FCAM
Decentralised Digital Investing

Monthly Commentary

MARCH 2023 PERFORMANCE

TOTAL NET RETURN

PERIOD	FUND RETURN
1 Month	+0.66%*
Life to date	-21.25%*

*Post management, performance and entry fees. Past performance is not indicative of future performance.

The Fort Stable Fund generated a return of +0.66% for the month of March 2023. ETH ended 11.5% higher at $1830, another difficult to manage, volatile monthly range of 31.5% between a low of $1400 and a high of $1846. The main reason for the volatility this month was the failure of various mid sized US banks. Largely the industry has shrugged off the regulatory activity. The options structures we held allowed us to participate in the rally and we used those gains to add to more medium structures that dragged a little of performance late in the month. The fund remains long 26% ETH.

Its all about the Macro this month.

This month we have seen a significant shake out in the banking industry in the US, and also in Europe with Credit Suisse. The collapse started with Crypto forward bank Silvergate and the tide has since risen to take out Silicon Valley Bank and Signature Bank in the US and Credit Suisse (CS) in Europe. There have been back stops put in place to protect depositors of other US regional banks, and receivership instituted with Management, equity and bond holders having all suffered the consequences of the bank failure. The situation remains, and it therefore makes some sense to try explain how we got here.

Modern Banking:

Fractional reserve banking is a system in which only a fraction of bank deposits are required to be available for withdrawal. Banks need to maintain a specific amount of cash on hand and can create loans from the money you deposit. Fractional reserves work to expand the economy (and money supply) by freeing capital for lending.

Commercial banks are the ones who facilitate this activity, co-ordinating the capital between those with excess capital (savers/depositors) and those with a deficit (borrowers). In order to generate revenue, banks take balance sheet ‘gap’ risk, they borrow short term (from depositors) and lend (invest) longer term. This activity creates liquidity risk which need to be constantly and stringently managed. The mismanagement of this liquidity risk is what ultimately led to the demise of the abovementioned Banks.

The Regulators and Monetary Authorities attempt to manage this system by adding or subtracting liquidity (quantity) and changing the cost of money (interest rate) with the goal of generating economic activity, employment and in keeping inflation under control.

From this brief explanation I hope it’s obvious how many moving parts there are, and consequently the margin for error managing this system isn’t wide. The authorities carry out a process of constant intervention to attempt to keep things in balance. Post 2008, regulators imposed onerous regulations on the banks which have made them safer, the risks haven’t exactly disappeared they have just moved elsewhere (we will get to where soon). The 2008 crisis saw the introduction of new tools for Central Banks to manage the price and quantity of money in the short and long term (yield curve).These new tools include communication of their intentions (forward guidance), and Quantitative Easing.

Quantitative easing (QE) has become a key monetary policy tool used by central banks post 2008. QE in simple terms increases the quantity of money available, the mechanism to do this is through the central bank buying government bonds or other securities from commercial banks. They take the bonds off the commercial banks and others in the economy paying then printed cash which increases the money supply. The increased money supply is intended to encourage lending and investment, which in turn leads to increased spending and economic growth.

QE puts money in the system that is available for the funding of economic activity, however its very crude as a tool as there is no way to know or control the purposes that this excess liquidity is going to. The increase in demand for government bonds and other securities can lead to higher prices for these assets, and therefore lower yields across the interest rate spectrum. As a result, investors (and Banks) may seek out riskier investments with higher returns, such as stocks or corporate bonds, driving up the prices of those assets as well.

Fast forward to 2018. There had been to this point minimal efforts to remove this "excess" liquidity. It was viewed and argued that the impacts had been net a positive helping the global economy recover from the depths of the GFC. In 2018 the FED has begun to indicate that they would begin tapering purchases of bonds, in essence with withdrawing liquidity. The response of the market was referred to as the "Taper Tantrum" – yes the market behaved a lot like a 3 year old who was having their favourite toy taken from them.

Something called the "repo market", which is a facility that banks use to manage short term cash needs, experienced a sudden increase in demand for cash from all banks, which led to a shortage of available funds. This was due in part to a confluence of events, including the US Treasury issuing large amounts of debt to fund government spending and the Federal Reserve as mentioned above reducing its holdings of Treasury securities.

The shortage of funds led to a spike in the overnight rate, which jumped to as high as 5% in some cases, far above the target range set by the FED of 1.75-2%. The high interest rates prompted concerns about financial stability and the potential for contagion in the financial system.

To address the crisis, the Federal Reserve injected liquidity into the market through various measures, including increasing the amount of cash it was willing to lend in overnight repo operations and conducting large-scale open market operations to purchase Treasury securities and baulked on hiking rates any further that cycle.

The reason for the history lesson is really to highlight that history does indeed rhyme. 2008 we commenced QE, 2018 we tried unsuccessfully to wind it back. The Covid crisis of 2020 saw policymakers take unprecedent measures to address the severe economic downturn. Monetary authorities pulled out all stops, QE, forward guidance, and zero rates. Simultaneously fiscal authorities stimulated with unprecedented levels of stimulus (spending). We are not here to argue that what was actually done was wrong, its more just that it was unprecedented and bound to have consequences.

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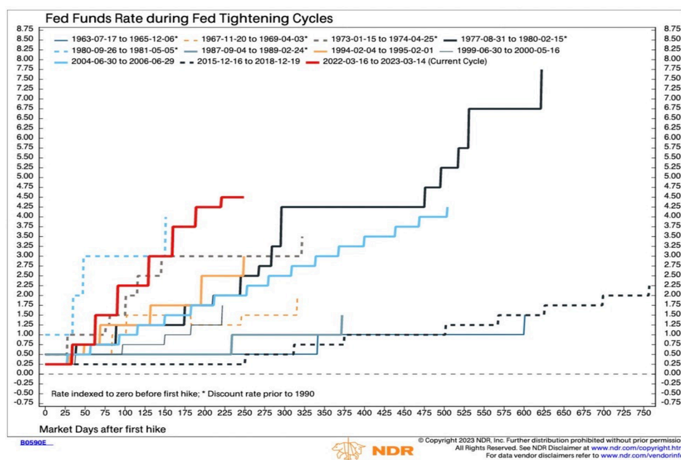
It's for sure been a large part of the cause of the current inflationary backdrop, it's also been the sole cause of the historic run up in asset prices and the bubble that resulted.

The FED (and other global monetary authorities) over the last 12 months has increased interest rates in an effort to quell inflation through slowing growth and increasing unemployment (Fig1.). They have hiked rates at pace not seen in history. They have also commenced the unwinding of QE, what's termed Quantitative Tightening (QT). The combination of these policies has seen interest rates across the yield curve increase dramatically.



This brings us to the events of the last month and the collapse of a number of banks that were more exposed to the more speculative end of the economic spectrum in starts ups and Crypto businesses.

The order of events;

- QE and Fiscal support see the economy flooded with cash 2020/21.
- This cash finds its way into the banking system and deposits explode
- Silicon Valley Bank (SVB) deposits for example grew from $65 billion in 2019 to $189 billion in 2021
- The way a Bank makes money is to pay less on its deposits than it loans the money out for (gap risk). Given the limited demand for loans SVB bought safe Government Bonds and Mortgage Backed Securities. This is also what the entire US banking system has done
- Here comes the BOOM – The FED hiked rates at pace so rapid, and commenced removing liquidity, that the bond market has suffered losses not seen since the 1960's.. This means that ALL banks are sitting on unrealised losses in their investment portfolio for bonds purchased with these deposits. (Fig 2.)
- The above is NOT a problem as long as no-one needs their deposits back quickly. As the bond that they own against that deposit will pay them back the full notional, if they can wait they would be fine.... Given the concentrated portfolio of depositors that SVB and Silvergate had in start-ups, that were burning cash, and Crypto firms who has seen asset values decline the problem had been forced to a head, they needed their money back.
- SVB tried to raise capital through a rights issue but it was perhaps too late and Silvergate had been in trouble for a few months.

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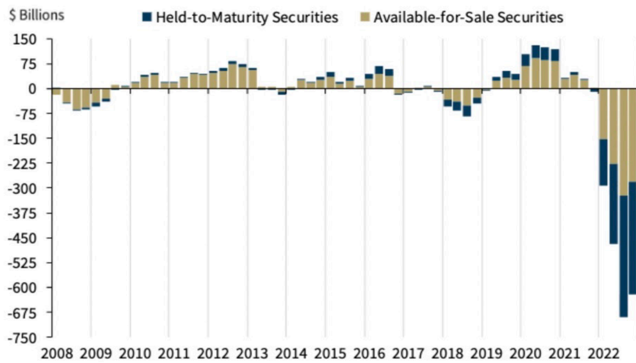
- The last bank in Signature Bank had a much more diversified client base (80% commercial real estate loans) and while seeing some stresses was wound up also although there is conjecture as to whether it was more politically motivated. Read here

Fig 2.

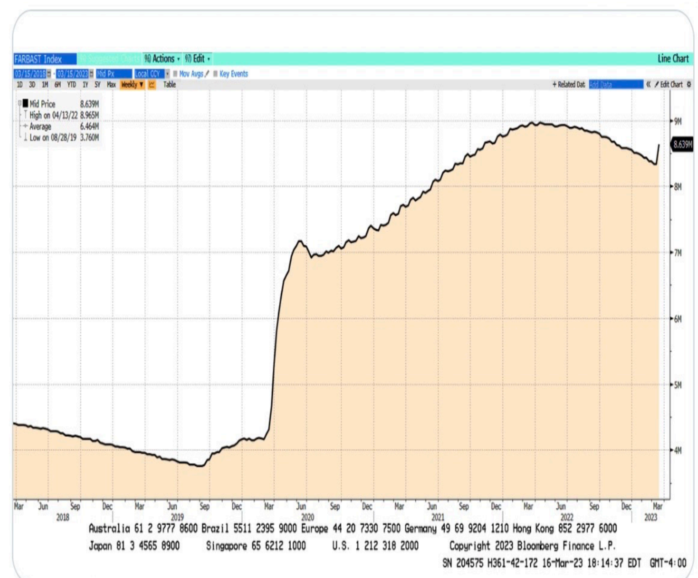


The wash-up:

The initial response was to backstop the banks depositor base and ensure they were made whole through the creation of the (BTFP) Bank Term Funding Program. This program is extended to any U.S. federally insured depository institution who could place eligible securities and receive the par value (that is the face value NOT the current market value) This means that the bank can meet the demand for withdrawals. The limitations are that it's for 1 year only, the cost isn't exactly attractive at the US 1y rates plus 10bp however it buys the bank participating time to restructure, merge and importantly survive. This technically isn't QE as the money is already in the system, it's just underwritten the losses as they currently stand that will be reduced as rates come down.

The estimate is that up to $460 bn could be pledged to this facility. This is based on the amount of uninsured deposits at six US banks that have the highest ratio of uninsured deposits over total deposits. This however is still enormous compared to historic usage of the so-called discount window. That facility isn't used greatly as it has a stigma attached to it, this facility is anonymous and its expected that it will be used.

The last months ructions have seen the market start to position for the idea that the FED to begin positioning for a pause in hiking rates. While they hiked 25Bp this month the economy is indicating its slowing and inflation while still elevated has begun to taper. This shock also will dramatically see lending conditions tightened which will lead to refinancing risk which is equivalent to a further tightening of conditions. So, if we are near the end of the rate hiking cycle and this facility has been argued is a precursor to QE in another guise (Fig 3. Shows that the balance sheet has grown $330bn in one week post the crisis)



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Over to Europe:

CS has been acquired by UBS for EUR 2bn with the Swiss National Bank providing backstop liquidity to UBS to ensure that the takeover went smoothly. This writing down of equity to very low levels and the writing down of the AT1 bonds ($17bn) to zero has caused plenty of consternation. These bonds are designed to convert into equity when a lender runs into trouble in normal circumstances however the Swiss issued bonds were a little different. In this case the bond documentation shows that Swiss regulators held the right to upend the usual hierarchy and wipe out these investors. The legal wash-up may take some time to resolve. This measure has successfully cauterised the risk of a contagion of confidence loss in the wider banking system.

The bodies are floating to the surface:

The Fed and Treasury are happy to backstop the banking system as its systemically important. However there are numerous liquidity mismatches everywhere that become apparent in a period of stress. A lot of risky activities were pushed off bank balance sheets in 2008, they sit inside Asset Managers and in what's known as the Shadow Banking system. The likelihood has certainly skewed the FED and global central banks to be more concerned about liquidity and a slowing economy given the last few weeks. The imprecise tools they have at their disposal are unfortunately lagging in their impact, the hikes of the last 12 months have on just started to impact economies with minimal effect on inflation so far.

What does this all mean for digital assets ?

- Potentially more liquidity is a net positive – we are nearly there.
- Rate cuts are a net positive – not quite yet.
- The DeFI system is NOT a wholesale replacement for the Traditional Finance System but it has continued to function. There has to be a role for it out of the ashes of this banking meltdown for a Blockchain technology to be used to move assets or monitor them on-chain.
- Development continues – the Shanghai Upgrade is scheduled for April 12th. The layer 2 Zero Knowledge protocol token for Arbitrum just airdropped its token to users.

While the regulatory backdrop is definitely a headwind, the macro currently is a tailwind that has seen the Digital Asset space benefit from its original premise of limited supply and it sitting outside the conventional fiat system. With the prospect of dramatic increases in rates diminishing from here and the likelihood of increased liquidity potentially needing to be considered the outlook has certainly improved for Digital Assets while equally dimming for the broader economy.

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