MARKET UPDATE

March 14, 2023

THE SVB FINANCIAL FAILURE

On Friday of last week, the FDIC took control of Silicon Valley Bank, ending a frenetic 48 hours which saw the bank go from being solvent to insolvent. With $209 billion in assets, SVB is the 2nd largest bank failure since Washington Mutual's failure in 2008. Below we summarize what transpired, we provide our opinion on the risk of further contagion, and we discuss the potential impact this failure has on the direction of interest rates and the economy.

Silicon Valley Bank – What Happened?

The core business of a bank is to take in customer deposits which the bank, in turn, lends out or invests. The profitability of a bank is dependent on the spread between the interest they pay depositors and the interest they earn on their loans /investments.

Customer deposits are liabilities on the bank's balance sheet, and they're considered short-term because a customer's demand for their cash must be immediately met. While these liabilities are short-term, not all the bank's assets (the loans and investments they made with the cash) are. Bank reserves contemplate this duration mismatch; however, the sufficiency of those reserves depends on the unique facts and circumstances. In the case of SVB, those facts and circumstances resulted in the failure of the bank.

The composition of SVB's depositor base made them uniquely susceptible to a bank run in the current environment. SVB primarily catered to venture capital sponsored start-ups. During the pandemic, low interest rates and monetary easing allowed start-ups to raise capital in droves. That cash was deposited at SVB which, in turn, loaned that cash to borrowers or invested that cash in mortgage-backed securities, Treasuries, etc. Rapidly rising interest rates in 2022 caused two problems for SVB:

- First, rising interest rates and the tightening credit environment made it difficult (and expensive) for SVB's depositor base to attract additional venture capital financing. As a result, their customers increasingly needed to use their cash. The large cash inflow SVB experienced in 2020 and 2021, turned into a large outflow.
- Second, the increase in interest rates in 2022 devalued SVB's asset base. Traditionally, the investment securities SVB purchased would be held to maturity, allowing SVB to recoup their losses. However, with so many of their depositors withdrawing their deposits, holding assets to maturity was no longer an option and liquidating those investments at a loss risked the bank's solvency. Simply put, SVB took too much duration risk in their portfolio.

SVB attempted to address the problem by raising additional equity capital. However, their attempt unnerved both investors and their customers which further accelerated withdrawal requests. The bank run began and ended quickly.

Why Is This Different Than 2008

Leading up to 2008, a lack of regulation in the financial sector allowed banks and hedge funds to engage in reckless lending practices. In this environment, the subprime mortgage bubble formed and grew to epic proportions. Then, through complex securitization, those risks were magnified and simultaneously cloaked. What resulted was swift and significant, nearly resulting in a collapse of the global financial system. In the aftermath, financial regulators imposed much stricter risk and liquidity controls on banks. SVB's failure was not the result of the same speculation that undermined the financial system in 2008. Rather, their unique customer composition, their questionable risk controls, and the percentage of their deposits over the FDIC limits, among others, made them especially susceptible to what transpired. While SVB's failure shows that regulatory controls don't provide absolute protection, we also do not believe the failure of SVB is a harbinger of a systemic issue.

Taking a page out of the Great Financial Crisis playbook, the Federal Reserve acted over the weekend. The Fed classified both Silicon Valley Bank and Signature Bank (which the Fed took control of on Sunday) as systemic risks to the financial system. This action enabled them to backstop uninsured deposits (i.e., deposits over the $250,000 FDIC limit) at both institutions. Without this action, uninsured deposits at both institutions were at risk of loss. Additionally, the Fed announced the Bank Term Funding Program (BTFP) that allows banks to borrow funds for up to one year by pledging qualifying assets as collateral. These assets will be valued at par, rather than their current depressed market values. This temporarily addresses the maturity mismatch and allows banks to meet withdrawal requests without having to liquidate their assets. Lastly, the Fed announced they stand ready to address any liquidity pressures that may arise in the future. The enactment of these measures and the Fed's messaging seems to have calmed depositor and investor nerves which is crucial to preventing financial contagion.

The Market's Reaction

A flight to quality resulted on Thursday and Friday. Bond yields experienced meaningful declines and equities sold off as investors evaluated the potential impact on future interest rate increases and the economy's trajectory. Economically sensitive stocks, such as energy, became collateral damage as fears of a recession increased. Monday's market activity was muted as investors continued to weigh longer range implications of SVB and the Federal Reserve's actions.

Looking Ahead

The financial sector will likely continue to struggle as investors digest what this means for future profitability. While the deposit outflows from SVB were an outlier, banks have been dealing with outflows broadly this year as money market mutual funds offer much higher yields than bank deposits. If banks want to stem those outflows, they'll have to raise the rate they pay on deposits, compressing their net interest margin and lowering profitability.

At a macro level, investors' expectations for the future path of the fed funds rate have changed. On Friday, investors were pricing in a 60% chance of a 25-basis point hike and a 40% chance of a 50-basis points hike at the next FOMC meeting. Now, markets believe there's a 75% chance of a 25-basis point hike and a 25% chance of no hike at all.

We expect the Fed to remain committed to more interest rate hikes if it becomes clear the systemic risks posed by this event are contained. However, we agree with the consensus view that this event warrants less hawkishness from the Fed given the potential for more stress in the financial system.

While less hikes could be interpreted as easing financial conditions, that is only one side of the story. Banks will likely tighten up their lending practices and shore up liquidity, creating a headwind for the economy as credit availability wanes. Markets are betting on slowing growth as the 5-year inflation breakeven rate fell nearly 40 basis points as these events unfolded. As this event creates greater uncertainty around the future path of monetary policy and the broader economy, it is likely to be accompanied by greater financial market volatility.

We have not made any portfolio changes because of these events; however, we will continue to evaluate opportunities for improvement that may result from temporary dislocations.

As always, thank you for your continued trust and confidence.

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