The Advisor

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Market Update - Second Quarter, 2023

BEHIND THE BANKING CRISIS. The first quarter was eventful, to say the least. Stocks were up, bonds were up and by now you've read the headlines and stories about how Silicon Valley Bank as well as Signature Bank failed. So did Silvergate Bank. First Republic Bank needed a $70 billion dollar lifeline from a consortium of 11 large U.S. banks. Overseas, Credit Suisse was on the verge of collapse before the Swiss National Bank and UBS came to the rescue.

We fielded many questions of, "What happened?" The answer is pretty straightforward, regardless of the specifics of each situation, which is to say in some form or fashion the banks could not meet the liquidity demands of their customers. It's not normal for banks to fail or need a lifeline so it's worth a deeper dive to explore the implications to the economy and financial markets.

We begin with liquidity and what that means within the monetary and banking system. In the old days, banks were depositories of physical cash in their vaults. Liquidity, therefore, was centered on managing actual cash in the vault and being able to cover the withdrawal demands, in physical cash, of their customers at any given time. If you guessed this is where the term bank run originated you would be correct – literally running or getting to the bank location ahead of the next person so you could withdraw your actual cash and coins before the bank ran out.

Today, physical cash is no longer the primary means of monetary exchange; it's largely irrelevant which is why banks no longer keep mountains of vault cash on hand. Instead, electronic means of exchange, recorded as book entries, rule the monetary world. Think about when you make a purchase with your debit card. There is no physical cash exchanged. Your bank receives a debit notice for the amount of your purchase which they send electronically to the receiving bank who then credits the seller's account.

Now think about the sheer number of transactions that occur every single day across the global financial system that must be matched and settled between banks – some banks will owe more (deficit) and others will receive more (surplus). What happens if a bank faces a deficit, a shortfall? They can secure short-term financing from other banks and financial intermediaries to meet their settlement obligations. This is called the wholesale market and it provides the elasticity, conversion and redistribution of money throughout the system.

We take the time to make this important distinction of how the monetary system evolved because it means liquidity is no longer measured by the amount of physical cash in a bank vault. Instead, liquidity is now tied to a bank's access to wholesale money; in other words, to lending and short-term financing between banks, financial institutions and even the Fed. If a bank has the capacity on the balance sheet to freely lend and borrow in the wholesale market – that is liquidity. If the bank does not – that is trouble.

To the right is an overly simplified but useful example of a bank balance sheet. Taking a look at the assets, cash is the most liquid. The securities are liquid as well, but they carry a market value that can be more or less than the purchase price. The loans are the most illiquid asset given they are paid back over time. On the liabilities side the deposits at the bank are owed back to the customer. Total deposits are greater than the amount of cash.

Assets	
Loans	45
Securities	45
Cash	10
Total	**100**

Liabilities	
Checkable Deposits	45
Other Deposits	45
Borrowed Capital	10
Total	**100**

In the normal course of business, a bank can go to the wholesale market and use their securities and loans as collateral to receive short-term financing. This provides the bank liquidity above and beyond the cash they have on hand – much like if you were to get an equity line on your home. Your house isn't your most liquid asset but it can be used as collateral and you get a line of credit. Your liquidity improves because you have converted a portion of your home into spendable money.

Now that we've covered some background let's go back to Silicon Valley Bank (SVB) and the crisis because this gets really interesting. We know a large number of SVB customers took their money out, essentially at the same time, and moved it elsewhere. This forced SVB to quickly raise liquidity because they had to return deposits to their customers. To be expected, SVB turned to the wholesale market to secure financing but still could not overcome the shortfall. SVB also became forced sellers of securities, such as U.S. treasuries, that had declined in value because interest rates had substantially risen since the time of purchase. The death spiral had begun and it happened very quickly.

There were other important factors that contributed to SVB's fall and some are quite complex such as their treasury portfolio and risk management. That aside, the important takeaway actually isn't about a run on one particular bank but rather a system that became inelastic and therefore liquidity dried up. That is why the crisis wasn't isolated to just Silicon Valley Bank – there were others. Dealer banks and financial intermediaries at the center of the wholesale market maintained a risk-off approach, raising their own liquidity, tightening standards and preserving capital. It was everyone for themselves once the tipping point was breached.

So, how does something like this crisis impact the economy? To summarize, we'll point to the Fed's Beige Book which is an anecdotal report on economic conditions with commentary from each Federal Reserve Bank across the 12 Districts. The April 19th report, published post bank crisis, stated, "Lending volumes and loan demand generally declined across consumer and business loan types. Several Districts noted that banks tightened lending standards amid increased uncertainty and concerns about liquidity." In our view, this is the key issue to follow – less lending, less borrowing, less economic activity – not fear of a banking system failure.

As it relates to financial markets, it all comes down to recession, or not. Sure, it's more nuanced than that but for stocks, in particular, keep in mind the value is in the future cash flows the company is able to deliver to the investor. Naturally, the economic conditions the company operates in matters and there are still many questions surrounding what those conditions will be as 2023 continues to unfold. We do believe there is opportunity for investors which is reflected in our plan of action to capitalize on the yield environment while maintaining prudent equity exposure and positioning portfolios with an eye towards preservation.

To our clients, thank you for the opportunity to serve your investment needs and please do not hesitate to contact us if you experience any material changes in your personal situation or would like to discuss any specific matters.

To our other readers, if you would like a complimentary review of your investment accounts or any other financial matters, please do not hesitate to contact us. As fiduciaries, we will happily provide you with an opinion based on your specific situation.

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