CAPITAL CREEK PARTNERS REPORT – MARCH 2023

Credit: The Lifeblood of the Economy

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About Scott

Partner, Chief Strategist

Scott is a partner of the firm and the Chief Strategist. Before joining Capital Creek, Scott was the Head of Asset Allocation at UTIMCO, where he served on the firm's Management, Investment, and Risk Management Committees. Scott has 35 years of investment experience as a strategist and portfolio manager. Scott spent most of his career in New York, working at Kidder, Peabody, Morgan Stanley, and Tudor Investments. Scott studied at the University of Texas at Austin, where he received a BBA in finance in 1988. Scott is also a Chartered Financial Analyst, CFA.

About Capital Creek Partners

A Private Investment Firm, Founded by Families.

We are an investment partner organized to serve the needs of family offices, foundations, endowments, and private investment companies. Established in 2018, Capital Creek Partners was founded as a boutique multi-family office to serve a small number of prominent families. Our firm's culture is rooted in *Integrity, Humility, and Excellence*.

CAPITAL CREEK PARTNERS

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"Gold is money. Everything else is credit."

John Pierpont Morgan Sr.

Credit: The Lifeblood of the Economy

What our best credit-related indicators are telling us about a potential credit crunch and its impact.

An ocean of ink has been spilled on the recent bank failures from SVB to Credit Suisse. We are focused on the second and third order effects of the crisis. In the modern financed based economy, we consider the creation, distribution, cost, and demand for credit as the lifeblood of the US economy. In our research, we discovered that the Fed's year long, fast and furious tightening campaign aimed at reducing inflation has been weighing on credit conditions since the second quarter of 2022. Fed tightening cycles are designed to reduce the availability of credit along with the demand for credit. Tightening slows down the economy, reduces the demand for labor, and finally reduces the rate of inflation. Monetary policy is designed to work with "long and variable lags." Those policy lags have now hit home in the form of a banking crisis.

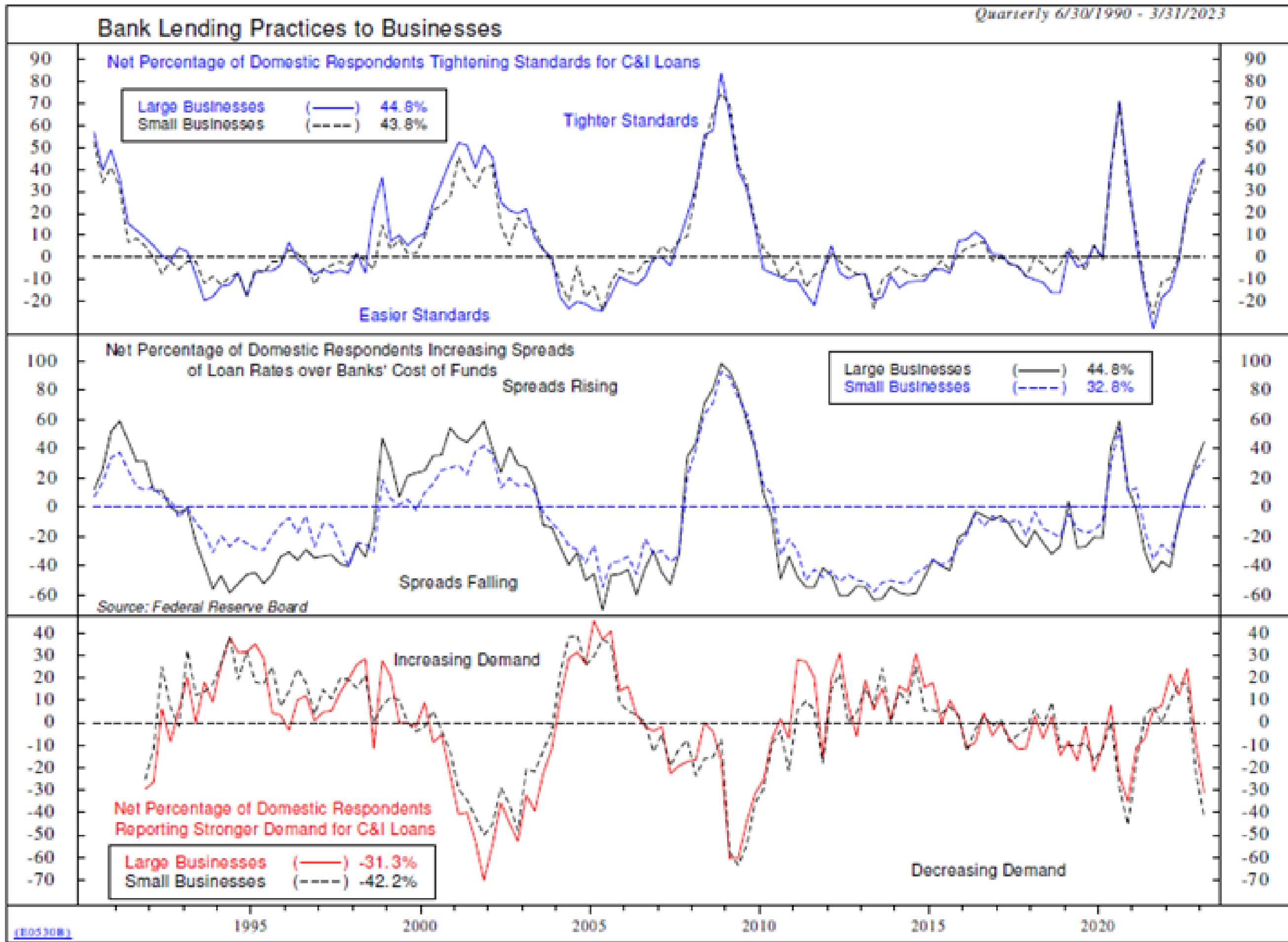
To get a handle on credit trends, we have developed a battery of credit indicators over many years. Most of these indicators are coincident in nature. However, we know that current credit trends are leading indicators for the economy, employment, earnings, and inflation. One of the best sources for credit trends is the Fed Senior Loan Officer Opinion Survey (SLOOS). I consider this the ISM Survey of the banking system. In this quarterly survey, the Fed asks many large, medium, and small banks three basic questions:

1. Are your lending standards tightening?
2. Are your lending spreads widening or shrinking?
3. Is the demand for borrowing increasing or decreasing?

In analyzing the January SLOOS data, which reflects trends in the fourth quarter of 2022, the answers to the above questions are unequivocal. Lending standards have been rising sharply since 1Q2022—in other words, banks are raising the bar on making loans. Lending spreads are increasing, so margins on the loans they do make are rising reflecting greater risk in making new loans. In reaction, bank customer demand for credit is falling. Borrower demand is declining for commercial and industrial loans, commercial real estate loans (CRE), mortgage loans, and consumer loans. These trends are clearly illustrated in Charts 1 and 2 below.

Exhibit 1: Bank lending practices to businesses

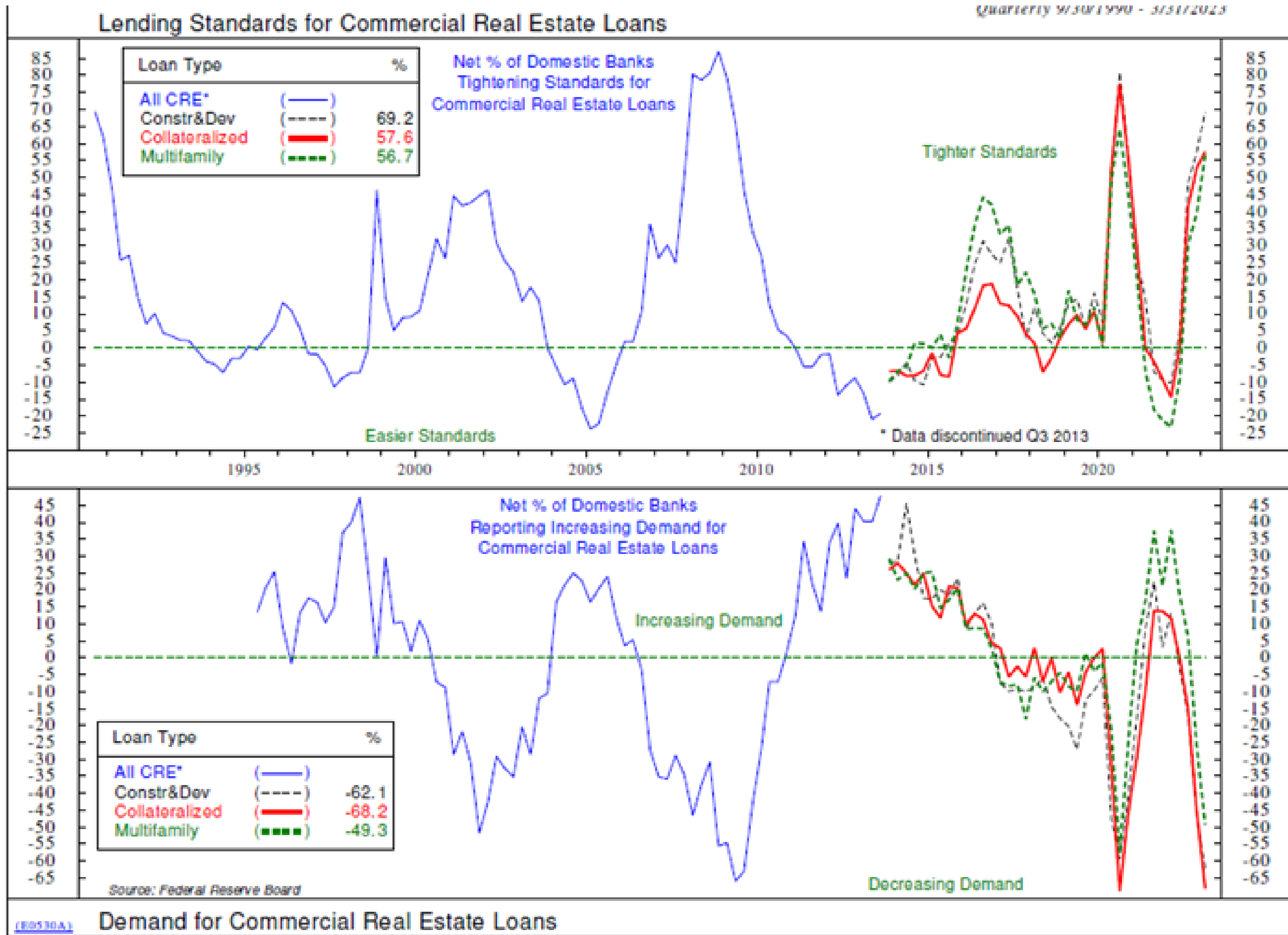
Source: Ned Davis Research



Demand for loans from CRE firms has plummeted to levels last seen at the depths of the Global Financial Crisis (GFC) and the Covid pandemic. Clearly real estate professionals know the Fed tightening program is deleterious for their business, and they do not want to take on additional leverage. Real estate investors have plenty of "dry powder" to buy assets, but returns are unattractive at current prices/interest rates. This is consistent with the cautious message we received at the Capital Creek Partners Investor Conference last October. We believe the real estate industry is in recession.

Exhibit 2: Lending Standards for Commercial Real Estate Loans

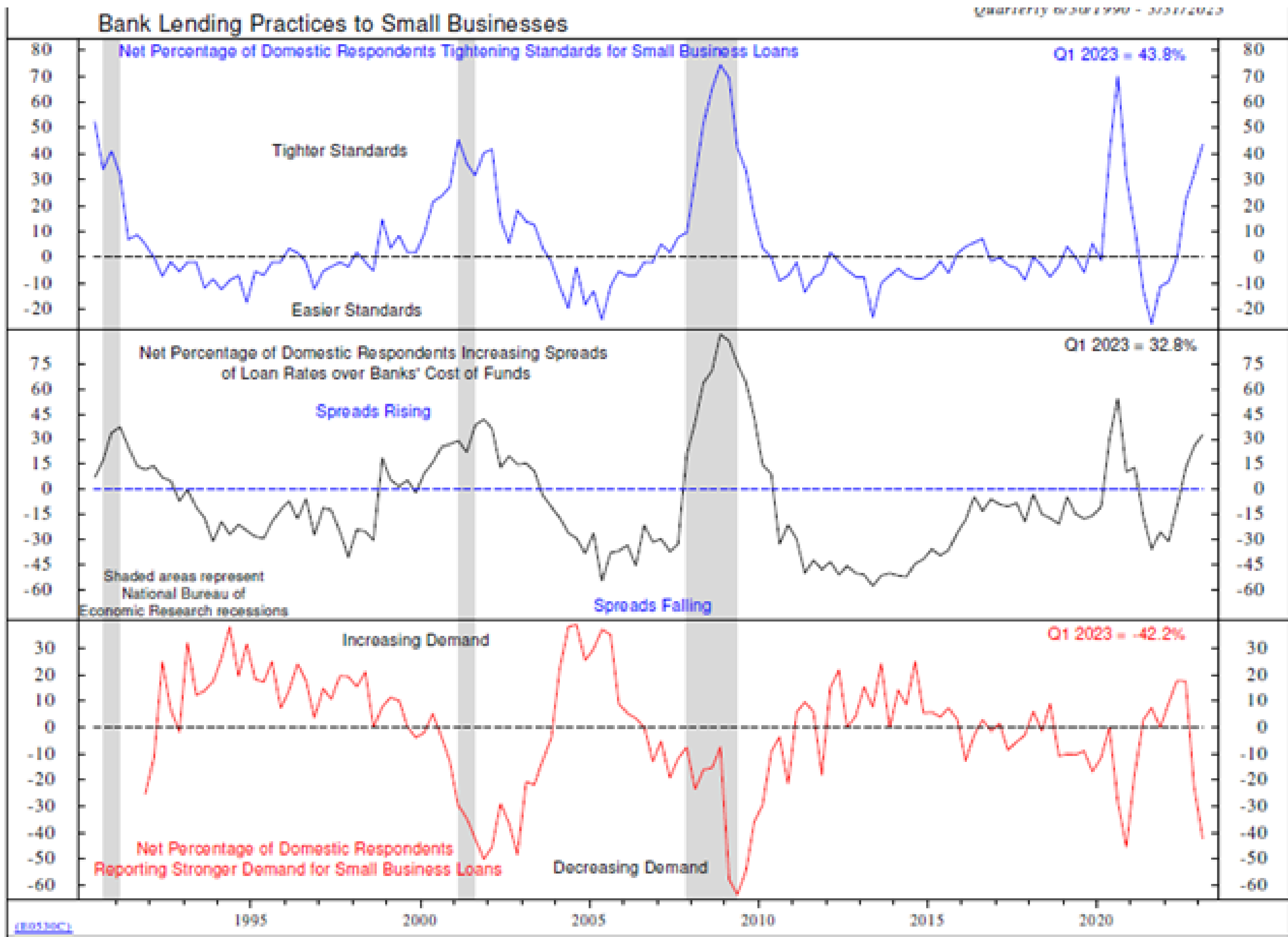
Source: Ned Davis Research



Loans to small businesses in the USA have also been under pressure since mid-2022. The Fed's persistent and rapid tightening campaign has discouraged banks from lending and small businesses from borrowing. Those smaller businesses that have borrowed have had to pay much higher rates along with wider lending spreads. The cost of borrowed capital has gone up and the availability of capital has gone down. The recent banking crisis will further impact the small and mid-sized banks that lend heavily to small businesses. According to the FDIC, small to mid-sized banks hold almost 40% of small business loans. Community banks originate and hold approximately 30% of all commercial real estate (CRE) loans.

Exhibit 3: Bank lending practices to small businesses

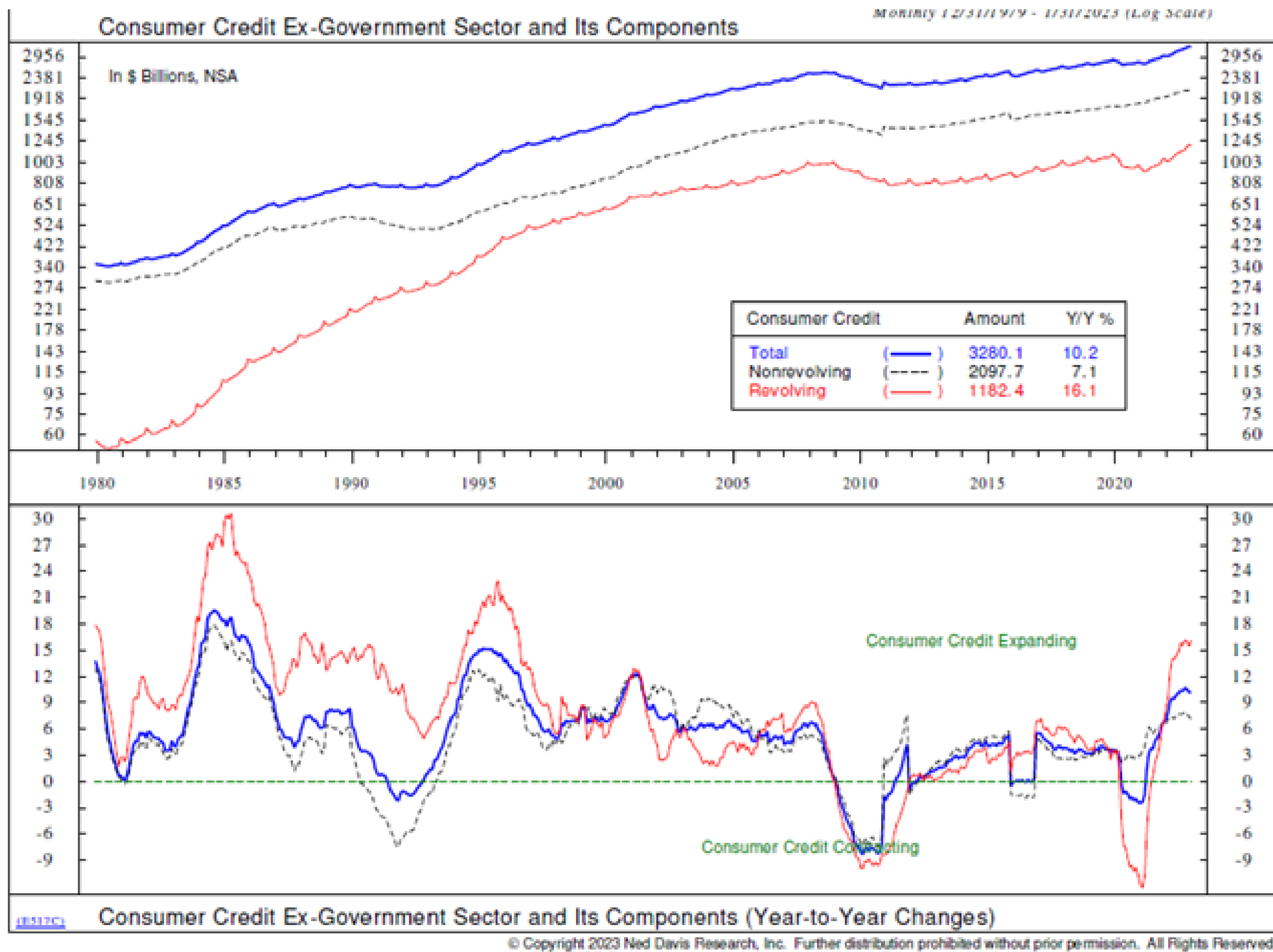
Source: Ned Davis Research



Consumer credit demand has been rising since the pandemic lows. Banks have been willing to extend credit to consumers, but at significantly higher interest rates and spreads. However, it appears in the bottom panel of Chart 4 below that consumer borrowing has potentially peaked for the current credit cycle.

Exhibit 4: Consumer credit ex-government sector and its components

Source: Ned Davis Research



Enter the Banking Crisis

The recent failure of SVB, Signature Bank, and Credit Suisse among others should lead to even tighter lending conditions and may well indicate the beginning of a traditional Fed induced credit crunch. The Fed has finally tightened far enough and fast enough to break some of the weakest financial institutions that had poor business practices, too much concentration risk, along with insufficient risk management. Credit crunches come with the territory during high inflation driven tightening cycles. The implications of the banking crisis and the Fed "breaking something" are the following:

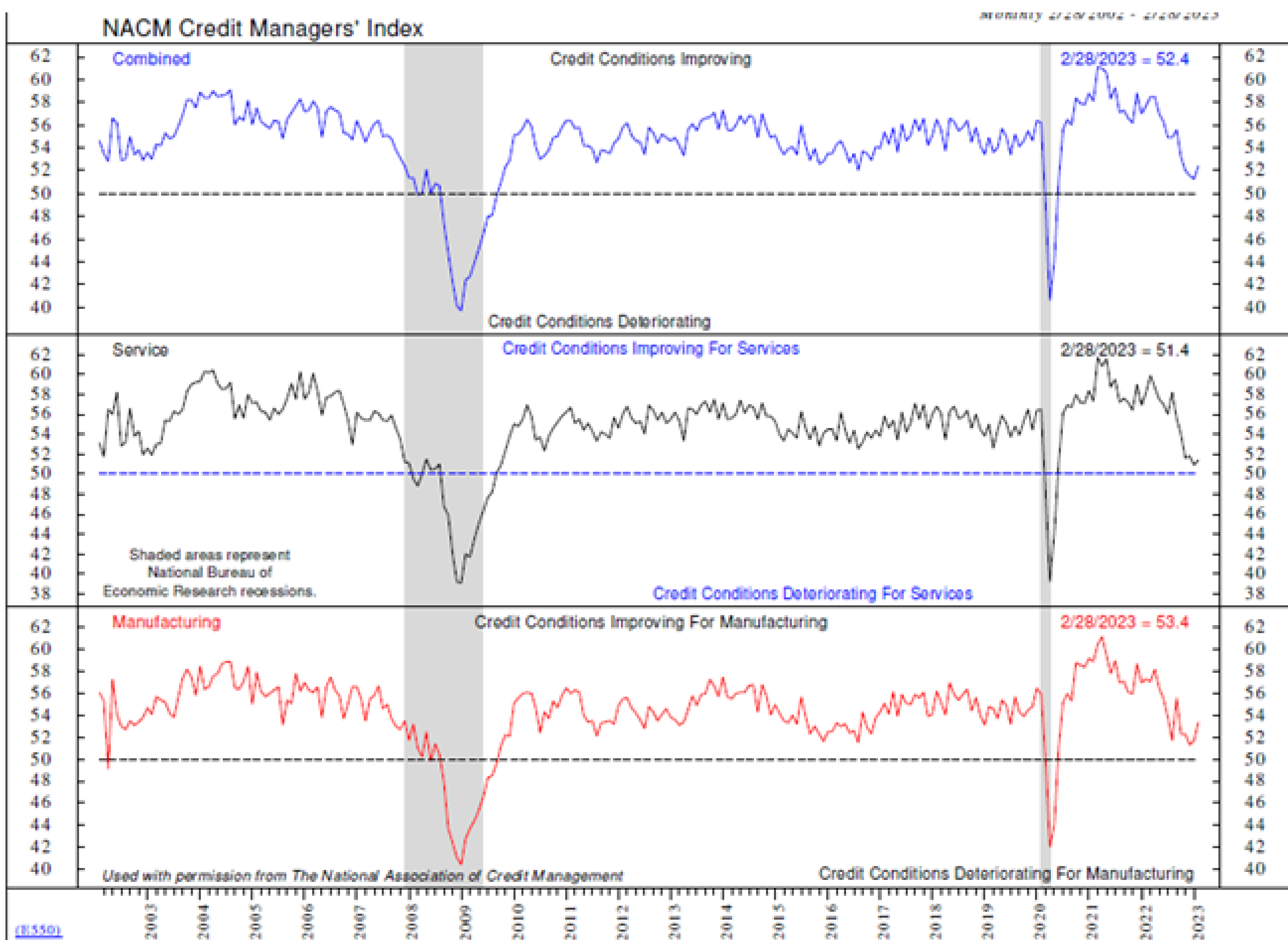
A. The risk of a traditional credit crunch is rising. Banks will be more likely to husband capital, and their appetite to make loans will continue to contract. Borrowers will be less willing to take on leverage.
B. Due to less credit availability, the US economy is likely to slow further, and the odds of an economic recession have risen. In addition, the timing of a potential recession has been pulled forward into 2023.
C. The Fed will be much more cautious about raising rates at coming policy meetings. The Fed will no longer be able to have single minded focus on its inflation mandate. Financial stability will now have to be a greater factor in their future policy decisions.

D. History and logic informs us that the recent banking crisis is the equivalent of the Fed raising rates by an additional 100 basis points on top of the 500 basis points they have already given us. Quantitative tightening (QT) has also added to overall policy tightening. The combination of rate hikes (500 bps) + QT (50 bps) + banking crisis (100 bps), theoretically puts policy rates well into restrictive territory.
E. The Fed is nearing the end of this historic tightening cycle. The Fed statement at the 3/22/23 policy meeting made this clear.
F. The banking crisis is inherently disinflationary and will likely add to the speed of slowdown in inflation.

Conversely, the widely followed NACM Credit Managers Index remains around neutral, having fallen from extremely accommodative territory over the last two years. This key indicator does not indicate a credit crunch but does reflect an increasingly less favorable credit environment.

Exhibit 5: NACM Credit Managers Index

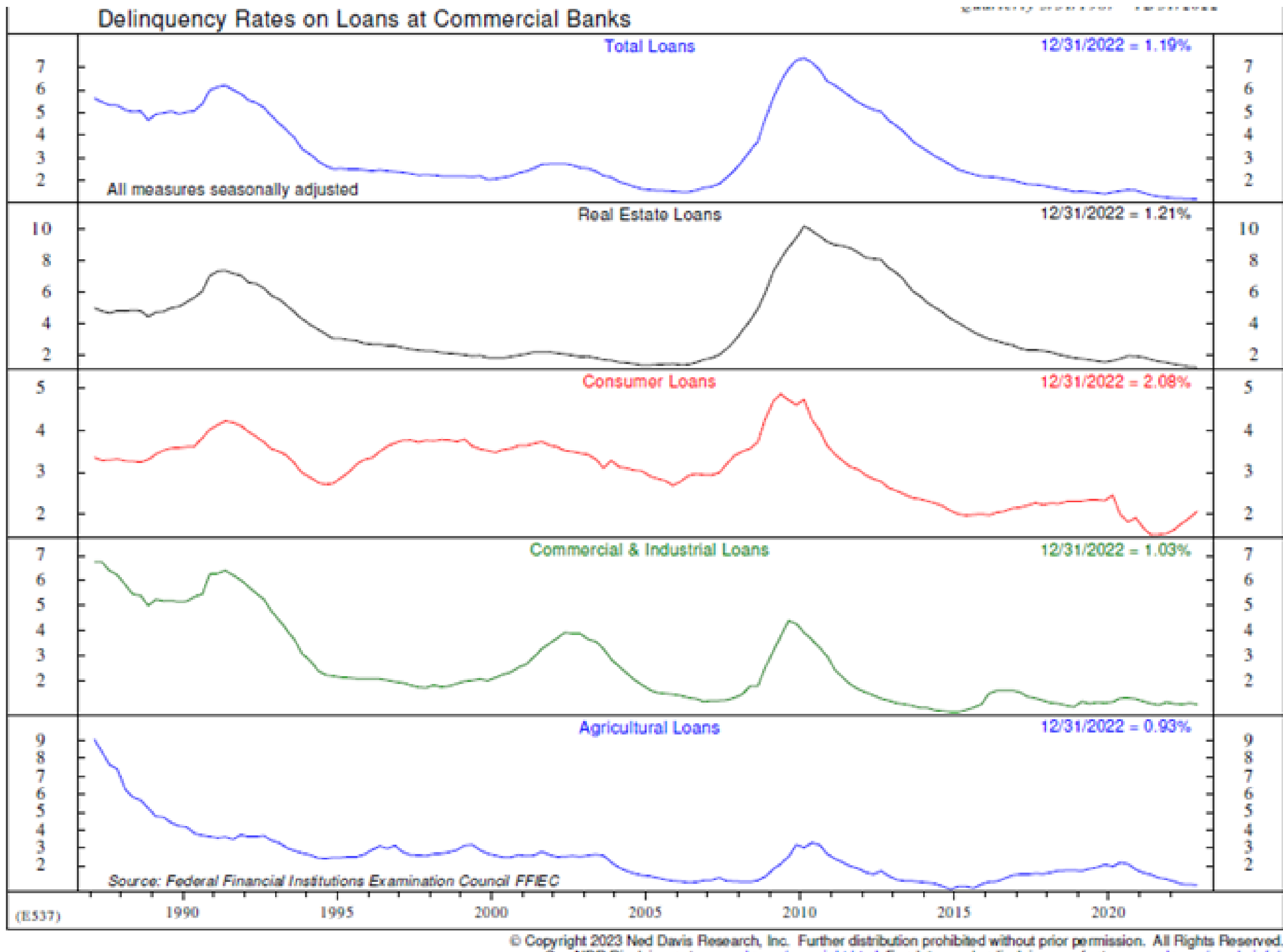
Source: Ned Davis Research



Delinquency rates on bank loans are only beginning to bottom out and turn up. Of course, this is a lagging indicator, but we are some ways away from banks having to take major charges on their balance sheets to reflect bad loans. Perhaps banking system assets are in better shape than many realize.

Exhibit 6: Delinquency Rates on Loans at Commercial Banks

Source: Ned Davis Research

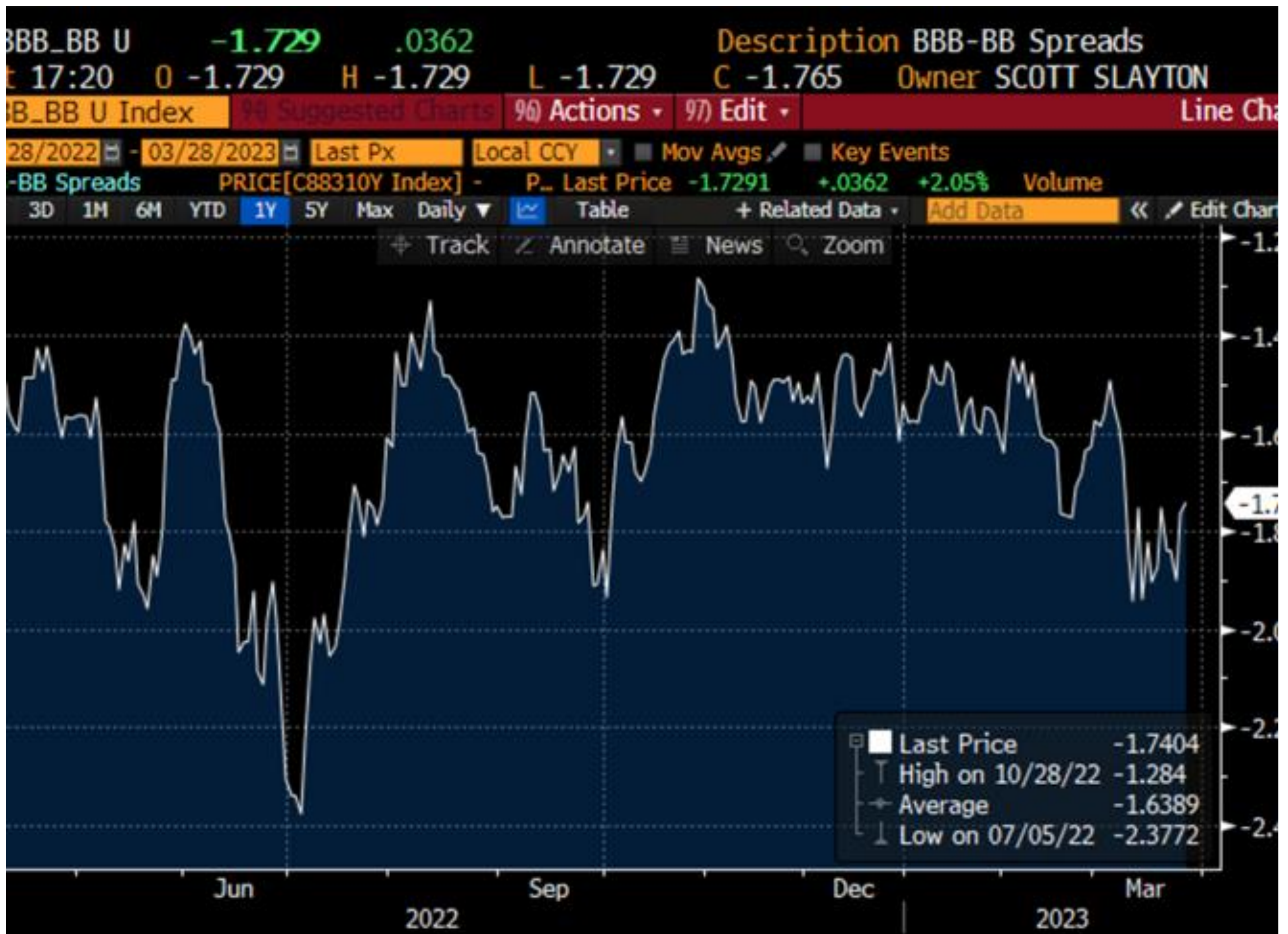


Surprisingly, market-based credit spreads such as BBB-BB have not crashed as a result of the recent crisis. They remain well behaved. However, if the spread in chart 7 breaks below the -2.0 level we will be increasingly concerned. Deterioration in credit spreads is one of the best leading indicators for trouble in the equity market and the economy.

Exhibit 7: BBB Corporate Bond Yields Minus BB Corporate Bond Yields

Lower reflects greater credit quality fears

Source: Capital Creek Partners Research, Bloomberg

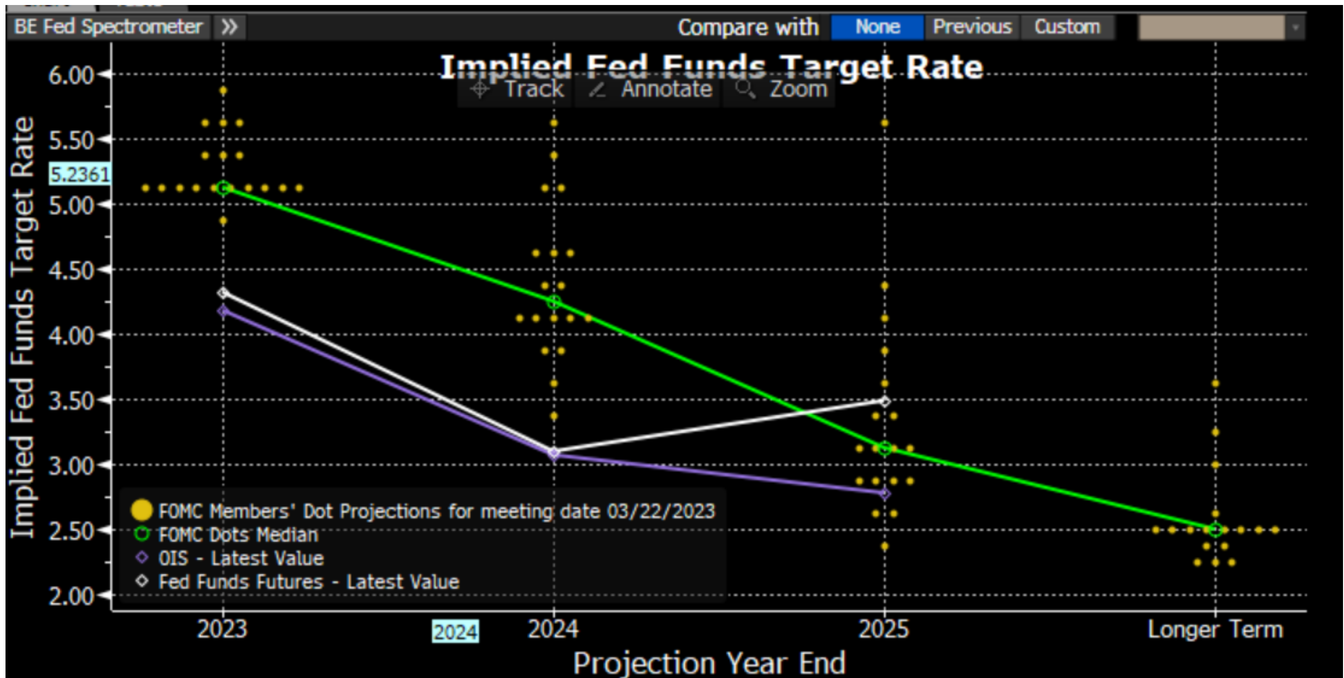


Why are Equities Up Since the Banking Crisis Began?

Just like the fixed income markets, the equity market is betting the Fed is almost finished raising rates after the March meeting. Of course, this depends on how the inflation data evolves. If inflation remains sticky on the upside, the Fed may well continue to hike irrespective of greater financial instability. The marketplace is in total disagreement with the Fed "dots" and is now pricing in around 75 basis points of cuts by year-end 2023.

Exhibit 8: Fed "Dots" in Conflict with Market Pricing

Source: Capital Creek Partners Research, Bloomberg



The Fed's balance sheet is growing again as a result of the recent banking crisis. US banks and international banks have tapped the Fed's discount window to a near record degree over the last two weeks. Banks use the discount window to access rapid funding in size during times of financial stress. The future path of quantitative tightening is now in doubt and that is bullish for stocks. The equity market has suffered under QT and having it shelved in the name of financial stability may be constructive for stock prices.

Exhibit 9: Federal Reserve Balance Sheet – Growing Again!

Source: Capital Creek Partners Research, Bloomberg

The technical uptrend in the S&P 500 remains in place with the Index trading above the 50, 100, and 200 day moving averages. Even the bears must admit that equities have traded exceptionally well in the face of financial system turmoil. Perhaps this trend is largely a result of improving liquidity conditions combined with extremely depressed investor sentiment and positioning.

The CCP Strategic View

The macro-outlook is extremely complex today. The financial markets are confronted with high inflation, a banking crisis, a land war in Europe, a US/China cold war, falling earnings, and a potential credit crunch leading to a recession in 2023. All of this in the context of still unsupportive valuations for bonds, credit, and equities.

We like to use our best models and indicators to cut through the miasma and add clarity during highly uncertain times. Our Tactical Equity System (TES) remains on a neutral signal and our Tactical Asset Allocation Model (TAA) remains uniformly negative on risk assets.

At the same time, we respect the technical indicators, which remain constructive for the equity asset class. We also recognize that interest rates have fallen sharply over the last two weeks in response to the banking turmoil. Lower rates are directly bullish for bonds and supportive for equity earnings multiples. Bottom Line: We continue to look for opportunities to add risk asset exposure at prices where we believe we are being well compensated for taking additional risk for clients. Our tactical equity buy levels on the S&P 500 Index are illustrated in Chart 10. The goal is to get clients closer to target public equity and fixed income levels opportunistically in 2023.

Exhibit 10: Tactical Downside and Upside Buy Levels for SPX

Source: Capital Creek Partners Research, Bloomberg