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Maryland Capital Advisors

INVESTMENT COMMENT

March 11, 2023

Some Perspective on Market Concerns over a top-20 U.S. Bank Failure

Market participants began last week girding for Friday's all-important Employment Report. This data release is always a first glimpse of the prior month's economic activity and is particularly important now, as the Federal Reserve has been actively increasing short-term interest rates to slow inflation (by cooling the economy). By the time Friday morning's data was released (yet another stronger-than-expected monthly report), this information was overshadowed by a widening banking system concern.

Selected Asset Classes As of March 10, 2023	**Last Week**	**2023 YTD**
PORTFOLIO **RISK** SEGMENTS		
US Large Cap	-5.1%	+1.1%
US Large Cap Value	-4.9%	-3.9%
US Small Cap	-7.9%	+1.2%
US Small Cap Value	-7.9%	-0.2%
International Large Cap	-3.5%	+3.9%
International Large Cap Value	-3.4%	+4.3%
International Small Cap	-3.1%	+3.3%
International Small Cap Value	-3.0%	+5.0%
Emerging Markets	-3.9%	+0.4%
Emerging Markets Small Cap	-2.4%	+2.7%
Emerging Markets Value	-1.6%	+5.5%
US Real Estate Investment Trusts	-7.0%	-2.0%
International Real Estate	-4.3%	-2.7%
SELECTED PORTFOLIO **LOW-RISK** SEGMENTS		
US Treasury 1-3yr Notes	+0.6%	+0.4%
US Treasury 7-10yr Notes	+2.3%	+2.0%
US Treasury 20-30yr Notes	+3.6%	+6.6%
US Treasury Inflation-Protected	+0.1%	+1.6%
Inv Grade Short Duration	+0.2%	+0.6%
Inv Grade Intermediate Duration	+0.5%	+1.7%
Inv Grade Long Duration	+1.0%	+3.6%
Mortgage-Backed Securities	+0.8%	+1.0%
Municipal Bonds	+0.7%	+1.0%
International Bonds (US$ hedged)	+1.3%	+2.1%
MARKET INDICES		
MSCI All-Country World Index	-3.5%	+2.2%
S&P 500 Index	-4.5%	+0.9%
Bloomberg US 1-5 Yr Bond Index	+0.5%	+0.7%
BALANCED PORTFOLIOS		
Vanguard 60/40 Fund	-2.6%	+1.3%
DFA 60/40 Fund	-2.7%	+1.5%
DFA 25/75 Fund	-1.0%	+1.1%
OTHER NOTABLE MARKET DATA		
Crude Oil Futures	-3.8%	-4.8%
Gold ETF	+0.8%	+2.5%
US Dollar (Trade-Weighted)	+0.1%	+1.0%
High Yield Bond ETF	-1.7%	+1.1%

Source: Bloomberg, Maryland Capital

Note: Returns include reinvested dividends

What happened? Thursday's news was that Silicon Valley Bank (SIVB), a top-20 U.S. bank by assets, realized substantial losses on its bond portfolio to meet redemption requests from depositors. They made a failed attempt to raise investor capital to shore up their balance sheet, but it was too late – California regulators and the FDIC stepped in on Friday. FDIC's press release stated that "*All insured depositors will have full access to their insured deposits no later than Monday morning…*"[1].

The FDIC acted swiftly and insured account-holders will experience little disruption, but customers with accounts in excess of the $250,000 insurance limit are in an uncertain position. FDIC's release stated that uninsured depositors will receive an "advance dividend" this coming week and a

[1] https://www.fdic.gov/news/press-releases/2023/pr23016.html

“receivership certificate” with payments to follow as they sell assets. What portion of uninsured accountholder balances will be covered by the initial advance dividend? *There is anxiety and speculation surrounding that imminent announcement.* Meanwhile, the impact of SIVB’s shutdown has reached beyond its concentrated Venture Capital customer base and disrupted at least one payroll processing company[2]. Interestingly, SIVB also has bank branches in China, Denmark, Germany, India, Israel, and Sweden, so there is an international component, too. This weekend we also learned that one of the crypto market’s largest so-called stablecoin (USDC) has $3.3 Billion on deposit with SIVB. Crypto stablecoins are meant to trade at or very near $1 per coin, but this news caused USDC to drop as low as $0.87 before recovering to $0.96-0.97 by Saturday evening when the company behind USDC announced that normal 1 for 1 redemption will resume when U.S. banks open Monday[3].

Is this a “Lehman Moment” like the 2008 Global Financial Crisis? This bank insolvency is relatively unique because SIVB badly mismanaged two risks:

- **Interest-rate risk.** We wrote about this topic in our October 3, 2022 Investment Comment[4] and noted that “…there is a risk to holding a bond portfolio with average maturity longer than when you need the money.” SIVB invested most of its customer deposits in longer-dated US Treasury and agency mortgage-backed securities. Deposits, of course, can be flighty and must be available on demand, while longer-term bond prices can change quite a bit when market interest-rates move. This is a classic case of an asset-liability mis-match mistake.
- **Concentration of depositors.** SIVB catered to venture capital funds and their funded startup companies. Focus on this customer base left SIVB vulnerable to herd exodus and that was a catalyst to the forced the sale of SIVB’s bond portfolio (at a substantial loss) to return depositor cash. Focus on this customer base also led to a substantial percentage of accounts that were in excess of FDIC insurance limits.

So, the question is, how widespread is this type of mismanagement? Morgan Stanley analysts wrote a note on Friday morning that was widely quoted as saying “The funding pressures facing SIVB are highly idiosyncratic and should not be viewed as a read-across to other regional banks”[5]. However, late-Thursday and Friday trading was dominated by sell-offs in the banking sector overall, with greater selling pressure on select banks deemed to have marginally mismanaged the two risks mentioned above. This fear also drove US Treasury prices higher (yields lower). US 2-year yields dropped from 5.08% to 4.58% in a day – a huge move to safety.

[2] https://twitter.com/parkerconrad/status/1634237386564730882?s=20
[3] https://www.circle.com/blog/an-update-on-usdc-and-silicon-valley-bank
[4] “Capital Markets Update and Focus on Bonds”, available by request from Maryland Capital Advisors.
[5] https://www.cnbc.com/2023/03/10/silicon-valley-bank-tumbles-for-a-second-day-weighing-on-the-bank-sector-again.html

The bottom-line: there are several banks that have large potential losses on their bond portfolios if they are forced to sell to raise liquidity. The focus of this weekend's FDIC, US Treasury, and Fed discussions will be to avert widespread depositor withdrawals of uninsured balances. Businesses with high operating balances and individuals with more than $250,000 need to be assured by policymaker actions that their deposits are safe. Otherwise, accountholders with larger balances will migrate to large "too big to fail" banks, resulting in potential "runs" on smaller, regional banks.

What are we doing? First, our portfolios are broadly diversified and *direct exposure to SIVB stock (that traded above $300/share a month ago and is now worthless) is minimal* - well below 1/10 of 1% of each portfolio's overall Risk Asset holdings. We have reviewed all fund holdings to analyze the direct impact on each portfolio investment. Please feel free to contact us for a more specific estimate of your exposure if you are interested.

Second, many clients may notice holdings of insured bank CDs in investment accounts. An important part of our portfolio management process is monitoring each client's bank exposure to ensure we remain at or below the $250,000 per-bank insurance limit.

Although the past few days have been somewhat volatile, U.S. Risk Asset segments are relatively flat on the year. International and Emerging Markets have generated positive returns YTD. Note that, as of Friday's close, the best-returning asset class segment YTD is US Treasury 20-30yr Notes (+6.6%). We are regularly monitoring portfolios during these market gyrations for potential rebalancing opportunities.

During market turmoil we may also find favorable investments to add or swap in portfolio holdings, while adhering to each client's Investment Policy Statement. For example, fear of bank insolvency might offer some opportunistic purchases of cheap (lower price, higher yield) insured CDs if some investors find themselves above insured limits and want to reduce their risk.

This will be an interesting and busy week, but we are always more than happy to discuss details of your portfolio investments and financial plan.