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QUARTERLY PERSPECTIVE

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IN SEARCH OF LIQUIDITY

Will Williams
Chairman, President & CEO

As the recent saga of Silicon Valley Bank (SVB) might suggest, a commercial bank's ability to manage liquidity is essential. Banks use the term "demand deposits" precisely because clients can demand their funds on a daily basis. For bank customers, having liquid cash held by a bank is all about convenience, security, and earning a reasonable interest rate.

For a bank, however, these deposits fuel the interest income and earnings power of the institution. Essentially, deposits are a short-term liability. The bank is renting your dollars and, in turn, putting them to work in one of two ways:

- Funding loans, or
- Investing in a fixed income portfolio.

In both instances, the goal is to prudently earn a rate of interest that exceeds the cost of deposits (i.e., a positive yield spread). Responsibility for managing the bank's liquidity is assigned to the *Asset Liability Committee* (ALCO) which monitors and attempts to forecast deposit flows, loan demand, investment security calls and maturities etc. It's a real balancing act.

The job of ALCO committees has become considerably more challenging in recent years, as the impact of the pandemic took its toll on the economy and forced extraordinary measures by both Congress and the Federal Reserve.

Consequently, there was a surge of liquidity that entered the money supply—through record amounts of fiscal spending and highly accommodative monetary policy. For most banks, deposit growth far outpaced loan growth, forcing the hands of bank ALCO committees to invest excess deposits into their fixed income portfolios.

Given artificially low short-term interest rates, many banks elected to extend the average maturities of these portfolios in an effort to gain access to slightly higher interest rates and to earn a small measure of positive yield spread. At the same time, many banks also decided to take advantage of an accounting treatment referred to as *Held-to-Maturity* (HTM)—whereas prior to 2021, most banks opted to categorize most of their fixed income holdings as *Available-for-Sale* (AFS). The goal of the HTM election was to reduce the balance sheet impact if interest rates began to rise and fixed income prices, in turn, began to fall. Securities categorized as HTM would simply sit on the balance sheet at amortized cost (versus the AFS

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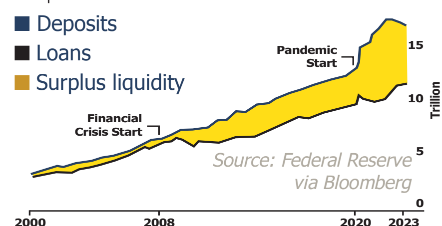
Surplus Liquidity

The gap between deposits and loans surpassed $7 trillion in 2021 and is now at $5.5 trillion for US commercial banks



THE GREAT DIVIDE

Brian Christensen, CFA
Senior Vice President & CIO

In my 30+ years of stock market participation, I can't recall a time when market analyst opinions were as widely divided as they are today. Normally, there are only a handful of outliers among a large herd of sheep. It's why, with patience, our contrarian tendencies have often been rewarded. Currently, however, we're seeing two relatively equal camps:

Bulls

- Doggedly holding on to expectations for the Fed to pivot and begin lowering interest rates while at the same time starting to re-expand their balance sheet;
- Anticipating positive momentum surprises in the macro economy, continued consumer resilience, disinflation, corporate cost-cutting, and stabilization of the banking sector; and
- Renewed economic traction from China's re-opening, positive near-term seasonality and the contrarian signals from depressed sentiment indicators.

Bears

- Confident in their expectation for a *higher-for-longer* Fed interest rate policy combined with persistent "sticky" inflation in the U.S. economy's Services sector;
- A 10-20% downside risk to consensus corporate earnings estimates, as well as recession signals from the inverted yield curve and the collapse in money supply growth; and
- Credit crunch implications resulting from the recent banking turmoil—including bank stock sluggishness, an adverse commercial real estate market impact, and stretched stock valuations.

Both sides have a laundry list of data points to support their cases. But this vast divide is highly unusual—running completely counter to Wall Street's transaction-driven mind set—and causing many investors to slow down their decision-making process. As of March 30, money market fund assets totaled a record $5.2 trillion as investors remain non-committal to longer-term investment strategies.

Among the most debated fundamentals today are two key metrics: the future direction of interest rates and the pace of corporate earnings growth. T. Rowe Price recently studied nearly 50 years of U.S. stock market data (January 1974 – December 2021) to evaluate market performance during Fed interest rate tightening cycles. They discovered that the market has tended to perform strongly after the Fed has begun a new hiking cycle. Out of the 21 rate hike cycles during the period examined, the S&P 500® index generated a positive total return during the 12 months following the initial hike on 17 occasions (81% of the time). In the 6 months after the first hike, the stock market delivered positive returns in 16 cases (76% of the time).

And since 1984, the stock market experienced a positive total return during all 11 rate hike cycles in the 6- and 12-month periods after the first increase in policy rates. The average return of the S&P 500 for the 6-month window was 6.4%, while the 12-month window saw a 14.3% total return.

As of the last week of March, industry analysts projected S&P 500 earnings per share of $220.45 this year and $247.57 next year. That translated to a 0.3% increase in earnings this year, but a substantial 12.0% increase in 2024. With Q1 corporate earnings about to be released, we will soon have clearer insights and a better perspective on the 2023 outlook. Forecasts for 2024, however, appear attractive.

While the Wall Street analyst community debates the market direction for the next 6 to 12 months, patient long-term investors should consider taking advantage of current values. As the chart below demonstrates, volatility abounds in the short term, but longer time horizons have produced impressive total returns with minimal volatility. The age-old combination of patience and discipline remains well-rewarded.

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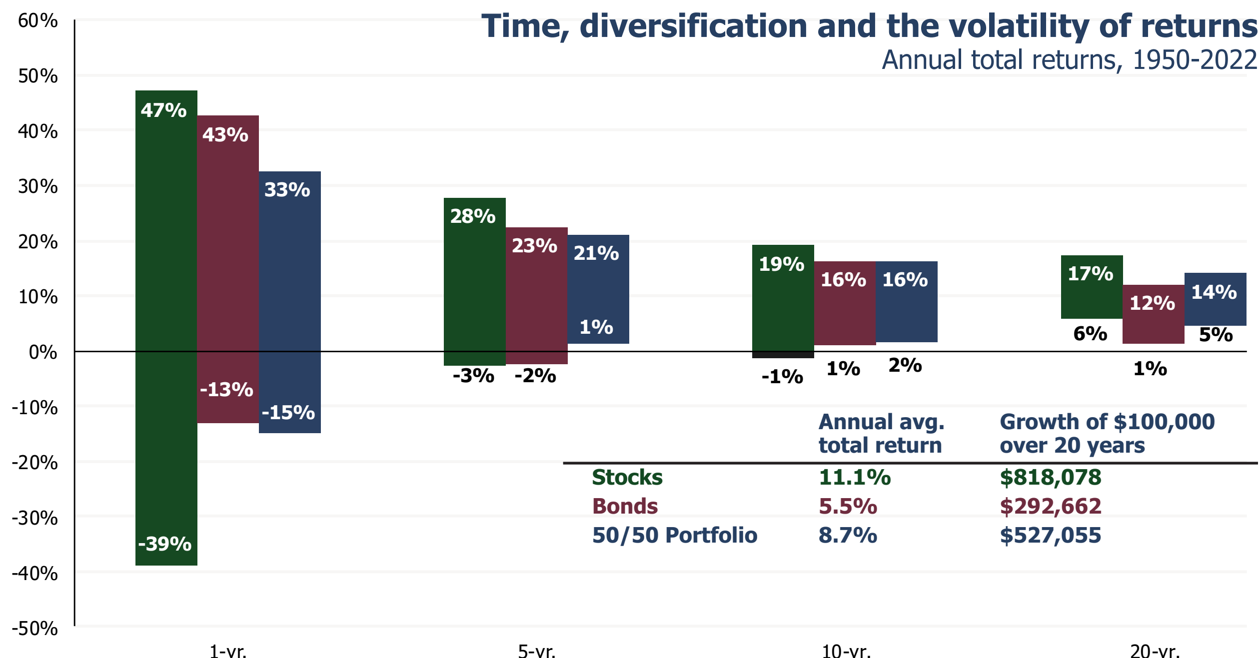
THE GREAT DIVIDE *Continued from Page 2*

Brian Christensen, CFA
Senior Vice, President & CEO



Source: J.P. Morgan Asset Management. Returns shown are calendar year returns from 1950 to 2021. Stocks are represented by the S&P 500 Shiller Composite and bonds are represented by Strategas/Ibbotson for periods from 1950 to 2010 and the Bloomberg Aggregate index thereafter. Growth of $100,000 is based on average total annual returns from 1950 to 2022

IN SEARCH OF LIQUIDITY *Continued from Page 1*

Will Williams
Chairman, President & CEO

accounting treatment where security values would fluctuate based on their current market price). At the time, the rationale for this election reflected the intent that these securities would truly be held-to-maturity, but it also reflected an accounting hedge if rates began to normalize.

Silicon Valley Bank (SVB)

The fundamentals for SVB were similar with many of their regional bank peers during this time-period, but their growth trends were far more dramatic.

Deposits:

- Not only did SVB benefit from the liquidity awash in the system, they also attracted significant deposits from tech and biotech start-up companies as a result of their primary locations in Silicon Valley and Boston.
- As a practice, SVB required lending companies to exclusively use them as their deposit bank. As a by-product, according to S&P Global, this resulted in 93.9% of domestic deposits being uninsured (i.e., they were deposits exceeding the $250,000 FDIC insurance coverage amount).

Investment Securities:

- Back in 2019, SVB's total investment securities portfolio was approximately $28 billion (allocated about evenly between AFS and HTM).

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	2019	2020	2021	2022	2019-2022
Deposits ($s in Blns)	$ 61.80	$ 101.90	$ 189.20	$ 173.10	$ 111.30
(% Change)		65%	86%	-9%	180%
Loans ($s in Blns)	$ 33.20	$ 45.20	$ 66.30	$ 74.30	$ 41.10
(% Change)		36%	47%	12%	124%
Investment Securities ($s in Blns)					
Available-for-Sale	$ 14.00	$ 30.90	$ 27.20	$ 28.50	$ 14.50
(% Change)		121%	-12%	5%	104%
Held-to-Maturity	$ 13.80	$ 16.60	$ 98.20	$ 91.30	$ 77.50
(% Change)		20%	492%	-7%	562%

Source: Factset

IN SEARCH OF LIQUIDITY Continued from Page 3

- By the end of 2022, the fixed income portfolio had grown to nearly $120 billion and the allocation towards HTM had tilted to more than 75% of the total.
- Of that HTM portfolio, nearly 65% of the securities held had stated maturities greater than 15 years—making the portfolio more sensitive to interest rate swings, and locking up capital for a much greater period-of-time.

Had SVB's deposit base been maintained, some of the now apparent flaws in their business model would not have been exposed. In fact, the accounting firm KPMG signed off on SVB's 2022 audit as recently as February 24, 2023. So, what turned the tide?

- Through much of 2022, technology companies that had access to venture capital funding were no longer able to tap that market. The trend became even more pronounced in early 2023. As such, these companies were forced to begin drawing on their cash liquidity at SVB.
- As the Fed continued in its war on inflation, higher U.S. interest rates punished the value of fixed income securities. The bond market experienced its worst performance in decades in 2022—a trend that persists in early 2023. The magnitude of SVB's AFS portfolio losses were well known and recorded in the shareholder section of the balance sheet. The HTM losses, on the other hand, were simply off the radar screen. As of 12.31.2022, the bank's unrealized AFS losses were $2.5 billion. This amount, however, was dwarfed by the $15.1 billion of unrealized losses in their HTM portfolio. Total SVB bank equity capital at year end was $15.5 billion and if you took into consideration the HTM unrealized losses, almost 100% of bank equity capital would have been completely wiped out.

A Timeline of Key Events

- March 8: Silicon Valley Bank issues a press release sharing that it had liquidated nearly all its remaining AFS fixed income portfolio (nearly $21 billion) and recognized a realized loss of approximately $1.8 billion. At the same time, they announced their intention to issue $1.75 billion in common and preferred stock.
- March 9: Venture capital firms and technology companies scramble to pull their uninsured deposits from SVB. It was reported that depositors attempted to withdraw $42 billion (nearly 25% of the entire deposit base) on that day alone.
- March 10: Federal regulators announced they had assumed control of SVB—becoming the second largest bank failure in U.S. history behind the failure of savings and loan Washington Mutual in September of 2008.

The March 8th announcement was a wake-up call to all investors in the banking sector. If there was deposit flight in a particular bank by their uninsured deposit base, did they have the liquidity to fund their exit? What would be the impact on shareholder equity if all unrealized losses in a bank HTM fixed income portfolio had to be recognized? The financial data has always been available—there's no other industry more regulated or required to provide public disclosure. It simply was never contemplated that there might be a "Run on a Bank" that was producing record amounts of cashflow and earnings per share. As to the velocity and magnitude of the deposit run off, what had once taken months was suddenly occurring in almost real time with the impact of social media and client access to electronic banking.

Unlike the 2008 financial crisis, this current disruption in the banking sector isn't attributable to significant loan deterioration. Instead, it's a liquidity crisis driven by a mismatch between the duration of bank assets and liabilities. As a means of addressing investor concerns about this issue, the Fed introduced the *Bank Term Funding* program. Banks that require liquidity to fund future deposit withdrawals can pledge HTM securities and receive 100% of their par value in the form of a loan despite the underlying value of the security being far less.

As always, we will continue to apply a disciplined rigor and skepticism to our investment process to manage through these once again challenging times.

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