First Republic Bank Seized by FDIC and Sold to JP Morgan

- First Republic has been seized by the Federal Deposit Insurance Corporation (FDIC), which is selling most of its business to JP Morgan.
- JP Morgan will assume all of First Republic's deposits, which amount to nearly $92 billion, and acquire most of the bank's assets, which total more than $203 billion.
- A loss-sharing agreement is part of the deal between the FDIC and JP Morgan, and the FDIC estimates that its insurance fund will take a hit of approximately $13 billion.
- JP Morgan will receive financing from the FDIC in the amount of about $50 billion.

What Happened

- First Republic faced pressure in March as part of a wider crisis among regional banks in the US.
- Last week, the bank disclosed that it had lost approximately $100 billion in deposits during the earlier turmoil, which intensified the pressure on the bank.
- Investors became increasingly worried about the future of First Republic, leading to a sharp decline in the bank's share price throughout the week.
- As a result of the FDIC's seizure of the bank and the sale of its business to JP Morgan, First Republic's customers are now customers of JP Morgan.
- First Republic Bank branches are set to open under the ownership of JP Morgan this morning, May 1.

Our Outlook

- JP Morgan confirmed that all funds over $250,000 are available and backed by JP Morgan moving forward.
- Mill Creek's private funds do not have accounts at First Republic Bank that exceed the FDIC-insured coverage of $250,000.

Monthly Update: Riptides

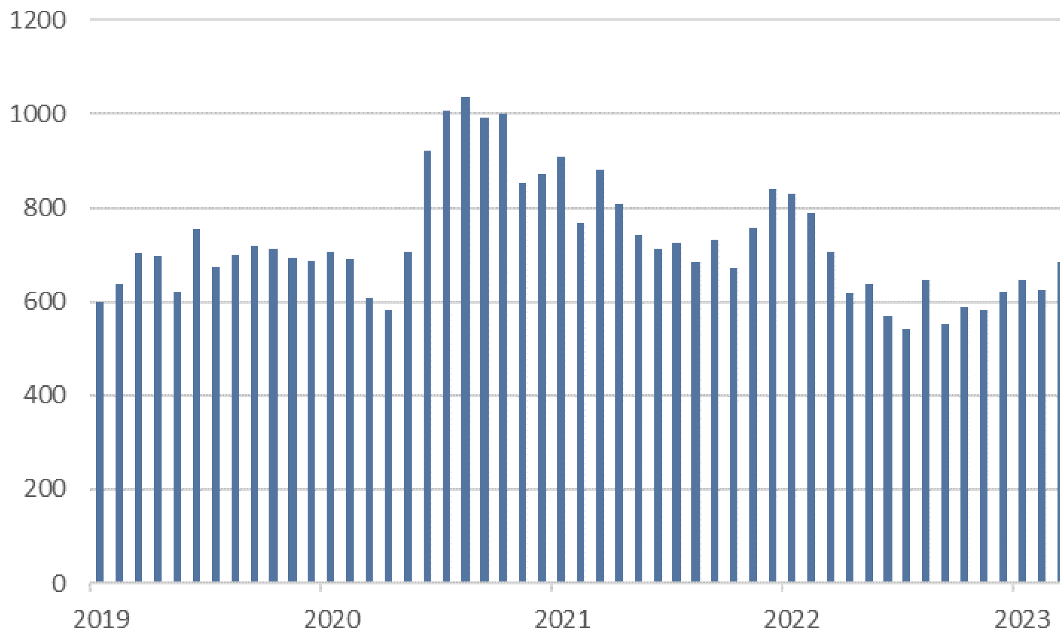
Riptides are powerful and potentially deadly channels of water that flow away from the shore and into the ocean. On an otherwise calm beach, a riptide can be especially dangerous because it can catch swimmers off guard. It is not always easy to spot riptides, and they can develop suddenly and unexpectedly.

Lifeguards instruct that if you find yourself caught in a riptide, you should try to swim parallel to the shore rather than directly back to shore, which can be exhausting and futile. Once you have swum out of the current, you can try to swim back to shore at an angle, using the waves to help you. Such a mindset is likely to be helpful for investors in the coming months.

On one hand, the investment beach appears sunny and calm:

1. The housing market, an important leading indicator for the US economy, has rebounded (Fig. 1) from 2022's contraction,
2. The labor market has loosened but remains strong,
3. Investment grade and high yield bonds credit spreads remain low and are not indicating signs of stress in public credit markets, and
4. Equity market implied volatility remains very low,
5. Analyst expectations imply we're close to a trough for S&P 500 earnings and forecast -1.76%, 9.83%, and 9.3% earnings growth in 2023, 2024, and 2025, respectively.

Fig. 1: New Home Sales



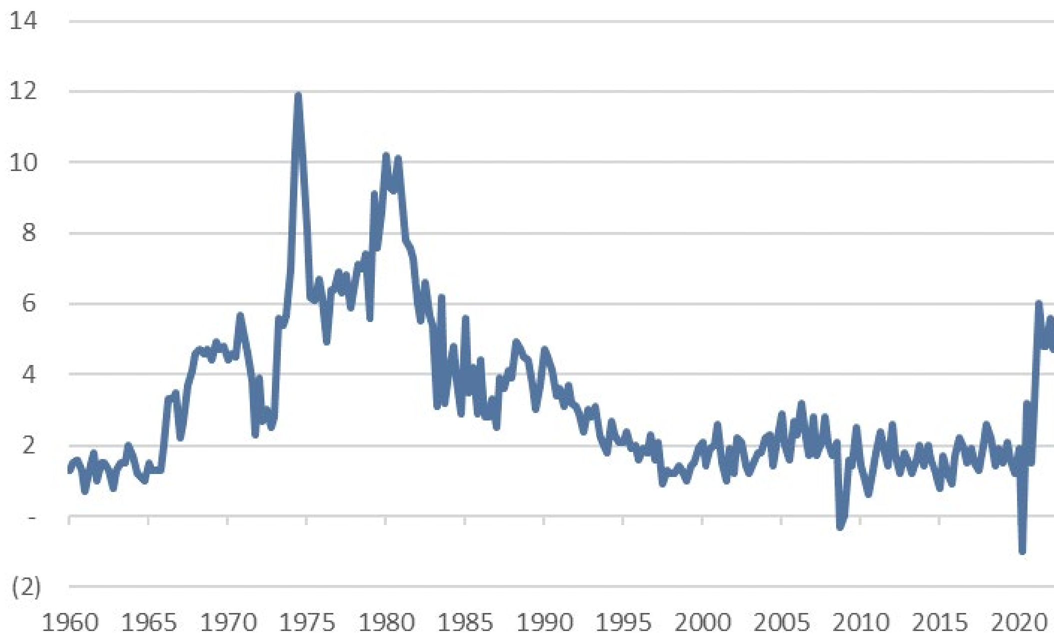
Source: Bloomberg, Mill Creek.

On the other hand, investment riptides are forming. For example:

1. Inflation remains too high and will not enable the Fed to transition back to an accommodative posture as quickly as market participants expect,
2. The debt ceiling is quickly becoming an unforced error for US policymakers. The cost to insure US Treasuries — the world's "risk-free" asset — against default is now five times higher than the cost to insure Mexican government bonds against default, and

3. Simmering turmoil and deposit contraction in the banking sector has the potential to unexpectedly tighten credit conditions and create financial instability.

Fig. 2: Core PCE (Quarter-over-quarter annualized)



Source: Bloomberg, Mill Creek.

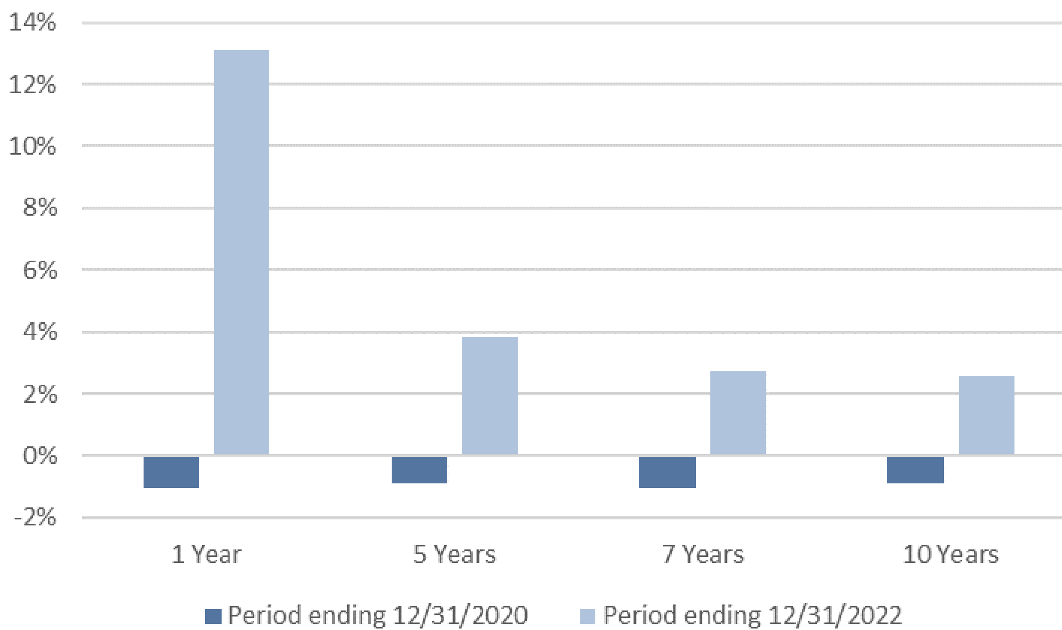
One response to a potential riptide, aquatic or financial, is to stay out of the water entirely. The downsides of such a strategy are self-evident and self-defeating. A riskless market is a returnless market. We prefer to remain fully invested but to also be prepared for potential risks. As we **discussed in our Q2 outlook**, we're defensively positioned within both equities and fixed income. Today's environment is also a good time to consider the role we expect diversifying assets to play in a portfolio.

A simple 60/40 stock/bond portfolio was hard to beat between 2009 and 2021. **As we've written previously, high-quality fixed income worked really well** as a diversifier during that period (the era of the *Fed put*) but failed in 2022 and wasn't reliable between 1965 and 1980. When the Fed is struggling to balance its dual mandate of price stability and full employment – a challenge they continue to face today — fixed income will protect against some riptides, but not all.

As a hedge against the "interest rate" riptide, we began allocating to low-duration, high-quality private lending and real asset strategies at the beginning of 2021. These positions were funded out of fixed income. As interest rates rose through 2021 and 2022, those strategies performed well on an absolute and relative basis. Today we're less worried about rising interest rates and have adjusted our positioning, on the margin, toward strategies that are well-positioned to step in as community and regional banks retrench.

Finally, investors love to hate, with some good reasons, absolute return strategies. These are a collection of investments that are intended to have as little correlation to equity and bond markets as possible while providing returns that exceed fixed income. At the end of 2020, absolute return strategies had trailed the bond market since the financial crisis and many investors were wondering if holding absolute return strategies was an exercise in futility. Fast forward two years and the opposite became true – absolute returns strategies have now outperformed bonds over virtually all rolling periods. The knowledge and ability to swim sideways instead of back into a riptide, can make all the difference in the world.

Fig. 3: Performance of absolute return strategies relative to bonds



Source: Bloomberg, Mill Creek. Absolute return strategies are proxied by the HFRI FOF Conservative Index and Bonds are proxied by the Bloomberg Aggregate Bond Index.

Investing frequently requires us to hold two, seemingly contradictory, thoughts in our heads at the same time. We can go to the beach, have fun in the water, and safely navigate a riptide if we need to. We can be optimistic about stock and bond returns (**as our capital market assumptions imply**) over the next 7-10 years and also accept that we will experience many periods of market stress and distress along the way. In our opinion, diversifiers like private lending, real assets, and absolute return strategies will continue to be important aspects of navigating those periods safely.

QUICK LINKS

- Q1 23 Private Equity Data: Down, but Not Out
- Losing Steam
- Q2 2023 Outlook: Red, White, and Overdue
- Stuck Between a Rock and a Hard Place

This week's contributor: Michael Crook, CAIA

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