Investment Newsletter

First Quarter 2023

The S&P 500 index had a strong start to 2023, returning +7.4% in the quarter. The MSCI All-Country World ex-U.S. index also performed well with a total return of +6.9% for the quarter. A recovery in technology stocks, the full reopening of China post its harsh COVID-19 lockdowns, a continued downtrend in inflation, and increased expectations for interest rates to peak and begin falling this year – especially given the recent banking crisis and weakening economic data – all positively contributed to market performance.

Despite the positive performance, a global banking crisis unfolded in the quarter, resulting thus far in the failure of four banks – a consequence mostly of the Federal Reserve's aggressive interest rate hiking campaign, which continues to 'break things.' The failed banks had lost their clients' confidence for various reasons, exacerbated in a few cases by high levels of uninsured deposits, and ultimately suffered deposit outflows they were unable to contain. So far, the market has absorbed these failures fairly well, aided by the federal government's bailouts of uninsured depositors, additional short-term lending to banks, and its assurances that this is not a systemic issue, but more the result of mismanagement by a handful of banks.

Fixed income also performed well in the quarter, with the Bloomberg U.S. Intermediate Government/Credit index returning +2.3% and the Bloomberg Municipal Bond Blend 1-5 Year index returning +1.5%. Bond yields had been in an upward climb, reflecting the Federal Reserve's intention to continue raising rates in response to strong economic and inflation data, but with the failure of multiple banks, yields declined sharply as investors quickly changed their outlook to one of recession and interest rate reductions. For example, the 2-Year Treasury Note traded in an extraordinarily wide range of 3.37% to 5.07%. The decline in yields resulted in positive investment returns for all U.S. fixed income sectors in the quarter.

Looking forward, it is difficult to predict the path of interest rates given the many uncertainties that lie ahead. On a positive note, inflation is trending lower, which supports lower interest rates. However, the debt ceiling and budget issues remain unresolved, and political pressures and internal conflict could induce more volatility in yields. For these reasons, we remain cautious and defensive. Our objective is to take advantage of periods of volatility to add new holdings at reasonable valuations. We continue to focus on adding higher-coupon, high-quality intermediate maturity bonds in both taxable and tax-exempt portfolios.

With its significant impact on global financial markets, how did the banking crisis unfold? It actually began in November 2022 with the collapse of cryptocurrency exchange FTX, which had $15 billion of assets, and whose founder and CEO would later be charged with fraud. This event claimed the first banking victim: Silvergate Bank of California, a bank with $11.9 billion in deposits that catered almost exclusively to cryptocurrency clients. Although Silvergate Bank announced FTX was only 10% of its deposits, customers lost confidence and withdrew -68% of the bank's deposits. This caused the bank to sell securities to cover those withdrawals, resulting in an earnings loss of $1 billion. On March 8, 2023, Silvergate Bank announced it would self-liquidate.

On the same day Silvergate Bank announced its self-liquidation, Silicon Valley Bank (SVB), part of SVB Financial, announced it had sold substantially all of its available-for-sale securities portfolio at a $1.8 billion loss to cover declining deposits. The massive loss was generated by management's fateful decision to invest in longer-term securities to earn a higher yield. These securities fell significantly in value when interest rates were raised aggressively in a short period of time. SVB simultaneously announced an attempt to raise $2.25 billion to

offset the loss. The following day, SVB's share price dropped -60%. Many of SVB's venture capital customers urged companies to move their deposits out of SVB for fear of the bank's failure. With 88% of the bank's deposits uninsured by the FDIC, many customers succumbed to that fear. By March 9, 2023, 22% of SVB's $191 billion in deposits had left the bank. The next morning, on March 10, 2023, SVB was closed by regulators.

On March 12, within 48 hours of SVB's failure, a third U.S. bank – Signature Bank of New York – had also failed. Like Silvergate Bank, it catered to cryptocurrency customers. In fact, 20% of Signature Bank's $89 billion in deposits were tied to digital assets. Moreover, the bank had deposit relationships with both FTX and its sister company Alameda Research, and a lawsuit would later be filed against the bank alleging it facilitated FTX's commingling of accounts between the two firms. Although Signature Bank was largely a commercial bank with different business lines, it and Silvergate Bank were the only two banks in the U.S. that specialized in digital assets, and in the end, that was the business line that doomed the bank. In addition, like SVB, Signature Bank had an excessive portion of its deposits uninsured by the FDIC (90%) and once fear and contagion set in, Signature Bank lost -20% of its total deposits in a matter of hours two days before it failed.

The banking crisis then went global, as one of the world's 30 systemically most important banks would fail next – 167-year-old Credit Suisse of Switzerland. After years of scandals, corruption, bad investments, and executive management turnover, Credit Suisse had already been in turmoil. In fact, in 2022, the bank's deposits plummeted -40% to 234 billion Swiss Francs and it reported a net loss of 7.3 billion Swiss Francs. However, once the bank's largest shareholder, Saudi National Bank, publicly stated it was not interested in investing more in the bank – just three days after SVB's failure – Credit Suisse's fate was sealed. By March 19, the Swiss central bank forced UBS to acquire it for just 3 billion Swiss Francs.

What caused the banking crisis? The federal government – specifically, in two ways: 1) the Federal Reserve kept interest rates artificially too low for too long (13 years), which enabled Congress to spend too much money, and which catalyzed the reach for yield by banks and consumers alike and gave the impression that money would remain cheap forever. Ultimately, however, it led to inflation and a dramatic rise in interest rates, as well as to the explosive uptake and increase in valuation of cryptocurrencies; and 2) lack of regulation – specifically, the change in the federal banking law in 2018 that allowed banks with under $250 billion of assets to no longer comply with stricter rules, and the virtually non-existent SEC regulation of cryptocurrencies.

Has the banking crisis been fully resolved? Not yet. First Republic Bank (FRC) also got into trouble and its stock is still down -90% from its recent high, despite receiving a $30 billion cash infusion from 11 of the largest U.S. banks. Moreover, U.S. banks still hold securities with unrealized losses totaling $620 billion as of year-end 2022 (FDIC). In addition, higher interest rates have also lowered the value of other bank assets, such as loans, which means banks likely have much higher unrealized losses as a percentage of their capital. Short-term bank borrowing from the Federal Reserve has also reached $350 billion – a level not seen since the credit crisis in 2008. All this could result in tighter underwriting standards, slower loan growth, and slower economic growth.

What preliminary lessons have investors learned from the banking crisis? Do not panic, do not engage in fear, do not try to time the market, and stick to one's investment strategy. There is always a new problem or crisis – the pandemic in 2020, inflation in 2021, Russia's invasion of Ukraine in 2022, and now the banking crisis in 2023. Throughout it all, the stock market has been volatile but ultimately fairly resilient over time.

Despite the economic, financial, and geopolitical crises past, present and future, we remain committed to maintaining our investment discipline by finding and investing in companies with the same consistent and compelling characteristics – low debt levels, solid free cash flow generation, great management teams, strong market leadership positions, and resilient businesses that continue to innovate – and by staying composed and focused on maximizing long-term performance and success.

Sources: FDIC, BEA, Federal Reserve Economic Data (FRED) and FactSet

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