think a few things are notable for now. One, that despite expectations for the economy slowing, analyst estimates for US company earnings are increasing again for firms in the S&P 500 Index.[5]



We think the reason for this might be that large companies are mostly self-sufficient when it comes to financing and are not overly reliant on credit to make investments. If we look at how the S&P 500 has compared to smaller firms (by market cap) which are more reliant on external financing, we can see those indices pricing in some degree of funding stress. Whereas the S&P 500 is up 3% to start the year and the tech-heavy Nasdaq 100 is up over 14% to start the year, the Russell 2000 Index of small cap firms is down 0.5% and the Russell Microcap Index is down by 5%.

Another anomaly is that the volatility of fixed income markets is higher than at any point since the 2007-8 financial crisis; whereas the volatility of the S&P 500 is relatively low.



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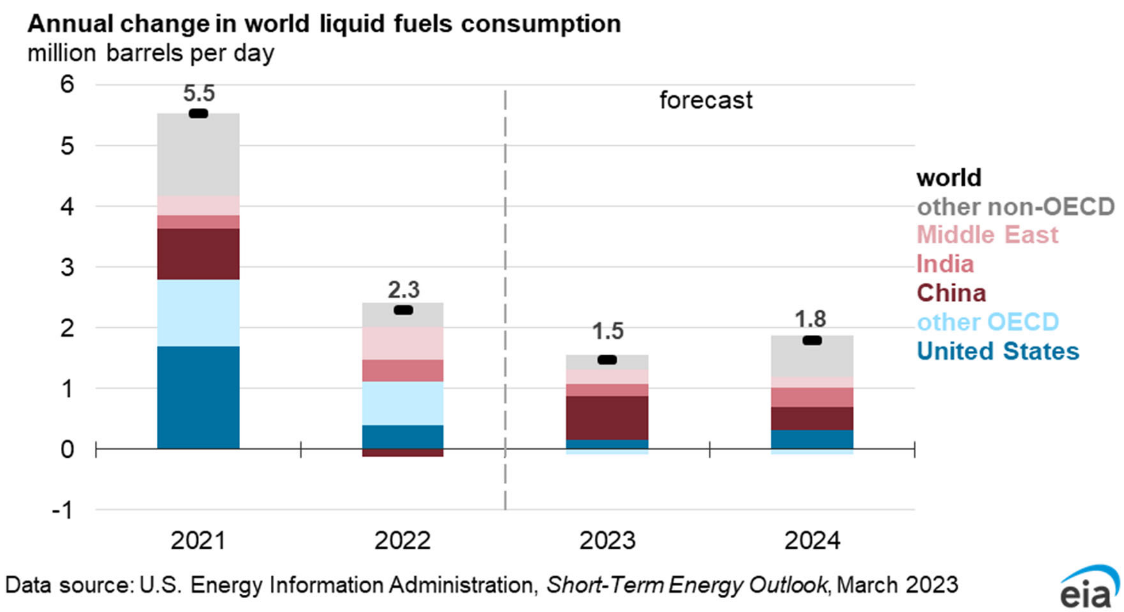
We're not surprised by the elevated bond market volatility given the extreme moves in Treasuries in the wake of this month's banking stress, as well as uncertainty as whether the Federal Reserve will continue its rate hiking cycle much longer. It is unusual, though, for stocks to hold up in the face of such extreme moves in fixed income. While many economists continue to anticipate a recession at some point this year, the fact that stocks have barely budged in the face of the worst banking stress in 15 years and extreme moves in bonds is perhaps sending a signal that for large U.S. firms that are well capitalized and not reliant on borrowing, the outlook isn't so bad.

That brings us to positioning. We still think that short-term Treasuries or even CDs offer attractive, low risk returns. The benefit of owning them is that you can get paid (at rates of 4-5% today) while waiting to see how the economy and broader stock market unfold in the coming months.

In the equities space, we think the correction in commodities markets has created a buying opportunity in conventional energy production firms – as well as the midstream pipeline companies. Global consumption of oil ended last year at 99.4 million barrels per day and is still expected to grow over the coming years (per the U.S. EIA). Supplies remain tight – largely in balance with demand and are expected to grow at a slightly lower rate.[6]



Following up on our January letter, the pace of advancement in artificial intelligence is gaining momentum with OpenAI's release of GPT-4 and Google's release of its similar Bard large language model. Below we have included a segment of Bill Gate's March 21st letter on artificial intelligence, entitled **"The Age of AI has begun"** (available at link).[7] AI is seemingly advancing at an exponential rate. This will have broad implications not just only for the world of technology, but for all firms and people. We continue to think that investments in technology firms that are either creating this new computing paradigm (such as the large cap tech firms) or that will benefit from it (such as semiconductor firms) make sense – with the caveat, of course that valuations still matter!

Microsoft

The Transcript
Weekly Quotes From Earnings Calls

In my lifetime, I've seen two demonstrations of technology that struck me as revolutionary. The first time was in 1980, when I was introduced to a graphical user interface—the forerunner of every modern operating system, including Windows...The second big surprise came just last year. I'd been meeting with the team from OpenAI since 2016 and was impressed by their steady progress. In mid-2022, I was so excited about their work that I gave them a challenge: train an artificial intelligence to pass an Advanced Placement biology exam. Make it capable of answering questions that it hasn't been specifically trained for. (I picked AP Bio because the test is more than a simple regurgitation of scientific facts—it asks you to think critically about biology.) If you can do that, I said, then you'll have made a true breakthrough. I thought the challenge would keep them busy for two or three years. They finished it in just a few months. In September, when I met with them again, I watched in awe as they asked GPT, their AI model, 60 multiple-choice questions from the AP Bio exam—and it got 59 of them right. Then it wrote outstanding answers to six open-ended questions from the exam. We had an outside expert score the test, and GPT got a 5—the highest possible score, and the equivalent to getting an A or A+ in a college-level biology course. Once it had aced the test, we asked it a non-scientific question: "What do you say to a father with a sick child?" It wrote a thoughtful answer that was probably better than most of us in the room would have given. The whole experience was stunning. I knew I had just seen the most important advance in technology since the graphical user interface....**The development of AI is as fundamental as the creation of the microprocessor, the personal computer, the Internet, and the mobile phone. It will change the way people work, learn, travel, get health care, and communicate with each other. Entire industries will reorient around it. Businesses will distinguish themselves by how well they use it.I'm lucky to have been involved with the PC revolution and the Internet revolution. I'm just as excited about this moment.**

Microsoft Co-Founder Bill Gates

When someone with the technology pedigree of Bill Gates says that new developments in AI are revolutionary – "as fundamental as the creation of the microprocessor, the personal computer, and the mobile phone" – we think it's worth taking seriously. The business, economic and social implications from AI will be profound and wide-ranging. We are confident it will be a topic we return to in future correspondence.

As always, please reach out if you would like to discuss your portfolio and any of the ideas in this month's letter. We hope you and your families are all well.

Sincerely,

Peter Karmin
Managing Member

Stuart Loren
Director

Citations and Disclosures

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[1] See: https://www.ncaa.com/news/basketball-men/article/2023-03-26/heres-how-6-people-somehow-predicted-every-final-four-team-correctly (March 26, 2023).
[2] Bloomberg (as of March 28, 2023). All data herein sourced from Bloomberg unless otherwise cited.
[3] Torsten Slok, Apollo (March 25, 2023), available at: https://apolloacademy.com/the-daily-spark/
[4] Bank of America Global Research (March 21, 2023); Bloomberg.
[5] Truist (March 28, 2023).
[6] U.S. Energy Information Administration, Short-Term Energy Outlook (March 7, 2023), available at: https://www.eia.gov/outlooks/steo/report/global_oil.php

[7] Bill Gates, The Age of AI has begun (March 21, 2023), available at: https://www.gatesnotes.com/The-Age-of-AI-Has-Begun; The Transcript.

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