Gerry's Journal

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The Fed's Moment of Truth and Acceptable Casualties

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For the last several quarters, the Federal Reserve has worked aggressively to raise interest rates and drain liquidity from the U.S. financial system. And the Fed will continue down this path until 1) they feel confident that the inflationary dragon has been slain or 2) something breaks within the U.S. financial system. For the first time during this rate-hike cycle, we saw stress fractures emerge in two banks. While there will certainly be plenty of analysis and finger-pointing in the coming weeks, the initial headlines point squarely at two seemingly rookie mistakes:

1) Failure to diversify one's customer base (i.e. revenue sources), and
2) Failure to align one's portfolio time horizon with that of one's liabilities. The net result is not new, and as always, ignoring the risks while gleefully counting on the good times to last forever often ends in tears.

In this edition of Gerry's Journal, we share some perspectives on the issues at Silicon Valley Bank and Signature Bank, and what learning opportunities these events can provide to the Fed, financial institutions, and individual investors. Especially now, we invite you to connect with your Wealth Advisor should you have questions about your cash reserves, liquidity needs, or wealth management strategy.

As you are surely aware, regulators took control of two banks within the last week: Silicon Valley Bank (SVB) in Santa Clara, California[1] and Signature Bank in New York City[2]. SVB was the 16th largest bank in the U.S.[3] and the bank's failure was the second largest in U.S. history.[4] Understandably, these developments have injected a new layer of volatility into the capital markets, and the financial media has seized on the topics of contagion, bank runs, and the strength of U.S. banking system in recent days.

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[1] FDIC*, FDIC Creates a Deposit Insurance National Bank of Santa Clara to Protect Insured Depositors of Silicon Valley Bank, Santa Clara, California (here)*

[2] FDIC*, FDIC Establishes Signature Bridge Bank, N.A., as Successor to Signature Bank, New York, NY (here)*

[3] Board of Governors of the Federal Reserve System, *INSURED U.S.-CHARTERED COMMERCIAL BANKS THAT HAVE CONSOLIDATED ASSETS of $300 MILLION or MORE, RANKED by CONSOLIDATED ASSETS (here)*

[4] Wall Street Journal, *Silicon Valley Bank Closed by Regulators, FDIC Takes Control (here)*

As with all headline news, understanding the mechanics behind what occurred is essential. In the case of SVB, the timeline that led us to today began in 2020, when large capital inflows were entering the capital markets and SVB's largest customers — tech startups and venture capital firms — had more cash on hand than they could readily deploy. As a result of this, between Q1 of 2020 and Q1 of 2022, SVB's deposits surged from $60 billion to nearly $200 billion. SVB, in turn, used these deposits to purchase long-term U.S. Treasury bonds and government-backed mortgages.[5] The goal of this approach was to generate a safe, modest return that would allow the bank to pay short-term interest to depositors while profiting from the remainder.

Though government-backed securities are sound investments, they do come with interest-rate risk: The risk that when prevailing interest rates rise, the market value of these securities will drop. SVB was managing a $91 billion bond portfolio[6] when the rate on the 10-year treasury went from roughly 1.5% in the middle of 2021 to roughly 3.7% last week.[7] That rate increase might have been manageable for the bank had it managed its liquidity profile consistent with the promises it made to its depositors. However, as the tide began to turn within the broader economic environment and in particular, the tech sector, SVB's customers were, on aggregate, requesting more funds than they were depositing.[8]

To fulfill depositors' requests for cash, the bank was forced to sell a sizable portion of its bond portfolio last week, selling nearly $21 billion of these securities at a $1.8 billion loss.[9] At the same time, the bank sought financing or an acquisition in its final days, but was unable to find a partner. As large customers became aware of the bank's troubles, the pace of withdrawal requests accelerated, and on Thursday of last week, depositors and large investors tried to withdraw $42 billion from the bank — resulting in a textbook "bank run."[10]

While there are many moving pieces to this saga, many of which will be revealed in the days and weeks ahead, the bank's troubles can be boiled down to two fundamental topics which comprise many of our advisory meetings: the need for *diversification and liquidity.*

- **Diversification:** The vast majority of SVB's business model was serving the technology sector. In particular, technology companies with high burn rates on cash. For much of 2020 and 2021, these companies financed their operations using capital raises.[11] When those capital raises began to cool off, these companies began funding their cash needs by drawing down deposits. And because SVB's customer base was so heavily concentrated within the tech space, a sizable portion of their customers needed cash at the same time within the business cycle.

[5] Wall Street Journal, *What's Going on With Silicon Valley Bank? (here)*
[6] Forbes, *Silicon Valley Bank's Meltdown Could Fuel Widespread Job Losses (here)*
[7] Federal Reserve Bank of St. Louis, *Market Yield on U.S. Treasury Securities at 10-Year Constant Maturity, Quoted on an Investment Basis (here)*
[8] Wall Street Journal, *What's Going on With Silicon Valley Bank? (here)*
[9] Forbes, *Silicon Valley Bank's Meltdown Could Fuel Widespread Job Losses (here)*
[10] Bloomberg, *SVG Depositors, Investors Tried to Pull $42 Billion Thursday (here)*
[11] Wall Street Journal*, Tech Downturn Slows Early-Stage Startup Funding (here)*

- **Liquidity:** A core tenet of managing wealth is the need to match short-term liabilities against short-term assets, and long-term liabilities against long-term assets. As we have written about in the past, it becomes very problematic when an individual, family, or corporation is required to sell *long-term* assets to satisfy their *short-term* liabilities. This is exactly what SVB was forced to do last week, when they sold $21 billion of bonds that had not yet reached maturity in order to address the immediate liquidity needs of their depositors.

The Fed's Response
To understand the Fed's response, it is important to understand the macroeconomic environment in which we are operating: Over the last year, the Federal Reserve has raised interest rates at a pace and magnitude not seen in recent memory.[12] And while the management team at SVB gravely miscalculated the risk inherent within their business model and bond portfolio, the pace of these rate hikes was the tinder that enabled last week's fire.

On Sunday evening, the Federal Reserve released a joint statement between the Secretary of the Treasury Janet L. Yellen, Federal Reserve Board Chair Jerome H. Powell, and FDIC Chairman Martin J. Gruenberg. In short, they are allowing shareholders, bondholders, and the bank's management to fall by the wayside — there will be no meaningful "bailout." However, they are protecting depositors. The communication specifically mentioned that:

- SVB and Signature Bank would be designated "systemic risk exceptions," a step which grants the Fed more power in taking action to protect depositors and unwind the banks
- Depositors will have access to all of their deposited funds starting on Monday of this week
- No losses associated with the resolution will be borne by the taxpayer
- Shareholders and unsecured debt holders of both institutions will not be protected
- There will be additional funding available for eligible banks to help them meet liquidity needs[13]

Taken in aggregate, we feel this move was appropriate and prudent, particularly the step of providing other banks with financing opportunities to ensure they maintain sufficient liquidity. One big question remains how many other banks are in a similar financial position to SVB, and this step removes *some* of the uncertainty around that question. However, this is a rapidly developing challenge and the coming days and weeks will provide more clarity to this important question.

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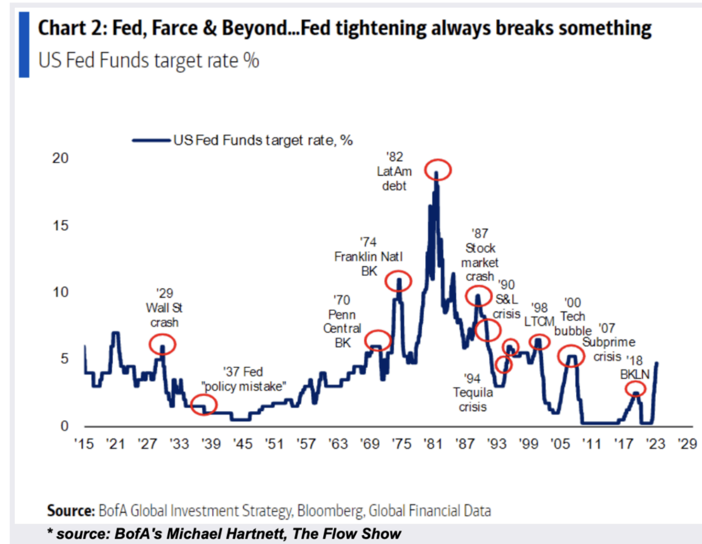
[12] Board of Governors of the Federal Reserve System, *Federal Funds Effective Rate (here)*
[13] Board of Governors of the Federal Reserve System, *Joint Press Release on March 12, 2023 (here)*

The Fed's Moment of Truth

While this is decisive action on the part of the Fed et al. which has the potential to mitigate the near-term fallout from SVB's collapse, this event is a canary in the coal mine moment that should give the Fed pause as it relates to the pace of future rate hikes. It's also a good reminder of past moments when rate hikes ended up "breaking" something in the global economy, a topic which we referenced in the opening paragraph of this journal and is underscored by the chart to the right.



It's important to recall that the Fed has a dual mandate: One is to support price stability within the economy (most recently defined as an *average* 2% inflation), and the second is to maintain "maximum" employment. And while this dual mandate continues to be true, there is a mandate that takes precedence over both… *to ensure the safety, soundness, and stability of the U.S. financial system*. To that end, you cannot have a functioning capital market system if people are afraid that the dollars, they deposit into a bank are not going to be available when they need them at a future date. And for this reason, we feel that the Fed made the right decision to support the needs of depositors in these situations. The larger question for us remains, how will these events impact Fed policy moving forward? And how many other banks will participate in the Fed's newly established lending program to address liquidity needs? These are both critical questions that we will be monitoring very closely in the coming days and weeks ahead.

Closing Thoughts

We certainly hope that the Federal Reserve remains committed to taming inflation. At the same time, we hope this situation highlights the need for the Fed to take a more measured approach as it relates to raising rates and reducing their balance sheet moving forward. Undoubtedly, consumer price index data such as what was released earlier this morning (+0.4%) [i] will continue to be just some of the data points that the Fed is focused on as it attempts to thread the needle between taming inflation while at the same time not creating unintended dislocations that could potentially undermine confidence in our financial systems.

Regardless of the Fed's path forward, we remain committed to you and your family's financial objectives. This remains a volatile period for the capital markets, and history has shown us that defining a thoughtful asset allocation strategy that addresses short-term and long-term liquidity needs is the best way to navigate choppy waters. To that end, we invite you to connect with your Wealth Advisor should you have any questions about how to protect your cash reserves, your liquidity needs, or your personalized wealth management strategy in the days ahead.

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[i] February Consumer Price Index https://www.bls.gov/cpi/