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Investment Strategy Update March 2023

MBL Advisors Market Update: March 12, 2023ⁱ

Good afternoon, the failure of Silicon Valley Bank shook markets last week as investors try to comprehend the uncertainty of this situation for the entire banking industry. It's a tragic situation for those involved. We have listed several thoughts below.

We are not "bank experts," nor were most other investors until 48 hours ago. Having said this, our thoughts and interpretation of the situation are that Silicon Valley Bank ("SVB") failed for a few main reasons.

- A. We have noted some more complex details below, but Jim Bianco termed things most concisely in noting that this is "an old fashion 1930's liquidity crisis." Bianco elaborates that "too many depositors demanded cash at once (as in right now) and SVB could not convert loans and securities to cash that quickly." The fact that billions of dollars can be moved in 24 hours by people from their iPhones has changed "banking" forever and will require regulators to adapt. As we note several more times below, the Fed should act with authority to this situation (e.g., unlimited FDIC insurance like 2008, etc.). Unfortunately they are not set to meet until tomorrow (Monday) mid day. The additional commentary below gets more into the details of this situation but might be less important than this simplistic take from Bianco Research.
- B. SVB has/had a unique client base: VC / start up businesses with high cash burn rates. These businesses were raising massive amounts of capital in 2020 / 2021 when the economy was hot. In turn they were depositing these assets into SVB (& other banks) during this same time frame. The opposite has been true for the last year. Minimum amounts of outside capital have been invested into these businesses, meanwhile continued high cash burn rates and lack of outside capital infusions have driven steady outflows from deposits from SVB.
- C. There is no shortage of commentary noting that SVB exhibited TERRIBLE balance sheet management over the last couple of years. They invested short term liabilities (customer deposits) into long term assets in the form of mortgage backed securities and long term treasury bonds. This was a profitable trade for these banks in 2020 & 2021 by earning 1% - 2% on these assets while paying 0% on deposits. But since interest rates spiked over the last year, this has meant massive losses, on both their held-to-maturity (HTM) and available-for-sale (AFS) securities portfolios. But by law, banks can carry these assets at cost, so these losses remain "unrealized." However, markets are well aware of exactly how

many losses exist – even though the banks haven’t marked them yet. It is currently unclear how much hedging of this risk SVB did, other than that it clearly was not enough. To some extent, all banks are in the business of borrowing short-term deposits and owning assets that are longer term loans. SVB is not alone in this as the banking industry had roughly \$15B in unrealized losses in 2021, which was estimated to be \$610B of unrealized losses at the end of 2022 (source: Tom Lee & FSInsights). However, these forces were extreme at SVB, which had the bad fortune of receiving a massive influx of deposits during all time low interest rates (which were invested in low yielding bonds) and having to provide cash rapidly during multi-decade highs in interest rates.

- D. One estimate we saw noted that less than 10% of deposits at SVB were FDIC insured. In other words, most accounts had balances well in excess of the FDIC \$250k per owner limit. In turn, many SVB depositors withdrew funds immediately as the negative headlines began to cascade after the failure of Silvergate Bank earlier last week. While not the only cause of the failure, a volatile and concentrated deposit base certainly made the situation more difficult for SVB. Other banks with low levels of FDIC-insured deposits and large unrealized losses (relative to book value) in their HTM and AFS securities portfolios could be the next targets if the Fed doesn’t act with some authority in the very near future (before the end of the weekend would be ideal).
- E. We are seeing estimates that SVB customers will ultimately recover somewhere between 80% - 100% of their deposits. Nonetheless, this may take time, and many companies who were SVB customers will have issues in striving to make payroll, among other things next week.

This is different than 2008 in the following senses:

- A. Banks are not holding a mountain of bad debt from a credit perspective as they were on 2008. Again, per Jim Bianco, this is a liquidity crisis – not a solvency crisis.
- B. There isn’t the same contagion risk through the derivatives markets as there was in 2008. The exposure to the actual bad asset was levered up several times back in 2008. Thankfully there is no door behind the door behind the door this time around. These banks are holding high (credit) quality securities with losses due to a sharp rise in interest rates. This is not good by any means, but not the same as 2008.
- C. Banks have been vigorously stress tested for the last 10 – 12 years. Including against another 2008 type scenario.
- D. Regulators now openly acknowledge that the biggest banks are “too big to fail” and if anything, they are likely over capitalized. In this regard, systemic risks to the banking system are not the same.

Although there are many differences in the current situation relative to 2008, there is little doubt we are at the point where “things” are starting to “break”. We are not going to get into those details in this note, but this is the eventual result of most interest rate hiking cycles.

The Fed now seems to have backed themselves even further into a corner in the sense that they are not satisfied yet with their fight against inflation, yet at the same time the financial system

cannot handle higher interest rates. We don't think it would be unreasonable to speculate that the banking system NEEDS lower interest rates, but we emphasize the use of "speculate" in this comment. Government actions always have unintended consequences, and it wouldn't surprise us if the Fed has just begun to consider the eventual ramifications of the unrealized losses on bank balance sheets as a result of the Fed's historically aggressive (and largely appropriate) interest rate hiking cycle.

Michael Hartnett from Bank of America Research has a great phrase – "markets panic until policy makers panic." On Friday he wrote that investors will need to be ready to buy risk assets once the Fed panics – but nobody has any idea right now if that is a week away or a year away.

Along with the other secular forces already in place, this only furthers the thesis that inflation will remain sticky to the upside as the Fed will (eventually) ultimately prioritize the health of our banking system (if necessary) above either of their two stated mandates (price stability & full employment). Although we should mention that lower bank deposits and the main funding source to Silicon Valley possibly not existing anymore would be disinflationary.

Markets will likely move big one way or another on Monday / next week. A lot of this will likely depend on the Fed's and the regulators' responses in the days ahead. Little response will likely mean other banks (low FDIC insurance on deposits & large unrealized losses relative to shareholder equity) are targeted next week.

Finally, banks are going to have to start to pay reasonable rates of interest on deposits in order to prevent continued outflows. This will be a direct dent to bank profitability (lower net interest margins), which is why banks have been resistant to do this as of yet. The banking world change dramatically last week, and it will likely take time for participants (banks, regulators, investors, customers, etc.) to adapt.

Within our clients' equity portfolios, we remain relatively defensively positioned as we have for the last two years. Yields dropped sharply last week (bonds up), and we would expect this dynamic to continue if banking sector / economic concerns continue to be top of mind for investors (yields down is also good for bank balance sheets in reducing their unrealized losses).

We will be in touch as we have additional thoughts and information. We are honored to serve you during these challenging times.

Sincerely,

A handwritten signature in black ink, appearing to read "Brian Gift", with a stylized flourish at the end.

Brian Gift, CFA

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ⁱ *March 16th Update: The U.S. Government did step in late Sunday (after our initial update) with assurances to depositors at SVB, and implicitly other banks, that their deposits are safe. The first step was announcing that SVB and SBNY depositors were going to have their deposits fully guaranteed with immediate access. This removed significant uncertainty for depositors with balances above FDIC insurance limits. In addition, the Federal Reserve announced an additional funding option for banks through the creation of the Bank Term Funding Program (BTFP). The new program provides banks with access to additional liquidity through pledging their underwater securities at full par value. Taken together these measures are aimed to (i) reduce concerns of depositors with balances above FDIC limits to prevent another swift bank run and (ii) provide banks with embedded losses the ability to meet incremental deposit redemptions without realizing significant losses. While this does not fully alleviate the pressure the past 12 months of rate hikes have put on the banking sector, we believe these were important steps in reducing the risk to depositors of other financial institutions. #5515124.1*