# COMMENTARY & OUTLOOK
# BANKING SECTOR
April 18, 2023

CARLSON INVESTMENTS

## Bottom Lines Up Front

We see a potential for bank enterprises to become "utility-like enterprises" with profitability highly regulated. As a result, we are currently doing work to evaluate potential non-bank candidates for the portfolio and see this continuing through 2Q 2023.

"Office Property is the New Mall." Malls throughout the past two decades have overwhelmingly lost the battle against the rise of online/ecommerce activity, and while many still exist the cash flowing properties of the space have never fully recovered to the halcyon pre-internet days they enjoyed for decades. We see many office properties suffering a similar long-term decline in occupancy as well as valuation.

### What was the portfolio's exposure to Silicon Valley Bank, Signature Bank, and/or Credit Suisse before their collapse?

Our portfolio had ZERO direct exposure to the aforementioned institutions. Coming into this event our financial sector positions included 4 out of 8 GSIB (Global Systemically Important Banks: JPM, MS, BK, and BAC), as well as PNC, the nation's 5th largest deposit institution. While we did not predict such a sudden and sharp downturn in the regional/community bank system due to Held-to-Maturity portfolio issues, we have maintained an overly cautious stance due to a confluence of issues building within the Office and Retail Commercial Real Estate markets since mid-2022. Our positioning in the large-cap GSIBs has reflected those concerns.

### What steps were taken to mitigate the risks associated with these banks before their collapse? Were there any early warning signs that were overlooked?

As mentioned, we positioned away from the community and/or regional bank system at large. Our chief concern has been commercial real estate issues that have built up over the last 18-24 months. At this moment we believe these concerns are rising to the forefront however the challenge of going through the potential CRE "crisis" lies ahead.

Regarding the issue of mishandled interest rate risk that resulted in the collapse of Silicon Valley Bank, we believe a number of smaller banks face similar "held-to-maturity" unrealized losses on their balance sheet, but the initial "digital bank run" fever pitch has subsided and for the moment the situation has stabilized.

After the initial impact of the SVB bankruptcy, out of an abundance of caution we made the decision to reduce our direct bank exposure by eliminating our position in PNC Financial shares. PNC maintains a strong capital base however we sought to eliminate any non-GSIB bank shares, and will likely maintain that position until further clarity regarding additional FDIC deposit insurance is achieved.

## How has the portfolio been repositioned since the collapse of these banks?

Since our initial sale of PNC we maintain a cautious view on bank valuations and shares as the regulatory framework regarding additional FDIC deposit insurance across the system has yet to fully resolve. We expect further failures at the community and perhaps regional bank level due to an overreliance on Commercial Real Estate loan defaults moving higher throughout the year. We expect further backstop facilities from the Fed to be needed as CRE refinancing needs arise. Bank ROEs may continue to see pressure as well as investor appetite to maintain exposure to bank shares may reduce over time. We monitor weekly Fed deposit data for further clues on "deposit flight" from small to TBTF institutions. While the initial "shock" from the SIVB bankruptcy has likely peaked, our view is investor concerns will uptick again as we enter 2Q earnings and into June when Congressional debt-ceiling negotiations come into focus.

## What is your outlook on the banking sector for the short and long term, considering potential regulatory changes, macroeconomic factors, and the overall market environment? Are there specific areas within the Financial sector that you believe are more resilient or susceptible to risks?

Our short-term outlook is somewhat benign as the severity of the drop in the KRE largely reflects the known concerns facing our community/regional bank system at large. However, comments from Treasury Secretary Janet Yellen have left investors to draw their own conclusions about additional deposit insurance (and costs, who funds? Etc.) in some regards. In our view the system remains vulnerable as we have yet to resolve the novel problem of a "digital bank-run".

Our longer-term outlook is more constructive as we take a bit of a contrarian position that the Fed rate hiking cycle is likely finished after the expected 25 basis point hike in May. We believe year over year CPI comps starting in June will result in a sharp drop in CPI reports throughout the summer and concerns from the Fed about further destruction in the banking/CRE sector will supersede the view of "entrenched" or 1970s-like "sticky" inflation. As WACC (weighted average cost of capital) peaks and begins to fall we believe this will unlock a "flow of funds" trade allowing investors to move from a defensive/value stance to more of a GARP (Growth at a Reasonable Price) stance. In other words, a reasonable Risk On trade through the balance of 2023.

## How are you evaluating banks and financial institutions in terms of their risk management practices, lending policies, and balance sheet strength? Are there specific criteria or metrics that you're focusing on?

We have and will continue to rely on the resources provided from our sell-side partners for various screening metrics for financial institutions. Specifically, we will seek to avoid any shares with significant uninsured deposit anomalies, unconventional lending policies and/or risk management practices. While the market has done a fair job of identifying bank equities with said issues already, we do NOT believe it

is time to consider positions in these shares, as there are still many "unknown unknowns" potentially to play out. There may be a time in the next several months to evaluate the distressed banks but simply said we are not there yet.

Specific areas of concern are New York, San Francisco, Seattle and Chicago Office loan exposure. As corporate tenants seek an employee "5-day return to office" policy we believe a hybrid (WFH/RTO) model is more likely to stick, which will result in many office property cash-flows to decrease, thereby affecting LTVs upon refinancing, cap rates, and ultimately a decline in investor interest as many properties will face permanent impairment. The cost of repositioning said Real Estate (to residential housing for example) is for too high in our view, absent substantial tax incentives from the government.

## How are you factoring in the potential for further defaults or collapses within the banking industry when constructing the portfolio? Please share any scenario analysis that may be available.

We expect further bank defaults to occur over the course of the next 2 or 3 quarters. While it is possible the SIVB shock uncovered the "bad actors" who mishandled interest rate risk over the last 18 months of the rate hike cycle, it is unlikely that there are no other smaller shocks that will wipe out some smaller banks in the months ahead. Several macro conditions could cause a "Second Wave" in our view (e.g., a sharp rise in CRE defaults, additional hikes from the Fed beyond May) but we do not forecast a systemic bank crisis looming on the horizon.

To end on a point of optimism, bank P/Es are largely reflecting these concerns in our view and while we are not overly constructive on valuations in the medium term in is unlikely to see another "leg down" in valuation as we approach 2Q earnings season.

In addition to a potential floor in bank equity valuations, the opportunity for M&A in the financial sector will likely increase in months ahead. While the proverbial dust is still settling in the wake of SIVB/CS, opportunistic distressed investors will shortly arrive to evaluate any undervalued assets and we will monitor this closely as well. Earnings guidance from reporting banks will be an excellent data point about the collective and individual outlooks for our financial sector as it seeks to recover from a system shock less than two months old.