In November of 2019 the Federal Reserve eased rules on small and midsized banks. These rules were put in place as a direct result of the financial crisis of 2008 and 2009. The new rules categorize banks based on their size: the first category is for global systemically important banks (GSIB), the second for banks with assets of $700 billion or more, the third for banks with $250 billion or more in assets, and the fourth for banks with assets of $100 billion or more. The most onerous standards would be applied to the GSIBs and the standards would drop through the categories. The rationale behind the easing of these rules is that the largest banks, the ones whose stability mattered the most to the financial system, would have the most stringent regulations, and those who were less systemically important would have looser regulations in order to encourage their growth. Silicon Valley Bank (SVB) was in the fourth category.

Silicon Valley Bank was on a growth spurt during the pandemic, nearly doubling its deposits in just a year. The technology and health care startups that made up the majority of the bank's depositors were flush with cash and so the bank's deposits skyrocketed. As deposits from startups grew, their venture capitalist backers demanded that SVB pay more interest on their client's deposits, and since SVB was so dependent on the venture capitalists for deposit growth they conceded. At the end of 2022 an interest-bearing checking account at SVB was paying approximately 2.22% per year versus approximately 0.78% for its regional banking peers, and approximately 0.30% for GISBs. This put the bank in a very rough spot: Its deposits were growing at a very healthy pace but because its clients didn't have large requirements for loans and the interest rates it paid those customers on their deposits was so high, it needed a place to park all this cash.

Prudent risk management at a bank would match deposits in interest bearing checking accounts with short-term assets. As funds flow into and out of those accounts quite frequently, the short-term assets could be sold, or held to maturity, without much worry about interest rate risk. Shorter-term bond prices are less sensitive to movements in interest rates than are longer-term bonds but long-term bonds pay more in interest, which was important to SVB as it sought a higher rate of return. The bank was using borrowed short-term money from its depositors, who could be asked to be repaid at any time, and investing it in long-term assets which were harder to sell. This strategy worked until interest rates started rising rapidly.

When interest rates shot up the bank was saddled with losses on its long-term investments. Worse still was that the startups that made up its deposit base were burning through cash, and because venture capital funds had cooled dramatically, the cash was not being replaced. This meant that SVB had to sell those long-term investments at a loss to satisfy the deposit outflows. Because of the changes in regulations made in 2019 the bank did not have to report these losses to investors until it actually sold its long-term investments. When SVB finally reported those losses, investors were spooked sending the bank's stock price down by about 40%. Depositors feared the worst and started pulling their money from the bank. On Thursday, March 9th depositors withdrew funds totaling $42 billion from SVB. On the morning of Friday, March 10th the California Department of Financial Protection and Innovation seized Silicon Valley Bank and placed it under the receivership of the Federal Deposit Insurance Corporation (FDIC).

Silicon Valley Bank's business model was a 'boom or bust' model. Its deposits were funded by companies that were on the frontier of the risk spectrum. Therefore, it makes sense that a dramatic shift in the bank's operating environment would cause pain for its depositors and thus pain for the bank. As the Federal Reserve continues to increase interest rates, the companies most vulnerable to risks from higher rates are starting to fall. However, we should view this as a sign of progress because the intended consequences of the interest rates hikes are starting to play out.

As the full effect of higher rates starts flowing through the economy, the economy will start to slow down and as a result inflation will start to soften. This is what we are seeing now as we are in the middle of an economic slowdown and, sure enough, inflation is falling. This suggests that we are nearing the end of the interest rate hiking cycle, which could very well mean that the bottom in the stock market is behind us.

Markets recover quicker than the actual economy does. The reason for this is because market participants want to capture future growth and so will attempt to buy before the actual economy recovers. And, while the future is impossible to predict, the most likely outcome, for now, appears to be that interest rates have reached their highest point and inflation has peaked.

Our overall strategy during, and following, the pandemic has been rather conservative. The economic operating conditions that lead asset prices to reach Olympian heights in 2021 predictable gave way to price declines in 2022. Now that it appears that the Fed's tightening cycle is coming to an end, we will start, in a very deliberate and thoughtful manner, to put more risk back on. This doesn't mean a rapid change in the orientation of portfolios but rather the unwinding of our most conservative pandemic era positions which we will replace with opportunistic positions that favor growth. We are starting to position ourselves for the next economic growth cycle, while acknowledging that we are not past this current economic down cycle.

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