# Mischief Managed

**John M. Gustafson – 30 March 2023**

*"You cannot escape the responsibility of tomorrow by evading it today." - Abraham Lincoln*

With all the focus currently on the banking industry across the globe, which I'll get into in a moment, in my opinion, the greatest economic danger still hanging over all our heads is Congress dealing with America's self-imposed "debt-limit." To make things crystal clear before any politics gets in the way – Congress has already spent this money and are now simply arguing about how / when / if we should pay it back. This is completely insane nonsense with dire consequences.

When you "negotiate" which of your debts you will pay, that is called bankruptcy and if there is even a whiff of doubt as to whether the U.S. will pay debts in full and on time, we might as well pack things up and move on. That is the very definition of banana republic nonsense.

Do I think even the Freedom (chaos) caucus in Washington is dumb enough to let that go too far toward the edge of the cliff? I don't believe they will, but as indicated in previous notes, we are currently ruled by the tyranny of the minority in Congress and only a few of them together can certainly cause trouble. And if we didn't believe it previously, these last few years have truly proven that the only actual goal of those currently in D.C. is to *remain* in D.C. That requires constantly raising money via small-dollar donations from those least likely to be able to afford those payments – and the way you do it is to tell the stories they want to hear on TV, keep them agitated and on your side and not actually think or talk about what will help the country.

The most frustrating part of all of this isn't just that the debt ceiling is a strange, self-imposed limit (that we NEVER stick to) - it's that nobody in the Capitol ever speaks of reigning in spending until disaster is at the door. (And then they kick the can down the road once again, to a deadline they hope is politically useful to them and not those across the aisle.) Stay tuned and be ready for the storm.

If you recall, the last time we really went to the brink on this issue was the 3rd quarter of 2011 when the Tea Party decided to openly talk about perhaps not honoring our debt with the "full faith and credit" of the U.S. Treasury – the market promptly lost 15% within a couple of weeks until sanity was restored. Apparently, none of the new group of bomb-throwers can remember that period and also foolishly believe they can blame it on the other team. (That didn't work back then and it's unlikely to work now.)

*"How many legs does a dog have if you call his tail a leg? Four. Saying that a tail is a leg doesn't make it a leg." - Abraham Lincoln*

Another ongoing news theme that doesn't exactly line up with reality is the constant news regarding layoffs, right alongside the fact that there remain more open positions in America than there are workers who are unemployed. Most of the announced reductions have been concentrated in technology companies.

Flush with cash with many new companies formed, expanded and re-made during the pandemic, tech companies did what many in their shoes tend to do – they over-expanded and now that capital has become a little more scares and expensive, belt-tightening is on the menu.

And if you look closely at the markets, this is actually helping technology stock shares rise after a dismal performance last year.

*"Character is like a tree and reputation like a shadow. The shadow is what we think of it; the tree is the real thing." - Abraham Lincoln*

It is partially this turn of events in the tech-world that also triggered some agita across the banking industry of late. The damage appears to be segregated within a company that clearly didn't manage risk well and is unlikely to be widespread across the globe. Again, despite what is continually trumpeted in the media, Silicon Valley Bank (SVB) was a bit of a unicorn.

The reality is Silicon Valley Bank had a highly concentrated depositor base who was flush with cash while rates were historically low. Once that changed, so did the metrics of using their deposited funds for general operations versus the cost of continually raising new dollars.

We have mentioned in these notes for years and years that a favorite (and accurate) market quote is, "There has been more money lost throughout history reaching for yield than at the point of a gun." An age-old lesson that SVB failed to heed.

What do I mean by this and why don't I think it will not be more widespread? All banks, not just SVB must invest their deposits either by lending them out or holding bonds to earn some kind of return on their assets. Because of the way banks are regulated, many of these bonds are required to be US Treasuries or in some cases mortgage-backed bonds guaranteed by the government. Since the 2008 crisis put quite a dent in mortgage-backed bonds, the very liquid, very safe alternative are boring old Treasuries, which as well all know, didn't pay much interest for the decade following the great recession.

However, despite all the restrictions on which types of bonds the banks may own, there don't seem to be many requirements as to the duration of those bonds. In other words, how long to maturity for their reserve portfolio. SVB was "reaching for yield" by purchasing longer-maturity Treasuries to pay their depositors more than other banks and didn't need to worry (so they thought) about having longer-term bonds because money was continually flooding in the doors as deal after deal was finding VC & PE funding. (Until it wasn't...)

For a normal bank that isn't as heavily concentrated in one industry, this likely would not matter much. Except in the case of a severe recession – or another pandemic that shuts *everything* down – it is highly unlikely that *ALL* the bank's customers would need their money at the exact same time. Almost the entirety of SVB's customer base was either in some sort of technology business, secured funding for tech companies at different stages of their lives or were the

founders and employees of technology companies and they, like many other sectors of the economy, move as a herd. Boom or bust, they all seem to feel it in a similar manner. A single economic ecosystem more fully integrated than most other sectors of the economy.

*"I do not think much of a man who is not wiser today than he was yesterday." - Abraham Lincoln*

The failure of the SVB's risk managers to hear what the Fed has been telling all of us for well over a year now, *WE ARE GOING TO RAISE RATES UNTIL INFLATION IS UNDER CONTROL* is what sent them down the road to perdition. Had those managers simply begun to adjust their bond holdings to much shorter maturities while the cash was still coming in, they likely could have survived the heavy draws they began to see once rates reached a level where leverage became too expensive for the young companies and it made more sense to tap their savings to operate.

*My dream is of a place and a time where America will once again be seen as the last best hope of earth. - Abraham Lincoln*

The good news portion of this story is that the banking issues have not eliminated the need for the Federal Reserve to continue raising rates, but the cooling of the red hot tech sector via waning confidence is certainly doing some of the work for them. This moderation was seen at the last meeting where rates were raised, but only by 0.25% - 1/2 to 1/3 of what the Fed Governors had been doing regularly over the past year.

Clearly, inflation is alive in our economy in the short term, but the long term is already projecting at a more historically normal rate. You can see this in the 10-year TIPS market. (TIPS = Treasury Inflation Protected Securities) These are Government Bonds that have their interest rate set at the time they are issued via auction but will adjust their principal value at maturity based on what inflation has added or subtracted over their lifetime.

Currently, the TIPS market is predicting inflation will be roughly 2.5% over the next 10 years. Far more historically normal than the extreme lows we experienced for the decade following the 2008 banking contagion as well as the large spike we've recently experienced from the liquidity flood brought on by the pandemic. The market will regress to the mean eventually.

*The shepherd drives the wolf from the sheep's throat, for which the sheep thanks the shepherd as his liberator, while the wolf denounces him for the same act as the destroyer of liberty. Plainly, the sheep and the wolf are not agreed upon a definition of liberty. - Abraham Lincoln*

To wrap things up for the quarter and taking a look ahead we stand by the comments that despite the screaming media themes that fill the airwaves daily, interest rates and inflation are normalizing, the employment outlook in most industries remains strong and the number one risk to our portfolios remains the U.S. Congress and the debt ceiling.

Keep an eye out for a rebalancing of our accounts in the next few weeks. Now that things have calmed down a bit in most sectors, it's a good time to go back and level-set the portfolios to assure things are positioned the way we want to best fit our outlook. No major component changes – simply bringing things back into line for the best potential performance.

We will continue to closely monitor discussion in D.C. but can make no predictions at this point as to how far they will push things before the reasonable folks blink and do what is necessary to avoid disaster. As long as that happens, any volatility should be to the upside once the deal is done, but the longer they push it the more the volume of the negative news will grow and the weight will remain on the averages.

If you are one to occasionally email your representative in Congress, this wouldn't be a bad time to send a note urging them to do the right thing sooner rather than later and not hold everyone economically hostage with their usual grandstanding. As mentioned at the open, this money is already spent – the debt ceiling is merely a self-imposed limit that doesn't mean a thing externally. All political nonsense because clearly neither side has any interest in being fiscally sound.

Thank you, as always, for your business and friendship and never hesitate to reach out if you have questions, comments or just want to catch up on the world.

Cheers!