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Silicon Valley Bank (SVB) – An unintended consequence of Government and regulator panic

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By now, I assume that all of you have heard about the failure of a major U.S. bank, **Silicon Valley Bank**. This failure is a direct consequence of government and federal regulators reacting to a problem with unnecessary panic.

Problem # 1 (Pandemic)

To explain what happened, let me briefly take you back to history. In March 2020, we had a pandemic, and the economy needed to be shut down. Government intervention was required at that time to protect the businesses and individuals impacted by this unprecedented economic calamity.

Panic Mistake # 1

What the U.S. Government did was primarily an exaggerated panic move. The government was distributing taxpayer money to anyone, and everyone like it was going out of fashion. The stimulus package and other monitory measures resulted in disbursing **roughly 5 trillion dollars** to individuals and businesses without any regard for who needed it and who didn't.

Many of the recipients were individuals and businesses with high net worths who did not need these funds to weather the economic tsunami of the pandemic.

Most of the unaffected individuals and companies decided to save this windfall for a rainy day in their bank accounts across the country, leading to banks receiving a much larger deposit base than they usually do.

How banks make money?

Banks take deposits from their customers at nominal rates and then lend those funds out to other customers at a higher rate. In theory, this is how the banking business works.

The problem this time around was that banks had too much in deposits from its customers who were flushed with newfound cash from government panic actions but had very few customers who needed to borrow any new money (mainly because the U.S. Government took care of all their financial needs by giving them all this stimulus).

This bank dilemma led to a new problem in the making. Some banks decided to invest these excess customer deposits into long-term bond portfolios. The thought here was,

"We cannot make any money lending to individuals as there is low demand for that, so let's just buy long-term bonds and make money by collecting interest; & bond markets are generally safe so we will be ok from a risk point of view."

This investment of excess cash in bond portfolios by banks went on mainly for all of 2020 & 2021, and many banks started to adopt this new approach of making additional profits through this strategy.

Problem # 2 (Inflation)

Then in 2021, a new problem emerged: the rise of the prices for both goods and services. For most of 2021, the regulator's (Federal Reserve) approach was that the problem would fix itself on its own or, in their words (it is transitory). But by the end of 2021, the situation grew into a new economic Tsunami (CPI went from 1.67 % to 7% and growing). This is when Panic # 2 starts.

Panic Mistake # 2

By November of 2021, the Federal Reserve found themselves in an uncomfortable position of playing catch up with a significant economic problem of rapidly growing inflation primarily caused by their ignorance and exaggerated by the Russia-Ukraine war.

This led to panic move # 2, with the Federal Reserve raising interest rates at an unprecedented pace throughout 2022. The federal funds rate rose from 0% to 4.75 % in less than one year. Once again, the initial problem was starting to show signs of resolving as the inflation growth rate started to slow down, and inflation started to come down in the latter half of 2022.

But this panic move by the Federal Reserve was brewing an unintended consequence of its own in another part of the economy.

How do Federal Reserve rate hikes affect bond markets?

When the federal reserve raises interest rates, new bonds are issued at a higher rate. These new bonds make old bonds less attractive to investors and those old bonds start to lose value. If you can now invest in a new bond that pays 6%, why would you want to buy an old bond that pays 3%?

This time, the unintended consequence was the decline of the bond market in 2022. It turns out that this was the worst-performing year for the bond market since 1929! Barclays aggregate bond index, a standard measure of bond prices in the United States, was down a staggering -13.10%. Let me phrase this another way: Bonds, deemed to be a safe investment in theory, were down 13.10 %.

Silicon Valley Bank paying the ultimate price.

By now, you all can imagine how this can affect the balance sheets of banks like Silicon Valley Bank. Their strategic move of investing their customer deposits in bond portfolios, driven mainly by a zest for more profits by taking advantage of the government's panic mistake # 1, backfired because they failed to anticipate the Federal Reserve's panic mistake #2.

By February of 2023, Silicon Valley Bank's balance sheets had deteriorated so much in value due to losses in their bond portfolio that to comply with their regulators; they needed to raise additional funds of approximately **2.25 billion dollars.**

It is essential to point out that usually, this is not that big a task for a major company. Companies and even banks have raised new capital to shore their balance sheets in times of economic distress without paying the ultimate price.

But Silicon Valley Bank has a unique customer base. It is a large U.S. bank not because it has a large number of customers like JPMorgan Chase or Bank of America does but instead because it has a relatively smaller customer base with large deposits, mostly startup companies, venture capital firms, and technology companies with millions in deposits held with this bank.

This puts them at a unique risk of a bank run if those relatively small number of customers believe the bank will not be able to meet its depository requirements. It is like the Titanic in a perfect storm situation.

That perfect storm came to fruition late last week when the word of the bank's intended capital raise spread like wildfire in the venture capital community. Venture capital firms started to pull their cash out, and prominent industry players began to advise their clients to do the same. By Friday morning, 42 billion dollars had been withdrawn by its customers, and the bank regulators (FDIC) had to step in to close down this major bank.

At the time of this writing, the situation around the crisis is very fluid. Government agencies and regulators are working hard to reduce the impact of this crisis on the economy and to save the businesses and individuals directly impacted by this bank failure. It is hard to predict the fallout on the U.S. & global economy. If you just read the news regarding this, it can be unsettling to imagine how this will affect your portfolio.

Your portfolio at Parks Capital

While the true impact of this crisis on financial markets is still uncertain, we are happy to report to you that **we do not have any direct exposure to Silicon Valley Bank** and that our portfolios are performing the way the strategy intends for them to perform in times of such crisis.

Additionally, our bond market exposure before 2023 was relatively small as we saw little value in holding bonds yielding such low rates. The low exposure in bonds helped us to generally achieve our primary mandate of losing less than the market in the year 2022.

If you reviewed our outlook from Q1, you know that in the year 2023, we have been actively building bond exposure in our portfolios. Generally, the bonds are now discounted, and the yields are attractive enough to warrant taking a position in this asset class.

Ironically, in light of this new crisis, the market is now starting to expect the Federal Reserve to lower rates in the latter part of the year, causing our new bond portfolio to rise in value and thus provide some downside protection to the market fallout from this crisis.

Our strategy to manage risk.

Our current strategy to manage this crisis is to monitor the fallout carefully and manage risk wherever warranted while continuing to increase our exposure in our new bond portfolio until we reach the intended target exposure.

You will also most likely see a start of a new gold position this week. If you recall, we started a gold position in June of 2021 in anticipation of the inflation crisis. This time we intend to go back to this precious metal as a hedge against global economic contagion caused by this or another crisis, we see emerging soon.

I will discuss that crisis in detail in our upcoming market outlook, due to be released in April of 2023.

Thank you for your trust and for including us in your financial journey. As always, please feel free to reach out to me or Gina with any questions or concerns.

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