Streetlight Confidential

Inside This Issue:

Historic Rate Hikes Finally Hit Home
March Madness usually refers to the NCAA basketball playoffs. This year it's an apt nickname for the banking industry. Last year's historic rate hikes are finally being felt in the financial markets and economy. Here's what to watch for…

The Last Word…
Jay Powell has a tough job. Not only does the burden of US monetary policy fall to him, he gets to be the government whipping boy when things go wrong. Lately Elizabeth Warren has been cracking the whip. This month: An open letter from Jerome Powell to the Senator…

You Can't Make This $#!% Up!
Someone FINALLY asks the Fed Chairman THE BIG question. And you won't believe his answer…

The Streetlight Confidential Portfolio
The first quarter is just about in the books, so this month we're recapping 2023 so far…

Historic Rate Hikes Finally Hit Home

Four Vulnerable Sectors to Watch and a Game Plan for the Rest of the Year

-by Tim Collins

March Madness adopted a new meaning for 2023. When I hear the term, I think about the NCAA College Basketball national championship tournament. And while we've seen our share of craziness in basketball, it pales in comparison to the insanity of what's happening in the world of banking.

It began with Silvergate Bank — one of the two biggest banks that catered specifically to the crypto industry — voluntarily winding down operations. Next, Silicon Valley Bank — a bank heavily involved in the green tech sector — collapsed almost overnight. Then, the FDIC stepped in and assumed control of Signature Bank — another crypto casualty. Three banking entities in immediate succession. But it didn't end there.

While news outlets and social media pontificated on the potential downfall of regional and community banks in the United States, our eyes should have been overseas. Credit Suisse became the next domino to fall.

That's four major financial institutions that fell during this version of March (banking) Madness.

Despite this, the Invesco Nasdaq 100 QQQ Trust (QQQ) recently hit its highest level in the past six months, and if you're focused on those 100 names, you likely feel good about the market. But there's only a handful of names that have created this anomaly.

Mega-cap tech giants like Microsoft, Apple, Facebook, Google, and Nvidia are not only carrying the Nasdaq but also the S&P 500. These names are masking a severe underlying weakness in equities and we need to do our best to avoid falling into the trap of feeling better about the overall situation in equities.

In times like these, the choices we need to make now are not about what to buy, ***but what we should avoid buying***…

The Problem

It's important to understand where we came from in order to understand where we may be going. Just a little over a year ago, the Fed hiked rates for the first time, taking us off 0% on the low end of the range.

A year and nine hikes later (see the table below), the Fed Funds Rate has moved from a near zero range of 0%-0.25% to a range of 4.75% to 5% target range.

Years of zero-interest rate policy (ZIRP) erased in 12 months in a historic manner. Policy changes, especially historic actions like this, come with consequences. The four aforementioned banks are unlikely to be the only consequences.

Our eyes should be focused on commercial real estate, residential real estate, and small cap companies in addition to everything banking that isn't one of the ten largest banks in the public markets.

Let's talk about banks here quickly. This is the topic that has received the most exposure and discussion thus far. I believe we can simplify this to one main concept: $250,000.

That number matters.

The crux of the situation revolves around the concern about the security of funds above $250,000. FDIC insurance maxes out at $250,000 and professionals are worried depositors will withdraw excess money and deposit it in other banks or other types of accounts. The potential drain on deposits puts smaller banks at risk with their deposit ratios as compared to loans outstanding or investments they may hold.

A quick fix, and likely the correct one, is to extend FDIC insurance higher. Much higher.

Yellen has waffled around stating that bank accounts above $250,000 will be backed by the government. Yes, the FDIC Insurance for Silicon Valley Bank was extended beyond $250,000. We have no reason to believe the Fed won't take emergency action to insure accounts above $250,000 for any banks in the United States that fail or fall into receivership, but the Fed refuses to put it into policy.

The result: pessimism remains.

We've seen it reflected in the continued declining price action of regional bank stocks.

While we never want to assume anything, I do believe we can operate with the belief the Fed will

FOMC Meeting Date	Rate Change (bps)	Federal Funds Rate
March 2, 2023	+25	4.75% to 5.00%
Feb 1, 2023	+25	4.50% to 4.75%
Dec 14, 2022	+50	4.25% to 4.50%
Nov 2, 2022	+75	3.75% to 4.00%
Sept 21, 2022	+75	3.00% to 3.25%
July 27, 2022	+75	2.25% to 2.50%
June 16, 2022	+75	1.50% to 1.75%
May 5, 2022	+50	0.75% to 1.00%
March 17, 2022	+25	0.25% to 0.50%

not allow large account holders, those above $250,000, to lose money that is sitting in a simple checking or savings account. However, we've already seen well over $100 billion in deposits flow out of small banks during the first half of March and roughly 50% move into big banks.

That may not overcome the pessimism nor will it necessarily save all the regional banks, but it allows us to continue to press forward and consider opportunities rather than pressing the panic button.

That being said, the rapid increase in interest rates to combat rising inflation has created additional repercussions, some that extend beyond just stocks.

Living Under House Arrest

Some homeowners may become prisoners in their own homes in a manner of speaking. The rapid rise in the Federal Funds Rate has resulted in a corresponding move higher in mortgage rates. That's created a scenario where some homeowners may feel trapped.

Imagine having a $400,000 30-year mortgage with an interest rate around 3%. Your monthly principal and interest payment sits at $1,686.

Now, you find out you need to move. Or even want to move, so you start looking at possibilities. Unfortunately, home prices have continued to hold steady. That's great for your sales price but your purchasing power has now decreased dramatically with the increase in mortgage rates.

In order to maintain the same principal and interest payment of $1686, you can now only have a mortgage of $253,400 — a decrease of 36.65% compared to your current mortgage.

If you were to take out a new mortgage of $400,000, your payment will increase to $2,661. That's an increase of nearly $1,000 of a 95% increase on a monthly basis!

There are additional scenarios that could play out with the rapid rise in mortgage rates.

1. **Falling Demand:** When borrowing becomes more expensive, as outlined above, demand for housing can decrease. Buyers can't afford current prices, so prices will fall to meet until they find demand.
2. **Rise in foreclosures:** For homeowners with adjustable mortgages, rising rates can cause monthly payments to reach a level where the homeowner can no longer afford the house. If demand has fallen too low, then foreclosure may be the homeowner's only option. A rise in foreclosures can also flood the market with supply causing a drop in home values.
3. **Increase in rental demand:** Homebuyers may opt to rent instead of buy if they cannot afford the higher interest rates. When/if interest rates decrease, then they may become buyers again.
4. **Decrease in home values:** If either demand falls or foreclosures rise causing a supply increase, there's a strong chance the price of homes will need to fall to attract more buyers to create demand and/or soak up the housing supply.

These dominoes have yet to fall in terms of housing prices. Our driving thesis for why prices have not fallen yet is that supply is constrained in the near term because many people are trapped. They can't

Policy changes, especially historic actions like this, come with consequences.

afford the higher mortgage rates, so those that are not forced to move have decided not to list their house and play the wait-and-see game.

Similar to housing prices, home building stocks have held up rather well of late as compared to regional banks or small cap stocks. Still, there's no reason to buy into the group now.

Buyers will want to see at least two or even three of the four scenarios from above play out or interest rates to fall before considering buying any housing stock.

Commercial Crumbles

And speaking of real estate, commercial real estate also remains something to avoid. Spreads for commercial mortgage-backed securities have reached their widest point over the past three years.

This alone isn't a sign of an impending doom, but it is a concern when combined with higher rates, falling commercial property values, and any lull in the economy.

Thus far, businesses have continued to perform, but that's about the only thing propping up the commercial real estate market. If the Fed continues to hold rates high or push them higher, then a full blown recession would be the cherry on top for a commercial real estate steep decline.

Rising interest rates pose a wider problem to homeowners, commercial real estate, and companies with high debt levels, especially smaller companies with restricted cash flow.

We already discussed the impact higher rates have on homeowners with adjustable rate mortgages.

Fortunately, with rates hovering in the very low single digits for the past few years, many buyers were able to lock down fixed rates for 15 or 30 years.

Commercial real estate and company debt doesn't function like that. Developers aren't locking in 30 year loans on a strip mall. Small cap companies aren't issuing 20 year bonds. Terms are measured in months and years not decades.

That means the next time we see a round of commercial mortgages or company debt seeking refinancing or an extension of debt, the terms likely won't be as favorable for them.

Higher rates mean higher debt payment.

Higher payments result in a drain on free cash flow and profitability.

Lower profitability often leads to lower stock prices.

We're seeing that reflected in the trading action for many small caps and commercial real estate stocks. Although we're still avoiding these names, they are likely getting closer to a dip opportunity than housing stocks and regional bank names.

The Game Plan

Recession risks remain the most prominent risk for the remainder of 2023. While the banking situation is precarious, a repeat of 2008-2009 doesn't appear to be on the table. Staying conservative and liquid for the next several months, then getting more aggressive on the buy side into the fall is the current game plan.

The Fed could change all that with another rate increase or rate cut, but we anticipate rates will remain the same for the foreseeable future providing us the opportunity to buy quality names at an attractive reward versus risk level after the summer months pass us by.

The Last Word…

An Open Letter to Elizabeth Warren (from Jay Powell)…

-by Bob Byrne

Jerome Powell has a helluva job.

Not only does the burden of the country's monetary policy fall squarely on his shoulders, he also has to be the government's whipping boy when things go bad in the financial world and it becomes necessary for Congress to point their fingers at someone.

Few have been wielding the whip more actively than Senator Elizabeth Warren.

Most recently Senator Warren went full populist on the chairman, excoriating him for "an astonishing list of failures" which led to the implosion of SVB (and Signature Bank). She said he owed the public an explanation.

"Technically" she's not entirely wrong. (But there is a lot of blame to go around.)

So in a spirit of goodwill, I thought I'd write an open letter response on Chairman Powell's behalf.

==============================

Dear Senator Warren,

Thank you for your thoughtful comments. The Federal Reserve is always happy to receive insightful feedback from Congress to help us do our jobs.

In your letter you said, the fate of SVB was due to *"faulty supervision and in a weakened regulatory environment that you helped to create."* You continued, *"You owe the public an explanation."*

Perhaps I do. I'd like to do that now.

Senator, you are correct that the Fed does provide financial oversight for its member banks. And we do bear some responsibility when those banks fail. I can think of a couple immediate areas of interest to look at regarding this…

Perhaps we could start by not promoting regional Fed presidents like Mary Daly who: "actively supports the Bank's commitment to understanding the economic and financial risks of climate change and inequities…"

(I realize the government wishes to promote a diverse and inclusive agenda — one in which people are selected based more on their personal traits instead of their capabilities. That's a reasonable goal. But often it doesn't provide the optimal candidates for the job. I'm sure President Daly is excellent at promoting green investments.)

Perhaps, instead, we should just appoint capable candidates who actually have backgrounds in banking and are more interested in monitoring risk.

Or perhaps we shouldn't allow bank CEOs like Greg Becker, you remember him — until recently the CEO of SVB? — to sit on the board of the SF Fed. (That had to be a bad look.)

I would like to point out that SVB had received numerous warnings from the Fed in the past. Back in 2019 we issued the bank a "Matter Requiring Attention" notice warning them about potential holes in their risk management system.

Of course enforcement of these notices comes with its own downsides.

For instance, taking over the bank might have meant cutting off access to capital to those riskier "green"

depositors who ultimately had to drain their accounts in the absence of cheap money.

In any case, we will certainly look into all this.

But I'd also be remiss if I didn't mention some of the unusual external challenges we at the Fed face in doing our job. For example…

Your policy ideas — and let me say they are BIG and ambitious ideas — of government funded education, forgiving student loans, medicare for all, increases in social security and a green energy utopia — all have to get paid for by someone.

I know Congress does its level best to support industries *it* deems critical. But as I'm also sure you're aware, you and your Congressional colleagues have — once again! — tapped out your line of credit by hitting your $31 trillion debt ceiling. (With many programs that, over the years, promised to reduce the deficit, I might add…)

And where that government borrowing goes… I'd also like to point out that for the past two years, we here at the Fed have been your best customer.

Over the course of the pandemic alone we funded YOUR spending — that would be the debt of the US Government — to the tune of $2.7 trillion. (And that was just buying *Treasury securities*.) Without our (somewhat irregular) participation, your efforts would have been woefully underfunded.

With little to no fiscal (← that word means spending in case you weren't familiar) restraint, there is little we, as a central bank, can do on our own to right the economic ship.

Between you and I Senator, I'll admit, the founding of the Federal Reserve Bank was, in fact, the creation of a national banking cartel. A private organization that was given full authority over monetary policy. But you know as well as anyone the government doesn't give that kind of immense power to a third party without expecting something in return.

Sure the Fed has become politicized. But it's only because outrageous, reckless and, dare I say, insane fiscal behavior has forced it to become so.

Madam Senator, banks inflate bubbles to fuel a fake prosperity that you want to take credit for. But, despite what you may believe, all those bubbles eventually come to an end.

And let me be frank, all the regulation in the world won't help in an environment where moral hazard is constantly present as a result of zero interest rates and the imminent promise of "The Fed Put" (those would be the bailouts necessary to save the economy, the stock market or whoever).

And that, I'm afraid I have to admit, is what's necessary in the debt-driven economy that you and your colleagues in Congress have created today.

Sincerely,

Jerome Powell
Chairman, The Federal Reserve

================================

If you're reading, Jay, you're welcome to it…

You Can't Make This $#!% Up!

Someone Finally Asks THE Question…

I've been asking it here since last year…

THE question I believed someone needed to ask the Fed Chairman.

I mean, taking the bigger economic picture into consideration, it was probably the *only* question that reporters who cover the Fed should have been harping on.

Naturally they never did.

They kept their focus on data and economic numbers and dot plots and projections. They kept trying to find different ways to get the chairman to "let slip" some official detail they could scoop the market with. They kept asking about how the Fed would interpret this development or that development in terms of future rate hikes.

They asked everything… except what appeared obvious.

Well FINALLY… a reporter from Fox Business got the mic at this month's FOMC press conference and had the nerve to ask it (my emphasis)…

> *Thank you Mr. Chairman. Edward Lawrence from FOX Business. Inflation has been rather sticky, so* ***do you need help from the fiscal side to get inflation down faster?***
>
> *[Jay Powell]* ***We don't assume that.*** *We don't give advice to the fiscal authorities and we assume that, we take fiscal policy as it comes to our front door. Stick it in our model along with a million other things, and we have responsibility for price stability. The Federal Reserve has responsibility for that. And nothing's going to change that. So, and we will get inflation down to 2 percent in time.*

> *[Lawrence] And if I can follow on that, but they're working,* ***the spending that's happened is working against what you are doing, right? So it's prolonging inflation.***
>
> *[Powell] You have to look at the impulse from spending, because spending was of course tremendously high during the pandemic and then as the pandemic programs rolled off, spending actually came down, so* ***the sort of fiscal impulse is actually not what's driving inflation right now****. It was at the beginning perhaps, part of what was driving inflation, but* ***that's not really the story now****.*

Earlier this month, President Biden submitted his annual budget proposal to Congress. According to the Wall Street Journal:

> *The overall budget, including non-discretionary entitlement programs like Social Security and Medicare,* ***would cost $6.9 trillion, an increase over the roughly $6.4 trillion the administration expects the federal government to spend in 2023****.*

Good to know the "fiscal impulse" isn't what's driving inflation right now!

And now a look at our portfolio…

The Streetlight Confidential Portfolio

A Look Back at Q1 2023…

The first quarter is nearly in the books. And it's been a somewhat exciting first quarter.

After some encouraging inflation reports toward the end of last year, the Fed chairman added a new word to his FOMC vocabulary at the committee's January/February meeting — Disinflation. Arguably it was the word the market had been waiting to hear. (Unfortunately he said some other things the market didn't take so well.)

In the face of slower inflation, the Fed slowed the pace of their rate hikes. Through two meetings the FOMC raised rates a total of 50 basis points.

And with rates hiked from zero to 5%, we began to see some of the impacts of their previous year's handiwork in the shape of a mini financial crisis with three regional banks collapsing.

Overall, the stock market broke out of the gate higher this year. January closed up which often suggests a positive bias for the rest of the year. It didn't last for too long.

Whether it was Jerome Powell's warning at his February 1 FOMC press conference…

> *We continue to anticipate that ongoing increases will be appropriate in order to attain a stance of monetary policy that is sufficiently restrictive to return inflation to 2 percent over time.*

…or something else, since that initial push things have been decidedly less rosy. The S&P 500 is still up on the year, but only some 5%.

As my partner Tim mentioned earlier, the bigger story of the year so far is the comeback in tech. After giving up who-knows-how-many billions in market cap throughout 2022, the sector seems to have righted itself. If you look at the Invesco QQQ Trust (QQQ), you see a much more positive picture…

S&P 500 YTD

Source: barchart.com

Invesco QQQ Trust

Source: barchart.com

Up over 18% so far this year, the Q's are benchmarked to the Nasdaq 100 index which is made up of the 100 biggest companies listed on the Nasdaq exchange. That makes this index somewhat of a barometer for both mega-cap and technology stocks.

Drill into the index components a little and you can see some spectacular rebounds driving the rally.

Year-to-date…

Microsoft (MSFT) is up nearly 17%… chipmaker Intel (INTC) is up 19%… and perennial powerhouse Apple (AAPL) gained roughly 28%.

You might think this is great — until you realize these were *the dogs* among the big performers. Those who got beat up the worst in 2022 have rebounded even better…

Facebook parent Meta (META) rose from the dead this year up just over 64%… Elon Musk and Tesla (TSLA) are up 78%… and GPU maker Nvidia (NVDA) has soared a whopping 88%.

So is the good tech news spilling over into our portfolio?

Unfortunately, not quite.

For better or worse, the stock market is now an interest rate sensitive animal.

And since interest rates look to continue to stay high for a while, investors who are venturing back into the tech pool have been looking for value in more established technology companies. And the biggest value has been in the bigger companies who got beat up the worst.

For instance, through the decline of 2022, Nvidia's valuation fell to around 39-times earnings. (It's now back to around 150x!) Tesla's P/E dropped to around 29. And Meta, who lost some three-quarters of its value, fell to 8-times earnings. You could argue they were all bargains.

That means the renaissance in tech has largely been limited to the big guns at the expense of the more speculative smaller-cap players. So for the most part, our portfolio is still lagging.

But that's not to say things aren't looking up for our holdings a little. On a year-to-date basis (that would be for Q1 — and note these numbers were calculated mid-week so actual Q1 gains may be slightly different) the Streetlight portfolio as a whole is up 0.3%.

But a couple of our tech holdings have performed better than average. Unity Software (U) is up 8.5% on the year… Cathie Wood's brainchild ARK Space Exploration & Innovation ETF (ARKX) is up nearly 11%… and DigitalOcean Holdings is up over 38%.

DigitalOcean Holdings Inc

Source: barchart.com

Outside of tech, Genius Sports Group (GENI) is up just over 29%!

So there are some bright spots.

And here's the full portfolio for your review…

Symbol	Name	Comments	Entry Date	Entry Price	Current Price	Annual Dividend	Percent Gain
FPI	Farmland Partners, Inc	Buy shares of Farmland Partners (FPI) up to $18 per share	9/2/2022	$14.22	$10.39	1.68%	-26.9%
VOO	The Vanguard S&P 500 ETF	Bear market portfolio: 20% position per the July 2022 Issue	7/5/2022	$351.06	$370.89	1.60%	5.6%
IJR	iShares Core S&P Small-Cap ETF	Bear market portfolio: 20% position per the July 2022 Issue	7/5/2022	$93.35	$94.93	1.89%	1.7%
VTV	The Vanguard Value ETF	Bear market portfolio: 20% position per the July 2022 Issue	7/5/2022	$131.74	$136.63	2.48%	3.7%
IJS	iShares S&P Small-Cap 600 Value ETF	Bear market portfolio: 20% position per the July 2022 Issue	7/5/2022	$89.52	$91.80	1.79%	2.5%
SCZ	iShares MSCI EAFE Small-Cap Index ETF	Bear market portfolio: 10% position per the July 2022 Issue	7/5/2022	$53.43	$59.28	4.72%	10.9%
VEA	The Vanguard FTSE Developed Markets ETF	Bear market portfolio: 10% position per the July 2022 Issue	7/5/2022	$40.01	$44.96	3.89%	12.4%
DOCN	DigitalOcean Holdings Inc.	Buy a half position up to $60, reserving capital to purchase the remainder of your position on a dip.	6/2/2022	$49.31	$36.80	N/A	-25.4%
ONDS	Ondas Holdings Inc.	Buy a full position up to $8.75	6/2/2022	$7.55	$1.06	N/A	-86.0%
WONDF	Wonderfi Technologies Inc.	Buy a half position up to $0.60, reserving capital to add to the position on a pullback.	6/2/2022	$0.45	$0.11	N/A	-75.6%
VMAR	Vision Marine Technologies Inc.	Buy shares of VMAR up to $5.45 as a speculative investment in the growth of electric powertrains in the boating industry. UPDATE August 2022: Buy up to price was raised to $6.50.	5/2/2022	$4.27	$3.95	N/A	-7.5%
U	Unity Software	Buy a 25% starter position between $95 and $99. Then scale into the remainder of the position adding another 25% every 15% to 20% down. †	2/3/2022	$77.27	$29.34	N/A	-62.0%
EPD	Enterprise Products Partners, L.P.	Buy shares of EPD up to $23.00 as an income-generating investment.	12/1/2021	$21.20	$25.75	$1.86	21.5%
ARKX	ARK Space Exploration & Innovation ETF	Buy shares of ARKX up to $22.00	11/1/2021	$20.48	$13.75	N/A	-32.9%
MSOS	AdvisorShares Pure US Cannabis ETF	Buy shares of MSOS at market up to $33. Be prepared to add to your position on a dip to $27 ††	10/5/2021	$28.95	$5.77	N/A	-80.1%
GENI	Genius Sports Group	Buy shares of GENI up to $22.50	10/5/2021	$16.99	$4.90	N/A	-71.2%
JD	JD.Com	Buy shares of JD.com (JD) up to $80 per share	8/30/2021	$76.69	$44.40	N/A	-42.1%
CZR	Cesars Entertainment	Buy shares of CZR up to $101.75	8/6/2021	$90.50	$46.87	N/A	-48.2%
	Current Prices as of 3/30/2023	**Price Notes:** Entry prices are closing prices the day the issue is published. † Per our entry instructions a 25% position was initially purchased at $96.99 on 2/3, then another on 3/7 at $82.45, another on 4/27 at $71.10, and a final on 5/6 at $59.55 giving us an average entry price of $77.27. †† Adding an equal weight positon at $27 on 10/27 gives us an average engtry price of $28.95					