The Baker Group

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Thoughts on the Effects of Silicon Valley Bank and Related Events

Overview:

The speed and magnitude of Fed rate hikes has been unprecedented, and we have emphasized that if continued it would likely force something to break. The enormous increase in funding costs in less than a year claimed its first notable casualty Friday in the form of Silicon Valley Bank, an institution built on funding from venture capital firms related to crypto startups and tech-related ventures. Unlike traditional community banks, SVB had very little funding from sticky “core deposits” or solid legacy retail accounts. Instead, they relied on volatile liabilities from high-risk commercial accounts and very rate sensitive funding. That business model worked well until Fed rate hikes exposed a classic asset/liability mismatch like what the S&Ls faced in the ‘80s.

Fortunately, most banks have more stable and diversified funding than SVB, but there are lessons to be learned for all and the coming weeks will be interesting. SVB was unique indeed, but the whole system is stressed from rapid Fed tightening. Before the weekend was over, the state of New York had taken control of another institution, Signature Bank, and regulatory authorities issued a joint statement of policy which was aggressive in its assurance to depositors.

Joint Statement:

In their statement, Treasury Secretary Janet Yellen instructed the FDIC to make-whole all depositors with both banks out of its insurance fund, and not just those with deposits under the $250k limit. All depositors will have access to their funds. Rather than being borne by taxpayers, losses “to support uninsured depositors will be recovered by a special assessment on banks.” In addition, the Fed is introducing a generous new lending facility to supplement its existing repo facility and the discount window. Known as the Bank Term Lending Program (BTLP), the new facility will make loans of up to 12 months in duration to banks, credit unions, savings associations, and other types of depository institutions. Most importantly, the qualifying assets to be used as collateral for those loans will be valued at par rather than marked to market. The Treasury will use $25bn from the Exchange Stabilization Fund to cover any losses the Fed incurs from the BTLP. It looks like the Fed will be accepting collateral at par value at the discount window too.

Where To from Here:

Markets are busy repricing to the new reality. The 2yr T-Note has traded below 4% this morning… it was 5.07% five days ago, and futures markets have reset pricing on fed funds contracts to remove expectations of further rate hikes and price-in potential ease instead. Treasury trading is somewhat chaotic as markets search for clarity, but the market is strong and opportunities to reposition bond portfolios should be seized.

It's hard to imagine that the Fed didn’t see this coming. They pumped trillions of dollars of liquidity into the banking system for two years after the pandemic. That created an inflation surge that forced them to reverse and drain liquidity in spectacular fashion with 475bps of rate hikes in less than a year. During the “free money” years of 2020-21 all sorts of non-traditional high-risk assets (and some hairbrained schemes) popped up involving SPACs, NFTs, meme stocks, crypto-currencies, etc. And SVB was largely funded by a deposit base of firms backing those things.

It's important to note that, though most banks are not anything like SVB, in the current environment they need asset/liability management and liquidity risk management advice more than ever. The Fed tightening campaign has put enormous upward pressure on funding costs and pummeled asset values regardless of credit…. For investment portfolios it’s just the math of the price/yield function for bonds. It’s not about lending practices or credit, it’s all about liquidity and interest rate risk. Financial institutions must have the tools, partners, and resources and to manage those risks. And as always, the bond portfolio must be

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managed as a store of safety and liquidity and a tool for managing interest rate risk as well as an earning asset that compliments the loan portfolio.

As for Fed policy, when COVID first hit they had no idea how long it would last or how bad it would be, or what the appropriate policy response was. Now that we've gone through massive stimulus, the inflation-surge, and unprecedented rate hikes, the system is feeling really stressed. So how will they pivot… or will they at all? We'll know more after this week's CPI release among other things. But the price action Friday sure felt like the early days of the 2008 financial crisis. It seems like a good time to stop with the tightening.

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