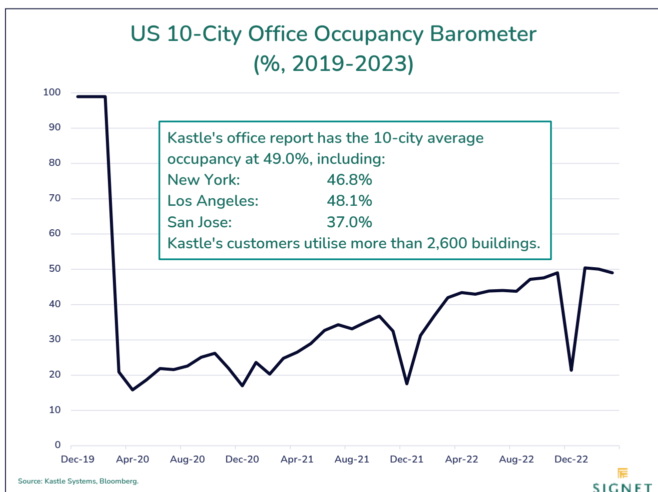
# Beneath the Surface

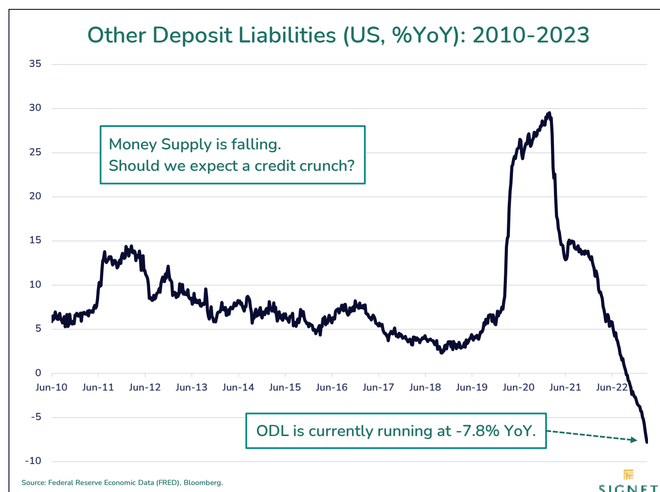
March 2023

SIGNET

## *Vulnerabilities on the Balance Sheet*

- The Federal Open Market Committee meeting minutes of 01 February 2023 concluded "In their discussion of issues related to financial stability, several participants discussed vulnerabilities in the financial system associated with higher interest rates, including the elevated valuations for some categories of assets, particularly in the CRE sector; the susceptibility of some nonbank financial institutions to runs; and the effect of large, unrealized losses on some banks' securities portfolios." The impact of recent monetary policy actions on some of the more entrepreneurial banks has become all too apparent in the last month, and the velocity of the crises at banks such as SVB and Credit Suisse speaks volumes about the vulnerabilities within the banking system. Critically, however, the Fed's two financial stability reports of 2022 highlighted the shadow banking complex (non-bank financial intermediaries), and not the conventional banking network, as the leading potential source of system fragility.
- Shadow banking remains a concern of ours as well, given its relatively unchecked evolution in recent decades, and especially now that monetary conditions have tightened significantly. Market valuations are being challenged and the opportunity cost of holding liquid safe assets has been upended. Private markets (equity and debt) have boomed recently; propelled by easy credit and suppressed interest rates. McKinsey have just reported that private markets' AuM had reached $11.7tn by June 2022, having grown by 20% per annum since 2017. That's fine, unless those acquisition valuations lacked discipline, and are now exposed to deteriorating refinancing and exit conditions.
- Commercial real estate (CRE) – specifically Offices and Retail – is another area that looks vulnerable. The National Association of Real Estate Investment Trusts (NAREIT) assesses US CRE to be valued at around $20tn, with Offices and Retail comprising 16% and 19% of the total, respectively. Approximately half of the commercial real estate loans are provided by banks, and 70% of those bank loans are extended by small and medium sized banks. These are all 'assets' on a banks' balance sheet, against deposits on the 'liability' side of the balance sheet. Approximately $2.9tn of CRE loans are due to be refinanced in the next two years. The formal US Metro Office vacancy rate has recently ticked up to 18.7%, having averaged 17.1% since 2012, so there is limited hard evidence for structural concern. However, office life continues to evolve post-Covid and the trend against office space may well be another source of shadow weakness. Office security company Kastle has monitored office occupancy rates since the pandemic shutdown and their analysis (chart left) shows us that offices are still not even half full. Users of office space will adapt and downsize, and investors in office space may be forced to re-visit their cap rate assumptions.
- Money supply is an important part of aggregate economic growth so it's important to monitor, but it also difficult to meaningfully interpret. Other Deposit Liabilities (ODL, chart right), derived from M2 broad money supply, is the main source of funding – credit – for bank loans and investment, making it a useful indicator of liquidity and inflation conditions in the US. The ODL measure of money supply is currently declining at a rate of 7.8%; the fastest annual pace on record. Credit conditions like these are normally associated with recessions and declining market valuations.




- **Therefore:** We remain cautious so remain defensively invested. Fixed Income: there are opportunities to target quality and liquidity. Equities: target quality but there's no rush. Commodities: target precious metals.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