46 PEAKS
INVESTMENT ADVISORY GROUP

Is it (Bank) Flu Season?

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That escalated quickly. I mean, that really got out of hand!
– Ron Burgundy

In a remarkably sudden turn of events, the FDIC seized Silicon Valley Bank (SVB) on Friday and Signature Bank on Sunday. The failure of SVB is the second largest bank failure in U.S. history. So, while SVB may not be a household name to most people east of the Mississippi, it is a big deal.

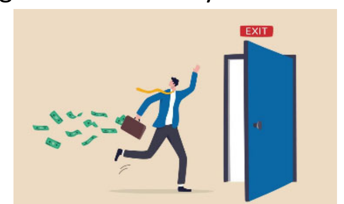
Also a big deal is the Government's response over the weekend. Late Sunday afternoon they announced that all client deposits at the banks would be backstopped 100% - even those amounts over the well-known $250,000 FDIC limit. In today's politically charged environment, and with newscasters seeking to fuel emotional flames, many will trumpet that this was an unnecessary bailout for the rich. It **was not a Bailout**. At least not in the traditionally unsavory fashion. Investors in these banks' stocks and bonds will lose most or all their money. Management will be fired. But the individuals and businesses (both large and small) who bank with these banks will not lose a cent. And thus, those businesses will be able to meet payroll this week. And taxpayers will not pay for it. To us, this is a great outcome.

In spite of this good news, the week has gotten off to a volatile start. Uncertainty remains. The fear is that there's "*never just one cockroach*" and that the flu that infected SVB will spread to other banks. During times like these, it's a good idea to take a deep breath, keep a cool head, and objectively assess the situation.

Let's start with what happened to Silicon Valley Bank. Importantly, a very large percentage of SVB clients were all in the same industry – startups companies and Venture Capital Funds. Things were going great for a decade or longer – inviting dangerous hubris – *what could go wrong*? You can already see where this is going. Imagine a bank that had nearly all their clients in the oil business (and then the price of oil tanked). Or all their clients were farmers (and then a drought hit the Midwest).

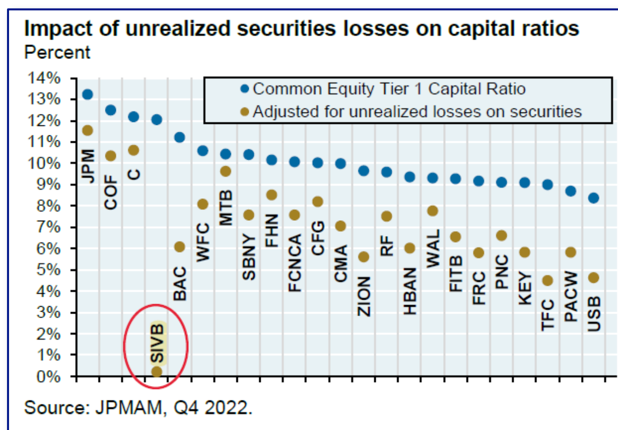
That concentration created a risky situation, and last year the firecracker's fuse was lit when VC funding and investment dried up. As a result, less money was going in to SVB and more was coming out. This likely would not have caused a problem unless SVB screwed up. They did. With everyone expecting inflation to be transitory and rates to rise only gently, you can kind of sympathize with them, but they unwisely invested too much of their assets in longer-term bonds. And then the Fed raised short-term rates. Bond yields jumped and bond prices dropped sharply. SBV did not adequately hedge their interest rate risk. On top of it, like many banks, they did not pay an attractive interest rate on deposits, so more money started to leave.

Due to money leaving, SVB had to sell assets. They sold enough at a loss that it became a problem. They needed to raise capital. Now here's when things escalated quickly. Normally, the capital markets would oblige and there would be no crisis. But investors balked. And then, one of the most prominent figures in the VC community yelled "*Fire!*" in a crowded movie theater - advising his investors on Thursday that they should take their money out of SVB. A few decades ago, this might have taken days or weeks to make its way through the community. Not now. **Thanks to our digital world** - word spread in an hour or two. And then thanks to the ease with which we can all transfer money on our phones, computers, and



tablets, money poured out of SVB. By some estimates, as much as $40 Billion in two days. A classic "**run on the bank**." Making matters worse, up to 86% of SBV's deposits were in accounts over $250,000, so compared to a mom-and-pop retail bank, an unusually large percentage of SVB's clients had strong incentives to move their money first and ask questions later.

It's important to note two things – SVB did not make bad loans, to uncreditworthy borrowers, on bad assets. They were invested in high quality bonds. Yet, this chart shows how uniquely bad their balance sheet management was – after adjusting for unrealized losses on their holdings, they were out of Tier 1 capital. No other bank on this chart is anywhere close.



Source: JPMAM, Q4 2022.

And SVB's concentration in one industry was also fairly unique. The other two banks – Silvergate and Signature – were also concentrated, but in a different, and even less stable industry – cryptocurrency. No surprise they ran into trouble.

So these banks appear largely unique and different from the vast majority of American banks that are more diversified, have stronger capital positions, and more prudent risk management. Clearly, **this is not 2008** when too many banks had excessive exposure to speculative real estate. These factors, coupled with the Government's significant response, should extinguish the flames of this crisis quickly. But we can't rule out continued volatility as the fog of crisis and uncertainty may be slow to dissipate.

Surprisingly, Charles Schwab is also in the headlines, as its stock price is getting pummeled based on fears of excessive interest rate risk on their balance sheet. We think this is misplaced. Firstly, Schwab is not alone in its stock price getting punished over the past few days– dozens of financial services companies are. In contrast to the banks experiencing trouble last week, Schwab's business is both very diversified *and* growing nicely – they are having record growth this year. Plus, Schwab has always been managed conservatively. Importantly, the bank does not have a lot of aggressive lending. Finally, Schwab's Broker/Dealer (where our client assets are held) and Schwab Bank are two separate entities. Schwab brokerage account clients do have their cash balances swept to a Schwab Bank vehicle, but none of our clients have over $250,000 in Schwab Bank – we have already moved them to higher yielding, non-Bank alternatives.

Obviously, the key question for you and I is..*what might this mean for the economy and investing*? For the economy, it's likely to restrain lending somewhat – it's hard to imagine how a banking crisis, even if contained, does not result in tighter lending standards. While this could slow economic growth, remember that public enemy #1 lately has been inflation. So tighter lending could be constructive toward slowing inflation.

It's already had an outsized impact on interest rates. As recently as last week, markets were expecting the Fed to hike rates another 1.25%. Now, only a few business days later, markets are unconvinced that the Fed will even raise 0.25% at their next meeting! It seems likely that the Fed will now tolerate a little more inflation risk instead of continuing to aggressively hike short-term rates and risk further "breaks" in the system. We think Fed Chair Powell is not going to want to be "that guy" who insisted on hiking rates to a level that triggered further shocks.

Looking at bonds – the 10-year U.S. Treasury was yielding 3.98% only a week or two ago. This morning – 3.45%! These are huge moves in a short period of time. Furthermore, we think the events of the last few days are likely to result in less political risk in the U.S. going forward, including the potential for a standoff over the debt ceiling later this year. Following the 2nd largest bank failure in U.S. history, what politician or policymaker will want to stick their neck out to potentially create another crisis in the months ahead?

So while you may not have expected to hear this – as far as stocks and bonds are concerned, the banking crisis of the last few days may very well be, in due time, **bullish**. We obviously don't know, and with both recession risk and contagion risk still elevated, and the future of inflation still highly uncertain, now is not the time to be aggressive. But it's also not the time to panic or do anything drastic. Thanks to the unique circumstances surrounding these three banks and the Government's impressive response this weekend, this event may be largely forgotten sooner than most think.

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