FIVE MILE RIVER *Investment Management, LLC*

Five Mile River Investment Management, LLC
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The Fed hikes until something "breaks"..... Jeffrey Gundlach*

Many financial pundits have recently been quoted saying that the Federal Reserve Chairman Jerome Powell's continued interest rate hikes might "break" something. On Friday, March 10th the first thing to break was Silicon Valley Bank (SVB). SVB was a very unique banking entity, for both their concentrated speculative lending to Venture Capital (VC) pre-IPO companies, and for their sources in funding these loans. Both practices suggested this was a risky business model. Lending to IPOs has always been risky, however, when funding was from large deposits made by the mega-wealthy partners of the large VC firms, the risk factor multiplied. Why? In large part, the bank's collapse was triggered by the March 7th announcement by Peter Theil, a marquee VC name, that he withdrew money from his personal account at SVB. This message telegraphed a warning to wealthy clients with large deposits at SVB. In only FOUR HOURS withdrawals amounted to over $40 billion.

The Federal Reserve took control of the bank on March 10th. The bailout that Chair Jerome Powell instituted on Sunday, March 12th was exactly what the financial system needed to prevent bank withdrawals from becoming widespread. This backstop gave SVB (and the banking system) access to cash liquidity.

SVB had committed a classic banking error by lending long-term loans of 10+ years and funding these loans by borrowing with short-term investments using 2-Year Treasury Notes. Most banks hold U.S. government securities on their balance sheets at par or redemption/maturity value, and do not reflect any changes in market prices. While U.S. Treasuries are the most securely guaranteed of any debt instruments, if a bank had to mark to market its holdings of government bonds, or worse had to sell them, then there would be a substantial capital loss, crippling its capital base.

Why did Peter Thiel make the decision to withdraw his money from SVB on March 7th? One can only speculate that he realized that the price declines of SVB's government holdings had put SVB's capital at risk. The 2-Year Treasury Notes moved from a 4.0% yield to a 4.85% yield leading up to Mr. Theil's withdrawal. If SVB sold these assets to meet potential liquidations, the SVB paper losses would have reduced their capital base by as much as 50%. Further, on Monday, March 6th there was discussion that the 2-Year Treasury Notes would have to yield closer to 5.25% if Fed Funds rates were to be increased. This translated into grave concerns for SVB's financial stability.

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The March 12th bailout funding obviously came too late for SVB, another bank, Signature Bank, and for the investment bank, First Boston. Powell's program to raise rates so aggressively in 2022 and 2023 has had the unintended consequence of losing these three institutions. Both SVB and Signature Bank were miss-managed by practicing careless business models. Ironically, the 2-Year Treasury is now back to a 4.1% yield, and unfortunately SVB has filed for Chapter 11.

The Great Financial Crisis of 2008 and 2009 caused the loss of Bear Stearns, Lehman Brothers, Wachovia, and Washington Mutual. That was a time of severe capital shortfall because banks had made what proved to be worthless investments in collateralized debt obligations (CDOs), collateralized mortgage obligations (CMOs), as well as, reverse and leveraged instruments of the same. The current situation is quite different. Today's situation speaks of poor interest rate and risk management by only a handful of banks as opposed to the 2008/2009 wide-spread investments in worthless CDOs and CMOs.

As a fiduciary, Five Mile River (FMR) is committed to the stewardship and growth of our clients' assets, and that means to be prepared for the unpredictable. The portfolio managers at FMR have experienced a full gamut of economic, social, and geo-political events and therefore can provide a careful perspective and a conservative investment approach. FMR management of clients' portfolios benefits from the wisdom gained from FMR portfolio managers' investment experience during difficult market cycles such as recessions, bear markets, market crises, and black swans. And importantly, FMR's custodial bank, Royal Bank of Canada (RBC) provides safeguards that are unparalleled in the industry for the protection of clients' portfolio assets. All FMR clients' assets are custodied at RBC. RBC is a rock-solid custody bank because:

1) RBC does not comingle FMR client assets with bank assets This protects FMR portfolios from potential bank issues.
2) RBC pays for the highest tier of FDIC coverage, $5MM for each FMR portfolio.
3) RBC maintains insurance for each FMR portfolios through Lloyds of London for up to $100MM per account.

FMR's conservative investment strategies involve choosing investments for client portfolios by screening for companies that generate growing free cash flow. This methodology has provided extra protection in down markets, and small underperformance during up markets. In 2022, the S&P 500 with dividends index declined 18%, while the average FMR account was down roughly 4% to 9% depending on the investment strategy. Conversely, in 2021 when the S&P was up 27%, FMR accounts performed on average +20%.

It is likely the events surrounding the last two weeks will cause the Federal Reserve to increase rates tomorrow (Wednesday, March 22nd) by only 0.25%, or simply pause interest rate increases for now. The good news is that inflation is slowing, which is the Federal Reserve's job. Having said that, first and foremost of the Fed's mission is to secure the stability of the U. S. banking system. To address this top priority, the March 12th move to shore up the bank system was smart and timely.

Fortunately, inflation is slowing, and this gives Chair Powell a "cover" to use this as a reason to pause further rate increases. SVB's demise was one of the unintended consequences of the rapid increase in rates orchestrated by Federal Reserve Chair Powell. Hindsight may show that the collapse of SVB will be used to explain the cause for rates peaking now. There is no doubt that the last 1 ½ years of rate increases will slow the economy, and eventually bring down prices. However, the lag between rate increases and a slowing economy can be as long as 12 to 18 months. It is the lagged effects of policies that give the Federal Reserve until 2025 to reach their targeted 2% inflation rate. Should this prove to be true, then there could be a significant tailwind behind equity prices.

If you have any questions regarding the information in this letter, or would like to discuss the current market events, please feel free to call or email at any time.

FMR makes available, on request, their annual ADV Part II. The ADV is a document that is registered annually with the SEC and describes FMR practices and organization in detail. FMR's Proxy Voting Policy and Client Privacy Policy are also available on request.

Wishing you a delightful spring season.

Best,

Lee Todd Martha

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*Quote originally attributed to Jeffrey Gundlach, Founder of DoubleLine Capital, who is famously known as the Bond King.

The S&P 500 Index reference in this letter a market capitalized weighted index of 500 companies. It is a growth-biased index because the larger the capitalization of a company, the larger the weighting it contributes to the S&P 500 Index performance. The S&P Index with the dividends is also referenced in this letter and include the dividend issued by these 500 companies. This index is used often for a comparison for FMR accounts.

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