Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2019			0.1%	0.3%	4.3%	-4.2%	0.1%	-0.1%	0.9%	-4.1%	7.5%	6.0%	10.5%
2020	-6.2%	-2.0%	2.5%	12.4%	3.6%	-6.6%	19.6%	12.1%	-3.0%	-7.1%	2.1%	11.9%	41.6%
2021	1.1%	3.5%	-0.5%	6.3%	19.5%	-3.2%	4.0%	-5.2%	6.0%	9.9%	-8.1%	-1.4%	33.0%
2022	1.5%	11.5%	5.7%	3.7%	1.6%	-5.9%	-1.9%	1.0%	0.2%	-1.4%	4.9%	4.6%	27.5%
2023	-2.0%	-0.1%	-3%*										-5%*

- **The root cause of the recent bank failures are years of easy money being unwound. More trouble lies ahead.**
- **In the short term, equities have done OK. This is likely driven by position unwinds; do not read too much into it.**
- **In the medium term, banking crises, if uncontained, are contractionary. We think a recession is now a near certainty. Watch Wells Fargo, DB and BNP for risk of contagion.**
- **In the long term, governments will print money again to protect the system when it threatens to break. We must own real assets to protect against this likely eventuality.**

Dear investors,

Life comes at you fast. In our recent investor letter (shared in early Feb), we had cautioned that sharply higher interest rates will hurt borrowers, asset valuations and the economy at large, yet even we were surprised by the rapid deterioration in the banking sector. Over the span of less than three weeks, we have seen the second largest bank collapse in US history, de facto expansion of deposit guarantees to above the prior US$ 250k limit and a forced merger between UBS and Credit Suisse after a run on the latter:

March 2 (Thu) – Silvergate Bank delays 10K filing, evaluates ability to continue as going concern
March 8 (Wed) – Silvergate Bank announces voluntary liquidation
March 9 (Thu) – Bank run on Silicon Valley Bank (SVB)
March 10 (Fri) – SVB taken over by FDIC
March 12 (Sun) – Signature Bank (SBNY) taken over by FDIC
March 13 (Mon) – All depositors of SVB/SBNY guaranteed; BTFP Program announced
March 16 (Thu) – $30bn of coordinated deposits injected into First Republic Bank
March 16 (Thu) – $54bn loan granted to Credit Suisse by SNB
March 19 (Sun) – UBS agrees to acquire CS for $3bn, wipes out AT1

Markets seemed to have calmed down but it is an evolving situation. We wanted to take this time to share some of our thoughts.

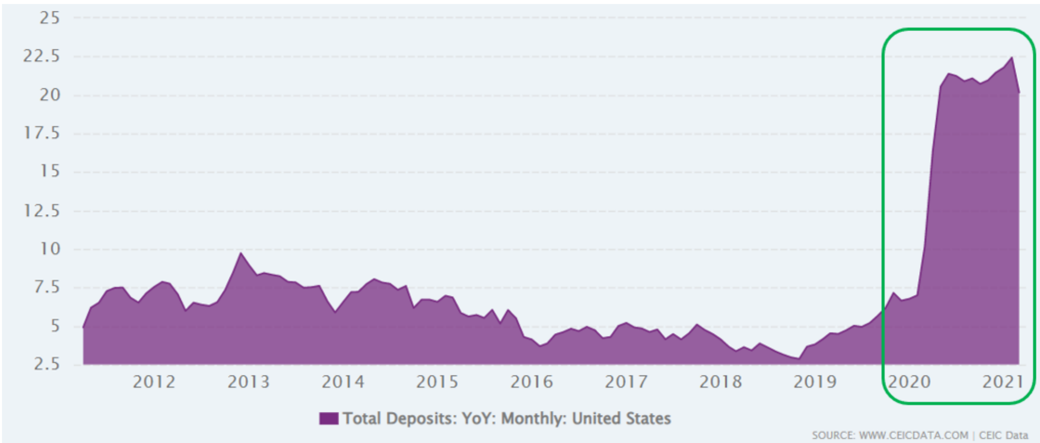
The Root Cause – "Free" Money from Lax Monetary Policy and Fiscal Handouts

Attention in the short run will naturally be focused on the state of the banking system and the regulatory response. However, it is important to understand that the root cause of these failures is a decade of easy money turbocharged by massive fiscal stimulus in the wake of Covid. Just as the subprime bust in 2008 was the symptom of an over-levered US housing market, these failures can be

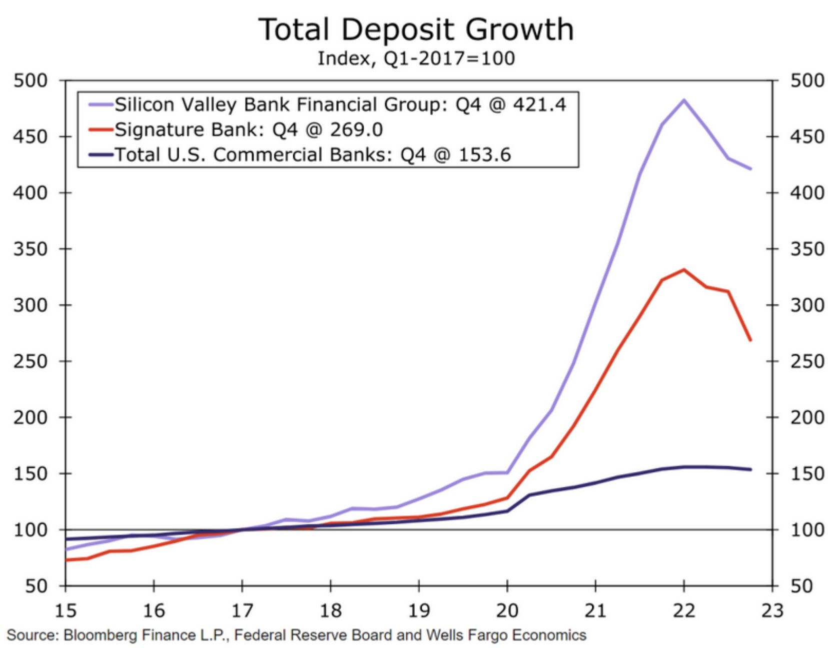
* March 2023 based on preliminary estimates

traced to policy decisions that pushed ever more money into the financial system, giving rise to excessive risk-taking and FOMO. This “free” money is now being unwound, with consequences on the most levered players in the market.

Historically, the US banking system has grown its deposit base by on average 5% a year but the fiscal response to Covid resulted in deposits growing at 4x the long-term average.



Silicon Valley Bank was one of the largest beneficiaries of this largesse – deposits grew at an annualized rate of nearly 80% in 2020 and 2021, propelling it into the ranks of the top 20 US banks. This surge is both a blessing and a curse since it is not easy to deploy so much money. Instead, it was easier to put these into securities like Treasuries and mortgages – [investments in securities grew fourfold]() versus 2019, while loans only doubled. Unfortunately, SVB was investing in Treasuries and mortgages at precisely the worst time to do so, when they were trading at the [lowest real yields in history]().



Just as the 2008 housing bust began with cracks in subprime, this time around it is also the most-levered players that crumble first. The most speculative instruments like crypto and profitless tech (ARKK) were the first to ring the bell when they began their decline in 2021; the baton has now been passed on to the real economy – witness the mass layoffs at Amazon, Google and Meta and of course these bank failures.

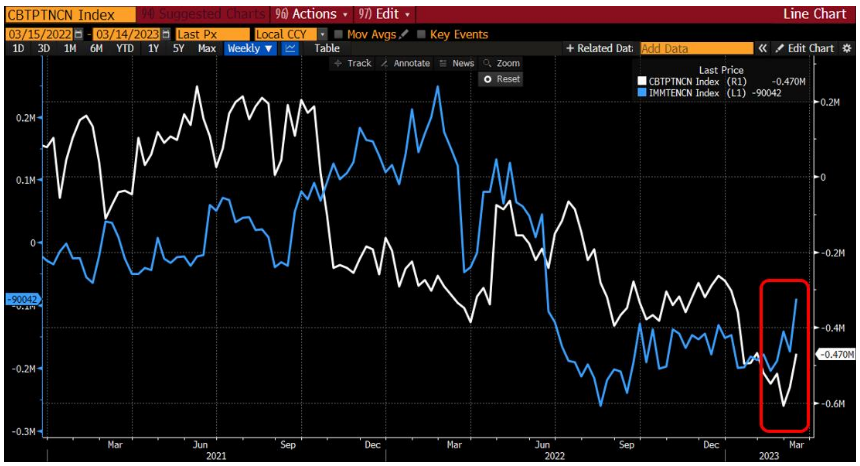
So while BTFP and forced mergers may calm the banking system, the underlying problem is a huge "everything bubble" fueled by easy money. As long as authorities continue to deflate the bubble, other crises will arise.

Near Term – Positioning Drives Price Action

If one had known at the start of March that 3 banks would fail in the US while the second largest bank in Switzerland needed to be bailed out, one would probably have wagered that stocks would fall. Yet after a brief wobble, stock indices have recovered for the most part.

Ostensibly, the recovery in stocks was driven by 1) aggressive response by regulators to eliminate systemic risk and 2) a massive rally in interest rates across the curve.

Away from the prevailing narrative, CFTC data shows that investors were positioned very short both bonds and stocks in the past half a year. Investors were initially long stocks and bonds in 2021, before aggressively reducing positions and moving net short last year. In fact, short positions were the largest they have been since 2021 at the beginning of this year. Given this, it is plausible that the issues with the banking system (bad for economy hence lower rates) and the attendant regulatory response (guarantee all deposits, ie stealth QE) fueled position unwinds of bond and equity shorts, causing the former to rally strongly and the latter to not collapse. The recent uptick in both lines seem to corroborate this thesis, ie it was short covering driving price action.



S&P 500 (Blue), US 10Y Note (White): +ve → Investors are Net Long, -ve → Net Short

All of which is to say that while we must not neglect recent price action, we need to keep in mind that short term moves are often driven by position unwinds more so than by fundamentals.

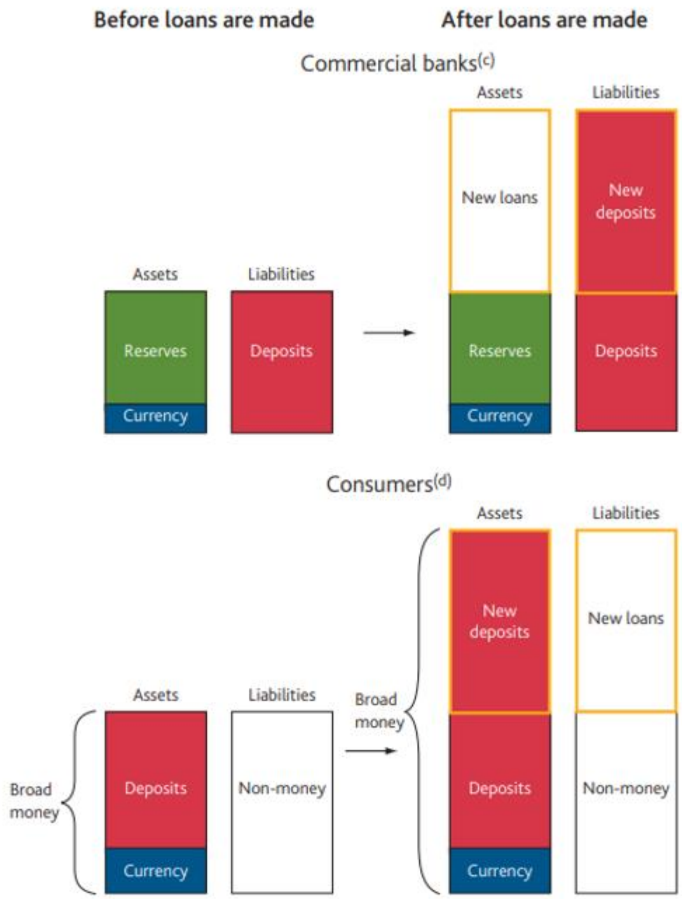
Medium Term – A Banking Crisis is Recessionary

Since the collapse of SVB/Signature and the announcement of BTFP, much ink has been spilled on whether this is a bail-out of depositors, if this is a new form of QE and of course the likely impact on financial markets. So far, price action has been positive for risk assets (especially in the most speculative segments, eg tech and crypto), supporting an optimistic spin.

However, if we understand the role that banks play in the economy, these bank failures are unambiguously negative for the economy. We had previously written about the risk of a recession; this now almost guarantees it.

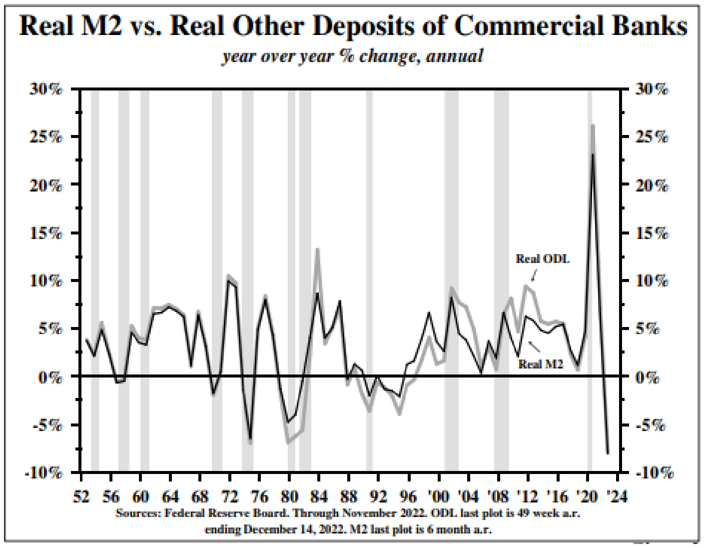
Banks *create money*. Whenever a bank makes a loan, it simultaneously creates a matching deposit in the borrower's bank account, thereby creating new money. Healthy banks promote economic growth through credit creation; the reverse is also true.

Figure 1 Money creation by the aggregate banking sector making additional loans[a]



The collapse of 3 banks in the US over the course of a week shows how fragile the banking system is. The ensuing "bail-out" of depositors and introduction of BTFP shows us how worried regulators are about financial stability. Last week's collapse of Credit Suisse and the zero-ing of AT1 bondholders ensures that all banks will face higher cost of capital going forward. In our view, it is extremely unlikely that banks, which are now facing deposit flight, increased governmental oversight and rising defaults, will be eager to lend. Instead of the normal expansionary process of credit creation leading to economic growth leading to more credit creation, this process will now work in reverse, painfully so.

In fact, real M2 and deposits growth (chart next page) entered negative territory even before the recent bank failures; the situation is likely to worsen. As we can see, while monetary contraction is not a necessary condition for a recession (grey) to occur, nearly every episode of contraction has coincided with one.



Finally, it is worth reading [Ray Dalio's thoughts on the SVB situation]():

> *...it is a very classic event in the bubble-bursting part of the short-term debt cycle in which the tight money to curtail credit growth and inflation leads to a self-reinforcing debt-credit contraction that takes place via a domino-falling-like contagion process…*
>
> *[This time round, the bubbly sectors] are negative-cash-flow venture and private equity companies as well as commercial real estate companies that can't take the hit of higher interest rates and tighter money. Based on my understanding of this dynamic… this bank failure is a "canary in the coal mine" early-sign dynamic that will have knock-on effects in the venture world and well beyond it…*
>
> *Because a) we are in the early stage of the contraction phase of this cycle and b) the amount of leveraged long holding of assets is large, it is likely that this bank failure will be followed by many more problems before the contraction phase of the cycle runs its course. Before the cycle ends, there will be 1) forced sales of assets at very low prices that require big losses to be reported and cause further contractions in lending, 2) equity dilution, i.e., selling at prices that are at significant discounts to conservative estimates of the present values of their future cash flows, 3) attractive acquisition prices for strong synergistic companies to buy distressed ones, 4) credit problems being a negative for markets and the economy, and eventually 5) the Fed easing and bank regulators providing money, credit, and guarantees because the problem becomes system-threatening.*
>
> *..thus producing more new credit and debt, which creates the seeds for the next big debt problem until these short-term cycles build up the debt assets and liabilities to the point that they are unsustainable and the whole thing collapses in a debt restructuring and debt monetization.*

In the meantime, pay attention to these systemically important banks. They will give a clue as to whether the worst is over or if there is more pain to come in this space.

Deutsche Bank (White), BNP Paribas (Red), Wells Fargo (Blue)

Long Term – Governments Will Print Money Again; We Must Own Real Assets

As for the long term, the end game is clear. The US and other developed markets economies will engage in money printing again when the going gets tough. In 2008, it took the collapse of Bear Stearns, Lehman and AIG before enough political capital was amassed to enact the Emergency Economic Stabilization Act (which included US$ 700bn in TARP funding). It then took 6 years and 3 rounds of QE for the Fed to expand its balance sheet from under US$ 1 trillion to over US$ 4 trillion. After Covid broke out, it took only 3 months for the Fed to grow its assets from US$ 4 trillion to US$ 7 trillion. This time, a weekend was all it took for authorities to offer de facto deposit guarantees and bailouts. If we believe that there will be more problems down the road as the everything bubble unwinds, there is no doubt that the powers-that-be will once again whip out their monetary bazookas.

DM is the new EM

Developed market economies are fast becoming the new emerging markets. Ever growing debt-to-GDP ratios, fiscal and monetary indiscipline, societal conflicts and poor demographics plus exogenous shocks are just some of the problems that developed markets. Is it so unthinkable that we may experience a crisis in DM like we have in EM previously?

Emerging Market Crises of the Last 25 Years

When	Where	GDP	Inflation	Stock Market
1997-1998	Asia (Thai, Indo, S Kor.)	-7% to -15%	+10 to +58%	-70% to -85%
1998	Russia	-5%	+85%	-75%
1999	Brazil	+0.3%	+9%	-30%
2000-2001	Turkey	-6%	+69%	-60%
2001-2002	Argentina	-4% to -11%	+41%	-75%
2008-2011	Iceland	-4% to -7%	+19%	-90%
2010-2018	Greece	-5 to -9%	+5%	-90%
2012-2013	Cyprus	-3% to -6%	+4%	-98%
2013-2014	Ukraine	-7% to -10%	+49%	-50%
2014-2015	Russia	-3%	+16%	-30%
2014-2016	Brazil	-4%	+11%	-40%
2018	Turkey	-1%	+25%	-45%
2018-2020	Argentina	-2% to -3%	+54%	-50%
2022-	*Developed Markets*	*???*	*???*	*???*

Emerging market crises tend to be set off by capital flow reversals – foreign lenders become unwilling to finance specific economies, eventually resulting in these countries defaulting on foreign currency debt. Even though developed economies are not dependent on foreign currency borrowings, they are not immune. In the case of SVB, SBNY and Credit Suisse, it is domestic lenders (depositors and other counterparties) that are pulling the plug. While these failures have so far been contained, is it so hard to imagine a system-wide revolt on the DM banking system should we continue down the primrose path of monetary and fiscal indiscipline? Isn't this risk precisely what regulators were fighting to truncate over the past 2 weekends by backstopping the US and Swiss banking systems?

While a banking crisis is not a given, this possibility can no longer be dismissed lightly; witness how quickly things unraveled in recent weeks. Frankly, we do not even need a crisis to stoke fears of sharp economic contractions, sky-high inflation and falling stock markets – we are experiencing a mild version of this very reality right now. How then should we invest?

Own Real Assets

By this point, it may be tiresome to regular readers, but we *need to* own real assets. As we have written in previous letters:

i) the real world is structurally short real assets because of capex underinvestment
ii) the financial world is short real assets from the perspective of portfolio allocation
iii) real assets (especially energy) are an excellent inflation hedge
iv) energy transition will substantially increase demand for real assets (critical minerals)
v) real assets are in the part of the capital cycle where forward returns are likely to be high

The recent events further cement how essential it is that real assets form a part of any investor's portfolio. When the going gets rough again (could be next week, next month or next year), authorities will default to their QE playbook. Our only protection against that is to own tangible “stuff” that cannot be created at a keystroke.

Conclusion

In the past year and a half, many long-held investment beliefs have been challenged – robustness of the 60/40 portfolio, death of inflation in Japan, impossibility of bank runs in the developed world, the unshakeable reliability of the Swiss, Treasuries being the ultimate risk-free assets. What other sacred cows will be sacrificed to the market gods in the coming weeks, months and years?

While the SVB/Signature/CS collapses may be no more than a storm in a teacup, it seems clear that they are the consequence of many years of monetary largesse that is now being unwound in the fight against inflation. There is still a long way to go in this fight and these companies will probably not be the last casualties in this battle; attention has already now shifted to the commercial real estate sector.

We will keep a close eye on the situation for you and provide updates when we can. We hope to share a quick review of our various investment themes in the coming weeks as well. As always, thank you for your support and we look forward to connecting again soon.

Sincerely,

Yongchuan Pan
24 March 2023