A Tale of Two Banks

Q2 2023 Market Update

Victoria Greene CFA®, CRPC®
Chief Investment Officer

"If you owe the bank $100 that's your problem. If you owe the bank $100 million, that's the bank's problem. – J. Paul Getty

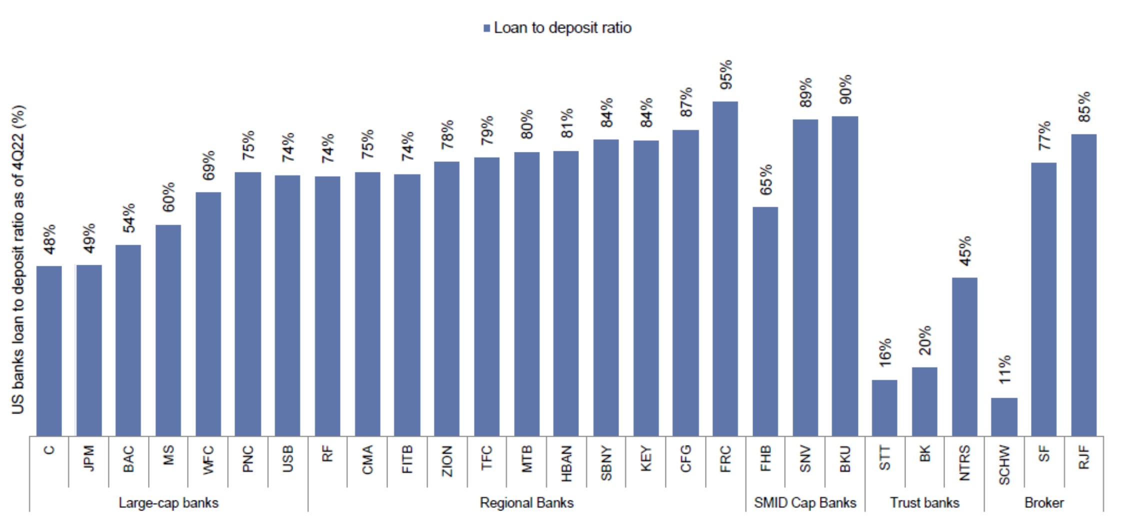
Robert Frost was a fortuitous man, as he only had 2 diverging paths in the woods to choose from. If only we were so lucky. Right now, it feels like the dispersion of potential market outcomes is growing at a rapid and expanding pace. Recent banking events have stressed the markets, specifically the financial and energy sectors. Yet, equities have remained resilient in the face of 2 bank failures and Credit Suisse doing Credit Suisse things. Even though participants have access to the same data at the same time (earnings releases, economic data updates, breaking news etc.) markets have multiple ways one can analyze data and forecast the future. Hindsight is always 20-20 but every manager has a preferred way of looking at information and weighing the probability of return in the future. Investors are currently confronted with extremely muddled data and no clear signals to follow. How do you read the road signs when the signs are all pointing in different directions?

Information is plentiful, but it's how you weigh the data that determines how you feel about the markets and our economic health at this moment. The 3 major types of indicators we are watching right now are Macroeconomic health, Fundamental stock measures, and Technical charting indicators. The conundrum right now is that all three of these methods of analysis are giving different signals on the direction the market is headed. These conflicting signals make it hard to know where the markets may head. Compounding the confusing data is the banking system stress and its effect on the economy, equities, and fixed income. There is a heightened focus on financial firm's balance sheet health, and there is a renewed effort to review specific data points that were not considered material a few short weeks ago.

	Negative	Neutral	Postive
Technicals			X
Fundamentals		X	
Macro	X		

Currently overriding all indicators is the looming threat of bank failure contagion. March became dominated with the failure of Silicon Valley Bank (SIVB) and Signature Bank (SBNY) as well as the Credit Suisse (CS) merger with UBS to save their company from going under. When we have breaking stories as consequential as a run on a bank and massive government intervention in the financial sector, it tends to overrule any trends or other news we were watching. The CPI data release day had been a make-or-break data point, but in March it passed with nary a comment as the world was consumed by the banking crisis. We are now pouring over minor data points in bank financial disclosures to see how far their Held-to-Maturity bond portfolios were written down, loan to deposit ratios, percentages of assets covered by FDIC insurance, as well as any hints of a crack in their balance sheets or deposits fleeing.

Exhibit 1: Banks loan to deposit ratio averaged 67% in 4Q22



Source: Company data, Goldman Sachs Global Investment Research

It is important to note that this banking crisis is very different than 2008. In 2008 many financial firms had gambled on investments that failed or were going to fail via housing and fixed income derivatives. The bad investments were now worth much less, and would continue to be worth much less in the future due to the collapse in the housing market. The collapse in housing destroyed investments and derivatives linked to their value, which many of them never recovered at any significant level and some actually defaulted or became defunct. So far, in 2023's crisis nobody has looked at the Held-to-Maturity portfolios of financial firms and said there was a huge credit event or wipeout that made the bonds worthless. Yes, there was a duration miss-match and, in both failures, very poor risk management and alignment between duration of assets and duration of the liability portfolio. However, the loss of value in their liability portfolio in 2022 was due to duration and interest rates rising, not a credit event or defaults. Poor planning, poor execution, but they didn't take depositors assets to Vegas and lose it all on the casino floor, they have very poor risk management and did not proactively manage interest rate risk.

Prior to their March 10th collapse, SIVB was a very well-liked bank across the street. You are hard pressed to find an analyst that saw this one coming. Yes, we can all look back now and note the asset losses and write-downs in the footnotes of their financial disclosures, but they reported earnings 1/19/2023 and no red flags were raised. The stock was up 25.19% YTD through the end of February. JP Morgan, on 3/9/23 released an updated report on SVB reaffirming their Overweight weighting and a $270.00 price target. Their byline read, "Guiding down EPS, B/S restructuring and Raising Capital; Eventual Turn in Client Fund a Moving Target." Bloomberg Intelligence even released a report 3/1/23 entitled *SVB Protected against Realizing Securities Loss*, a title that now is so wrong its almost ironic.

SVB Protected Against Realizing Securities Loss


Herman Chan
Team: Banks
BI Senior Industry Analyst


Sergio Ferreira
Team: Banks
BI Associate Analyst

SVB's Balance-Sheet Flexibility Fortifies Against Liquidity Risk

Though SVB is sitting on a $15 billion unrealized loss position in its $91 billion held-to-maturity securities portfolio, its ability to shift more deposits onto its balance sheet alleviates concerns that a liquidity crunch would force the bank to realize losses. Meanwhile, slowing cash burn and startups opening up to lower-valuation rounds can help stem the deposit outflow seen in recent quarters. (03/01/23)

1. Loss Position in Investment Portfolio a Low Risk

Though the fact that SVB's startup clients are burning through cash represents an earnings risk, a potential scenario that would require the bank to harvest losses in the securities book looks remote to us. SVB is sitting on $15 billion in unrealized losses in its held-to-maturity investment portfolio, a 17% mark that reflects higher interest rates. Available-for-sale securities hold another $2.5 billion unrealized loss. The potential risk is that deposit attrition from client cash burn could force SVB to sell securities to meet outflows. Deposits are down 5% year over year.

We view this risk as low as SVB wields deposit flexibility via off-balance sheet funds that can be transferred into deposits. Such funds were $168 billion in 4Q, while the bank has said about half could be shifted into deposits if necessary. (03/01/23)

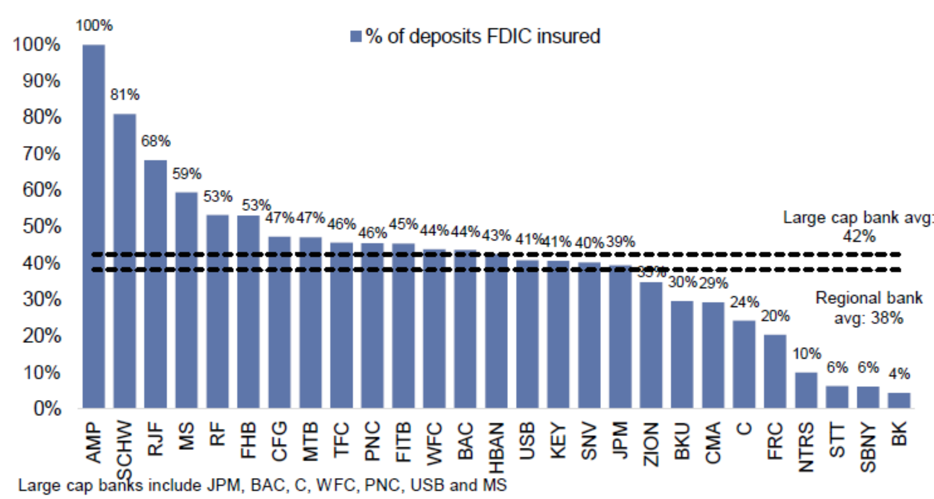
Fair Value and Unrealized Losses to Off B/S Funds

Source: Bloomberg Intelligence

I am sure those analysts would like to recall both those reports in hindsight. But it shows that analysts were digging into the balance sheets, aware of the portfolio losses, and still thought the company was strong and solvent. Again, this was not a credit event, this was a panic and a run on a bank. Aggressive companies do tend to be punished during times of stress, and SVB failed in many aspects of risk management and portfolio construction.

Honestly, the 2023 banking crisis was kicked off by a good-old-fashioned run on a bank. SIVB was absolutely an aggressively managed and concentrated bank compared to their typical peers. They focused heavily on venture capital funding and technology sectors as well as being dominated by larger depositors well above FDIC insurance limits. This left them exposed, as large depositors tend to get antsy and panic move at any sign of a potential issue at their bank. Venture Capital and technology companies were pressured by poor performance and having to downsize and struggle in 2022. This caused some to have to borrow more to fund operations or draw down deposits to keep their companies afloat. This trifecta caused pressure on the bank (natural deposit flows out to support tech companies in trouble, concentration in large depositors, aggressive nature of loan portfolio). The straw, however, was Peter Thiele metaphorically shouting "fire" in a crowded theater by advising people to take their money out of the bank. This is the first time we have had a financial crisis in the day and age dominated by social media and the exponential multiplier effect of a large, well-known investor advising companies to withdraw their money from SIVB was instantaneous. 25% of depositors demanded their funds back on that fateful Thursday alone.

Exhibit 3: FDIC insured as a % of deposits averaged 42% for the large cap banks and 38% for regionals in 4Q22

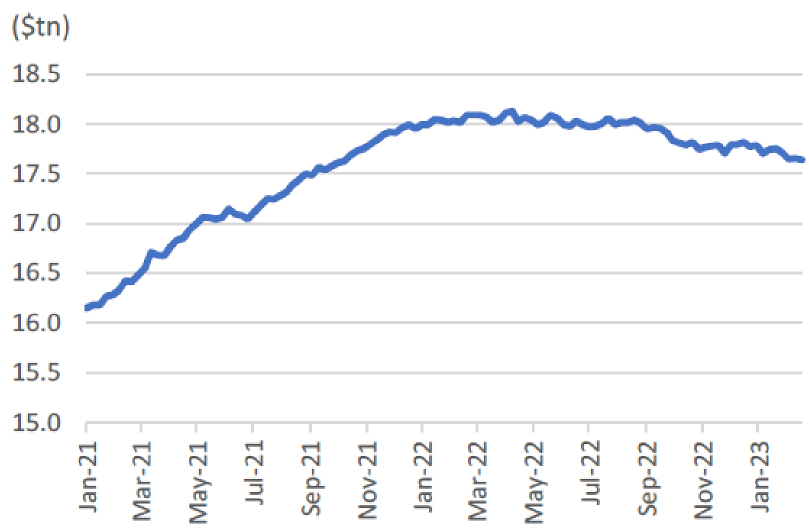


Source: Company data, Goldman Sachs Global Investment Research, SNL Financial

In some ways, a run on the bank is scarier than banks making poor investments; it's like a panicking herd of Wildebeest. Once depositors lose faith and get spooked, it becomes difficult to stop the flows. At least in the 1920's they could just close and lock the doors of the banks, nowadays with wires and ACH, monies can flow instantly from one institution to another. Panic is also difficult to sense as it is not logical. There are 2 other financial firms- First Republic and PacWest that also looked to be teetering on the brink of problems. However, with backing from the Fed and Treasury, as well as other financial firms stepping in to send them deposits, it looks like they will survive. However, we don't know how deposits have been flowing. The last real data points we have were financial reports 12/31/22. All the behind-the-scenes workings, as well as how much pressure their companies are under from financial outflows, are opaque and difficult to gauge.

The banking system was undergoing a decline in deposits starting back in the summer of 2022. The Federal Reserve estimated that from June 2022 — Feb 2023 over $422 Billion in deposits had moved out from bank deposits into either Treasuries, money markets, CDs or was spent. Interest rates made high yield savings deposits and other low risk fixed income investments attractive and the average bank was still paying 0.00% on checking and 0.05% on savings deposits. The rapid move up in rates during 2022 was already triggering deposit outflows from the entire banking system into areas that were yielding 300-400bps more.

Figure 1: Change in Deposits for Banking System



Source: J.P. Morgan estimates and Federal Reserve Data

What does the trouble brewing in the banking sector mean for the economy, equity markets and fixed income? That is unclear for now. We must understand the full scope of the runs on the banks including if we have any other failures, or some shotgun mergers. There is a lot of excess capital in the system still with pent up monies in Private Equity, as well as highly capitalized large banks such as JPM or BAC. Even Berkshire Hathaway (BRK/B) has been sitting on a stockpile of $128.58 Billion in cash and short-term investments as of their filings 12/31/22. Warren Buffett has been waiting for an opportunity to find value and deploy capital, and he may find more targets in the coming months. I would argue that an Apple (AAPL) with $165B in cash and cash equivalents or AMZN with $70B on hand may also be looking to expand more into a financial arm. AAPL already has invested in Apple Cash and Apple Pay, so they may be in the market for some type of financial firm investment. We anticipate consolidation in the financial system, however not a collapse by any means. Some firms will walk away from this crisis with bargain deals on strong portfolios of loans, mortgages and client relationships.

Equity markets have been remarkably stable throughout the 2 failures and the Credit Suisse/UBS buyout. During the 9-trading-day period covering the 3 events, From March 7th through March 17th, the S&P 500 was down only -3.26%. Yes, a pullback, but not a panic or full capitulation. The 3,815 line in the sand held, and we have seen a stabilization since then.

The Fed and Government also have a role to play in how the saga will end. After hiking rates another 25bps on March 22nd to a range of 4.75%- 5.00%, Powell and the Fed acknowledged that banks have been destabilized by the rate hikes, but that there was no case for rate cuts at this current economic expansion. The Fed is stuck between inflation and a very strong labor market and the stress on the banking system. The Dot plot has been adjusted down, and the Fed added verbiage to provide them a lot of wiggle room to maneuver if financial conditions further deteriorate. The only forward guidance they provided is that the FOMC sees "some additional policy firming may be appropriate." The Fed is concerned that the turmoil will result in tighter credit and lending conditions which were already on the way up before the pressure on regional banks. Tighter lending conditions and higher rates should further slow economic expansion. As Powell put in his press conference, "there are costs to brining inflation down to 2%, but the costs to leaving inflation higher are more severe."

How much further governments want to intervene in the financial sector will depend on asset flows and stability within some of the pressured banks. Both the government and private industry have shown an indication to act, if not preemptively, at least quickly to stop any contagion fears or market wide failures.

There is a famous Prussian field marshal, General Helmuth von Molke, who is credited with the phrase, "no plan survives first contact with the enemy." General Molke is recognized as the creator of more modern methods of communication and strategy on the battlefield. Data will constantly be changing and one has to be ready to adapt to new information in a prudent manner. Panic in your portfolio can be as deadly to your goals as panic on the battlefield. The banking failure news was certainly the enemy to many portfolios, but how you respond to future events needs to be an evolving strategy that considers and carefully weighs new information and data.

G SQUARED PRIVATE WEALTH
A Boutique Approach

1470 Copperfield Parkway
College Station, Texas 77845

(979)314-4830
GSquaredPrivateWealth.com