CION INVESTMENTS

Q2 OUTLOOK:
BANK RUNS, RENTAL BOOMS, AND HIDDEN DECLINES

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Early in the morning of October 22, 1907, an anxious line began forming outside the mid-town Manhattan headquarters of the Knickerbocker Trust Company.

The rumor was that the Knickerbocker, one of the largest banks in the U.S., was insolvent. The line grew into an angry crowd, all clamoring for return of their money. Police were called to maintain order as the tense throng grew more rowdy.

In a desperate display of showmanship, several vans of cash were conspicuously delivered in full view of the crowd. That bought some time, but for every depositor that received their money ten more lined up. By the end of the day the Knickerbocker Trust Company was wiped out, and the Panic of 1907 had begun.

There are echoes of the Knickerbocker in the recent failure of Silicon Valley Bank (SVB). It was the first U.S. bank to fail since 2020 and the first so-called “Twitter-fueled bank run.” Shortly after SVB failed, Signature Bank closed, and Credit Suisse was taken over by UBS. For now, panic has receded, although deposits continue to flow out of banks.

With bank chaos, higher rates, and continued elevated inflation, what should investors expect in Q2 and beyond? Below we discuss what will happen to the lending market as small banks pull back, the hot market for rental homes, and the asset decline that no one has noticed.

Q1 2023 Market and Economic Summary

Markets*

	As of 3.31.2023	Q1 Return	2022 Return
S&P 500	4,109.31 pts	7.0%	-19.4%
NASDAQ	12,221.91 pts	16.8%	-33.1%
The Dow	33,274.15 pts	0.4%	-8.8%
Global Equities		9.4%	-17.9%
Emerging Markets		4.1%	-22.4%
Energy		-5.3%	57.6%
Gas	$3.97/gal	3.1%	6.8%
Gold	$1,969.28/oz	8.0%	-0.3%
VIX	18.70 pts	-13.7%	25.8%
10-Yr Treasury	3.47%	-40.7 bps	236.5 bps

*Source: Bloomberg. *See endnotes.*

Alternatives*

	Q1 Return	2022 Return
Direct Lending	3.1%	-10.7%
CLOs	3.0%	-3.6%
Private Equity	7.1%	-38.9%
Hedge Funds	0.0%	-4.4%
Equity REITs	0.6%	-27.8%
Residential REITs	1.2%	-33.7%
Industrial REITs	9.1%	-31.6%
Wine & Cheese	-0.5%	-9.8%
Rolex Watches	-1.0%	-10.0%
Crypto Market	59.7%	-70.2%
SPACs	4.7%	-24.1%

*Source: Bloomberg. *See endnotes.*

U.S. Economic Performance:

- Inflation CPI peaked at 9.0% in June 2022, and is now at 5.0%
- Real GDP[1]: The Conference Board estimates this at 0.7% FY 2023 (vs 2.1% 2022 actual)
- Consumer Sentiment now 63.4 in March (vs 59.4 in March 2022), but still nearly 40% off pre-COVID highs
- Unemployment rate remains low at 3.5% in March, matching pre-pandemic levels
- Nearly 60% of respondents think a recession is "likely" in 2023 according to a March NABE survey

Monetary Policy Overview:

	Date	Hike	Range
↑	3/22/2023	+25bps	(4.75%-5.0%)

- Projections for the terminal interest rate, i.e., the peak fed funds rate, remain at 5.1%. The Fed says it won't cut this year; the futures market disagrees.
- The Fed's balance sheet swelled in Q1 thanks to its new Bank Term Funding Program (BTFP), which was introduced to stabilize banks carrying large hold-to-maturity losses. Dubbed "Quantitative Teasing" by Fed oracle Concoda, the program reversed four months of QT balance sheet reductions in just four days. BTFP loans won't have the same asset price impact as QE, since the proceeds will be used primarily to fund deposit outflows from banks.

Where are assets flowing? We are no longer in TINA's world. The acronym stands for There Is No Alternative [to holding equities] because of low rates. Say hello to TARA, short for "there are reasonable alternatives [to holding equities]." Deposits continue to leave banks and flow into the money market for safety and yield.

2023 Q1 Returns[2]

Investment Grade	High Yield	Leveraged Loans
3.35%	1.8%	2.24%

Credit Market Performance:

- Yields have surged from one year ago, causing heavy mark-to-market losses even for risk-free treasuries. The yield on 1-year treasures has increased 10x from the start of 2022
- Borrowers continue to be squeezed as low-rate debt rolls over at much higher rates
- Defaults are predicted to increase to more normal levels. Fitch Ratings estimates that 2023 default rates will be 3.0%-3.5% in HY (current is 1.3%) and 2.5-3.0% in Leveraged Loans (current is 1.6%)

U.S. and Global Market Summary:

- Global stock markets were mixed in Q1 coming off a universally dismal 2022. The energy sector, 2022's bright spot, was down (5%). Gold caught a bid, up +8% for the quarter
- With inflation persisting, investors are watching earnings compression. Revenue keeps growing but margins aren't, as companies aren't able to pass along higher costs. What happens when interest rates and inflation remain elevated?
- Investors are focusing on the Fed instead of fundamentals. Equities earnings yields have yet to fully adjust to a world where bonds and CDs offer good yield

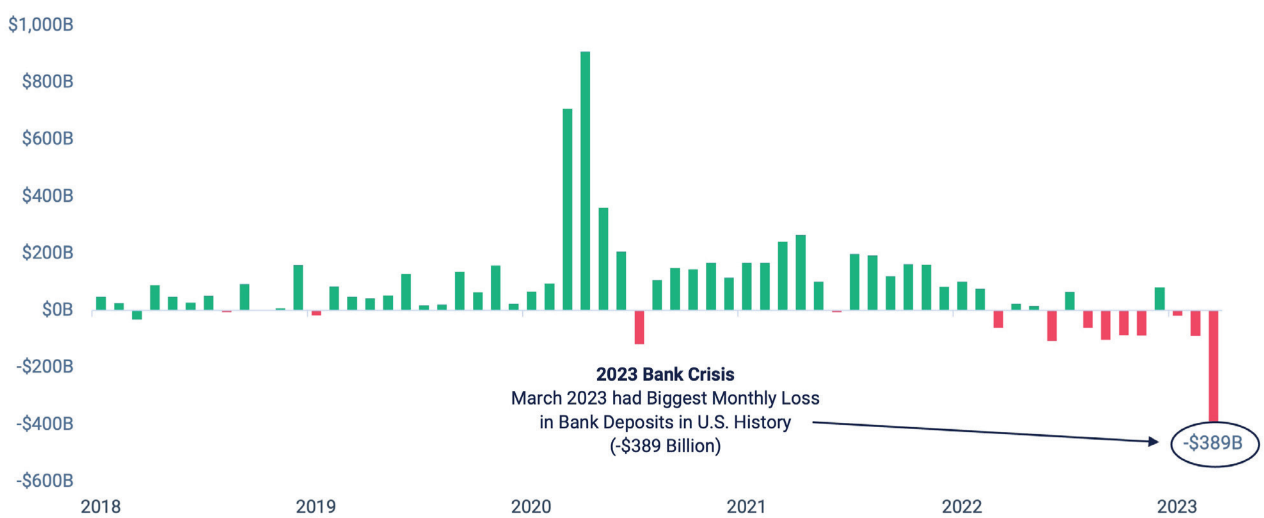
Quarterly Outlook – The Items We're Tracking in Q2

I. The Decline and Fall of the Regional Banks

Community and regional banks (CRBs) were disappearing long before SVB failed. Forty years ago, there were over 14,000 banks in the U.S. vs just 4,200 today. The top 13 largest banks now represent more than 50% of all banking assets. CRBs aren't being replaced with new banks, they are being displaced by giants.

The deposit run continues. After becoming flush with deposits during COVID, those funds are now leaving. Industry consolidation will likely be accelerated as depositors flee to the safety of large banks or the yield of money markets. The CRBs that remain will have less capacity to serve their traditional role in small business lending.

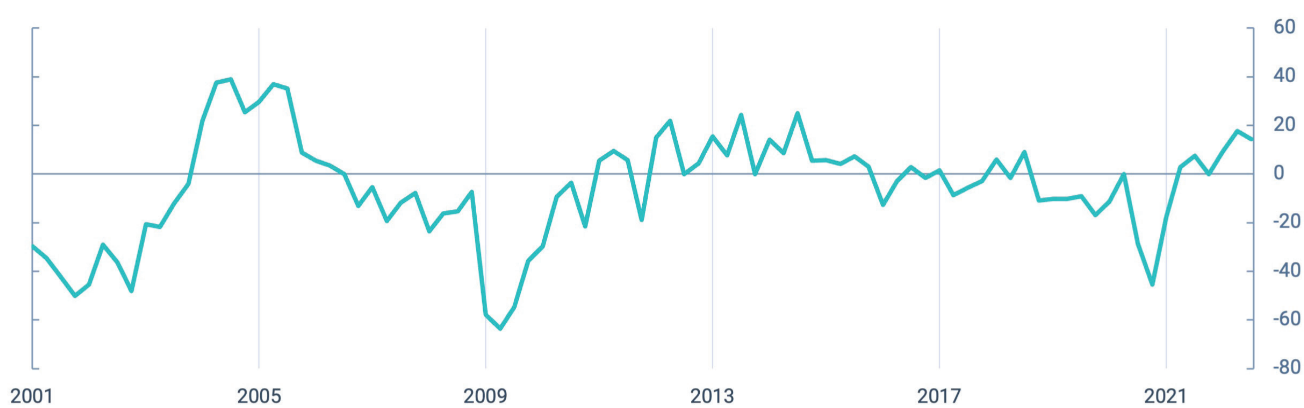
Monthly Change in Bank Deposits 2018-2023



Source: Federal Reserve

CRBs are essential sources of capital for small firms. Goldman Sachs research shows that banks with under $250 billion in assets account for 50% of commercial and industrial lending, 60% of residential lending, 80% of CRE lending, and 45% of consumer loans. Until more alternative sources of funding step up, those borrowers will be starved of credit.

Net Percentage of Banks Reporting Increased Demand For Commercial & Industrial Loans by Small Firms



Source: Board of Governors of the Federal Reserve System (U.S.)

New Lenders are Moving to Meet Demand for Credit

The pullback of CRBs in their traditional lending role will open the door for alternative sources of capital. Online lending platforms are emerging as an alternative for small borrowers seeking credit. Relying heavily on automation, online lenders provide credit to small businesses and solo entrepreneurs but aren't able to offer the personal service and flexibility of CRBs.

Larger loans require more capital and research, possibly benefitting large asset managers with experience in direct lending. These non-bank institutions can move quickly and offer more flexible terms than traditional banks. Direct lending favors larger asset managers with more robust sourcing capacity and industry connections; similar to banking, lending is a relationship business. Institutional capital has been ahead of the curve in taking advantage of the asset class, which is now becoming an option for retail investors. Direct lenders are capital rich and tech savvy and are well positioned to grow their market share.

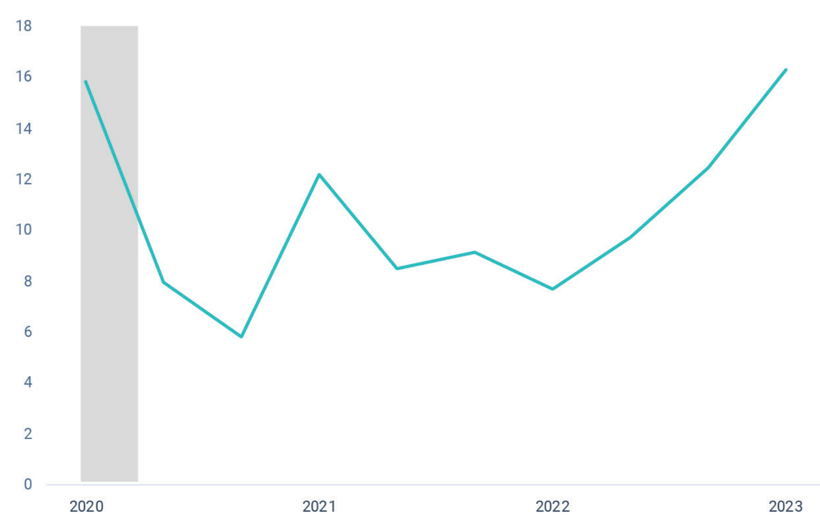
II. Why Rental Homes are the Rage

Three million households making over $150k are now renting homes, according to the Wall Street Journal. The rising cost of homeownership and higher mortgage rates has made home rental more popular than ever.

The cost of homeownership is high and growing. It's increased over 70% in the last three years compared to rental cost growth of 20% over the same period, says Bloomberg. As WFH became widespread, the mobility and flexibility of renting helped mainstream renting into a valid long term choice instead of a stopgap. From a value perspective renting makes sense. The buy-or-rent premium is at its highest level since 2006, according to the National Multifamily Housing Council.

Current mortgage rates are encouraging home rentals. 72% of homeowners have locked in a mortgage rate below 4%. They aren't going to buy again until rates decline. These "accidental landlords" are stuck. Since 2020, mortgage rates have more than doubled, making it more difficult for many people to afford a home. A $700k house at 3% is $2,900 mortgage payment, at 7% it's $4,650. Refinancings are also becoming more difficult.

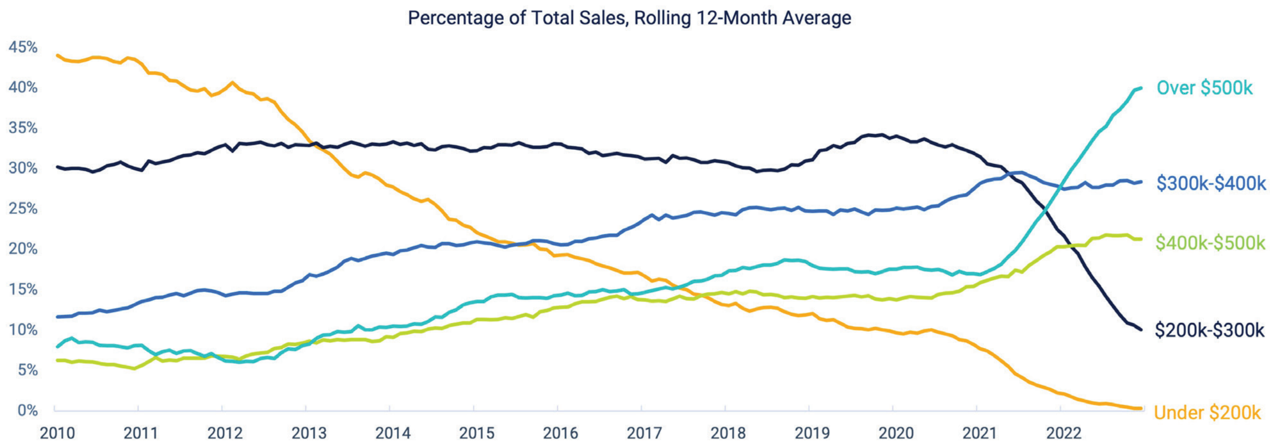
Mortgage Refinance Rejection Rate Over Past 12 Months (%)



Source: Federal Reserve Bank, New York. Recession shaded.

And it's not just higher rates making homes more expensive. There are no more value-priced homes. Previously inexpensive metros have seen house prices boom. The Federal Reserve data charted below shows the trends. Just 10 years ago 40% of home sales were under $200k, today there are effectively zero homes sold at the price. Over the same time homes selling for over $500k went from under 10% of the market to 40%.

New Homes Sold By Sales Price

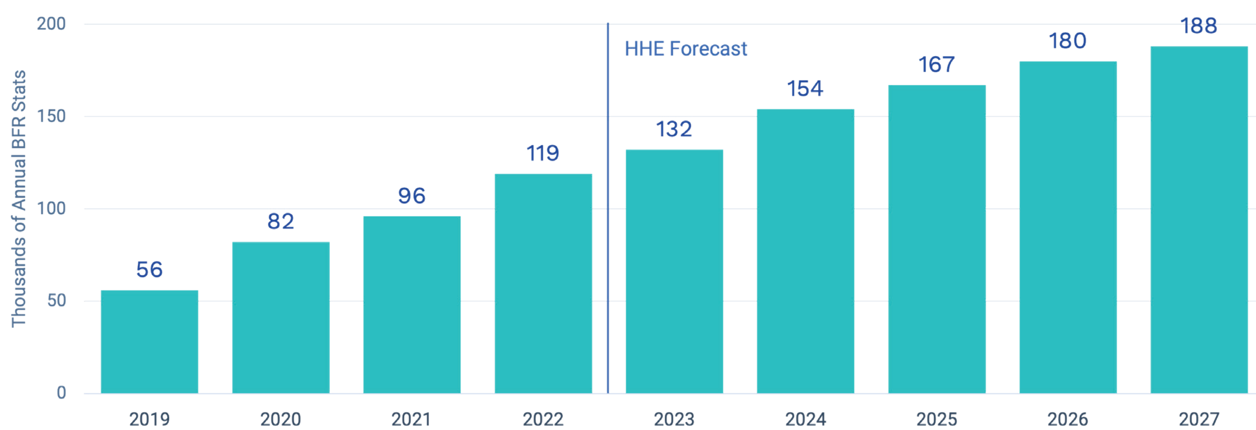


Source: U.S. Federal Reserve

The popularity of home rentals will continue to increase as even those who can afford higher home prices and mortgage rates are seeking out rentals. Rentals allow more flexibility and affordability than purchasing. The rental market no longer exists for reasons of pricing or temporary living, but is more diverse, with a mix of young professionals, families, and retirees all deciding to rent.

The market is responding by building more homes to meet increased demand, but the new supply isn't coming online fast enough to lower rents. As a result, home price appreciation in certain markets is expected to pick up due to low supply.

Annual Built-for-Rent Housing Production



Source: Estimated Utilizing Census and NAHB Data with Hunter Housing Economics (HHE) Forecast

For single family rentals, rents are rising even as home prices have flattened out. In most of the U.S., rents are rising faster than home prices, according to the Commercial Observer.

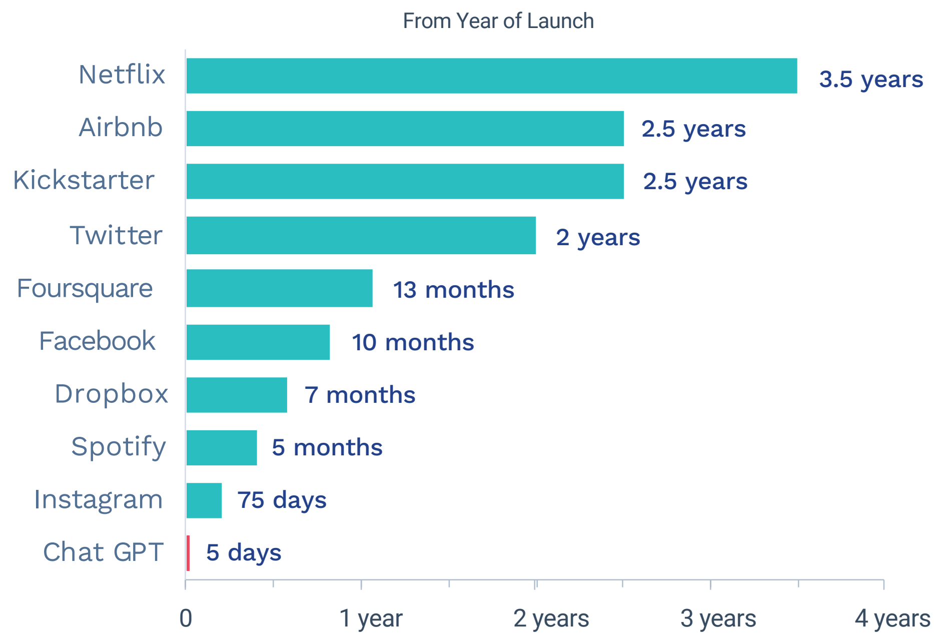
III. ChatGPT – A Stochastic Parrot in Schumpeter's Gale

Economist Joseph Schumpeter popularized the theory of Creative Destruction, which posits that economic innovation emerges from the dismantling of outdated forms through technological advancements and increased efficiency. The Baltimore Opera Hat Company and Transatlantic Zeppelin necessarily have to fail for Nike and Jet Blue to become ascendent. The release of ChatGPT 4.0 on March 14th may eventually be seen as Schumpeter's white-collar hurricane as content creators of all types just got devalued by 75%.

The GPT family of language models doesn't reason, per se. The model has no logical principles—thus explaining its tendency to hallucinate plausible sounding nonsense. Its replies are based on the probabilistic relationship of text in the model's corpus of training data. Hence the reason for the derisive term for the models as Stochastic Parrots. LLMs can recite words but have no capacity for reasoning. Nevertheless, with enough parameters and a gigantic corpus, the results can be useful in an array of fields. Programmers have already used ChatGPT to create executable code from a plain text description, artists have used it to create songs. ChatGPT has already passed the bar and medical school exams.

Knowledge workers have historically benefited from technology. Tools such as computers, email, and, especially, the internet allowed them to work faster, automate tasks, and collaborate more effectively with colleagues. Increased efficiency came with higher status and wages. ChatGPT and the more advanced large language models (LLMs) that will inevitably follow may upend that dynamic. Tasks traditionally performed by knowledge workers, such as writing reports, analyzing data, or even answering customer service inquiries, can now be automated using LLMs. Entry level roles in the legal and finance services are especially vulnerable.

Time to Reach 1 Million Users



Source: Statista

Already large investment managers are folding ChatGPT into their processes. Ken Griffin's Citadel is planning to deploy it company-wide. Adoption is rapid; ChatGPT 3.0 reached 100 million users in just two months, outpacing even TikTok's growth. Ultimately, although technology has generally increased the productivity of knowledge workers, the emergence of LLMs like ChatGPT may lead to disruptive consequences for the future of work and opportunities for innovators to profit.

If you visit the Empire State Building and gaze north up 5th Avenue to where the Knickerbocker once stood, you will not see a single trace of the white 40-foot tall Corinthian columns that once lined the Roman-temple style bank. The building, like the bank itself, is gone for good. But in the chaotic aftermath of the panic the banking system ultimately became more resilient and safer.

The key to successful investing lies in learning from the past and adapting to the ever-changing financial landscape. By exploring opportunities beyond traditional stocks and bonds, investors can build resilience into their portfolios and potentially uncover new sources of growth and income. These alternatives may include real estate, private equity, infrastructure, or even art and wine. Investors should maintain a long-term perspective, rather than reacting impulsively to short-term market fluctuations, even in the face of ongoing volatility and uncertainty.

Footnotes

1. The Conference Board Economic Forecast for the US Economy, Real GDP Growth forecast, December 2022
2. "Investment Grade" represented by the Bloomberg US Corporate Bond Index. "High Yield" represented by the Bloomberg US Corporate High Yield Total Return Index Value Unhedged. "Leveraged Loans" represented by the S&P/LSTA Leveraged Loan Total Return Index.

Endnotes

"Direct Lending" represented by the DLX Direct Lending Index. "CLOs" represented by the Palmer Square CLO Debt Index. "Private Equity" represented by the Invesco Global Listed Private Equity ETF. "Hedge Funds" represented by the HFRXGL Global Hedge Fund Index. "Equity REITs" represented by the MSCI World Equity REIT Index. "Residential REITs" represented by the MSCI US Residential REIT Index. "Industrial REITs" represented by the MSCI US Industrial REIT Index. "Wine & Cheese" represented by the Bloomberg Wine & Cheese Index, tracking global producers of wine and cheese. "Rolex Watches" represented by the WatchCharts.com Rolex Market Index. "Crypto Market" represented by the Bloomberg Galaxy Crypto Index. "SPAC Market" represented by the IPOX SPAC Index. "Global Equities" represented by the iShares Global 100 ETF. "Emerging Markets" represented by the iShares MSCI Emerging markets ETF. "Energy" represented by the Energy Select Sector SPDR Fund. "Gas" represented by the Bloomberg estimated US Average Gasoline price per gallon. "Gold" represented by the gold spot price in US Dollars per ounce. "VIX" represented by the Chicago Board Options Exchange's CBOE Volatility Index.