The Long Run

INVESTMENT LETTER
APRIL 2023

REYNDERS, MCVEIGH CAPITAL MANAGEMENT, LLC

*"It ain't what you don't know that gets you into trouble.
It's what you know for sure that just ain't so."*
—Mark Twain

The executive leadership of Silicon Valley Bank (SVB) knew for sure that the ecosystem of Silicon Valley entrepreneurs and investors would be staunchly loyal. For decades, the community valued SVB's deep understanding of the local market and the bank's long history of lending to emerging companies in the area. How could anyone question SVB's stability, when its CEO sat on the board of directors at the San Francisco Federal Reserve, the body responsible for regulating his bank? Few imagined trouble could find a start at *this* bank—least of all, it seems, its own management. As it turns out, the idea that depositors won't move deposits when risks appear and safer options with greater returns exist *just ain't so*. Never has been.

It wasn't as though SVB management hadn't been warned. Silicon Valley Bank's risky practices had been on the Federal Reserve's radar for more than a year. Supervisors at the Federal Reserve Bank of San Francisco issued six citations in 2021. Those warnings, known as "matters requiring attention" and "matters requiring immediate attention," flagged that the firm was doing a bad job of ensuring that it would have enough available cash on hand in the event of trouble. By July 2022, Silicon Valley Bank was in a full supervisory review and was ultimately rated deficient for governance and controls.

The simplest explanation of the problem is that SVB mismatched its assets and its liabilities. The bank held longer-dated mortgage-backed securities and other assets that it planned to hold to maturity. It also faced short-term draining of deposits in 2022, as the many start-up firms, venture partners, entrepreneurs, and almost any business touching Silicon Valley needed funds to operate, with the once red-hot IPO market closed for business. When the Fed raised rates, SVB's longer-dated securities lost more value than management expected, and their deposits were far more vulnerable to withdrawal than they imagined possible. In early March 2023, SVB was forced to sell securities at significant losses to meet immediate needs for cash, confirming that it was not able to hold core investments to maturity. These forced sales exposed just how out of position SVB's portfolio was and led to a classic "run on the bank," when many Silicon Valley venture executives sounded an alarm that opened the withdrawal floodgates. In a frightening display of modern technological efficiency, $42 billion in deposits left the bank and landed at other financial institutions in a single day, effectively sealing SVB's fate.

As many clients of Reynders, McVeigh know, we have avoided investments in most traditional banks due to the lack of transparency into how revenues are sourced and how those revenues turn into earnings. Regulators can review bank portfolios and see how assets are priced on a bank's books, but investors have little insight into bank holdings, how portfolio asset prices are marked up or down by the bank, or how assets are matched against liabilities. Further, there is—and has always been—an embedded incentive mismatch in banking: Depositors expect deposits to be fully backed by bank investments and available whenever needed, but bank managers are incentivized to take risks and grow profits with the investments they make. In SVB's case, management took risks to make more interest income by buying longer-dated securities that lifted profits and, in turn, SVB's share price. Even when they were warned that their investment position could be out of step with their depositors' needs, management had little incentive to consider changes that might hurt profits—or their bank's share price.

A HISTORICAL PERSPECTIVE

As investors and economic observers, it is important to recognize that banking crises are a consistent feature of economic downturns. In times of economic growth and prosperity, deposits grow, investment portfolios expand, and—seemingly inevitably—profit motives distract bankers from their fiduciary obligations. During periods of economic contraction, we often find a segment of the banking industry in trouble. This is why we warned in our October 2022 *Long Run*, "After periods of easy, low-cost borrowing, the deleveraging process usually begins with forced sales of assets at unattractive prices as collateral values drop and loans are called in. We have seen this negative feedback loop play out in many markets this year as indebted investors are forced to sell shares at lower and lower prices . . . Those who lurched into banks and other lending institutions at the beginning of the year—betting that higher rates would lead to more profits—might want to think again."

While this current banking crisis will not have the same extraordinary systemic impacts that the global financial crisis had, thanks to the many guardrails that regulators have installed in the financial system over the last decade, we expect that there are other shoes still to drop and that the current stress in the banking system will continue for

some time. The pace and steepness of recent rate increases at the Federal Reserve have created a shock in the system that likely has many banks struggling with higher costs of capital and portfolios of lower interest rate loans that are deeply underwater.

In 1979, the savings and loan crisis was triggered after the Federal Reserve lifted interest rates to combat inflation. At that time, "S&Ls" had issued long-term loans at fixed interest rates that were lower than the newly mandated interest rate at which they could borrow. Attempts to attract more deposits by offering higher interest rates led to liabilities that could not be covered by the income from the lower interest rates at which they had loaned money. These problems were exacerbated by some S&L owners who took advantage of lax regulatory oversight to pursue highly speculative investment strategies. The result was that about one-third of savings and loan institutions became insolvent between 1986 and 1995.

WHAT'S NEXT?

There are real economic implications when banks find themselves struggling. As banks work to shore up balance sheets, improve net interest margin, and pull themselves out from under bad loans, they also, historically, have tightened lending standards. So for many businesses today that have become accustomed to using inexpensive loans to meet operating liquidity needs, or to fund new plants or new hires, the spigots may be closing off. We have been reading a great deal over the last year about how larger tech companies have been cutting staffing and costs (including restrictions on the use of staplers at Alphabet!), but we have some concerns that the impact on smaller companies is just beginning.

More than 50% of the job openings listed in the February job openings ("JOLTS") report were for companies with fewer than 50 employees. As Jefferies commented in the March 19 JefMacro Weekly, "This looks more like a Main Street credit crisis, where small businesses will soon find their access to credit restrained. The regional banks that have been fueling the small business boom that has been ongoing since the pandemic will be far more limited in their ability and willingness to lend, irrespective of their deposit stability or access to liquidity from the Fed."

The potential tightening of credit standards at banks and the likely cooling effect on the economy is bad news for recession hawks, but could be good news for inflation watchers. The Federal Reserve continues to discuss the need for additional rate hikes to slow the economy and reduce inflation in the system, but it may no longer be fighting this battle on its own. Although the Federal Reserve raised its target for short-term interest rates by another ¼ percentage point to a range of 4.75% to 5% on March 22, after SVB's failure, it significantly changed its guidance on future interest rates moves: "We no longer state that we anticipate that ongoing rate increases will be appropriate to quell inflation; instead, we now anticipate that some additional policy firming may be appropriate." In its statement, the Fed's policy committee said, "The U.S. banking system is sound and resilient. Recent developments are likely to result in tighter credit conditions for households and businesses and to weigh on economic activity, hiring, and inflation."

Time will tell us whether the Fed has finished its hiking, whether its aggressive response to inflation pushes the U.S. into recession, or whether there is more trouble ahead in the banking sector, but the investment implications are clear. We recommend continued focus on "high-ground" companies with strong balance sheets that can fund their own initiatives, are not saddled by rising costs for capital, and have the advantage of being able to buy weakened competitors or new technologies from reserves. We do not get caught up in the debate about when or whether we will be seeing recessions here or overseas but rather focus on the important directional reality: We are in a slowing global economy. The International Monetary Fund recently announced that global output growth is anticipated to decrease from 3.4% in 2022 to 2.8% in 2023. In this environment, we remain focused on investments in companies that are finding growth in areas of the economy that are more independent from the cyclical tailwinds of rising global GDP growth. We note the revolution in medical discoveries, the advance of automation and robotics applications, the expansion of electrification and grid technologies, and the use of new materials and processes across multiple industries. Each offers just a sampling of secular growth trends that we expect will support more resilient earnings growth in these uneven economic times. RM

Sources:

https://public.fidelityresearch.com/NationalFinancialNet/Api/ViewReport?doctag=US_Sector_Watch_04032023&feedID=2264&versionTag=4UID0S99QTPT7PFBRK7V7AR50A&displayText=Sector%20Watch&date=45019.1666666667&source=CFRA

https://public.fidelityresearch.com/NationalFinancialNet/Api/ViewReport?doctag=Daily_Economic_and_Earnings_Commentary_20230404&feedID=2853&versionTag=7JKH2G6K3NQFPB94BR3TJBL41E&displayText=Daily%20Economic%20and%20Earnings%20Commentary&date=45020.4125&source=Zacks

https://public.fidelityresearch.com/NationalFinancialNet/Api/ViewReport?doctag=WEC_100_20230403&feedID=1463&versionTag=36028WEC&displayText=Weekly%20Economic%20Commentary&date=45015.6579513889&source=Argus

https://fortune.com/2023/03/18/bernie-sanders-svb-ceo-on-regional-fed-board-overseeing-it-plans-bill-to-end-conflict-of-interest/

https://www.cnbc.com/2023/04/14/the-fallout-from-empty-offices-is-coming-heres-where-investors-could-see-the-pain.html

https://www.nytimes.com/2023/03/19/business/economy/fed-silicon-valley-bank.html

https://www.thestreet.com/dictionary/s/savings-and-loan-crisis

https://en.wikipedia.org/wiki/Savings_and_loan_crisis

https://www.bls.gov/news.release/jolts.nr0.htm

https://www.ft.com/content/945f754b-6323-4ad1-8b8c-76ef8d2e0a6a

https://www.brookings.edu/2023/03/22/what-did-the-fed-do-after-silicon-valley-bank-and-signature-bank-failed/

https://www.imf.org/en/News/Seminars/Campaigns/2023/Recap-Day5?cid=ca-com-recapoverview-recapday5-SM2023#:~:text=World%20Economic%20Outlook%20(WEO),increasing%20to%203%25%20in%202024

DISCLOSURE: This newsletter is proprietary to Reynders, McVeigh Capital Management, LLC ("RMCM") and should not be distributed without RMCM's prior consent. This newsletter is for informational purposes only. It is not investment advice or a recommendation to transact in a particular sector or in a particular manner. RMCM may not achieve the investment objectives described herein and cannot guarantee that its investments will be profitable. Past performance is not indicative of future results, and all investments involve risk, including a loss of principal. Any forward-looking statement does not guarantee future performance, and actual results or developments may differ materially from those discussed. This newsletter reflects RMCM's current, good-faith views at the time of publication, and such views are subject to change. All information has been obtained from sources believed to be reliable, but its accuracy is not guaranteed and RMCM assumes no obligation to provide recipients with subsequent revisions or updates to any historical or forward-looking information contained herein.

RM Reynders, McVeigh Capital Management, LLC   121 High St., 4th Fl., Boston, MA 02110   **(p)** 617.226.9999   **(f)** 617.226.9998   reyndersmcveigh.com   @ReyndersMcVeigh