FISCHER STRALEM

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Dear Client:

Our last monthly communiqué focused on the downgrading of the U.S. credit rating on concerns including soaring budget deficits, fiscal trajectory, and the mounting stresses to the nation's financial health. Coming more than two months after a deal to lift the U.S. borrowing limit was reached, the timing was a little strange but, as we noted, in downgrading the government's credit rating, Fitch Rating Agency made a reasonable argument encompassing an "expected fiscal deterioration" and "high and growing borrowing costs".

It stands to reason then that bank downgrades were sure to follow. Afterall, if money represents the lifeblood of the economy, then banks are the beating heart that pumps it around the system. The decision by another rating agency -- Moody's Investors Service -- to place the debt of ten major banks under review makes sense. Citing significant deposit outflows, asset quality deterioration, and the negative effect of higher interest rates on their fixed-income assets, the totality of this analysis points to a murky growth backdrop. Despite our current economic resilience, the warning flags are in line with the preceding sovereign downgrade.

As we know from the darkest days of the Great Financial Crisis (GFC), the rating agencies have a shockingly poor track record, and these downgrades are puzzling if only because they took so long. They come a full five months after three regional lenders -- Silicon Valley Bank, Signature Bank, and First Republic -- were brought down by deposit flight and a declining value of bond assets on their books. The banks were forced to reprice their loan books at a time of declining origination and rising commercial defaults. The largest banks managed to fend off speculative attacks and regulators have reiterated with numbing consistency that the sector is healthy. After all, banks are more profitable when interest rates rise because it increases their net interest margins (NIM). Today, however, the flight of -- and subsequent competition for -- customer deposits is a new and painful development and exemplifies banking's troubles. In the past, deposits were relatively sticky, and banks paid essentially nothing for them, meaning their NIM would only grow. Now banks are competing for deposits, paying higher short term rates, and lending at lower long term rates. That's a bad business to be in!

In many ways, Moody's actions feel very much like the proverbial stable door closing long after the horses have fled. Fitch seemed similarly behind the curve in downgrading U.S. bonds. It was a long time ago, but as we noted, these ratings firms kept the highest marks on the complicated financial products that brought the financial system to the brink in the GFC, even as the subprime sector was in flames. again, U.S. banks are once again in the regulatory crosshairs, and we would be wise to consider the far-reaching implications of impaired liquidity providers should things turn out not to be so different.

A client asked if this latest iteration of the banking crisis is past, and our reply was that it is possible that the *beginning* is over. Historically, these events have a tendency to evolve slowly over prolonged periods, but the outcome tends to unravel all at once. The Fed has provided ample liquidity to calm markets, but that will not fix what's broken. There are a lot of banks that own various tranches of public and private debt originated during the pandemic when the Fed funds was at zero. They typically carry very low coupons and a trickle of cashflows. The Fed has increased interest rates' more than 5% over the trailing 18 months and low-to-negative cashflows are a genuine concern for smaller institutions that over-reached when the cost of capital was negligent. It is not a set-up that should be ignored.

Regards,

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U.S. Large Cap Equity Strategy