MILL CREEK

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MARKET COMMENTARY

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Move Quickly and Break Things

There's a mantra in Silicon Valley to "move quickly and break things," but now it equally applies to the Federal Reserve. The sharp increase in interest rates last year led to a significant decline in the market value of fixed income assets. Most investors simply experienced a painful decline in the value of their investment portfolio, but the collapse of Silicon Valley Bank (SVB) shows how higher rates can create solvency risk for certain institutions.

SVB faced a problem shared by many regional and community bankers in 2020. The increase in money supply during 2020 and 2021 led to massive deposit inflows for banks. SVB's deposits, for example, increased from $62bn at the end of 2019 to $190bn at the end of 2021. Banks can't lend out assets that quickly, so they ended up purchasing bonds. Then the Fed, who had been saying interest rates would remain low for years, then moved quickly (to raise rates) and broke things.

Many banks explicitly hedged interest rate risk or purchased short-duration bonds with their excess deposits (bonds that exhibit little interest rate risk), but some, like SVB, did not. SVB used their new deposits to purchase over $80bn of mortgage-backed securities (MBS) with an average yield of 1.56%. They then held those securities in a portfolio that was explicitly designated as "hold to maturity" and didn't require SVB to market it to market. Had it been marked to market, their MBS position likely lost 20% of its value in 2022. Despite being designated as "hold to maturity," SVB announced that they had sold a portion of their MBS portfolio at a loss to fund outsized deposit outflows and that announcement led to a run on the bank. Game over.

Repairing the Damage

The Treasury and Fed worked quickly to stem contagion over the weekend by taking three specific policy actions:

1. The FDIC invoked the "systemic risk exception" to guarantee all deposits at SVB and Signature Bank. In the case of bank failure, FDIC insurance technically only covers $250k per account and over 90% of deposits at SVB exceeded the limit. This action creates an expectation that uninsured deposits will be protected in the instance of additional bank failures, but it is important to recognize that the FDIC has not made this an explicit guarantee (yet).
2. The Fed and Treasury created a new bank funding facility that lends against Treasuries and agencies at par values for the next year. In other words, banks can take an MBS trading at 80 cents on the dollar and borrow $1 (the par value) to shore up their balance sheets.
3. The Fed lowered the haircuts they place on collateral at the discount window, which is how banks borrow directly from the Fed.

Importantly, the "bail-out" of uninsured depositors was not a bail-out of the equity and debt holders of SVB, which is likely responsible for some of the price action we've seen in the market today. The Fed and Treasury appear to be drawing a bright line between depositors and debt/equity holders and are willing to put insolvent banks in receivership if necessary.

It's not clear these actions have been enough to stem deposit outflows from smaller, less diversified banks. It is difficult to know who has unrealized interest rate losses on their balance sheets and absent explicit FDIC insurance for 100% of deposits we would not be surprised to see the outflows continue. Further policy action is likely to be announced.

Economic Impact

It was just last week that we saw a hawkish pivot from Fed Chair Jerome Powell during his Congressional testimony. Powell entertained a potential 0.5% hike at the upcoming Federal Open Market Committee (FOMC) meeting and, considering the Fed just downshifted from 0.5% to 0.25% at their last meeting, it was a clear signal that they would likely hike by that amount on March 22. Market participants priced in additional rate hikes and expected the Fed funds rate to end the year above 5.5%.

One weekend later the expected Fed Funds rate for December 2023 has fallen to 4%. Where does this leave us? Economic growth remains strong, but we're late cycle. We have an acute banking crisis, but it's due to interest rate risk, not a deterioration of credit on bank balance sheets. Our sense is that the immediate bond market reaction is overblown and that the Fed explicitly differentiate between the tools they are using to promote financial stability and the tools they are using to fight inflation. Fed funds rate hikes are likely to continue, but perhaps just at 25bps per meeting. Pausing rate hikes and allowing inflation to accelerate would exacerbate, not help, the challenge for banks holding interest rate-sensitive bonds.

Our Investment Exposure to Financials

Our equity model portfolios are underweight financials (9-10% versus 14.6% for the MSCI All Country World Index) and banks (3-4% versus 7% for the MSCI All Country World Index). Our taxable fixed income portfolios

hold a slight overweight to financials (11% versus 7% for the Barclays Aggregate Bond Index), but the exposure is concentrated in the large money center banks.

Our Exposure to SVB

As we communicated on Saturday,

- Mill Creek does not have any client deposit accounts at SVB and does not have any direct exposure to SVB.
- However, many private equity, venture capital, and private credit managers banked with SVB as depositors and creditors. The FDIC's announcement that all SVB deposits would be available as of this morning has alleviated any operating cash flow concerns for those entities.

QUICK LINKS

- House View Summary
- Private Remains Resilient Amid Tech Sector Downturn (White Paper)
- March Update: Pivot (again?)
- TINA Has Left the Building

This week's contributor: Michael Crook, CAIA

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