Strategically Speaking - March 15, 2023

THE CANARY IN THE COAL MINE

Over the last week we have witnessed significant volatility in the global banking industry due to the collapse of Silicon Valley Bank (SVB), the 16th largest bank in the U.S., and, to a lesser extent, Signature Bank. The global banking sector has declined -9.2%[1] month-to-date through March 13, 2023 versus the broad market return of -2.26%[2], while the U.S. banking sector was down -18.57%[3].

Is this signaling a larger global issue?

Are these recent developments the proverbial "canary in the coal mine" signaling a global financial crisis? Given the unique circumstances of SVB's business and the immediate steps taken to assure depositors, including the introduction of a new Bank Term Funding Program, liquidity pressures and contagion should be contained.

SVB was unique. Depositors were concentrated in the technology and bio-technology start-up sector and there was very little economic diversification in depositors. Plus, SVB's percentage of deposits greater than $250,000 (the amount insured by the Federal Deposit Insurance Corporation or FDIC) was high when compared to other U.S. banks. Additionally, the assets supporting these typically shorter-term deposits were invested in high-quality investments with longer maturities. SVB did not collapse due to a credit crunch, but from balance sheet stress due to

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[1]As measured by the GICS banking industry classification performance of the MSCI ACWI Index.
[2]As measured by the MSCI ACWI Index.
[3]As measured by the GICS banking industry classification performance of the Russell 1000.

Source: FactSet

the mismatch of maturities of their assets and liabilities, exacerbated by the level and velocity of interest rate increases over the last year. This was a classic “run on the bank.” Without additional financial backstops, any regional or community bank risks insolvency if many depositors ask for their money at the same time. Would SVB still be solvent today without the concentration of its depositor base and the attempts to withdraw assets at the same time? We will never know.

Is this equivalent to Bear Stearns or Lehman Brothers in 2008, signaling broader systemic risk?

We would argue it is closer to the non-systemic default of Orange County in 1994, an isolated incident resulting from poor balance sheet management and leveraged exposure to higher interest rates. Even in periods outside of a financial crisis or economic downturn, the U.S. averages one bank failure per year.

For the modern-day fractional reserve system to work, however, confidence that deposits will be available when needed is required. The Bank Term Funding Program does this by making funding available so that institutions can meet the needs of depositors, including deposits greater than $250,000. Instead of selling assets at a loss and suffering capital

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erosion, an eligible institution can borrow at the book value of an asset for up to a year, thereby precluding the balance sheet stress faced by SVB.

In addition to the volatility of bank stocks, we have seen volatility in interest rate markets. Investors rushed to safety, and expectations for a slowdown in monetary tightening — and even monetary ease — flowed through the market. As an example, the yield on the 2-year Treasury declined by -12.47% on Monday, March 13 since reversing 4.75% on March 14, 2023.[4]

This begs the question: Will the U.S. Federal Reserve forego its battle against inflation due to the stress placed upon SVB? We do not think so. The Bank Term Funding Program helps insulate bank balance sheets from the unrecognized losses incurred from rising interest rates. This allows for future interest rate increases without damaging the ability of banks to manage their liquidity.

The situation is ongoing, and we will continue to monitor the issues. We believe that regulations may change to guard against this type of event in the future. That said, there are many financial institutions with strong balance sheets that suffered due to market-based fear, which creates potential investment opportunities.

[4]Yield - 3/10/23: 4.59; 3/11/23: 4.02; 3/14/23: 4.21.
Source: FactSet

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info@cbisonline.com **or** **(877) 550-2247**