Eagle Strategies LLC

The Eagle Edge

Quarterly

MARKET & ECONOMIC OUTLOOK

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On the Radar Screen

1. **The recent spate of bank failures is likely to crimp credit growth.** The extent to which banks further tighten lending standards as implied by the Senior Loan Officers Survey and the degree to which growth in the outstanding stock of commercial and industrial loans slows will be indicative of the hit to activity the economy may suffer.
2. **Commercial real estate, particularly office and retail space, is under duress both from higher rates and shifting demand** (work-from-home and e-commerce respectively). Much of the debt carried by these operators sits on the balance sheets of the same mid/small banks that are already under pressure and so may compound the contraction in credit growth.
3. **Too-tight labor markets are forcing the Fed's hand.** A moderate rise in the weekly new unemployment claims data and monthly unemployment rate figure would be welcome when it comes to prospects for cooling inflation.
4. **We are again coming into the thick of earnings reporting season.** Analyst attention will be trained on changes in realized and prospective operating margins.
5. **Credit spreads widened moderately through the recent select bank failures.** Further widening would reflect accumulating stress and portend mounting economic weakness.

Insights from Multi-Asset Solutions' Portfolio Managers

"Experience isn't interesting until it begins to repeat itself — in fact, 'til it does that, it hardly is experience."

– Elizabeth Bowen

Doesn't this just feel a little too familiar? One should be excused for experiencing a sense of déjà vu of late. The recent collapse of SilverGate, Signature and Silicon Valley banks, together with the shotgun marriage of UBS and Credit Suisse, feels more than a little reminiscent of the early days of the Global Financial Crisis we endured a decade and a half ago. Let's be clear that while a GFC-type market and economic collapse is not our base case, let's explore the downside case. The chain of events back then began with the failure of specialty lender New Century Financial in February of '07 followed by JPMorgan's coerced acquisition of Bear Stearns about a year later, culminating with the collapse of Lehman Brothers in the fall of '08 that brought the recession to a crescendo. The root cause of systemic bank failures back then was that the quality of assets on their balance sheets—most notably subprime mortgages—was poor, and impaired assets represented largely unrecoverable losses. The issue today is somewhat different, stemming from interest rate management failures (losses that would otherwise be recoverable over time) and depositor flight (depriving banks of the time that is needed). In that regard, the Savings and Loan crisis of the late '80s might be a better analogue to today's troubles than is the GFC. Regardless of which historical precedent is more fitting, the effect of bank stress on the broader economy is more important than the source of that stress, and in this regard history is daunting.

Credit is as essential to a healthy economy as water and oxygen are to humans. Actions taken by the Fed over the past year in its effort to combat inflation, both "quantitative tightening" and rate hikes, render credit less available and significantly more expensive. The goal is to curb demand

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and slow business activity, thereby relieving upward pressure on consumer prices. This process was well advanced even prior to the emergence of a banking crisis, as evident in the dramatic reduction in home sales, the contraction of manufacturing surveys, and the collapse in corporate profit growth. Monetary policy acting with a lag, as it does, implies that those trends were already likely to become more pronounced in the months and quarters ahead, eventually causing employment to roll over. With their deposit bases feeling vulnerable and their asset portfolios coming under scrutiny, banks are sure to further tighten lending standards, starving borrowers of much needed capital. We've stated in prior notes that we have every expectation that this will ultimately end in recession. New developments imply that may happen sooner than anticipated.

"Everywhere you look there are multiple examples of the kind of lunacy [unconventional monetary] policies have fomented by reducing the cost of capital to virtually zero and forcing investors to take risks they would ordinarily avoid in order to find some kind of return." – Grant Williams. Free money may not have been free after all. The extraordinary policy actions taken over the past fifteen years may have resulted in large scale capital misallocation on the part of investors, overinvestment on the part of businesses, and overconsumption on the part of households. It's too early to say just where the excesses were most egregious, but that's likely to be exposed in the fullness of time. We're reminded of stories we heard during a recent trip to the desert southwest in which the drought has dramatically lowered the water level in Lake Mead, revealing boat wrecks, bodies in barrels, and all manner of other misdeeds. Our strong suspicion is that a similar parallel will play out in financial markets. As the sea of excess liquidity formed by the Fed gradually drains away, the past sins of investors will come to be revealed. Indeed, some have been already. Large losses in profitless technology, digital assets, SPACs and now a handful of regional banks can likely be connected, at least in part, to the tide of liquidity going out. There's more yet to come. Probably much more.

"Experience is a good school. But the fees are high." – Heinrich Heine. Within the group we have more than a few grey hairs. Many of us have been in the investment management business for decades. While our formal education was expensive (fortunately not the $90K/year it costs to attend an ivy league school today), the lessons learned on the job in the years since were arguably more costly still, and they are the ones remembered best. These past experiences leave us leery of the financial landscape we see before us and committed to a conservative posture within our portfolios: we're hoarding cash that can be redeployed when markets become truly dislocated; we're skewing gently away from lower credit quality instruments, particularly full duration high yield bonds; we're modestly underweight equities, and we tilt lightly toward defensive sectors. We're not firm believers in the adage "it's better to be safe than sorry" for we've found in both our professional and personal lives that the opposite is often true, but there are absolutely times when it is prudent to be cautious. We believe now to be one of them. For those of our readers old enough to remember the 1980's police drama series Hill Street Blues, let us leave you with the immortal catchphrase of Sgt Phillip Esterhaus: "Let's be careful out there."

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