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CHIEF INVESTMENT OFFICE

Investment Insights

A Unique Situation Leads to High Alert And Important Perspectives

March 2023

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AUTHORED BY:

Chief Investment Office

Data as of March 12, 2023

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The aphorism that "when the Federal Reserve (Fed) raises rates aggressively, something breaks" played out in real-time last week. This time around there are very different characteristics specific in nature that were at the center of the problem. Three banks were overly exposed to either high growth, very specific, concentrated deposit bases and/or speculative investment segments. One bank (Silvergate Bank) came under heavy pressure prompting a self-liquidation and the other two (Silicon Valley Bank and Signature Bank) were seized within days of each other, leaving the capital markets on guard against additional knock-on effects. We break it down below.

What just happened? The timeline and why this time may be different.

Regulators shut down the well-respected Silicon Valley Bank (SVB) on Friday, March 10, and seized its deposits in the second-largest U.S. bank failure in history and the first since the 2008/2009 Great Financial Crisis. Earlier last week—Wednesday, March 8—the bank surprised investors by attempting to raise capital to shore up its balance sheet as losses on its bond portfolio began to mount. At that point, concerns quickly grew across the Venture Capital (VC) community and deposits started to exit swiftly. On that Thursday—March 9—the bank's customers withdrew $42 billion from their accounts, and by that Friday, the bank's coffers were drained, and the institution was declared insolvent. The Federal Deposit Insurance Corporation (FDIC) took the bank into receivership.

The chain of events has created concern across the banking sector with the KBW Bank Index falling more than 11% combined trading from that Thursday and Friday. Regional and smaller bank shares in general have slumped the most. The concerns about the possible contagion effects created an additional cloud over the broader equity markets with the S&P 500 now back to about flat on the year from the solid, close to double-digit gains that began this year. Although we expect further fragility in the near-term, we believe the weakness specifically in the shares of the higher-quality Banking sector is overdone.

How does this individual situation compare to the average large bank business model and fundamental characteristics?

This situation is unique in that the company's business model was overly leveraged to one specific investment and business community that all had similar characteristics. In addition, SVB experienced out-sized, well-above normal deposit growth in the past couple of years which in turn was invested in its bond portfolio.

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Indeed, SVB posted industry leading growth in deposits during the early days of the pandemic as companies shored up liquidity, according to S&P Global. SVB grew deposits 65% year-over-year in 2020 and another 85% in 2021, compared to just 23% and 13% respectively for the median bank. From the end of 2019 to the end of 2021, SVB's deposit base tripled from $62 billion to more than $189 billion. Conversely, the four largest U.S. banks saw a more modest 36% increase in deposits over the same two-year period, according to S&P Global.

Flush with an influx of new deposits, SVB deployed its new source of funds like it always did—with a clear preference for its securities book instead of loans given the uncertain duration of its deposits and relative illiquidity of loans. Before the pandemic, securities accounted for 45% of SVB's total earning assets (securities + loans), nearly double the median bank's 25% mix of securities. Recently securities accounted for nearly 70% of SVB's earning assets versus a peak of around 33% for peer banks (Exhibit 1A and 1B).

Exhibit 1A: Uniquely Funded.

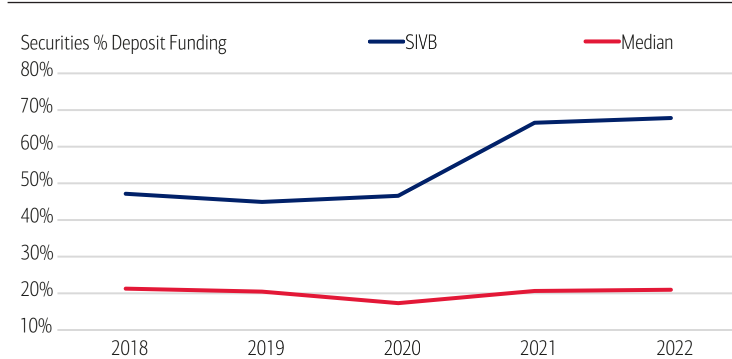
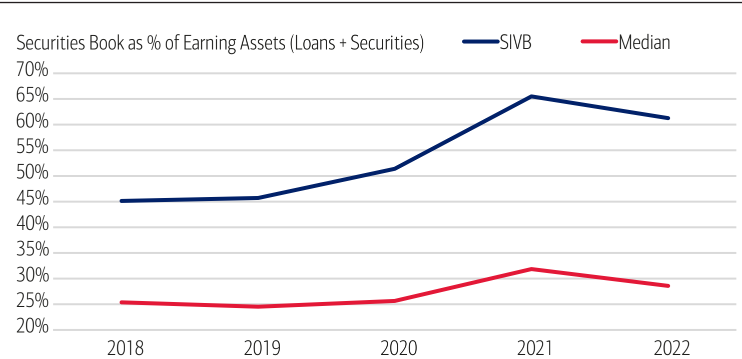


Exhibit 1B: Unique Asset Mix.

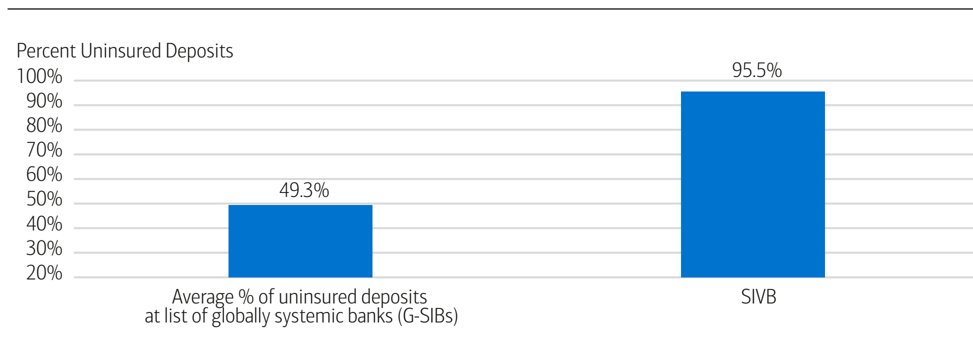


Source: S&P Capital Data as of March 12, 2023.

The portfolio ultimately suffered mark-to-market losses as assets were sold. Furthermore, since many high-growth, long-duration businesses (e.g., start-up companies) experienced slower growth as interest rates rose, the need for cash increased substantially. This "linkage" between the asset and liability sides of the balance sheet helps to explain the company's need to raise capital and one of the many major characteristic differences versus highly diversified banks. Given that many VC franchises became concerned that they would not have access to their liquidity, deposit outflows sharply increased forcing the need for the bank to raise further cash.

Compounding matters, approximately 95% of the deposits in SVB were not FDIC insured; as an important benchmark, according to the FDIC, around half of an average bank's deposits are insured (Exhibit 2). So SVB was an extreme outlier. And this, along with heightened liquidity concerns, concentrated deposits and a severe lack of capital ultimately led to insolvency.

Exhibit 2: Uninsured Deposit Mix.



Source: BofA Global Research. Data as of 2022.

Although the actual chain of events is not necessarily unique, the differences between SVB's very targeted business model (similar for Silvergate ala crypto) and the resulting linkages between depositors, investors, and their loan book versus relatively well-diversified, highly-capitalized, and tightly-risk managed large high-quality banks is significant.

What are the odds and concerns for further contagion?

Herd mentality during times of uncertainty and stress can be very difficult to predict and we expect sentiment to be on heightened alert throughout the resolution period of SVB. Beyond the banks, investor, business and consumer sentiment extends to other areas and the broader market itself. Near-term concerns pivot on other possible "look-a-like" institutions, the extent of any potential fallout in the VC community and the economic effect of a tech-led growth slowdown. Cash-burning startups are expected to face liquidity challenges in the near-term, although how this filters into the overall macro backdrop via rising unemployment, lost income, etc., remains to be seen. As a point of reference, the Technology sector accounts for only 2% of private sector employment, so headline-grabbing tech layoffs in the weeks ahead might not have an outsized effect on the overall U.S. employment picture. The risk is more to deteriorating investor sentiment.

In the coming days and weeks, we expect sentiment to remain fragile but eventually volatility should subside as it becomes clear that our highly regulated and capitalized banking system dominated by superior, well-diversified and strongly risk-managed large banks is very different than the unique situation that developed surrounding SVB.

And the situation today is significantly different from 2008. The large banking institutions today have very high-quality assets, significant excess liquidity, low exposure to high-growth start-up entities and significantly higher levels of capital by a wide margin.

What stress indicators should we be looking at, and what do they currently say?

The most important metrics to focus on measure "credit risk"; how likely are companies to repay debts when due? Longer-term metrics include Investment-grade (IG) credit spreads—monitoring the health of high-quality companies, both in the overall IG market and for the financial sector specifically (IG Financials) and high yield (HY) credit spreads, measuring the creditworthiness of weaker companies with significantly more debt than average.

Other metrics specifically measure financial system credit risk over shorter time periods—one- to three-months. They are calculated by looking at short-term financial bond yields relative to a risk-free U.S. government rate.

Currently, all metrics seem to be in a very normal range, signaling no concern of systemic risk, in our opinion. Obviously, this can change with new developments, but many are actually expensive relative to where we are in the business cycle. They have all moved very reasonably and as expected: HY has widened the most, IG only slightly wider, and short-term financial risk spreads have moved very little if at all, per the table below.

	Current Level	March 3 Level	Change (bps)	"Stressed" Level
IG	+ 136	+ 120	+ 16	+ 200
IG Financials	+ 147	+ 126	+ 21	+ 300
HY	+ 450	+ 397	+ 53	+ 650
Bloomberg Short-Term Bank Yield Index (BSBY) — Overnight indexed swap (OIS)	+ 0	-6	+ 6	+ 100
Libor-OIS	+ 12	+ 2	+ 10	+ 100
General Collateral Repo (Treasurys)	4.57%	4.57%	+ 1	6.00%

Sources: Chief Investment Office; Bloomberg; and BoA Global Research "Stressed levels" estimates of levels for a given metric would indicate significantly high systemic risk in markets, as of March 12, 2023. **Please see index definitions at the end of this presentation. Past performance is no guarantee of future results.**

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What should we be watching to assess further contagion?

The list runs the gamut—ranging from the actions of the regulators to deposit outflows from regional banks to credit spreads, the short-term funding markets, to intra-day Equity moves in Small-cap Equities that are unprofitable and leveraged to floating rates. The SVB collapse has also raised concerns overseas, so market moves in Asia and Europe are also key in monitoring.

Does this change the Fed's approach or key macroeconomic trends?

Yes, it is certainly possible that recent events could influence the Fed's next move via interest rates and quantitative tightening—notably if credit stress rises and economic growth slumps much more than expected. This could push inflation much lower, jobless claims and unemployment higher and prompt faster, downside earnings revisions for 2023 and 2024. It is possible that the Fed does not hike as much or even pauses sooner than expected if they switch to market stability mode versus price stability. The market is currently pricing in only a 25 basis point (bps) hike versus 50 (bps) at its next meeting March 22.

More recently, the Fed pivoted in 2016 and 2018, halting the rate hiking cycle in each case due to mounting financial stress. Yes, the inflation backdrop is different this time than in 2016 and 2018. Elevated levels of inflation limit the Fed's maneuverability, which explains why there is still a 15% probability of a 50 bps hike at its March 22 meeting, according to Bloomberg.

Against this backdrop, this week's print on consumer prices is key to near-term market action. However, in our view, the key is this: The Fed has exhibited flexibility in past cycles of credit stress, and we expect the same this time around.

What should investors consider for the short-term and throughout the rest of the year?

We continue to emphasize the differences between the unique business models of the three failed banks versus the large banking franchises and the overall very strong, solid, well capitalized financial system. We expect inflation to come down sharply, economic growth to likely turn negative, and the Fed to ultimately end the interest rate hiking campaign. The next step would likely be that financial conditions begin to ease again, which should lead to less market volatility, in our opinion.

We continue to expect a grind it out, choppy market environment with heightened concerns. We continue to emphasize higher-quality assets within Equities and Fixed Income as we expect higher-quality asset prices to settle down at attractive prices. Long-term investors should consider using a dollar cost averaging approach during outsized financial market weakness to rebalance exposure to the higher-quality areas with solid fundamentals. For the time being, in the very short-term, we would wait for the volatility to subside as new "resolution" plans are announced and pulled through.

Once we get through the final stages of the tightening cycle, financial conditions ease and the leading economic indicators bottom, we believe the environment is, once again, set up for the beginning of a long- term bull market in Equities. We emphasize adding higher-quality assets in general and believe the new leaders are the areas most starved of capital in the past decade and a half, which includes the old economy sectors.

What is the latest on a resolution plan and programs to help calm concerns?

The situation remains fluid, with the FDIC kicking off an auction process late Saturday—March 11—for SVB. Final bids my not be known until late Sunday or Monday morning. Other backstop measures are on the table. In fact, March 12 Sunday night, regulators

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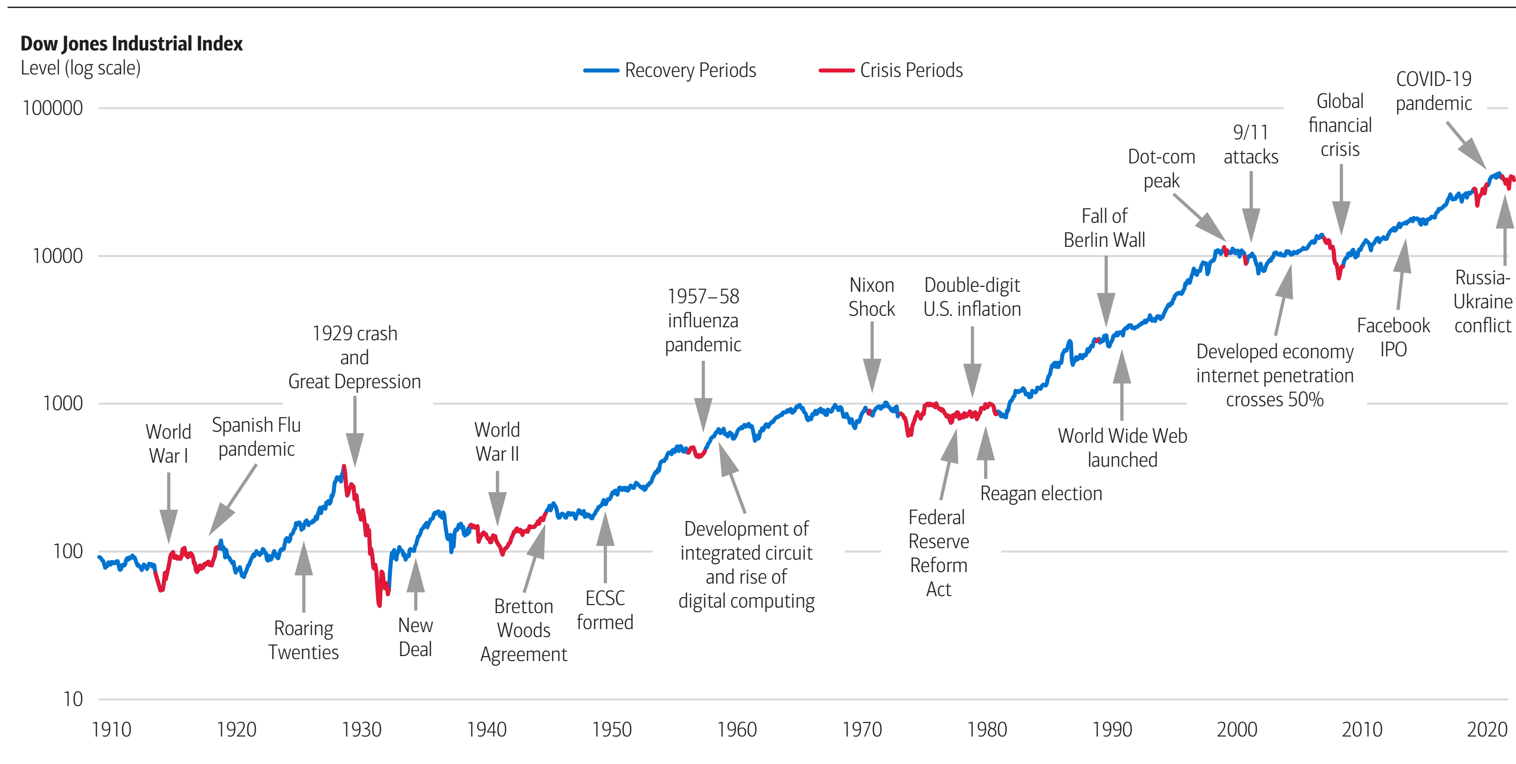
approved plans to backstop both depositors and financial institutions associated with SVB. The Fed also said it was creating a new Bank Term Funding Program aimed to help safeguarding overall financial stability, with the aggressive measures acting to calm the markets near-term. The key is that the government and monetary authorities have many tools at their disposal and is expected to deploy them in the next few days. We will continue to monitor the situation as it unfolds in the coming days.

Finally, seeing the forest from the trees.

As the Chief Investment Office has long and repeatedly stressed, sometimes the most difficult thing to do in investing is to look past the present and plan for the future. That is especially true given today's tumultuous investment landscape. A look at the past 100 years shows several periods of societal, economic, geopolitical and financial difficulty that eventually gave way to new patterns of activity (Exhibit 3). We believe maintaining a disciplined, long-term approach to investing is now more important than ever. We continue to emphasize and favor an approach that involves a longer-term horizon, detailed planning, and a disciplined and diversified portfolio construction approach.

Exhibit 3: Equity Market And Historical Periods of Crisis and Recovery.



Source: Chief Investment Office, Bloomberg. Data as of March 2023. **Past performance is no guarantee of future results.**

Index Definitions

Securities indexes assume reinvestment of all distributions and interest payments. Indexes are unmanaged and do not take into account fees or expenses. It is not possible to invest directly in an index. Indexes are all based in U.S. dollars.

S&P 500 Index includes a representative sample of 500 leading companies in leading industries of the U.S. economy. Although the index focuses on the large-cap segment of the market, with approximately 75% coverage of U.S. equities, it is also an ideal proxy for the total market.

Dow Jones Industrial Average Index is a stock market index of 30 prominent companies listed on stock exchanges in the United States.

KBW Bank Index is designed to track the performance of the leading banks and thrifts that are publicly-traded in the U.S.

Bloomberg Global Investment Grade Index is a rules-based market-value-weighted index engineered to measure the investment-grade, fixed rate, global corporate bond market.

Bloomberg Investment Grade Financials is a security has an investment grade rating if it has a rating that falls within the range of Aaa to Baa3 from Moody's or AAA to BBB- for Standard & Poor's. The company's securities have investment grade ratings if it has a strong capacity to meet its financial commitments.

Bloomberg High-Yield Index is a rules-based, market-value-weighted index engineered to measure publicly issued non-investment grade USD fixed-rate, taxable and corporate bonds.

Bloomberg Short-Term Bank Yield Index (BSBY)—Overnight indexed swap (OIS) is a proprietary index calculated daily and published at 7:00 am (EST) on each U.S. business day. The index has been developed to address the needs of the market by providing a series of credit sensitive reference rates that incorporate bank credit spreads and defines a forward term structure. BSBY seeks to measure the average yields at which large global banks access USD senior unsecured marginal wholesale funding.

Libor-OIS is the difference between Libor—the floating rate at which banks lend to each other – and overnight index swap rates, which are set by central banks.

U.S. Mortgage-backed Securities (MBS)/Bloomberg U.S. Mortgage-backed Securities Index is the U.S. MBS component of the U.S. Aggregate index. The MBS Index covers the mortgagebacked pass-through securities of Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC).

General Collateral Repo (Treasurys) is a measure of rates on overnight Treasury general collateral repurchase agreement (repo) transactions. General collateral repo transactions are those for which the specific securities provided as collateral are not identified until after other terms of the trade are agreed.

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