# Special Market Update

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## Educational Moment: Weak Chain-Links Break

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Bank regulators were caught off guard last week as three banks failed. First Silvergate Capital, then Silicon Valley Bank (SVB) on Friday, and Signature Bank over the weekend. Bank failures are rare. Yet, it should not be a surprise when a weak link in the chain breaks as monetary conditions tighten via higher interest rates and minimal money supply growth. History shows that leveraged situations become strained when financing costs rise and economic conditions slow. That is our present situation – slowing economic growth due to fast rising interest rates to fight high inflation.

Since 2008, the "cards" were being played by policy makers. Monetary policy was accommodative with zero interest rates (ZIRP) and Quantitative Easing (QE) policies. This provided seemingly infinite access to cheap money; even to risky ventures. COVID and its Great Lockdown of the global economy advanced additional easy monetary policies with added government aid of every kind and ballooning the money supply. We understand the result – fast rising inflation rates coupled with low unemployment. Government policies – monetary and fiscal - are proving to be too much for too long, and both created a large policy mistake. Unfortunately, the economy and investors suffer when safe assets such as deposits suddenly appear risky.

Silicon Valley Bank provides a worrisome example. It was the 16th largest bank in the US, and second largest bank to fail (be seized); first to fail since 2008.

- SVB held $55 Billion in assets at YE 2020; grew to $186 Billion at YE2022. SVB was "puffed up" by its own fast success. Deposit growth occurred because "cheap money" from low interest rates financed new private equity ventures, new initial public offerings (IPOs) and other Special Purpose Acquisition Companies (SPACs). These young companies with lots of "free" cash put their $$$ in savings and checking accounts at SVB. SVB garnered almost 50% of all new business finance money during the last 2 years. Most start-ups created relationships with SVB. These "savings" monies paid low to zero interest.
- In 2022 as the Fed started raising interest rates aggressively (to fight inflation), SVB made Mistake #1: investing accumulated large deposits in long-maturity, higher-yielding US Treasury and mortgage-backed bonds. They reached for yield by extending maturity.
    - Rising interest rates caused the value of the long-maturity bonds to fall; not a problem if SVB could hold the assets to maturity in 10 years. [The 30-year Treasury Bond is 4 times more volatile in price movement than a 2-year Treasury; 10-year Treasury is 2 times more price volatile than a 2-year Treasury.]. High rates by the Fed are slowing the economy and creating cash flow challenges on businesses (higher expenses with wages, supply costs, and transportation). The young businesses with deposits at SVB (and others) are withdrawing deposits (savings) to meet payroll and rising business expenses.
- Mistake #2: SVB sold long-maturity bonds at losses to provide for increasing withdrawals by depositors; the bank capital eroded by the size of its investment losses. As withdrawals increased and accelerated, a "run" began that exasperates the bank's capital reserves.
- Mistake #3: SVB could not react fast enough to raise additional capital from investors to shore-up its balance sheet; it could not react to a buyer's bid to buy equity in the bank.
    - The FDIC stepped in on Friday to insure deposits of $250,000 or less; uninsured larger deposit balances were frozen pending how refinancing develops.
- Mistake #4: SVB did not utilize a "risk committee" to follow Fed regulations to "match" assets to liabilities (ability to meet depositors' cash needs). And, their Board lacked bank finance experience. Banks rarely survive on one mistake; more will prove fatal.

A day of reckoning always arrives when the Federal Reserve needs to correct policy mistakes – either monetary or fiscal policy mistakes. We see evidence of those mistakes in two ways: high inflation and an inverted yield curve (where short-maturity interest rates are higher than long-maturity rates; this is abnormal). Greater challenges exist when both conditions occur at the same time. The Fed finds itself in a "tightrope" situation as it needs to maintain public confidence in the banking system, and needs to continue its efforts to curb inflation. The current plan is to cover all deposits with any losses by the FDIC to support unsecured depositors/balances, with losses recovered by special assessments on banks. The Fed will slow its interest rate hikes as it stabilizes confidence in the banking system.

We are seeing the first real impact of money supply growth – which was +30% in 2020 and is now -2% - grinding to a halt. Late last year, the crazy stuff (SPACs and crypto) got hit; followed by FANG and friends; now we're into the third leg of illiquid stuff (commercial real estate, venture capital and

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private equity). Banks that financed these activities or made internal policy mistakes are now being exposed with the current high interest rate environment, a big change from 2 years ago.

We should also clarify the term bank. Most of us think of a bank as one where we save or deposit our money, using checking and savings accounts for living daily lives. Businesses also deposit their money to pay bills, payroll and etc. Both borrow money from a bank to finance a home, car, and/or business operations. In the finance world, the term "bank" is also used for brokerage firms that also provide investment banking services. Investment banking involves assisting companies raise larger amounts of money by selling to investors bonds (loans) or stock (equity) for operating and capitalization purposes. Recall in 2008, two "banks" failed – Bear Stearns and Lehman Brothers. Both were "brokerage" type firms with large investment banking businesses.

IMPORTANT: Large, big banks are better capitalized today than before the 2008 financial crisis. Some regional and small banks with less diverse deposit bases are being closely monitored by the Federal Reserve during this time of raising interest rates. But "weak links in the chain" will break; they did in the past and will again.

An amazing observation, which longer investors can attest… when there is some smoke, when there is a small spark, why do a few players (speculators) light a fire with a blowtorch? A few mid-size and regional banks are being torched today by reckless speculators. Even Schwab is being hammered incorrectly. As our clients custody their investments with Schwab, let's understand their business model. Schwab's is the "baby that got thrown out with the bathwater", balance sheet is pristine, no crypto, no underwater low yield bond investments, no foreclosing mortgage loans, etc. It's a steady cash machine that does not operate like a bank or investment bank with a history of operating very conservatively.

Lastly, let's review a few key LESSONS of the day:

1. Choosing a strong reputable bank is very important – it is where we live our daily lives. Use checking and savings accounts with amounts that assure you can cover your lifestyle for 6 months or so (varies by individual/family situation).
2. Investment portfolios should pursue an appropriate investment objective based upon time horizon and purpose. Nvest Wealth Strategies uses the concept of "buckets of time" to establish a long-term investment objective. The 3 "buckets of time" are 1) "cash" (for money needed in a year or less); 2) "bonds" (for money needed in 2 to 5 years); and 3) "growth" or stocks (for money not needed for 5 years or longer). These buckets allow investors to match assets with time and purpose, and importantly allows them to weather any storm that financial markets will incur over the years. Important observation that high quality bonds are holding up nicely during this current stock market volatility.
3. Be wary of illiquid investments, or investments that control the owner. Nvest Wealth Strategies does not own any investment that is illiquid and/or not easily sold. The portfolio owner should always be in control of the investments. If the reasons for owning change, an investment can be sold promptly. Further, we focus on no-load mutual funds and ETFs that are actively managed – meaning the portfolio managers' repeatable process is proven; they own investments that meet their research criteria and are marketable; they are generally not index-oriented that indiscriminately include both high and low quality; they can differentiate. [Be wary of private equity, private placements or illiquid investment ideas like non-marketable REITs. Yellow flags should be raised for these and many annuity offerings.]. Nvest does extensive due diligence, before and ongoing, relating to the investments used in client portfolios. Quality (fund managers, investments used and the process) are imperative investment criteria. And, always manage risk via asset mix and diversification.

Bear markets are a function of time and price; a time when excess risk is withdrawn and new leaders are often born. Unfortunately, we, nor any investor can forecast either. Yet, events like SVB and related, even crypto are "shadows" that reveal excesses are being erased from the financial system. When "irrational exuberance" is erased with "irrational exasperation" the bear market bottom is established. It's where some investors "throw in the towel" saying "get me out." The shadows are starting to appear, which means the end of the bear is approaching. A new, future rally will develop and become the next new bull market. Bull markets occur with strong upward movement by the masses of stocks. Key is staying invested and making some adjustments to ready for the next rally => new bull market. It will come!