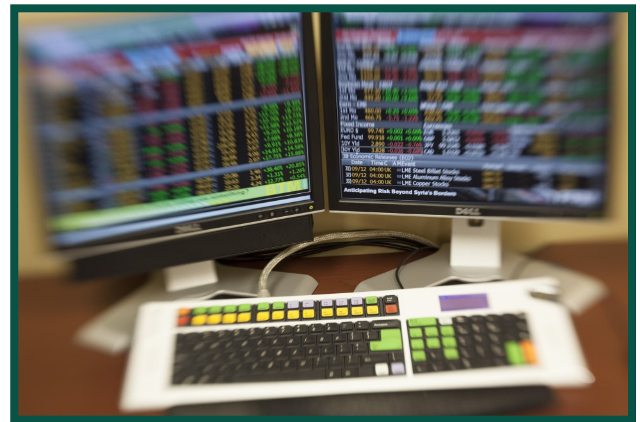
Wallington
ASSET MANAGEMENT

Quarterly Newsletter

2023: First Quarter **137th Edition**



" The recent failures of Silicon Valley Bank (SVB) in the United States and Credit Suisse in Europe, and the related stress in the banking system, underscore that simply satisfying regulatory requirements is not sufficient. Risks are abundant, and managing those risks requires constant and vigilant scrutiny as the world evolves."

~ Jamie Dimon, CEO of JPMorgan Chase

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CAPITAL MARKETS SCOREBOARD

Equities					
Indices	1Q23 Total Return (%)	2022 Total Return (%)	Index Characteristics		
Domestic			NTM P/E	P/B	Div. Yld. (%)
S&P 500	7.5	-18.1	18.2	4.0	1.6
DJIA	0.9	-6.9	17.0	4.2	2.1
NASDAQ	17.0	-32.5	26.4	5.0	0.8
Russell 1000 Growth	14.4	-29.1	24.2	9.9	0.9
Russell 1000 Value	1.0	-7.5	14.3	2.3	2.2
Russell 2000	2.7	-20.4	20.7	1.9	1.4
International*					
MSCI EAFE	8.6	-14.0	12.9	1.7	2.9
MSCI Emerging Markets	4.0	-19.7	12.2	1.6	2.7
MSCI United Kingdom	6.1	-4.8	10.3	1.7	3.7
MSCI France	14.7	-12.7	13.3	2.0	2.5
MSCI Germany	14.8	-21.6	11.4	1.5	2.9
MSCI Japan	6.4	-16.3	13.2	1.3	2.5

Fixed Income		
Indices**	1Q23 Total Return (%)	2022 Total Return (%)
Domestic		
U.S. Corp - Gov (1-3 Years)	1.5	-3.8
U.S. Corp - Gov (3-5 Years)	2.2	-8.0
U.S. Corp - Gov (10+ Years)	5.7	-26.9
U.S. Treasuries Master	3.1	-12.9
U.S. Corporates Master	3.5	-15.4
U.S. Municipals Master	2.8	-9.0
U.S. High Yield Master	3.7	-11.2
International*		
Developed Markets Sov Bond	3.0	-18.0

Commodities		
Resource	1Q23 Total Return (%)	2022 Total Return (%)
Precious Metals		
Gold	8.2	-0.4
Silver	-0.3	3.7
Industrial Metals		
Copper	7.9	-14.6
Aluminum	-1.0	-15.9
Energy		
Brent Crude Oil	-4.4	7.2
WTI Crude Oil	-5.6	6.4
Natural Gas	-50.5	20.0

Key Rates				
Rates	3/31/2023	12/31/2022	3/31/2022	12/31/2021
U.S. Target Fed Funds Rate	5.00	4.50	0.50	0.25
2-Year U.S. Treasury	4.06	4.41	2.28	0.73
10-Year U.S. Treasury	3.48	3.88	2.32	1.52
30-Year U.S. Treasury	3.67	3.97	2.44	1.90
10-Year German Bund	2.33	2.53	0.55	-0.18
10-Year Japanese Bond	0.32	0.42	0.22	0.07
30-Year Fixed Mortgage	6.54	6.36	4.17	3.10

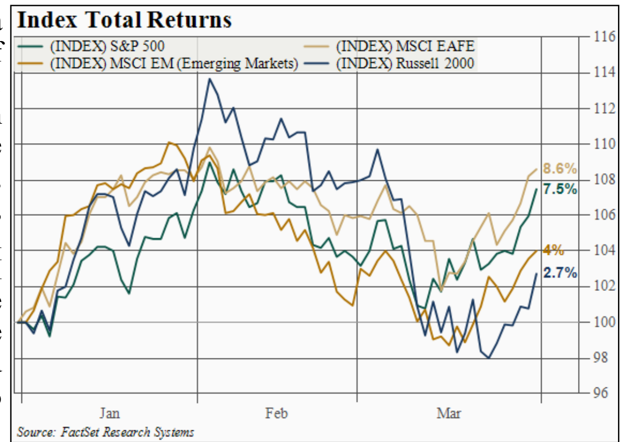
Currencies				
Indices/ Exchange Rates	3/31/2023	12/31/2022	3/31/2022	12/31/2021
ICE U.S. Dollar Index	102.51	103.52	98.31	95.97
USD per EUR	1.09	1.07	1.11	1.14
USD per GBP	1.24	1.20	1.32	1.35
JPY per USD	133.09	131.95	121.38	115.16
CAD per USD	1.35	1.35	1.25	1.26

*Returns denominated in U.S. dollars

**ICE Bank of America Merrill Lynch (BofA-ML) indices

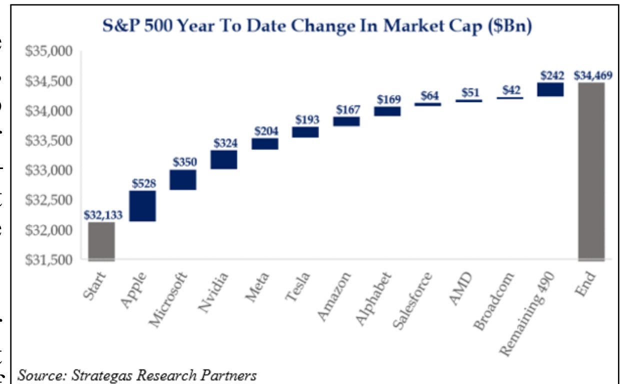
EQUITIES

- The Standard & Poor's 500 (S&P 500) index posted a total return (price appreciation plus dividends) of 7.5% for the first quarter after a forgettable 2022. Concerns over liquidity in the U.S. banking system drove investors to favor more liquid, large capitalization stocks. The Russell 2000 Index, composed of small capitalization stocks, underperformed the S&P 500, up 2.7%. International developed market stocks as measured by the MSCI EAFE Index outpaced U.S. stocks, up 8.6% for the period when denominated in U.S. dollars (USD). The MSCI Emerging Markets Index trailed developed markets, but still posted a positive total return of 4.0% in USD terms.



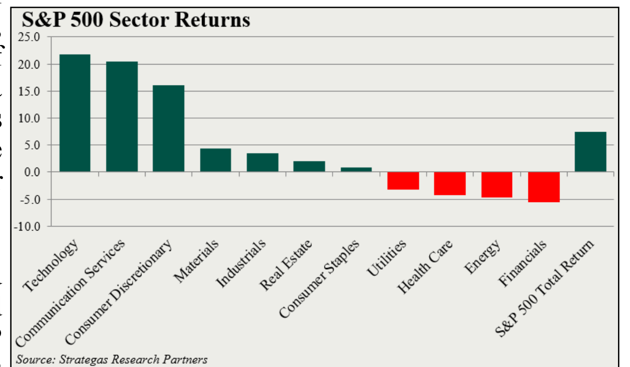
Source: FactSet Research Systems

- The S&P 500's return in the first quarter was once again highly concentrated, as just a few stocks accounted for nearly all the gain. This was similar to the composition of gains in years prior to 2022. For the quarter, ten of the largest S&P 500 constituents – companies such as Apple, Microsoft, and Alphabet (Google) – accounted for approximately 90% of the index's gain in total market value.



Source: Strategas Research Partners

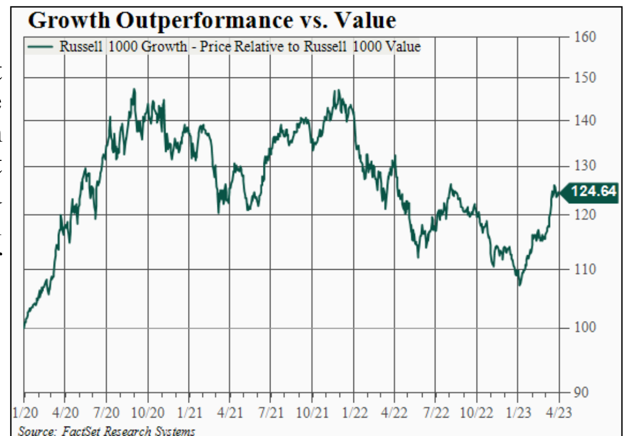
- Communication Services, Technology, and Consumer Discretion Sector stocks led the S&P 500 in the first quarter after shouldering responsibility for most of 2022's decline. Financials performed the worst, rattled by banking sector turmoil in the wake of Silicon Valley Bank and Signature Bank failures. In a reversal from 2022, last year's four best sectors (Energy, Utilities, Consumer Staples, and Health Care Sectors) rounded out the bottom of first-quarter performers.



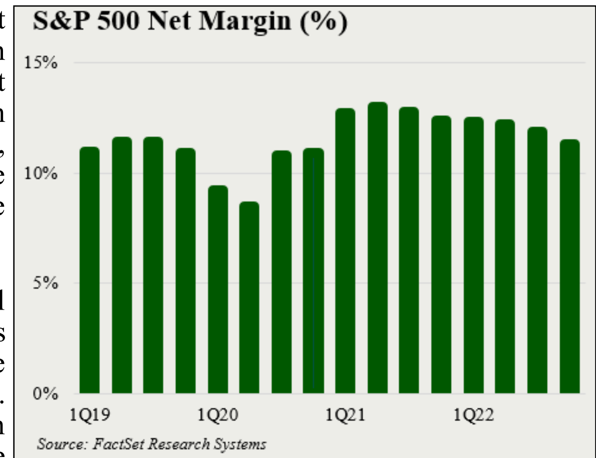
Source: Strategas Research Partners

- As part of a Global Industry Classification Standard (GICS) update, Standard & Poor's, Dow Jones, and MSCI changed the sector classifications of 14 S&P 500 companies during the first quarter. While this year's changes were not as impactful as the creation of the Communication Services Sector in 2018, the movement of payment processing companies is noteworthy. Approximately 20% of the Financials Sector is now comprised of former Information Technology Sector constituents due to the reclassification of Visa, Mastercard, and PayPal. Of note, the departures significantly increased the impact Apple and Microsoft have on the Technology Sector. The two stocks comprise more than half of the sector, which represents 26.1% of the S&P 500 index.

- After sustained underperformance since the Great Recession selloff in 2008, rising interest rates drove value stocks to outpace their longer-duration growth counterparts in 2022. The reverse was true in the first quarter of the year as investors began to eye the end of Federal Reserve (Fed) rate hikes and even potential rate cuts in the event of slower earnings growth and/or lower inflation.



Source: FactSet Research Systems

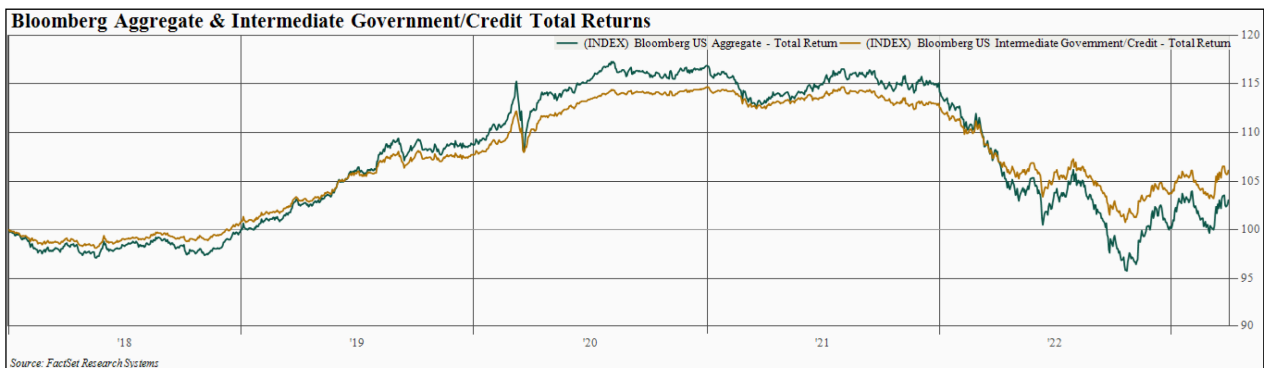


- After posting a sixth consecutive quarterly decline in net profit margins to end 2022, margins remain an important investor focus in 2023. Analysts expect continued margin erosion due to input cost inflation (including wages) and pricing power concerns. Of note, while margins have fallen significantly since 2021, the contraction has brought them back in line with more normalized pre-COVID levels.

- Analysts estimate aggregate S&P 500 earnings will decline by 6.6% in the first quarter following last year's fourth-quarter contraction of 5.8%. This would mark the largest earnings decline since 2020's COVID shutdown. Materials Sector companies are the primary driver. In the first quarter, analysts reduced earnings per share (EPS) estimates for 79% of the sector's companies. As of March 31, analyst projections called for a 35.9% year-over-year (Y/Y) Materials Sector EPS decline due primarily to lower commodity prices.

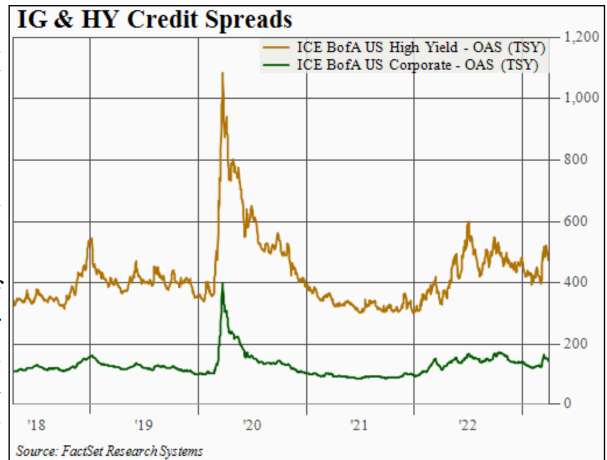
- Lower interest rates usually mean a lower discount rate is applied to future earnings. Therefore, lower rates often support higher stock valuations. Prior to last year's rate hikes, near-zero rates had driven the S&P 500's forward (next twelve months) price-to-earnings (P/E) ratio to its highest level since the turn of the century. Even after last year's decline in stocks, valuations are not historically cheap. In addition to P/E, price-to-book, price-to-sales, and most other valuation metrics reside above their long-term averages. The higher than historical valuations suggest equity markets expect lower interest rates to be supportive of stock prices, which is similar to what fixed income markets are reflecting.

- The first quarter of 2023 gave bond investors some reprieve from one of the worst years (2022) on record for fixed income markets. The total return for the Bloomberg U.S. Aggregate Bond Index was 3.0% in the first quarter. The Bloomberg U.S. Intermediate Government/Credit Index had similar performance, finishing up 2.3%. Investors turned towards bonds for safety following bank disruptions in early March with 2-year and 10-year U.S. Treasury (UST) yields dropping from their 2023 peaks of 5.06% and 4.08% to 4.06% and 3.49% respectively.

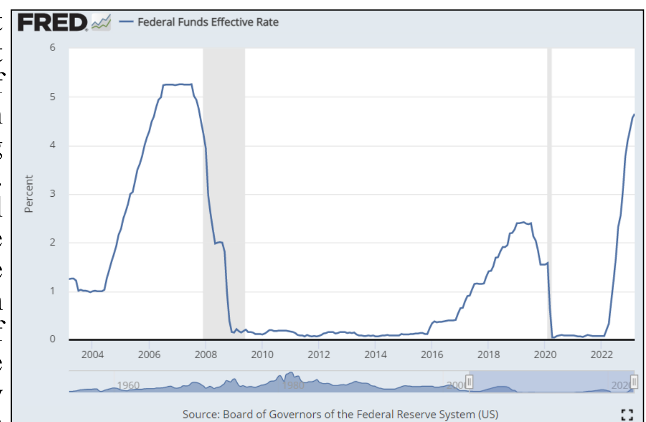


FIXED INCOME

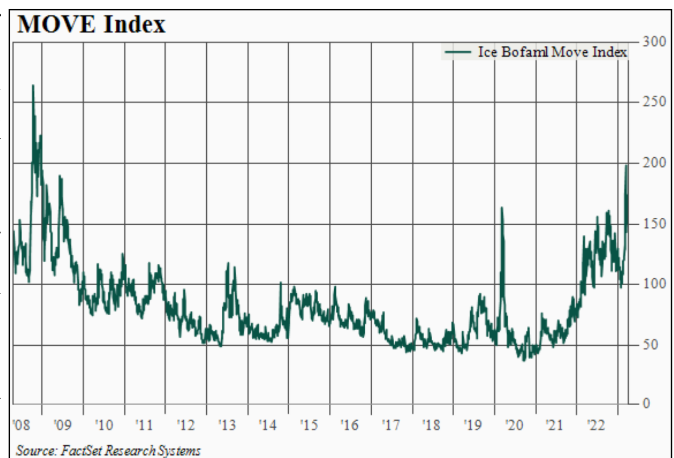
- Despite continued Fed hiking, bank runs, and historic volatility, credit spreads (the difference in yield between corporate and government debt) remained relatively dormant from the start to the end of the quarter. Investment grade spreads held steady until mid-March, when they saw a sharp increase from 1.25% to 1.62% over a two-week period. Spreads finished the quarter at 1.45%, not far from the 1.38% level at the start of the year. High-yield spreads were more volatile during the quarter, ranging from 3.94% to 5.22%. The back half of 2022 saw a steady decline in credit spreads, but their recent widening highlights the anxiety that has returned to fixed income markets. Coupled with the broad decreases in yields, the contained spread environment allowed most subsegments of the bond market to provide positive returns for the quarter.



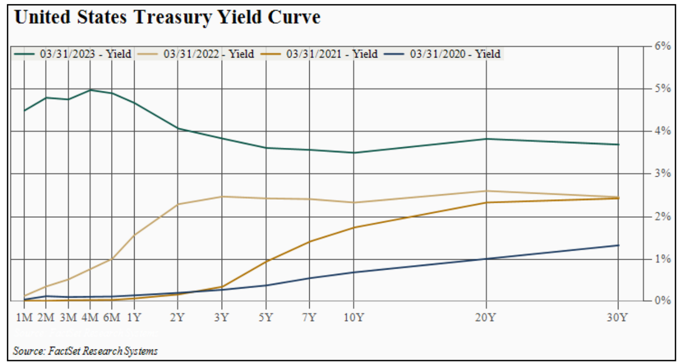
- The Fed continued its hiking cycle in the first quarter, raising the fed funds target rate 0.25% at both the February and March meetings. Estimates of the terminal rate in the hiking cycle have been volatile with futures markets in early March pricing in a peak rate of over 5.50% in the back half of 2023. Estimates have since dropped due to bank turmoil with the markets now implying only an approximate 50% chance of one more rate hike in May before the Fed starts cutting. This conflicts with the Fed which stated they expect rates to stay higher for longer. Of note, the Fed's hiking cycle is adding pressure to the federal deficit. For the past decade, the U.S. Treasury has been able to rely on tens of billions of dollars from the 12 regional Fed Banks. Through the first two months of 2023, the Treasury only received $55 million from the banks as higher interest rates increased the amount these banks are required to pay on their obligations.



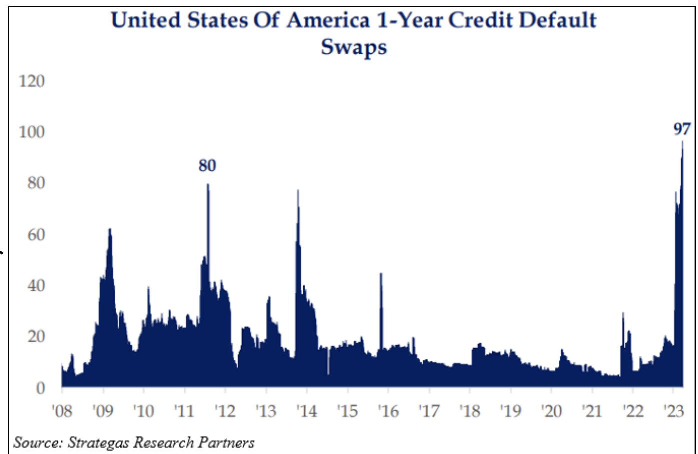
- The Bank of America MOVE Index, a proxy for bond market volatility, reached a high of 198.71 on March 15. This is the highest level the index has reached since topping 250 during the Global Financial Crisis. The creator of the index, Harley Bassman, has said a level above 150 indicates the Fed no longer has control of the bond market. Volatility at such levels can be very difficult for investors to withstand for a sustained period. Also, the role of being a lender increases in difficulty when rate volatility spikes. Lenders must increase their lending rates with a higher MOVE Index, all else equal, to provide cushion for the increased probability of an adverse move against them. Tighter credit conditions should help the Fed in its goal to bring inflation down; however, it may not be its preferred method of doing so.



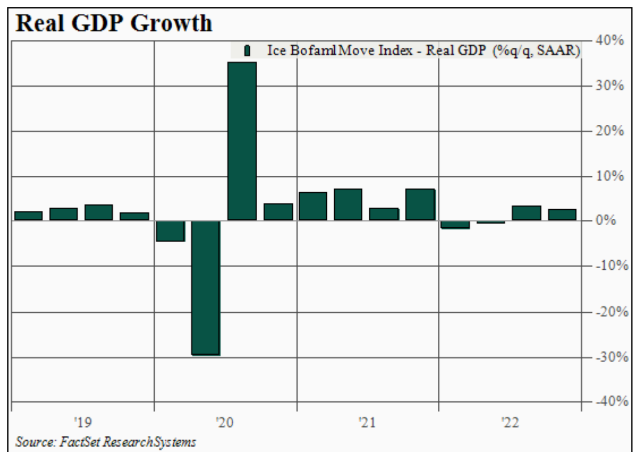
- The spread between the yield on the 2-year UST and the 10-year UST experienced its sharpest one-day move in the last 40 years, excluding September 11, 2001. Even though the move downward on March 13 in the 2-year UST yield was so sharp, the yield curve remained "inverted" across most segments, with longer-term yields lower than short-term yields. March 13 saw the inverted spread move from -0.89% to -0.50% in wake of the Silicon Valley Bank saga as front-end yields dropped on the prospects of future rate cuts. The inversion reached a level of -0.39% before finishing the quarter at -0.57%. As a reminder, all six of the previous economic recessions were preceded by yield curve inversions prior to a recession being declared.



- Financial markets are beginning to reflect concern over the U.S. not paying its obligations due to debt ceiling negotiations. Credit Default Swaps (CDS) effectively operate as insurance on debt, paying out when an entity fails to make its payments. Their spreads (or premiums in insurance parlance) reflect the risk of an entity not paying its debt, generally due to bankruptcy. UST CDS spreads have been on the rise since mid-January as the U.S. approached its debt limit. They increased further amid the uncertainty surrounding the banking system in mid-March with concerns of bailouts compounding debt issues. Spreads reached a level of 0.97%, higher than the previous record of 0.80% just prior to the Budget Control Act of 2011, which increased the debt limit. At 0.97%, there were 36 U.S. companies the market priced as being more creditworthy than the U.S. government. Some names included in this list were Medtronic, Colgate-Palmolive, Apple, Johnson & Johnson, Home Depot, Microsoft, and Union Pacific.

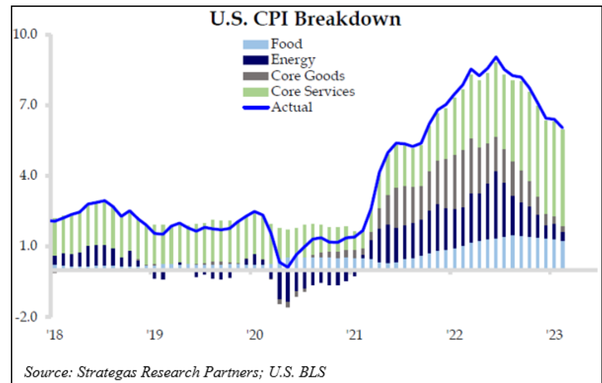


- Gross Domestic Product (GDP), the final output of goods and services, grew at a revised annual rate of 2.6% in the fourth quarter of 2022. It appears, however, the economy is slowing as the Atlanta Fed is currently projecting 2.2% annualized GDP growth for the first quarter of 2023. Consumer confidence remains near record lows as households face several headwinds including inflation, shrinking real (inflation-adjusted) wages, fewer pandemic funds, and the wealth impact from challenging real estate and financial markets. A highly-anticipated recession and turmoil in the banking sector have also negatively impacted confidence. Retail sales have been affected as they fell in three of the last four months through February on a seasonally-adjusted basis. While January was the only positive month, up 3.2% from December, it was due to seasonal adjustments. Since the holiday season brings consistently elevated spending in December, the Census Bureau adjusted for nearly a 20% decline in retail sales in January. Sales "only" decreased by 16.5% month-over-month, which is why the report came in positive. While a recession is highly anticipated among consumers, it is possible the economy will continue to face rolling mini recessions as is happening now in housing and manufacturing.

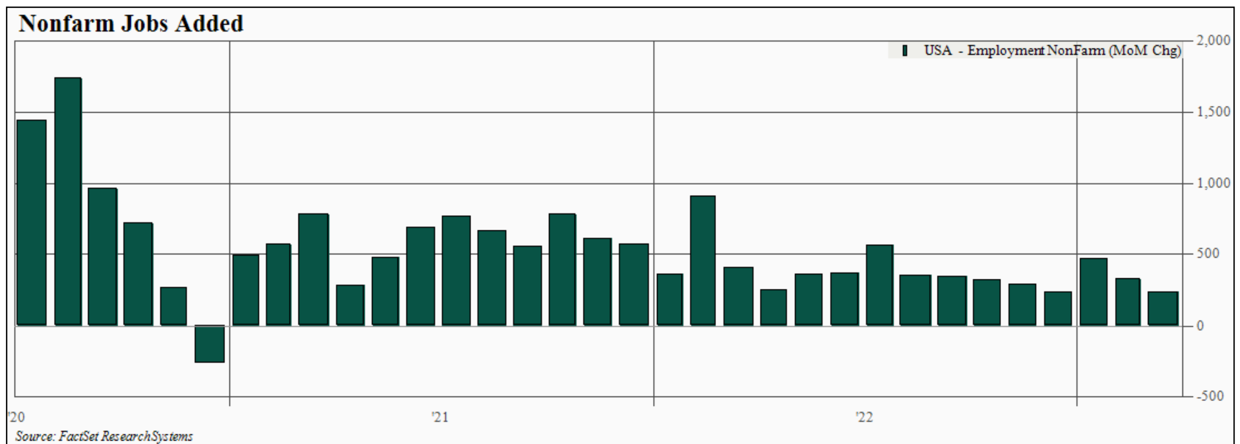


ECONOMICS

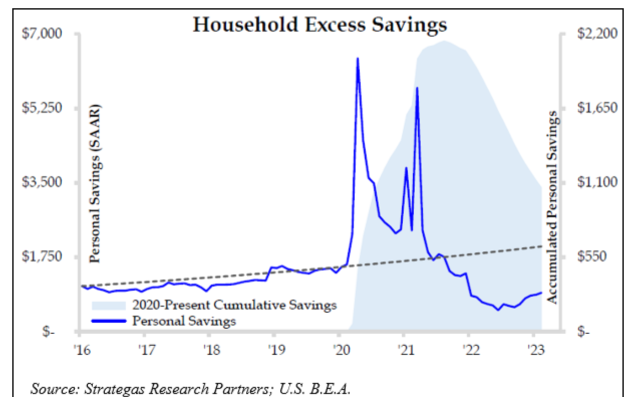
- Inflation is proving to be stickier than many economists originally thought. It has fallen from its peak of 9.1% Y/Y in June, but the downward trend is moderating. The Consumer Price Index (CPI) increased 6.0% for the 12 months ending in February compared to 6.4% for the 12 months ending in January. Core CPI, which excludes food and energy, increased 5.5% and 5.6% over the same periods. Sustained core inflation is due to services, which includes shelter costs, as goods inflation is running close to the Fed's 2% target. The Fed's preferred inflation index, the Personal Consumption Expenditures Price Index (PCEPI), rose 5.0% for the 12 months ending in February while core PCEPI rose 4.6%. Both were down compared to the 12 months ending in January, but not substantially.



- The January-March reports on labor reflected a still-strong market despite significant Fed interest rate increases over the past 12 months. However, the market is cooling. A revised 472,000 jobs were added in January and 326,000 in February. The initial March report showed 236,000 jobs added. This marked the slowest growth in jobs since December 2020. As with retail sales, seasonal adjustments distorted reality. Non-seasonally adjusted jobs fell by 2.5 million in January, but the model projected a loss of roughly 3 million jobs due to the assumed impact of hiring then letting go of temporary employees around the holiday season, resulting in the 472,000 increase.

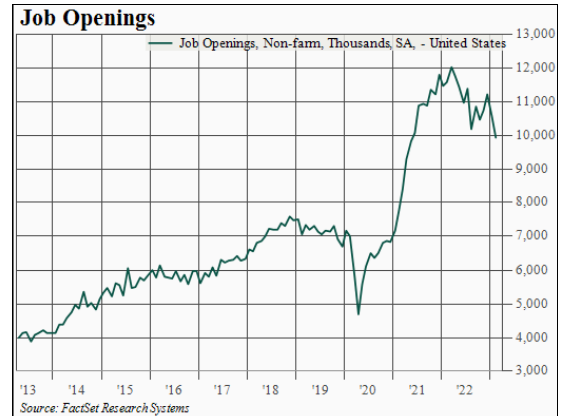


- The unemployment rate in March was 3.5%, down from February's 3.6%, but up from a 53-year low of 3.4% in January. The recent decline was due to a rise in the labor force participation rate. Average hourly earnings were up 4.2% for the 12 months ending in March, the smallest Y/Y increase since June 2021, and were up only 3.2% in the first quarter on an annualized basis. Since inflation was higher than average hourly earnings over the past year, growth in real wages was negative. The negative impact on the consumer has been significant. J.P. Morgan analysts are now forecasting accumulated excess savings, which increased to over $2 trillion in 2021 because of pandemic-induced stimulus, will likely be gone by mid-2023.

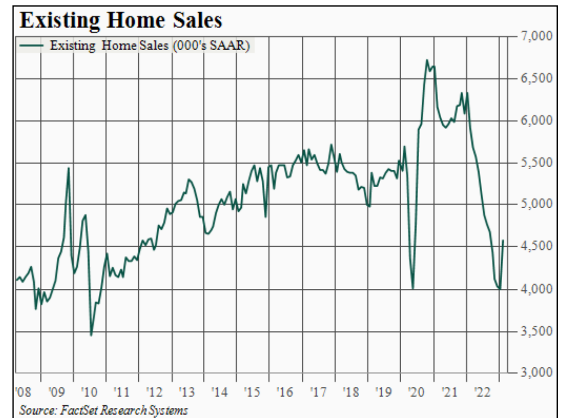


ECONOMICS

- The Bureau of Labor Statistics (BLS) released its Job Openings and Labor Turnover Survey (JOLTS) for February, and it reflected a weakening employment picture with fewer than 10 million reported job openings for the first time since June 2021. This was down from a record 12 million in March 2022. Still, it was above the 7 million job openings which existed at the start of the pandemic in February 2020. Job openings also far outnumbered the 5.9 million people who were unemployed, once again illustrating a solid but cooling employment picture. Of note, the number of people working part time voluntarily has risen to 22.1 million compared to 4.1 million who work part time involuntarily; the ratio of 5.4 is the highest in decades.



- The housing market appears to be stabilizing after a brutal 2022, when existing home sales dropped 17.8% from 2021, and home prices dropped 4.5% in the last six months of the year. Monthly existing home sales fell for 12 straight months through January 2023, but increased 14.5% in February. Prices of existing homes sold were 0.2% lower than in the previous February, the first Y/Y decline since 2012. Still, home prices on average are up almost 40% from three years ago. Contrary to what many believe, the luxury home market is not insensitive to higher mortgage rates. According to the Redfin Housing Value Index, the percentage of homes worth over $1 million decreased from 8.6% in June 2022 to 7.1% in January 2023. Apartment rents have also fallen in all major metropolitan areas for the six months ending in January due to a surge in new supply as vacancy rates increase. While the overall market may be stabilizing, Redfin recently reported the demand for vacation homes has been significantly waning as the number of people in February locking in mortgages for second homes fell to the lowest level since 2016. Redfin reported the demand continued to wane in March, with mortgage rate locks for second homes falling 52% from pre-pandemic levels on a seasonally-adjusted basis.



- It has been a volatile year for energy prices, but fortunately they have declined since the summer of 2022. U.S. crude oil prices declined from over $120 per barrel in June 2022 to below $70 for a short time in March, only to rise on the OPEC+ production cut of 1.66 million barrels per day starting in May. Average national retail gasoline prices have fallen from over $5 per gallon in June 2022 to just over $3.50 in March 2023. After almost reaching $10 per million British Thermal Units (BTUs) last year, natural gas prices in the U.S. have also fallen dramatically, briefly dropping below $2. Energy prices have fallen for several reasons. The Russia-Ukraine war has not been as disruptive to energy markets as originally thought. Many countries, especially China and India, are still buying Russian oil at a discount. The flow of natural gas from Russia has been curtailed, but the amount of liquified natural gas exported from the U.S. and the Middle East has increased dramatically. Slower global economic growth and a mild winter in the U.S. and Europe have also helped. Energy security has become a national priority for most countries and has brought to light the importance of fossil fuels in making an orderly transition to green energy.

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The Banking Business: A Different Type of March Madness

The core service of banking as a business model is to collect and protect cash deposits by offering interest and accessibility. These deposits are reflected on bank balance sheets as liabilities since banks will pay the depositors back at some point in time. Banks then reinvest a portion of these ostensibly liquid deposits into longer-term loans to families and businesses, with the goal of earning more in interest than they are paying. Banks, of course, must keep some depositor money on hand to fund withdrawals, but over the centuries the prescribed amount has grown to be highly regulated in what is known as a "fractional reserve banking" system. For depositor funds not held as fractional reserves or lent to customers, banks often invest customer deposits in investment securities, again with the goal of earning a higher rate of return than the cost of their funds. On bank balance sheets, these loans and investments are reflected as assets. Investment banking, securities trading, diversified services, technology, financial engineering, and central bank backstops have grown this relatively simple core business model to be almost unrecognizable today, especially for many of the largest banks. Banks are now exposed to many risks: credit risk on non-U.S. Treasury investments and from bad loans such as sub-prime mortgages leading into 2007, leverage risk when they have too much debt and too little capital, interest rate risk when higher interest rates create losses on financial assets, and regulatory risk when new regulations create operational difficulties or banks are caught conducting nefarious business. However, the concept of earning more on loans than is being paid out in interest to a stable deposit base is still foundational and is illustrative of the basic risks facing the industry. In typical environments where banks can earn more than they pay, their books of loans are creditworthy, and customers feel their hard-earned money is secure, the system has worked well.

Outside of Silicon Valley, most Americans had not heard of Silicon Valley Bank (SVB), but it certainly has everyone's attention now. SVB was the 16th largest U.S. bank and the biggest to fail since the Great Financial Crisis of 2008-2009. The bank's deposit base had quadrupled over the span of five years, leaving it with excess capital to invest. Given that well-capitalized venture capital firms and upstart technology companies funded primarily by equity investors were driving much of SVB's growth, there was very little demand for loans from the bank. With the lack of demand for commercial loans (which tend to be variable rate) and a very low interest rate environment at the time, most of the excess funds were invested in longer-term bonds with higher levels of interest rate risk rather than in short-term government securities. Further, most of the assets in SVB's investment portfolio were mortgage-backed securities which offered a higher yield than U.S. Treasury bonds but with more exposure to credit risk. Like the Savings & Loan Crisis in the late 1980s, SVB was a classic example of an asset/liability mismatch. Its liabilities (deposits) were short-term in nature but its investments with price risk/volatility were of longer duration. Symbolizing a broad lack of risk management controls, the bank did not have a Chief Risk Officer for the last eight months of 2022. Ultimately, SVB had more of a tech company mentality, like much of its deposit base, rather than that of a regulated bank. While inappropriate, the failure of regulators to monitor such behavior makes them also culpable for the bank failure. Frankly, an asset/liability mismatch should have been at or near the top of the regulators' monitor list, particularly with the significant increase in interest rates that occurred over the prior 12 months.

When the Federal Reserve (Fed) started rapidly raising interest rates in March 2022, there were two implications for SVB and many other banks. One, as interest rates went up, bond prices declined, causing losses on bond portfolios. Second, depositors started leaving banks for higher yields elsewhere. These dynamics were exacerbated at SVB because of its larger than normal bond portfolio and less diversified than normal deposit base. Not only was its deposit base less diversified, but its depositors tended to be major beneficiaries of the previous zero interest rate policy and were effectively carrying an immense amount of interest rate risk in their own business models. Essentially, when interest rates are near zero, investors are much more willing to invest in and support unprofitable or expensive companies with the hope they continue growing into the future. The same interest rate movements that put "conservative" bank bond portfolios under pressure arguably caused the BlackRock Future Tech Exchange-Traded Fund to lose nearly half its value in 2022. SVB attempted to raise capital to patch over its weakening deposit base and depressed assets, but the end result was the Federal Deposit Insurance Corp. (FDIC) declaring the bank insolvent and closing it down.

It appears the cost of the SVB bailout will be $20 billion to the FDIC fund, a fund which is financed primarily by assessments on insured banks. Many believe these insured banks will raise fees on customers to compensate for the assessments. FDIC Chairman Martin Gruenberg wrote in his prepared testimony for the Senate Banking Committee on March 27 that the ten largest deposit accounts in aggregate at SVB held $13.3 billion in deposits, with nearly 90% or $18 billion of the loss "attributable to the cost of covering uninsured deposits." One headline following this testimony coined the FDIC action as "The Billionaire Bailout." Debates will no doubt continue regarding whether or not Treasury Secretary Janet Yellen's comment that taxpayers will not foot the bill ultimately proves accurate. Of note, it is estimated that the FDIC bailout of Signature Bank, which regulators shut down the following Sunday, will result in $1.6 billion of additional cost to fund uninsured deposits.

While the more important risks in the banking industry are mentioned above, perhaps the biggest risk is moral hazard, the risk that providing insurance, guarantees, or bailouts incentivizes those being protected to alter their behavior. Deposit insurance is a prime example. The FDIC was created by the Banking Act of 1933 with initial coverage of $2,500 per "ownership category." FDIC coverage has increased over the years, with the last increase being in 2008 when it was raised from $100,000 to $250,000 (see the chart at the end for expanded FDIC information). If depositors are guaranteed to get their money back, they will be less vigilant in monitoring the risks of a bank. The FDIC previously assumed those with deposits of more than $250,000 would assess and monitor risk. If depositors do not monitor bank risk, it must be done by bank regulators at the state and federal government levels. The question now becomes where the excess insurance will stop. Other regional banks may well be facing similar problems. If so, will they get the same treatment as SVB and Signature Bank? In spite of the current administration's initial commentary on backstopping the entire banking system, the potential liability to the FDIC of $19 trillion is a sum much too large for any government to fund. If there are no consequences for any depositors, this would be the absolute epitome of moral hazard risk and increase the potential for adverse bank behavior. And let it be known, those depositors with excess capital invested at SVB were sophisticated people who knew they were well-above the FDIC threshold but chose to disregard the risk in order to earn higher returns, aka higher compensation.

Moral hazard can be exacerbated in the banking sector by the principal-agent relationship. Agents are those hired to manage a bank while principals are the owners of the bank. A problem arises when the interests of the principals and agents are not aligned, and agents' behavior creates risk detrimental to the principals. This can be a problem because of asymmetric information; the agent usually has more information than the principals. Agents have the propensity to act in self-interest, e.g., SVB's management growing their deposit base aggressively to extravagant customers while incentivizing them to keep all their money in one place. Banks try to align principal-agent interests using stock options and restricted stock, but it does not work well when stock incentives promote myopic behavior such as trying to maximize current profits at the expense of long-term goals or assuming much higher risk in search of higher returns and compensation.

Banking regulations can also create moral hazard by compelling risky behavior. For example, when banks buy bonds as investments and plan to hold them to maturity, they do not have to recognize losses (mark-to-market) on those securities if interest rates rise. Without getting into significant detail, in designating bonds as a Held-to-Maturity securities (HTM), banks must have a plan to hold them for that period of time. This is fine, that is as long as the plan works, and the bonds are ultimately held to maturity. SVB had a $102 billion bond portfolio of which 43% were designated as HTM with most being mortgage-backed securities. As interest rates rose, unrealized losses reached $16 billion, almost equal to the bank's equity capital. When a bank faces solvency problems, it has several options: raise more capital, sell assets, be acquired by another bank, or borrow from the Fed. As bank deposits declined, in an attempt to avoid a Moody's credit rating downgrade, SVB made the ill-fated decision to sell $21 billion of its bond portfolio at a loss of $1.8 billion and attempted to repair its balance sheet by raising equity capital. These dramatic actions, which it announced after market hours on Wednesday, March 8 and without hosting an investor call, prompted a run on the bank's deposits and caused SVB's stock price to open 34% lower on Thursday, March 9. Ironically, the recent banking turmoil started within days of the 15th anniversary of the start of the Great Financial Crisis when J.P. Morgan had to take over Bear Stearns, an investment bank. And, of note, it was Goldman Sachs who bought the bonds from SVB at a steep discount while also advising them on an equity capital raise that failed. Some reports have stated that Goldman made upwards of $60-100 million on the bond purchase and sale alone.

A run on bank deposits today is not like those seen in the movie "It's a Wonderful Life" with customers lined up at the door. SVB had a good digital platform, while digital messaging and social media made the bank run almost instantaneous; it was more of a Twitter panic than a run. Beginning on March 9, $42 billion of deposits left the bank before the FDIC declared SVB insolvent at noon on March 10. This presented a problem because 89% of SVB deposits were uninsured. Roku, a streaming company, had $487 million on deposit while many other tech companies were in a similar position. The FDIC, Fed, and Treasury Department decided to insure all of SVB's deposits to prevent contagion as several other banks were also experiencing deposit withdrawals. Signature Bank also had all of its deposits insured.

Moral hazard created by regulators is not limited to the U.S. as can be seen in Europe with UBS Group's takeover of long-struggling Credit Suisse. The controversy circulates around complex debt instruments called additional tier one capital securities (AT1s) also known as contingent convertibles (CoCos). These non-standardized instruments function as bonds with fixed payments but have built in contingencies. When the issuing bank violates specific solvency criteria, the CoCos may be written down or converted to equity in order to bolster the bank's capital. Traditionally in bankruptcy proceedings, equity owners will lose everything while bondholders will receive whatever assets are recovered in the corporate reorganization or liquidation. When a faltering Credit Suisse was "rescued" by UBS, a determination was made by the Swiss Financial Market Supervisory Authority that CoCo investors would lose their investments, equity owners would receive remuneration (albeit at a steep discount from where Credit Suisse was trading in February), and senior debtholders would be made whole. This created uproar amongst the CoCo investors who asserted they should be prioritized over equity holders, despite the legal defensibility of Swiss CoCos being written down. Financial regulators globally rushed in to reassure investors and stabilize the CoCo market. Similar to the abandonment of meaningful FDIC limits, these regulators are creating moral hazard and raising the possibility of unwarranted risk being taken in the future. Again, let it be known, the investors in CoCos were primarily sophisticated individuals who knew or should have known they could be placed below equity investors in Credit Suisse's capital structure, yet they assumed the risk for higher potential returns.

Whether it be SVB, Credit Suisse, etc., the fact is any type of bank bailout causes concern about moral hazard; if you save bankers and investors from the consequences of their actions, they are likely to take on even bigger risks. Although SVB's equity owners and bondholders have not been protected, and the CEO and CFO were fired, the acting CEO was reported to already be using "unlimited FDIC coverage even for new deposits" as a sales pitch to retain assets; behavior that is controversial at best. SVB was not considered a systemic risk or "too big to fail," but it did cause bank panic and turmoil that has spread to other regional banks in the U.S. and Europe.

The 2010 Dodd-Frank Act declared that any bank with more than $50 billion in assets was a systemic risk. The level was increased to $250 billion in 2018 because of the regulatory burden on small and mid-sized banks. It was also thought that problems for banks with assets under $250 billion would not cause systemic risk and initiate a financial crisis. SVB had $212 billion in assets at the end of 2022, and it did cause significant concern about the banking sector. This may result in further congressional action; bills have already been filed, hearings planned, and blame cast. FDIC insurance limits may be raised while regulations may be revised, something we believe should be accomplished and within a reasonable time period in order to avoid any type of nationalization of our banking system. Regulation asset levels considered to be a systemic risk may be reset, and more regulations for the 4,700 small and mid-sized U.S. banks may be implemented. The Fed has already set up a lending facility to lend against U.S. Treasury bonds and government guaranteed mortgage-backed securities. Whereas they used to lend up to the market value of collateral, it now offers loans up to the bonds' face value regardless of market value. But easier loan terms carry a cost. By creating the expectation that the Fed will assume interest rate risks in a crisis, it may create moral hazard by encouraging banks to assume even more investment risk.

Many of the problems of today's U.S. banking system are due to the government's fiscal stimulus programs and the Fed's lax monetary policies during the pandemic. Much of the $5 trillion of fiscal stimulus and bond purchases by the Fed ended up in bank deposits. Loan demand did not grow nearly as much as deposits, so many banks purchased government bonds and mortgage-backed securities. Yields were low, but capital requirements were also low. That all started to change early in 2022 when the Fed began its fastest rate hiking cycle in more than 40 years. At the end of 2022, unrealized losses in bank bond portfolios totaled $620 billion, more than 30% of tier one capital. This does not include unrealized losses on the $11 trillion of loans issued by banks. Fed rate hikes have created record losses for virtually all bond portfolios, and the recent turmoil has impacted the liquidity and volatility of the U.S. bond market. It is well known monetary policy operates with a lag, but recent events have shown that the effects do not necessarily occur smoothly. Now the Fed must decide whether to lower its commitment to fight inflation in order to ensure financial stability. Given economic uncertainty and pre-existing fears of recession, Fed officials are not in an envious position. As for investors, we would caution anyone from employing a philosophy that is built on the effects of moral hazard, i.e., the expectation that there is no price to be paid for disregarding regulations and behavior will be treated as opaque. It is simply imprudent to assume that level of risk, regardless of how lax regulators may ultimately prove to be and in spite of the fact the winners in Bank Bracketology this March were those who treated rules and regulations as hollow and insignificant.

"SVB would have had virtually no book value if they had marked them to market, but nobody was paying attention." Sandy Peters, CPA, CFA, Head of Financial Reporting Policy at the CFA Institute and author of the article "The SVB Collapse: FASB Should Eliminate 'Hide-'Til-Maturity' Accounting."

FDIC Deposit Insurance Coverage Limits by Account Ownership Category	
Single Accounts (Owned by One Person)	$250,000 per owner
Joint Accounts (Owned by Two or More Persons)	$250,000 per co-owner
Certain Retirement Accounts (Includes IRAs)	$250,000 per owner
Revocable Trust Accounts	$250,000 per owner per unique beneficiary
Corporation, Partnership and Unincorporated Association Accounts	$250,000 per corporation, partnership or unincorporated association
Irrevocable Trust Accounts	$250,000 for the noncontingent interest of each unique beneficiary
Employee Benefit Plan Accounts	$250,000 for the noncontingent interest of each plan participant
Government Accounts	$250,000 per official custodian (more coverage available subject to specific conditions)

Source: fdic.gov

Calculate personal insurance coverage at https://edie.fdic.gov

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