Opus CAPITAL MANAGEMENT

Nobody Wants to be the Screwup

Quick Look

- Positive returns aside, this quarter will be remembered for the collapses of Silicon Valley Bank and Signature Bank, the two largest U.S. bank failures since 2008.
- This current banking scare may continue to unfold in the coming months, but for now, it does not resemble the intricate toxic asset-counterparty-contagion soup of the Great Financial Crisis.
- For many industries, the move from a decade of easy money into a higher interest rate environment has presented its challenges.
- In short order, the Fed has created an emergency lending program for banks, while the U.S. Treasury has backstopped all uninsured deposits at the shuttered banks.
- Inflation isn't yet defeated, but things are now breaking. Recent activity suggests the market is betting the Fed's terminal rate has finally been reached.
- COVID-era policy may be yesterday's news, but it's impact on the economy is not. A recession is widely anticipated, and the events of the past month likely will hasten its arrival. Eventually, a higher interest rate environment should work to the benefit of savers.
- Rather than a 2008 redux of systemic nature, the most recent bank failures seem more attributable to events that occur during the end of economic cycles, or as Warren Buffett puts it, "when the tide goes out".

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About Opus Capital Management

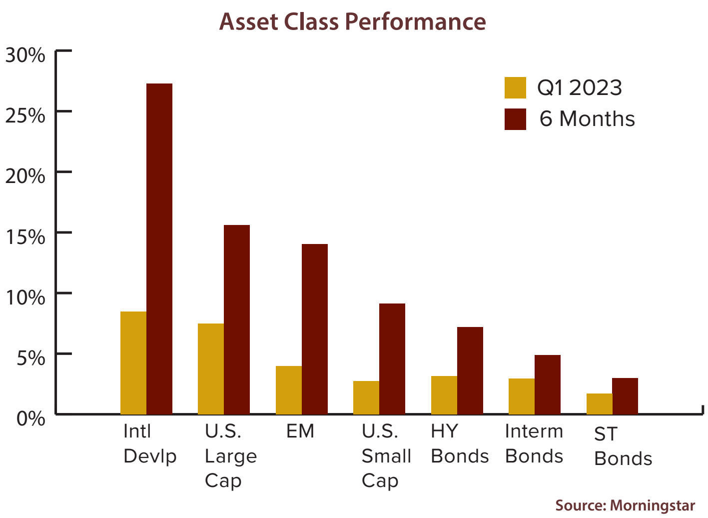
Opus Capital is an evidenced-based investment advisory firm driven by our overriding mission to help people. We believe the marriage of comprehensive financial planning + statistically proven investment principles creates the clearest roadmap to long-term success.

We are independent and transparent in all aspects of investment management decision making and financial planning. We selectively partner with like-minded individuals and families, endowments, foundations, and 401(k) plans in over 30 states.

Quarterly Investment Letter, Q1 2023

Prior to launching Opus, our co-Founder Len Haussler served as the Certified Cash Manager for a Fortune 500 company in the early 1990s. As Len puts it, managing cash is about managing downside, a thankless job. One can be tempted to reach for yield, but nobody remembers a small amount of extra income earned. At the end of the day, they only remember the screwups.

The pendulum of investor psychology has quickly swung from one extreme to the other. Two years ago, we saw a euphoric market which favored "disruption" over profitability and was bolstered by first-time investors who Yolo'd into cryptos, SPACs, and meme stocks. The only perceived risk was the fear of missing out. But that was back in the zero-rate days. Now that the risk-free rate is 5%, money market funds, CDs, and U.S. Treasurys are the cat's meow, and even those have the investing populace questioning the risk inherent within safe assets. The current psychology is undoubtedly more fearful than it is greedy, as nobody wants to be the screwup.



Given the current level of pessimism, one might be surprised to know that U.S. stocks gained 7.5% this quarter and are up 16% over the last six months. Developed International stocks have surged 27% since the end of September 2022. U.S. Bonds have gained 5% in the past six months, and this quarter's 3% gain represents the best quarterly return for the asset class since the onset of COVID. It's too early to tell if the gains of the past six months are lasting; current sentiment seems dubious, but it is worth noting that bull markets are born when only a few believe things will get better. Markets lead macroeconomics.

Positive returns aside, this quarter will be remembered for the collapses of Silicon Valley Bank (SVB) and Signature Bank, the two largest U.S. bank failures since 2008. Congratulations if you had "Banking Crisis" in your March Madness pool, which entered the tourney a #5 seed, at best, upsetting heavy favorites "Geopolitical Risks", "Debt Ceiling", and "Inflation Spiral" in the 2023 Tail-Risk Championship. For any investor over age 40, "banking crisis" is sure to trigger a bit of reflux, as certainly, nobody is looking for a replay of 2008. This current banking scare may continue to unfold in the coming months, but for now, it does not resemble the intricate toxic asset-counterparty-contagion soup of the Great Financial Crisis. Not that it can't evolve, but at present, this one is more of an old fashioned, black-and-white scare dealing with bank runs and liquidity issues.

SVB and Signature were, by all accounts, outliers within the banking industry whose concentrated exposure to the tech sector and cryptocurrency precipitated their downfall. In SVB's case, the bank saw an astounding tripling of their total deposits during COVID, nearly all of which came from the venture capital industry. Despite the paucity of these deposits being neither insured nor from stickier retail, SVB invested these deposits into long-maturity bonds, reaching for yield while disregarding the associated interest rate risk. The surge in interest rates in year 2022 caused these bond investments to lose value, while at the same, their struggling tech startup deposit base started to burn through their cash. Once SVB's closely-knit depositor base caught wind (mostly via Twitter) of the bank's balance sheet issues, they collectively pulled a staggering $42 billion out of the bank in a single day, representing 25% of the bank's deposits, thus making SVB a classic bank run (minus the inconvenience of long lines at the teller window).

SVB's demise was a shocking news story, and coupled with the scars of 15 years ago, sent all bank shares lower on concerns the entire financial system could be at risk. For many industries, the transition from a decade of easy money into a higher interest rate environment has presented its challenges.

U.S. EQUITY RETURNS (%)

As of 3/31/2023	Q1 2023	1-Year	3-Year	5-Year	10-Year
S&P 500	7.5	-7.7	18.6	11.2	12.2
Russell 1000 (Large Cap) Growth	14.4	-10.9	18.6	13.7	14.6
Russell 1000 (Large Cap) Value	1.0	-5.9	17.9	7.5	9.1
Russell 2000	2.7	-11.6	17.5	4.7	8.0
Russell 2000 (Small Cap) Growth	6.1	-10.6	13.4	4.3	8.5
Russell 2000 (Small Cap) Value	-0.7	-13.0	21.0	4.6	7.2

Source: Morningstar

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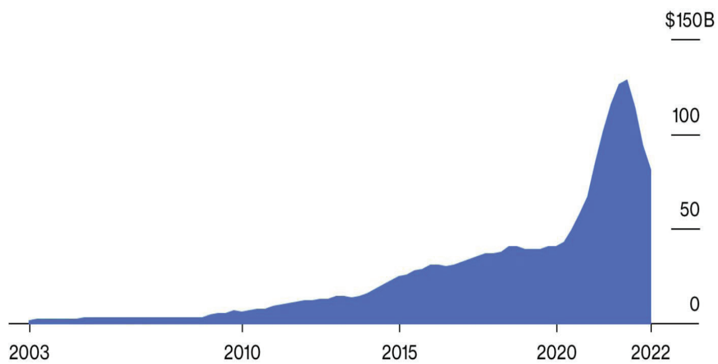
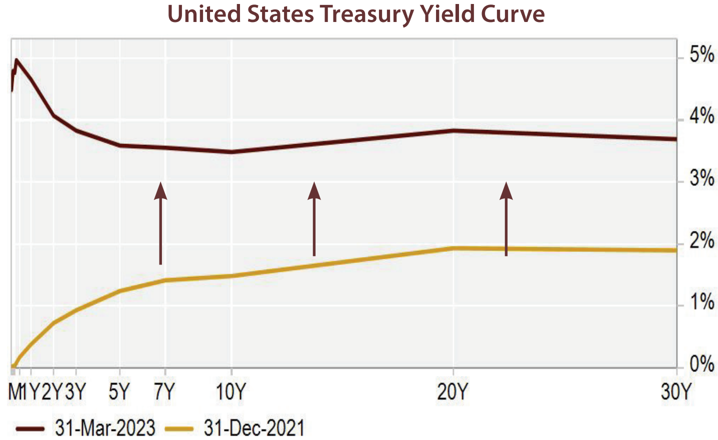
SVB's Deposits: Rose with Tech Boom, Fell as Startups Struggled



Source: Bloomberg

Understanding these challenges requires a quick primer on banking, which is hard not to make boring, because banking is boring. The core of bank business is the interest rate spread between deposits and loans. Banks take in deposits and, after setting aside a reserve, use those deposits to make loans or buy U.S. government bonds. These loans, bonds, and reserves are the bank's assets, whereas customer deposits are their liabilities. Before things got so complex, banking was built on the 3/6/3 Rule; 3% on deposits, 6% on loans, and 3 pm tee times.

United States Treasury Yield Curve

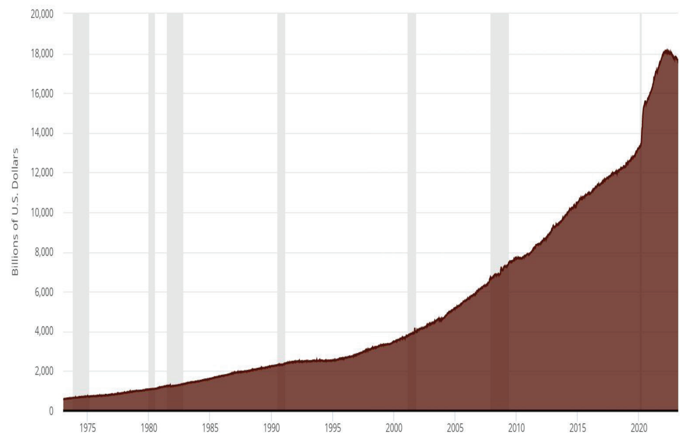


Source: Factset

The bank business model relies on an upward sloping yield curve. Over the past year, the curve's shape shift has been problematic for banks on two fronts. First, the curve's inversion wrecks bank profitability; paying deposits at a rate higher than loans is really bad for business. Second, the curve shift higher across all maturities discounts the value of bank's existing bond assets. Long-maturity Treasurys and mortgage-backed securities are credit-safe assets, backed by the U.S. Treasury or government agency, but are susceptible to interest rate risk. If held to maturity, there is no price risk. Issues arise, however, if the bank needs to sell these assets before their maturity dates. Once they become "available for sale", they are valued against prevailing interest rates. A 10-Year Treasury with a 1% coupon is not as valuable as a newly-issued 10-Year Treasury paying 4%, and thus the 1% UST will be sold at a discount.

The pandemic saw bank deposits grow at an unprecedented pace, exceeding 20% for several quarters. The majority of the growth came from household deposit growth, boosted by fiscal stimulus and reduced spending. During 2020-2021, banks took in a whopping $5.5 trillion in deposits, and, in turn, used those deposits to purchase $2 trillion of sub-2% coupon Treasurys and MBS. While small and community banks saw some deposit growth, the lion's share of deposits went to the largest banks.

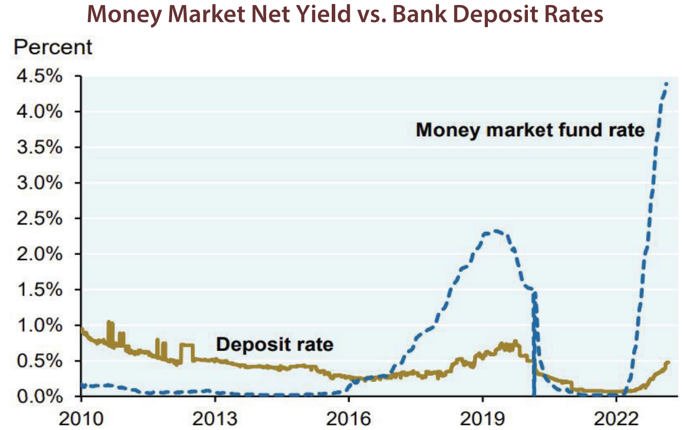
Deposits: All Commercial Banks



Source: Federal Reserve

Total deposits peaked in April 2022; over the past year, total deposits have declined by 3%. While this doesn't seem like much, it is the largest annual decline in at least 50 years. As you can see in the above chart, bank deposits have continually grown since time immemorial. This is the first visible downturn. Some of the decline in deposits can be attributed to higher spending needs from inflationary pressures. Some is working off excess savings and/or returning to pre-COVID spending levels. And quite a bit of it is cash moving out in search of higher interest found in money market funds. When the Fed Funds were zero, it meant cash was zero. But while the Fed has briskly raised the funds rate, banks have largely kept deposit rates at zero while money market yields have skyrocketed.

Money Market Net Yield vs. Bank Deposit Rates



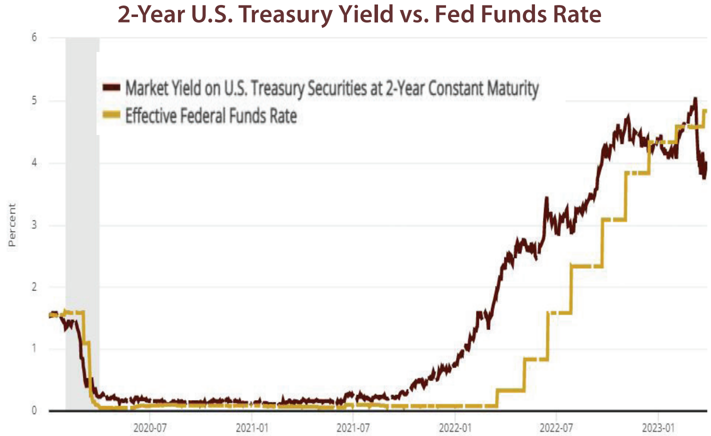
Source: Bloomberg, JP Morgan

Like what the pandemic did for technology (videoconferencing, e-commerce, etc.), SVB's bank run seems to be the seminal event that rapidly accelerated a slowly moving inevitability. Bank clients who had been slow to demand higher returns on cash (zombied from 15 years of mostly zero-rate policy) have suddenly been awakened at the opportunities in cash, and money is in motion. In the three weeks since SVB's collapse, the Federal Reserve estimates that large banks have gained $120 billion, while small banks lost $109 billion. There is irony in that the eight U.S. Global Systemically Important Banks are now perceived as providing a higher degree of safety because they are, in fact, too big to fail.

Unlike the dawdling that occurred during 2008, both the Federal Reserve and U.S. Treasury have acted swiftly to ensure there is a backstop to depositors and to provide liquidity. The Fed has created an emergency lending program for banks, while the U.S. Treasury has backstopped all uninsured deposits at the shuttered banks. The goal has been to restore confidence in our banking system and stem the tide of potential bank runs on smaller banks while giving them time to hammer out the regulatory details.

The Fed finds itself between a rock and a hard place. After waiting too long to get started, it entered the year with designs of tacking on a couple of more rate hikes to its hyper-drive restrictive policy, but may not get there. For its part, the Fed still enacted a quarter-percent rate increase at their March meeting, but they swapped out their language of forward guidance to the more opaque "additional policy firming may be appropriate". Inflation isn't yet defeated, but things are now breaking.

2-Year U.S. Treasury Yield vs. Fed Funds Rate



Source: Federal Reserve

The 2-Year Treasury is known for leading Fed policy on the way up and down, and its recent activity suggests the market is betting the Fed's terminal rate has finally been reached.

Rather than a 2008 redux of systemic nature, these bank failures seem more attributable to events that occur during the end of economic cycles, or as Warren Buffett puts it, "when the tide goes out".

Monetary tightening typically ends in a recession, and recessions are deflationary forces. Even if the Fed ceases further rate hikes, regional banks will almost certainly reduce lending activity in response to the issues outlined above, which will tighten overall financial conditions further. Banks are now in the limelight, and nobody wants to join the screwups.

COVID and pandemic-era policy may be yesterday's news, but it's still the pig in the python in its impact on the economy. A recession has been widely anticipated, and the events of the past month likely will hasten its arrival. Eventually, a higher interest rate environment should work to the benefit of savers. But the transition away from the decade-plus era of low rates has required an unpleasant adjustment period for both safe and risky asset prices, and the current drawdown is starting to feel a bit long in the tooth. Three considerations for the current environment:

» Take advantage of cash rates. Excess cash levels should be transferred to Treasury-backed money market funds or high-yield savings accounts. Keep bank balances under the $250K FDIC-insurance limit, particularly within community banks.

» Rates on safe assets such as Treasurys and CDs are as attractive as they have been in years. The high correlation between safe assets and risky assets that was prevalent in 2022 seems to be dissipating. Treasurys rallied last month as a flight to safety.

» For long-term investments, this is just the latest crisis until the next one. In the long run, stocks should provide returns in line with the sum of their dividend payments plus the growth in corporate profits. Excessive risk aversion can lead to missed opportunities during periods of uncertainty.

INTERNATIONAL RETURNS (%)

As of 3/31/2023	Q1 2023	1-Year	3-Year	5-Year	10-Year
Int'l Developed ex US	8.5	-1.4	13.0	3.5	5.0
Emerging Markets	4.0	-10.7	7.8	-0.9	2.0

Source: Morningstar

FIXED INCOME RETURNS (%)

As of 3/31/2023	Q1 2023	1-Year	3-Year	5-Year	10-Year
Aggregate Bond	3.0	-4.8	-2.8	0.9	1.4
Muni	2.3	-0.3	0.4	1.6	1.8
Int'l Bonds	2.6	-6.7	-1.5	-1.6	-0.5
High-Yield	3.2	-3.6	5.6	2.5	3.2
Short-Term	1.7	-0.7	0.9	1.3	1.2
90-Day T-Bill	1.2	3.3	1.2	1.5	0.9

Source: Morningstar

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