Quarterly Booklet Spring 2023

"No winter lasts forever; no spring skips its turn."

~ Hal Borland, American writer and naturalist



A Note from our Founder

So much for things settling down. Kicking off the year, certain American banks sputtered and failed, reminding many of us of the dark days of the 2008 financial crisis. At the same time, growth stocks went on a Q1 tear, notching total returns over 17%, as tech stocks sprang back from the dead.

In this booklet Jayne Bills at One Day In July does a nice job summarizing issues banks face, analysis no doubt helped by her years doing stress tests internally at Citibank. As you read these pages you might think "Why would the management team of a bank do anything so irresponsible?" But keep in mind there are immense pressures to generate returns, and when your peers are delivering those returns, unless you control the firm's shares and board it is not easy to say "we'll just be less competitive for the next five years." Particularly if you might get a bailout anyway.

- Dan Cunningham

Source: 17% Vanguard Large-cap Growth Index, total return.



The Latest from the Fed

On March 22 the Federal Reserve announced its 9th interest rate hike since last year. The latest 0.25% move brought the rate to its highest level in 16 years. Fed Chair Jerome Powell's commentary accompanying the hike left the door open for future rate increases, as stubborn inflation remains above target and recent jobs data are still robust. Referring to the recent failures of Silicon Valley Bank (SVB) and Signature Bank (SB) as well as the troubles plaguing First Republic Bank (FRB) and Credit Suisse (CS), Powell also suggested, "Events in the banking system over the past two weeks are likely to result in tighter credit conditions for households and businesses." In fact, even before SVB exploded there was a significant tightening of bank lending standards suggestive of recessionary type conditions. If banks continue to cut lending programs and begin hoarding cash instead, intensifying the credit crunch, this could help slow growth and hiring and put downward pressure on prices. Such trends could effectively slow down the economy enough such that the Fed can finally end its streak of rate hikes.

It's worth mentioning that, along with the rate hike announcement, Powell defended the soundness of the overall banking system, noting that the problems faced by SVB/SB/FRB/CS "are not weaknesses that are there at all broadly through the system."

[&]quot;Fed raises key rate by quarter-point despite bank turmoil," apnews.com, 22 Mar 2023 "Expect Volatility, Rolling Recession, But Watch For Contagion, Schwab's Sonders Says" fa-mag.com, 15 Mar 2023

What happened to SVB?

It's difficult to point to one single reason for the failure of Silicon Valley Bank (SVB). It appears to have been due to a combination of a flawed business model (including poor balance sheet management, a homogenous customer base, and overall shoddy approach for managing risk), lack of regulatory oversight, the convenience of digital banking, and the power of social media, all against the backdrop of a historically rapid rising interest rate environment. The short story is that venture-backed tech startup firms flooded the bank with cash during the good times, and then a bunch of them all came back to pull the cash out at the same time. But since SVB invested much of those deposits into long-dated U.S. Treasuries and other government backed securities with significant interest-rate risk, when the depositors came back for their money, SVB had to sell the long-term bonds for a loss (since interest rates had increased so aggressively, devaluing the bonds) and they could not raise enough cash to pay everyone back. Why did all the depositors simultaneously come clamoring at SVB's doors? Well, a few days prior to the bank run, the rating agency Moody's threatened SVB with a credit rating downgrade, a move that would seriously hurt the bank. In response, SVB's CEO told depositors to stay calm while the bank tried to raise some extra capital.

[&]quot;Here's how the second-biggest bank collapse in U.S. history happened in just 48 hours," cnbc. com, 10 Mar 2023

[&]quot;How credit ratings are playing a key role in the unfolding banking crisis," businessinsider.com, 16 Mar 2023

[&]quot;America's Financial Regulatory System Is Still Broken," fa-mag.com, 23 Mar 2023

This move unintentionally sparked a panic by depositors that was quickly fanned by Twitter flames among the close-knit venture-capital clientele community.

At the end of the day, SVB's failure was a case of asset-liability mismatch. They should have invested in some shorter duration bonds or hedged with derivatives to better manage the interest rate risk inherent in the long-dated Treasuries and mortgage-backed securities.



What is moral hazard?

Instead of allowing SVB to collapse, regulators quickly stepped in and announced that they would cover all of the bank's depositors, in full, despite the fact that the majority of the deposits exceeded the usual \$250,000 FDIC threshold. Hedge fund billionaire Ken Griffin is among the crowd who believes SVB should have been permitted to fail, claiming, "It would have been a great lesson in moral hazard...and it would have driven home the point that risk management is essential."

[&]quot;What is an Asset-Liability Mismatch?" morningstar.com, 12 Mar 2023

[&]quot;How Twitter helped push Silicon Valley Bank over the edge," cbsnews.com, 16 Mar 2023

Moral Hazard, Continued

"Moral hazard" in economics is when one party is incentivized to take on increased risk knowing that they will not be responsible for bearing the full cost of that risk. When it comes to bank bailouts, Matt Levine writes for Bloomberg that moral hazard is "the idea that if the government saves people from the consequences of bad bank behavior, that will encourage more bad bank behavior in the future." Moral hazard can be attributed to both the bankers as well as the depositors. Griffin noted, "There's been a loss of financial discipline with the government bailing out depositors in full." On the other hand, some folks are calling for the FDIC to guarantee 100% of bank deposits to help shore up confidence in the banking system in order to keep it functioning smoothly.

Sources:

Are failing banks contagious?

Looking back to the 2007-08 global financial crisis, it's clear that the current overall banking system is significantly more robust. Regulations are tighter, including tougher capital requirements on the biggest banks. Liquidity has improved and asset quality is higher. During the financial crisis, only 10% of bank assets were in government fixed income securities. Today, nearly 20% of commercial banking assets are invested in U.S. government securities. If you include cash, high quality assets comprise 33% of aggregate bank assets, nearly triple the level in early 2008.

[&]quot;Money Stuff: SVB Took the Wrong Risks" Matt Levine, 14 Mar 2023

[&]quot;Hedge fund billionaire Ken Griffin says US should have let SVB die," Protos.com, 24 Mar 2023

As we saw with SVB, higher interest rates do translate into declining asset values, which could imply liquidity and solvency problems. But, unlike the adjustable-rate subprime mortgages that troubled banks in 07-08, the government securities currently held by banks are typically structured to pay their nominal values at maturity as expected. This makes it easier for the government to step in to arrange a deal for another bank to purchase a failing one, if need be, or to offer borrowing at the Fed's discount window. Compared to losses on assets tied to subprime mortgages, the losses on the government securities held by banks today are relatively transparent and therefore easier to manage. If the economy does start to slow, interest rates will eventually come down, which will increase the value of bank fixed income assets and alleviate the problem caused by the higher rates. In contrast, housing prices tanked during the 07-08 crisis, leading to more foreclosures, which devalued the real estate markets and worsened the cycle.

The fact that household balance sheets are still in decent shape should also provide some protection against a crisis. Consumers are still spending down their COVID-induced savings surpluses, which should limit overall declines in consumption.

[&]quot;Banking Update: Separating Fact from Speculation," batesgroup.com, 21 Mar 2023

[&]quot;This Banking Crisis Won't Wreck the Economy," fa-mag.com, 21 Mar 2023

Fractional Reserve Banking

"Fractional reserve banking is both indispensable to the modern economy and inherently fragile. This combination has confounded policymakers since its inception."

~ John Arnold, American philanthropist, via Twitter Mar 13, 2023

Let's explore this. Most modern economies rely on the imperfect system of fractional reserve banking. Fractional reserve banking refers to the idea that banks only keep a fraction of their customers' deposits available for withdrawal at any given time. The rest of the deposits are either invested by the bank or leant out to customers in the form of mortgages, auto loans, or other products on which the bank can earn more interest than they pay depositors for the cash in the first place. Fractional reserves essentially create money that helps the economy grow and allows for efficient allocation of capital. If you deposit \$1,000 into your savings account and let it sit there for 2 years, it will earn some interest. Since you don't need that money during that timeframe, the bank can lend the bulk of it out at a higher rate, simultaneously earning interest while the money might be used to invest in a new business, generating even more cash and expanding the economy.

Source:

https://www.investopedia.com/terms/f/fractionalreservebanking.asp

That's all fine and dandy until there is a crisis of consumer confidence and panicked depositors decide they all need their money back at the same time.

Fractional reserve banking is the system that gives regulators great power over the economy through the manipulation of interest rates. Central bankers can influence bank lending practices by adjusting rates or by changing reserve requirements. This is a powerful tool, useful when the economy needs a boost. However, when the economy is expanding, too much money creation via increased lending can lead to rising prices and an overheated economy.



"After years of global growth being driven by record high government spending and record low rates, the world now needs the private sector to grow economies and elevate the living standards of people around the globe. We need leaders in both government and corporations to recognize this imperative and work together to unleash the potential of the private sector."

Variance Equals Strength

In the realm of evolutionary biology, there's a theory called Fisher's Fundamental Theorem of Natural Selection. Ronald Fisher, a statistician and biologist, asserted that the greater the diversity of a population, the more chances it has to produce new and improved traits through natural selection. You can't predict which traits will be useful, but if you create lots of traits, the useful ones will be somewhere in the mix.

There's an important analogy here about investing (it's also worth considering if you are thinking of starting a bank with all of your deposits coming from the tech-startup-venture-capital community). If you'd like help constructing a properly diversified investment portfolio, we invite you to schedule a free consultation with a One Day In July fiduciary financial advisor.



Source: Wikipedia.org

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