THE WEEKLY BEACON — MARCH 31, 2023

We will be giving some macro economic market updates on a weekly basis. No equity recommendations will be given in this commentary, and we encourage you to contact us if you have questions regarding any observations.

MacNicol & Associates
Asset Management

Contact us today if you would like to meet about your investment future. [*info@macnicolasset.com*](mailto:info@macnicolasset.com)

BEACONS OF THE WEEK

The two main purposes of a Lighthouse are to serve as a navigational aid and to warn ships (Investors) of dangerous areas. It is like a traffic sign on the sea.

Isla Chimana Segunda Light,
Venezuela

This lighthouse was put into commission in 1931. The Lighthouse flashed every 10 seconds when in commission. Tours are available from Puerto la Cruz to the beach below the lighthouse, known as Playa el Faro, where tours are available. Located on a bluff at the west end of the island, roughly 40 km northeast of Puerto La Cruz. Accessible only by boat.

Île aux Nattes Light, *Madagascar*

Photo by Albert Riviere.

Originally lit in 1914, this lighthouse station was originally established in 1882. The lighthouse is located at the southern end of Nosy Nato. The lighthouse recently reopened for visitors over the last decade after being decommissioned. Transportation is provided by local resorts to tourists.

**Feel free to send us your photos of Lighthouses to be featured in our weekly market observations. **

<u>Silicon Valley Bank (SVB) finds a buyer</u>

Two weeks ago, we went into great depth explaining the situation involving Silicon Valley Bank, Credit Suisse, and the entire banking sector. Market volatility has been led by financials as investors rushed to sell their holdings due to contagion fears. Fast forward to this week and a lot more has happened, so buckle up.

March 2023 was not kind to the banking sector, balance sheets were exposed, bank runs were conducted, U.S. regional banks were influx, bank shares traded like cryptocurrencies and suddenly the global economy looked like it was about to break. After all, the financials sector is historically a low-risk trade and what most consumers would see as a safe, and passive long-term investment with limited downside. If you don't believe us, ask a friend, or family member what they hold in their retirement portfolio and we guarantee they will barely mention the banks they hold as they see those holdings as boring, and essentially risk-free (we never saw holding financials or bank stocks as risk-free).

After our update two weeks ago, where we let you know SVB had a bank run where depositors demanded their money and SVB did not have enough liquid assets to cover said withdrawal requests. To cover these withdrawal requests, they were forced to sell long-term assets at a loss. Some customers figured this out and demanded their money. This all eventually led to the bank run and the bank's eventual collapse.

SVB purchased long-term debt assets (bonds and mortgage-backed securities) when interest rates were low in 2021. As interest rates rose, SVB had major unrealized losses on its balance sheet (when rates increase, bond prices decrease). Due to their liquidity crunch, they were forced to sell these securities before their maturity date and realize a massive net loss. SVB purchased over $80 Billion in these long-term debt securities due to an exponential growth in their customer base in 2020 and 2021 (fueled by easy money). As customer deposits grew, SVB was forced to put that money to work. At the same time SVB's loan book dried up (and could not meet the growth rate of customer deposits), so they decided to purchase long-dated debt securities.

Even though SVB was a federally insured bank, most of its deposits did not meet the FDIC requirements. The FDIC insures accounts up to $250,000. This caused massive panic among consumers and investors who worried the bank's failure could lead to a loss of investment capital and personal/business bank deposits.

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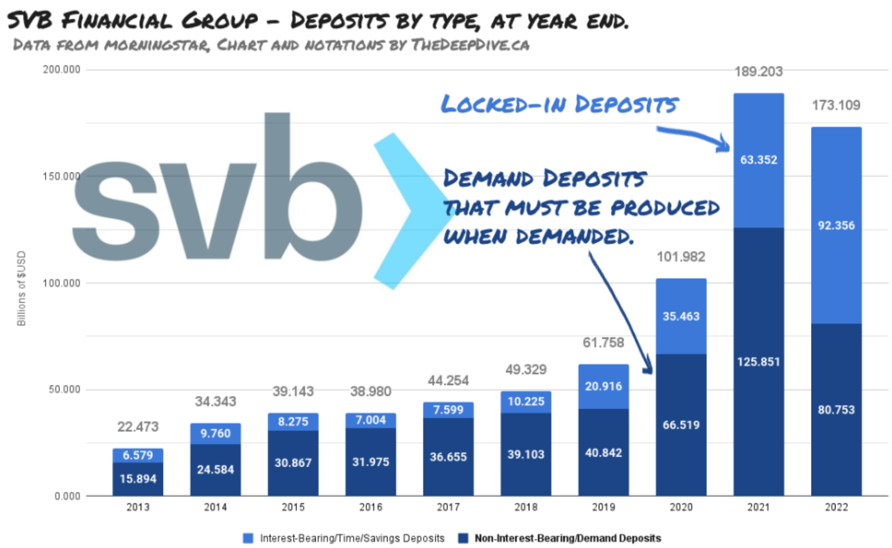

After the government announced they would back all depositors at Silicon Valley Bank, many thought this would be the end for SVB. However, just a few days after SVB announced its default, the government insurance gave them new life. The new CEO announced his bank was the safest place to deposit money in the country (even though the FDIC was running the bank). Although we disagree with what he was doing, his comments seemed factual. After all, no other bank had outright insurance on customer deposits from the government. But our main question remained: How can a bank that defaulted and that was bailed out, continue to operate? In the meantime, the FDIC was operating the bank.

Just a few weeks later, it looks like we have our permanent answer. A buyer, and the end of SVB (or so we think).

On Monday First Citizens announced it would be purchasing SVB and its 17 branches.

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First Citizens Bank is a North Carolina-based lender that operates out of 22 states. The company has 582 branches mostly concentrated in the Carolinas.

According to the FDIC, the transaction of SVB involves the sale of all deposits and loans of SVB to First-Citizens Bank. Both the FDIC and First Citizens will share in losses and the potential recovery on loans included in an 8-year loss-share agreement.

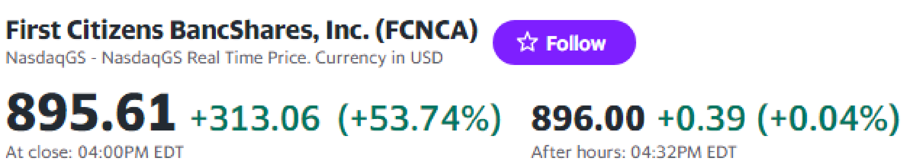
The FDIC will retain about $90 billion of SVB's $167 billion in total assets (as of March 10). First Citizens will acquire $72 billion at a discount of $16.5 billion. The FDIC estimate that the bank's default will cost the FDIC insurance fund close to $20 billion. The $20 billion loss accounts for 15% of the FDIC's total funds.

As a part of the deal, the FDIC received equity appreciation rights for First Citizens common stock with a potential value of $500 million.

With the loss-sharing agreement, it seems First Citizens has limited downside (government backstops for loan losses) as well as shared upside with the government.

First Citizens has reportedly completed 50 acquisitions since 1990, 23 of which went through the FDIC. This made the deal attractive to the FDIC and from the government's vantage point.

First Citizens shares popped on the deal announcement. Shares were up 54% on Monday.



Industry analysts seemed to like the deal, commenting on the downside protection First Citizens was granted. Many also believe First Citizens got to be selective with what they took on in terms of deposits and loans and what they left with the FDIC. By cherry-picking deposits and loans, First Citizens could have removed almost all the risk associated with the transaction.

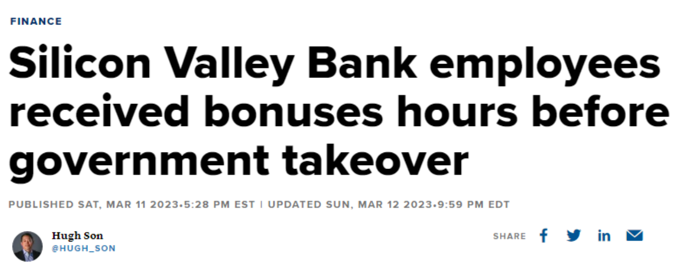
Markets seemed happy with this deal, as investors look for some stability and optimism in a sector that has been extremely volatile in recent weeks.

<u>What happened in Silicon Valley Banks' final days/months?</u>

The SVB story is fascinating. One that will eventually become a movie or documentary that we can all watch and look back at and perhaps learn something (similar to The Big Short and the Housing Crisis).

However, some glaring red flags are seemingly popping up as we learn more and more about SVB's failure. As we learn these facts, we ask ourselves: Who knew what, and when did they find out?

As SVB was failing, executives paid millions to employees in bonuses. Perhaps this was just coincidental timing and compensation was already scheduled to be paid, or perhaps they wanted to take care of their employees before their fate was sealed. Either way, we are not sure we will ever know.


FINANCE

Silicon Valley Bank employees received bonuses hours before government takeover

PUBLISHED SAT, MAR 11 2023•5:28 PM EST | UPDATED SUN, MAR 12 2023•9:59 PM EDT

Hugh Son
@HUGH_SON

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Executives also sold millions in stock in the months leading up to the bank's failure. It is possible that these stock sales were prescheduled, but it is also possible that SVB executives knew their balance sheet was in flux and it could not take any more stress, so they sold their personal holdings before something "big" happened.

It is important to note that no financial institution can withstand a bank run - no matter the state of their balance sheet.

Another red flag in the SVB saga was the increase in lending to officers and shareholders. Loans provided jumped from $66 million in Q3 2022 to $219 million in Q4 2022. This single-quarter surge in loans to insiders, officers, and principal shareholders has never happened in the company's history:

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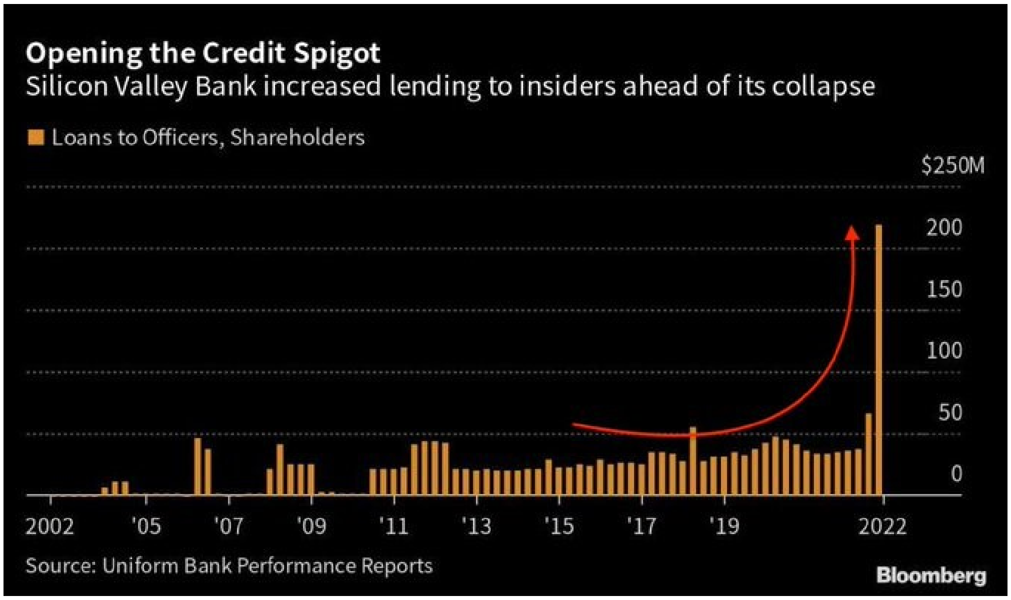


Many have raised questions about how ethical or how independent these loans to insiders or directors were. Due to an uncertain funding environment (2022), parameters could have been overlooked during the loan underwriting process at SVB. Many have reported that numerous advisors and insiders at SVB were venture capitalists and private equity investors (which makes sense). Who is to say they did not push through the loan process at their bank to allow their portfolio companies to receive funding (especially if those loans had favourable terms)?

Another one bites the dust

Crypto and fraud have unfortunately become two words used in high correlation over the last year.

We all know who Sam Bankman-Fried and FTX are. It appears the man who initiated FTX's downfall is having issues of his own at the crypto exchange he founded and led. Binance and its Founder, Changpeng Zhao (CZ on Twitter) were sued by U.S. regulators for violating compliance rules to attract users to Binance.

**CZ and Binance sold billions in FTT (FTT is the native token to FTX) which led to the collapse of FTX. The collapse of FTX obviously unveiled the fraud and crime the company was utilizing. **

The SEC filing has the potential to upend Binance's operations and is potentially just the first salvo in a regulatory crackdown on the world's largest crypto exchange. Last year it processed crypto trades worth about $65 billion a day. Beyond fines, the CFTC has looked for further penalties including trading and registration bans for Binance and CZ.

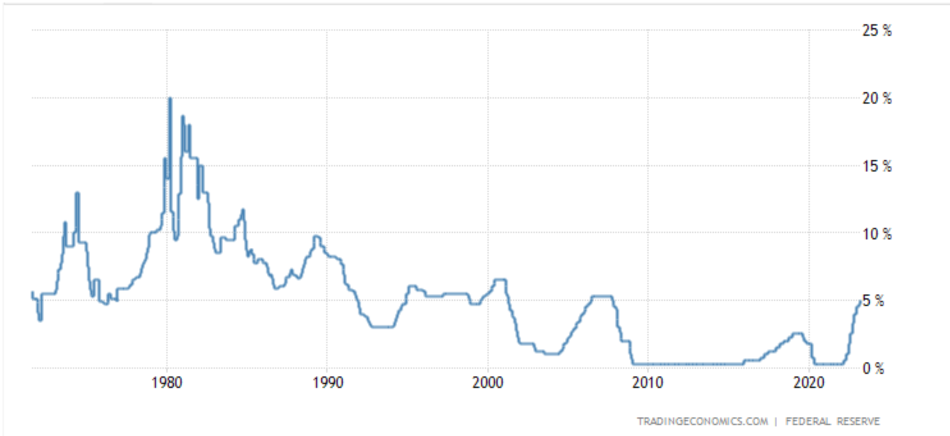
According to CNBC, "Binance and Zhao took steps to purposefully obscure where the exchange's subsidiaries were located, the regulator said. This was part of a larger strategy that Zhao said was an effort to 'keep countries clean', the regulator alleged in the filing."

Binance's native coin dropped 6% on this news as crypto traders await the fate of its largest exchange.

Unfortunately, these are the harsh realities of investing in crypto on these new exchanges. Perhaps, regulation for the exchanges will lead to better results, and investor safety.

Investors pricing in (huge) rate cuts

It's no secret interest rates have increased at their fastest pace ever (over the last year) across the western world. In order to combat rising prices (inflation), Central Banks have hiked rates to decrease the consumption of goods, which will eventually allow prices to stabilize and slow their increase. However, both consumers and investors were not ready for this phenomenon. Other than a brief period in the mid-2000s, Central Banks have not hiked rates in a significant way in 40+ years. Here is the U.S. Federal Funds Rate:

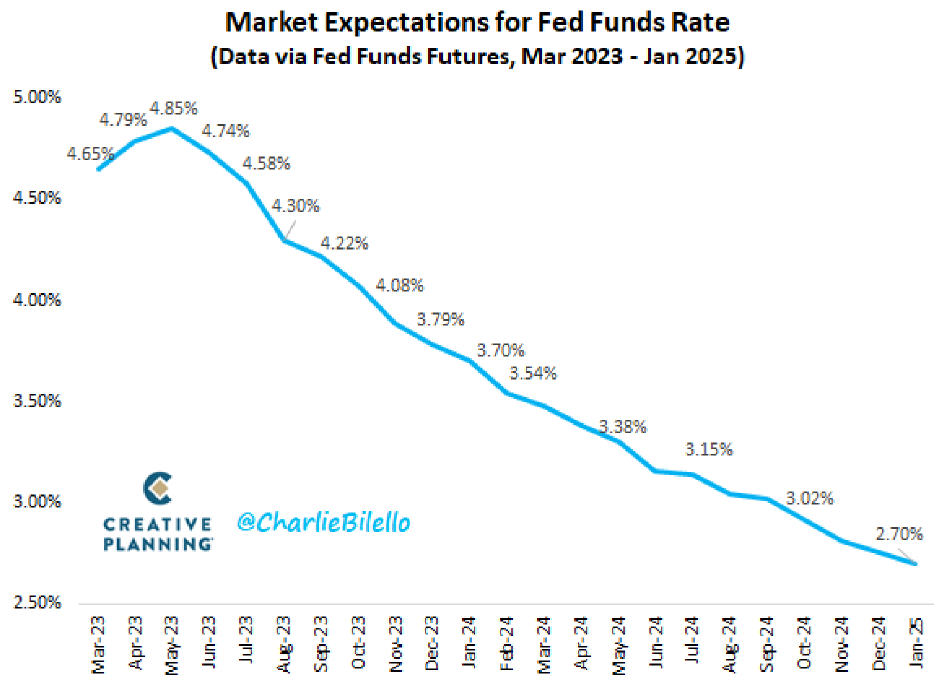


Here is the yield on the U.S. 10 Year Treasury note since 1980:

Interest rates have been in decline for 40 years and most people did not know how to react to a reversal in that trend. Investors fell asleep at the wheel using basement level discount rates and they could not react.

Fast forward to today and market participants are begging for rate cuts immediately due to market instability. Cutting interest rates will increase investment, decrease costs, and is historically a bullish sign for equity markets.

Here are market expectations for the U.S. Federal Funds Rate up until January 2025:



Market participants are expecting the FED Funds Rate to drop by almost 50% in the next 21 months. Talk about optimism. For Central Banks to slice rates by this much, something serious would need to happen (like a steep recession). We do not think this chart will be correct, but we do think the FED is seriously considering pausing its rate increases and considering an interest rate cut by the end of this year. However, we also believe there will be other waves of inflation as we saw in the 1970s. This will affect FED policy in the mid term where rates might have to be increased yet again.

We think rates will stay elevated for longer than most investors are forecasting. Investors are pricing in large rate cuts at the end of 2023 and in 2024 to make equity prices look more attractive. It seems investors who have benefited the most from 0% interest rates are currently the loudest when it comes to wishing for rate cuts.

It's good to be optimistic especially if you believe in something but false hope in finance can lead to wealth destruction. Do not expect every stock that has collapsed 70%+ over the last 2 years to return to their all-time highs anytime soon.

A signal to the future

Alibaba made huge news on Tuesday. The Chinese conglomerate decided to split its company up into various businesses.

Markets loved this announcement. Shares soared 15% on the day of the announcement.

Alibaba will split into six separate units reshaping Founder Jack Ma's empire and legacy. Alibaba is making the pivot from a conglomerate to a holding company. The company said the move is designed to unlock shareholder value.

Each business unit will be overseen by a different CEO and board of directors. Five of the six new business units will have the ability to raise their capital and IPO. Alibaba's market cap sits at $255 billion (USD) as of this writing. Alibaba is China's third largest public company as of March 29th, 2023 (size is ranked by market capitalization).

The announcement came a day after Founder Jack Ma made a public appearance. Ma has been very quiet in recent years, keeping a low profile since the CCP began its crackdown on the tech sector 2.5 years ago. In November 2020, Ma was forced to shelf an IPO of Ant Group, the financial affiliate of Alibaba. Chinese authorities forced Ma to shelf the $37 billion IPO days after he criticized China's banks and financial regulators. (Alibaba shares peaked in November 2020 above $300/share. Shares currently trade under $100/share.)

MARKETS | FINANCE

China's President Xi Jinping Personally Scuttled Jack Ma's Ant IPO

Senior government leaders were furious about wealthy entrepreneur's criticisms of regulators; rebuke was the culmination of years of tense relations

By Jing Yang Follow *and Lingling Wei* Follow
Nov. 12, 2020 12:56 pm ET

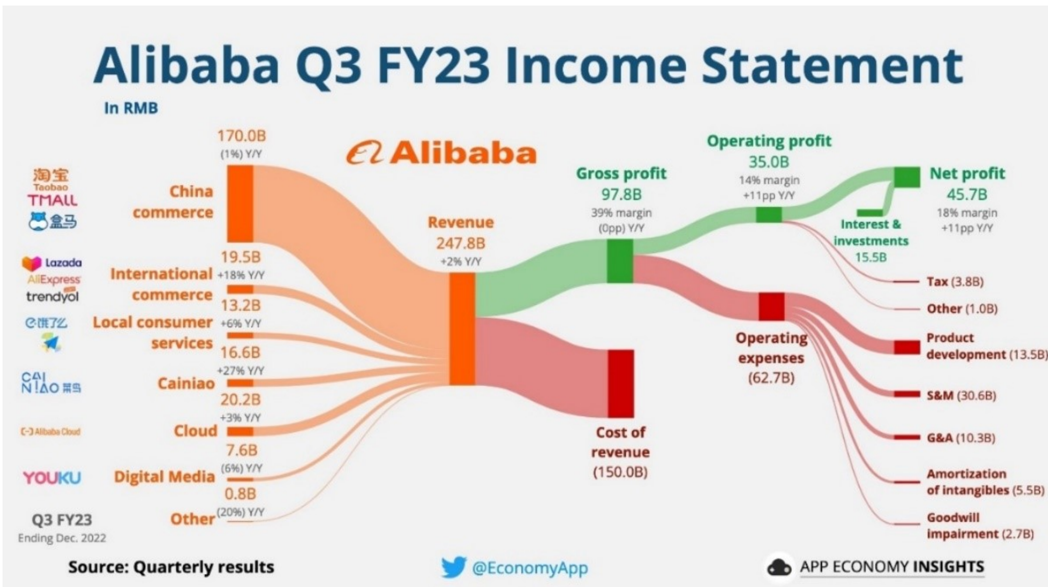
Many believe this move by Ma and Alibaba could be bullish for the Chinese technology sector as the CCP and President Xi relax their control of the sector. (We are not making a prediction and recommending any Chinese stocks as we think the geopolitical risk is too high currently. We will continue to follow the situation. Invest responsibly.)

Back to Alibaba.

The six separate business units will be:

1. Global e-commerce (Ali Express)
2. Local commerce groups (Taobao and Tmall)
3. Cloud computing
4. Local services (Food delivery (Ele.me) and Mapping)
5. Logistics (Cainiao)
6. Digital entertainment and media

Here are recent quarterly results by business unit for Alibaba:



The Chinese commerce unit will be the only business unit that will not be allowed to raise its capital or IPO. Taobao and Tmall will remain wholly owned by the operating company Alibaba. Perhaps this is the give-and-take that Alibaba had to partake in to get the green light from the CCP.

This move by Alibaba is just the latest move by a conglomerate to split itself up. General Electric, Johnson & Johnson, and Toshiba have done the same over the last few years.

Many believe that this move could help Alibaba fly under the radar of Chinese regulators as six smaller pieces present a much smaller target than one behemoth.

The separation of each business could kick-start a very dry IPO market in Hong Kong.

Eventually, there will be five separate IPOs and investors will be able to buy each separate business. Although Alibaba ADR is listed on the New York Stock Exchange, we are not sure if all 5 of these companies will get American listings due to American regulators and security issues. For example, the Cloud business unit which is described as an intelligence group with major efforts in AI could be barred from US exchanges for security reasons.

This move by Alibaba could be some foreshadowing for the world's largest companies. Amazon, Alphabet, and even Microsoft are conglomerates that have various revenue streams like Alibaba. Could the markets' reaction persuade these American companies to explore breaking up? We are not sure, but it is worth mentioning.

Even though technology stocks are enjoying great returns in 2023, they are still trading well below their all-time highs, a breakup could be a catalyst for some explosive returns, especially in the best parts of these conglomerates. Alphabet also regularly faces antitrust scrutiny from Congress as the market leader for search engines and the digital advertising market.

We are not saying these companies will break up, but it is an option for management to discuss to generate shareholder value moving forward.

Debt acceleration

We ran by a chart this week that made us stop in our tracks.

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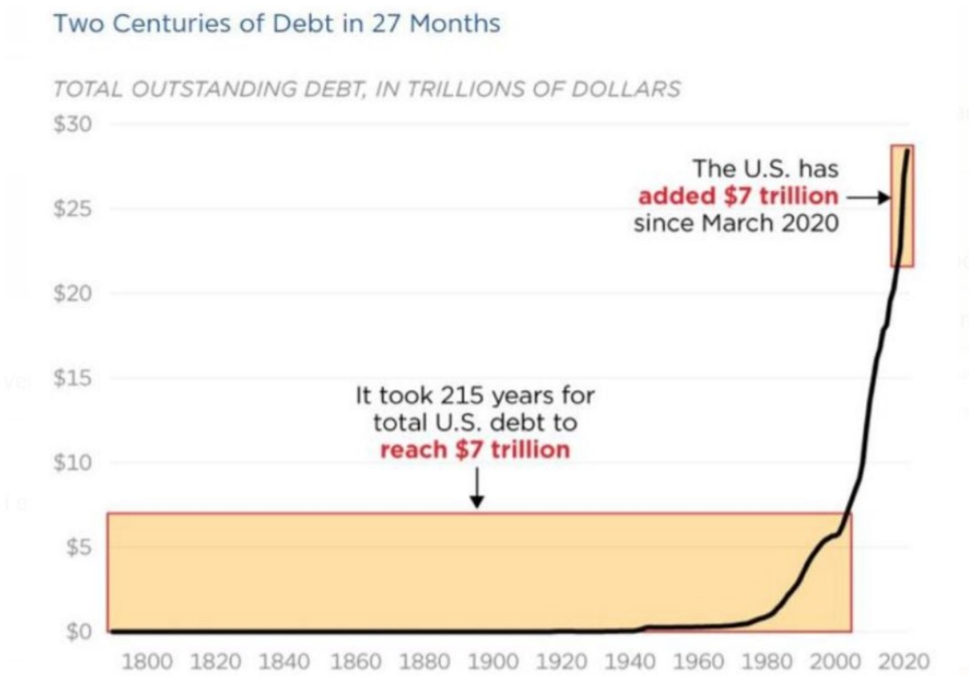

From March 2020 to June 2022, a span of just 27 months, the federal government added $7 trillion to the national debt as a result of a massive spending spree. It took the government 215 years, from George Washington to George W. Bush, to initially reach $7 trillion in debt.

The same amount of debt was added by the U.S. government over two periods of time. The first period began on July 4th, 1776 and ended in 1991. The second period began in March 2020 and ended in June 2022.

One of these time frames is unlike the other………

We knew debt had been added by Central Governments at record rates in recent years but had no idea it had been added this quickly (and at this magnitude) compared to the previous 200-250 years.

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