03.09.2023 - Has the Shoe Dropped?

As anyone knows who has visited the downtown of a big city lately, the foot traffic is considerably lower than a few years ago. In New York City, office occupancy is about 47% of pre-pandemic levels. In San Francisco it's about 44% and, even in freedom loving Austin TX it's about 67%.* I've known this for some time and it's been a bit of a mystery why, outside of a few office real estate related stocks, the stock markets haven't seemed to care (until today - 03.09.2023 - anyway). I mean, if the major office buildings in our big cities are not occupied, that "has to" lead to a lot of bad stuff, doesn't it? That bad stuff is starting to happen as major owners like PIMCO and Blackrock have recently "turned in the keys" to their banks and defaulted on the loans on some of their billion dollar properties^ (see picture at left. That's 650 California St. SF) . The owners/borrowers of those buildings have seen their values drop at least 20% or more (in some areas 40%) as lessors try to opt out of leases or attempt to sub-lease their excess space or quit paying their leases, all of which depresses lease rates. That, in turn, depresses the value of the buildings, which creates collateral problems for the loans behind the buildings. The domino effect caused by this has got to be huge. As owners' default and the value of the loans outstanding decline in value, it puts massive pressure on the capital reserves held by the banks and other non-bank financial companies. As long as interest rates hovered near 0%, the borrowers could skate along. Now, as loans come due and refinancings start to happen, what was feasible at 3% interest is no longer feasible at 8% interest or higher. Unfortunately, this is also happening in China.^*

*https://www.zerohedge.com/markets/hedge-funds-pile-new-big-short-next-credit-event-emerges

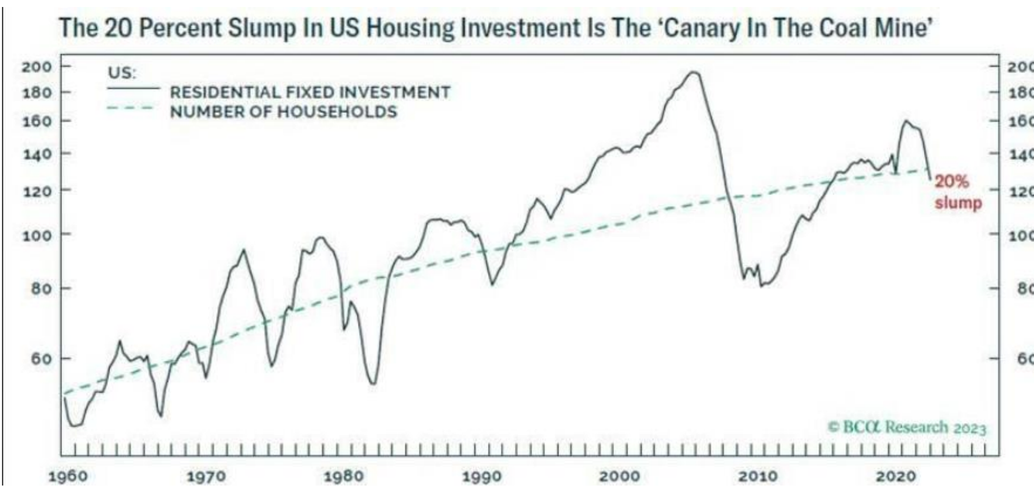
^https://www.zerohedge.com/markets/facing-unprecedented-challenges-and-soaring-rates-pimco-owned-landlord-defaults-17-billion

^*https://www.zerohedge.com/commodities/tsunami-new-supply-china-slumping-office-rental-market-faces-historic-crisis

These issues played out in the stock markets yesterday (03.09.2023) as the regional and large bank ETFs (KRE and KBE) crashed -8% and -7% respectively and non-bank lending companies (BDCs) fell -4%^^. The catalyst for this was one of the big Silicon Valley banks, SVB, lost 60% of value in trading yesterday after reports of various financial arrangements to raise cash were reported*. It is down another 60% today (03.10.2023) and the stock has been halted. This may just be the beginning of the big "credit" event that finally causes the wash out I've been expecting.

^^ Source: www.finance.yahoo.com

*https://www.zerohedge.com/markets/silicon-valley-bank-center-venture-capital-bubble-suffers-record-47-crash-amid-sudden



The reason I've been expecting another stock market decline is because of the crash in housing. Not in prices, yet, but in new starts. A significant fall-off in housing has always preceded a recession and we are having a significant decline in housing with a drop of 20% in housing related investment.* Of course, we all know the reason. Interest rates on new mortgages are in the 6% - 7% range.**Anyone with a pulse and a credit rating above sub-prime bought or refinanced in the last few years at historically low rates. We are all trapped now. If one has a 3% rate for 30 years, it would take a lot to move and then pay 6% or 7% on a new loan. For 40 years,

outside of a few short periods, rates steadily declined allowing people to make money on their home and easily move to a new location. That is pretty much gone, unless one has a paid off house. New mortgage applications have dropped to a 22 year low.^* Refinancings have dropped 99.5% since Q1 2021^. That means a "whole lotta" real estate and mortgage people have been or are going to be laid off. The cascading effects are many. New homes equal new appliances and new furniture. Jobs for contractors and all sorts of trades. This is why big drops in housing precede most all recessions (2001 and 2020 are the exceptions)*. I suspect we will see some major drops in price in most areas as developers are forced to lower prices as their notes come due at much higher rates.

*https://www.zerohedge.com/markets/us-housing-recession-canary-coal-mine

**https://www.bankrate.com/mortgages/analysis/

^*https://www.zerohedge.com/personal-finance/mortgage-applications-crash-22-year-low-monthly-payments-rocket-higher

^https://news.yahoo.com/heres-how-sharply-mortgage-refinancing-has-dropped-off-213344221.html

Right now, we are as conservative as I've ever been with our managed accounts at Nationwide. Lots of cash and short term bonds. Very little in the stock market. You can check your account to see your exact allocation. We just had two big down days (March 7th and 9th) and our accounts are down a relatively small amount. The concerns above are reasons I've been moving lots of client money to safe fixed accounts paying 5%+ or to accounts that have "buffers" that can protect as much as a 20% downside* or accounts that have no risk of loss^ and are linked to gains in the major indexes (up to a max cap). If I haven't talked with you yet about these options, please send an email to Deena (dredden@cfiemail.com) and she will set a time to chat.

*Buffered accounts may provide up to 20% protection from index declines while also allowing for 100% participation in the index chosen. Please refer to a product prospectus for specific information on costs, crediting methods and buffer protections.

^Guaranteed by the claims paying ability of the insuring company

As always, thank you for allowing us to be of service. Please let us know if you need anything.

Enjoy,

Tom

PS - One a side note, with all of this in mind, I wanted to provide some information about banks and the safety of your bank. As all know, we/the US Govt are deeply in debt, both "on the books" and "off the books." The current national debt is about $31.5 trillion and the unfunded liabilities are estimated at about $181 trillion.* As we get older as a nation, and because our political leaders don't see a constituency large enough to seriously reduce our obligations, this debt will, no doubt, grow. Until it can't. I love the old Herb Stein quote – "If something can't go on forever, it won't." When rates were at 0%, one could have infinite debt and it didn't matter (this is why the stock prices of companies with little revenue and no profits could soar to the sky) . However, throw a 5% or 6% or 8% interest rate onto that debt and suddenly a crisis looms. $31.5 trillion at 5% interest equals $1.575 trillion, which is over 25% of all current govt expenditures. Now, this would not happen for a long time as there is lots of government debt that is fixed for many years. However, shorter term notes are having to be refinanced at 5% or above. As government interest costs go up, that will leave little money for anything "discretionary." The FDIC fund has a small fraction of the amount necessary to insure all of us.* Will money be there if the rest of the government is in a funding crisis?

*https://www.pbs.org/newshour/economy/is-your-money-safe-at-the-bank-an-economist-says-no-and-withdraws-his

Anyway, without going into a long discussion, I think it's prudent to make sure your bank is safe. A few clients have asked for this type of information so I've done a bit of research and found the following links. I can't vouch for the accuracy of the articles and this is not advice or a recommendation to do anything. Just some resources if you wish. The

first article discusses whether bank testing done by the Fed Reserve is reliable and realistic. Some interesting stuff. They list some banks that should give one pause before depositing.

https://seekingalpha.com/article/4578549-the-fed-is-trying-to-pull-a-fast-one?mailingid=30584698&messageid=2850&serial=30584698.11641&utm_campaign=rta-author-article&utm_medium=email&utm_source=seeking_alpha&utm_term=30584698.11641

This second article also goes into the discussion of whether "your" bank is safe. Inside the piece are a number of links to notes on a number of banks, most of which you'll recognize. There is also a link to an article that discusses the possibility of a 'bail-in" rather than a "bail-out" in the next severe recession^. I should note, the author of these articles is also promoting a subscription service that one may join to get information on the safest banks. I have no financial interest in this and am not promoting it. Please do not call or email me with questions about your bank or what banks are safe.

*https://seekingalpha.com/article/4574762-as-market-heads-higher-now-is-the-time-to-protect-your-assets?mailingid=30445400&messageid=2850&serial=30445400.17791

^ https://seekingalpha.com/article/4515825-is-your-bank-safe-there-will-be-no-more-bank-bailouts?hasComeFromMpArticle=true

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