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Quarterly Market Insights

Financial Earthquake

What usually causes a bank to fail? The short answer is a loan portfolio stuffed with bad loans. In most cases, banking regulators close banks they view as insolvent before a bank run.

But that was prior to Silicon Valley Bank's (SVB) failure. What happened?

Stock Indices	Q1 2023 Return %*	One Year Return %
S&P 500 (large)	+7.50%	-7.73%
S&P 400 (midsize)	+3.81%	-5.12%
Russell 2000 (small)	+2.74%	-11.61%
MSCI EAFE (intl.)	+8.47%	-1.38%
Bond Yields	**3/31/2023 Yld. & Qtr. Change**	**December 31, 2022 Yield**
3-month T-bill	4.85% (+0.43%)	4.42%
2-year Treasury	4.06% (-0.35%)	4.41%
10-year Treasury	3.48% (-0.40%)	3.88%
30-year Treasury	3.67% (-0.30%)	3.97%
Commodities	**3/31/2023 Price & Qtr. Change**	**Dec. 31, 2022 Price**
Oil per barrel	$75.67 (-$4.59)	$80.26
Gold per ounce	$1,986.20 (+$160.00)	$1,826.20

*Stock indices include reinvested dividends and are not annualized for the 1st quarter.

SVB focused on wealthy venture capital clients. As funding for ventures began to dry up, bank customers drew down their balances. In addition, many of these depositors were above the FDIC limits (typically above $250,000 per customer) which created the risk that their deposits were not insured.

SVB was not saddled with bad loans. Instead, its portfolio of assets was concentrated in extremely safe, longer-term Treasury and Agency bonds. So far so good, until the surge in interest rates pushed bond prices lower. Bond yields and bond prices move in the opposite direction (when yields go up, the price of bonds go down and vice versa).

The bank wasn't subject to much credit risk (i.e., the risk of being repaid at maturity). Instead, it was exposed to **interest rate risk** (i.e., the risk of losing money if interest rates go up). It is not fatal, as long as the bank holds the bonds to maturity. But with deposits being drawn down by its customer base, SVB revealed late Wednesday, March 8, that it had sold $21 billion in bonds to free up cash, taking an after-tax loss of $1.8 billion.

It also announced a plan to raise capital and shore up its balance sheet. The next day, however, the stock tanked, plans to raise capital were scuttled, and deposits that were above the FDIC-insured limit began to flee the bank.

Welcome to the Digital Age

Depositors were not lined up at SVB branches. It was a bank run via smartphones, which was exacerbated by customers that announced their intentions via social media. The panic that ensued forced regulators to close the bank Friday morning, March 10.

In less than 48 hours, a bank that had a concentrated position in super-safe Treasury bonds was no longer.

One More Failure

Signature Bank, which was heavy in the cryptocurrency space, was closed on Sunday, March 12th. Without buyers for both banks, the FDIC made a 'systemic exception,' guaranteeing all bank deposits at the two banks (even those above the FDIC limits).

A systemic event is typically defined as an event that risks serious consequences to the financial system and spills over to the rest of the economy. Lehman's failure in 2008 was a systemic event, as it sparked the financial crisis.

As controversial as it was, Treasury and Federal Reserve officials feared massive bank runs could take place Monday morning, as worried depositors might flee to the "too-big-to-fail" banks or into Treasury notes and bonds.

In addition to full FDIC coverage, the Fed announced a new program that will allow banks to borrow at the maturity (par) value of high-quality bonds.

That way, if the need arises, banks would no longer be forced to sell their bonds at a loss.

Swift action to isolate the failed banks has not fully restored confidence in the financial system, but it has calmed frayed nerves, and there has been no contagion so far.

Customer cash accounts above the FDIC limit of $250,000 aren't new. But following the events of recent days, it has created new anxieties, even if they turn out to be temporary.

Fallout

Today's problems are not comparable to 2008 when poorly underwritten home loans threatened to blow up the financial system.

SVB's failure was tied to high-quality Treasury bonds that fell in value because of rising interest rates. Regulators will pour over the details, but the finger-pointing has already begun.

Meanwhile, the Federal Reserve was probably on track to lift the fed funds rate by a half-percentage point to 5.00 – 5.25% at its late-March meeting. That was before the crisis.

They opted instead for a quarter percent increase. The message: we still want to fight inflation (or at least give that appearance), but we are focused on the banks and financial stability too.

Currently, the Fed is trying to thread a very tiny needle, focusing on two conflicting goals: raise rates to fight inflation, which could add unwanted stress on banks. Or, abandon its inflation fight (at least for now), and shore up the financial system.

The crisis might do the Fed's job for it. You see, lending standards by banks were already tightening. The events of recent days could cause additional hurdles for consumers and businesses looking for loans, which would slow the economy and aid in the fight against inflation.

How much of a slowdown will occur or is a recession inevitable? No one knows for sure.

In recent days, sentiment has shifted on rates, but sentiment on rates is ever-changing, as we have seen this year. How the Fed responds in the coming months will depend on how the economic outlook unfolds.

In a nutshell, inflation has not been squashed, but problems with SVB have not spread to other banks. The crisis has waned. We are not seeing contagion among weaker banks, which helped stocks rally in recent days, and the first quarter ended on a favorable note.

What to do Going Forward

With all this uncertainty in front of us, what is the best approach to take today? We strongly believe the following:

- Clients should be well diversified between equities, bonds, and cash.
- Don't be too concentrated in any one security, sector, or maturity.
- One should have an allocation that is appropriate to their time horizon and risk tolerance.
- While an investor should not try and time the markets, we recommend tilting slightly towards a more conservative approach today. As an example, if your target allocation is 60% in equities and 40% in bonds (and cash), we would recommend being at or slightly under your neutral equity allocation.

Final Thoughts

We have updated our ADV which we file each year with the SEC. It gives detailed information about our firm. If you have an interest in receiving it, please let us know and we will be glad to forward it to you.

Also, we are pleased to have been named in both the ***Washingtonian*** magazine and ***Washington Business Journal*** as a top advisory firm in the DC Metropolitan area. While we feel fortunate to have been recognized for these awards, what gives us the greatest joy is to make a meaningful difference in our clients' lives. Thank you for allowing us to serve you.

Hopwood Financial Services, Inc.