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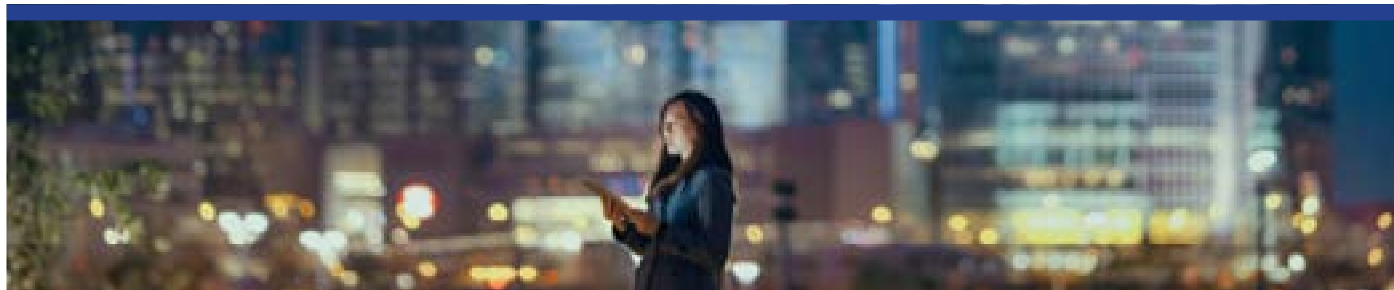

March 13, 2023

CIO Briefing Note

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Emergency Actions Taken by US Authorities

SUMMARY

The Federal Reserve, Treasury Department and FDIC took bold and unprecedented steps Sunday evening to ensure access to deposits at the two lenders that failed this past week, Silicon Valley Bank (SVB) and Signature Bank. Their actions should forestall further US bank runs at institutions that had similar balance sheet profiles, as well as to regional and smaller banks whose businesses could be impacted if deposits flowed "upwards" to systemically important banks.

This weekend, a number of US banks whose stocks had come under significant pressure have already used alliances with larger banks to strengthen their position with depositors. More are likely to tap a new Federal Reserve lending facility in the coming days.

US Treasury Secretary Yellen noted that rising interest rates used to combat the inflation caused, in part, by excessive liquidity used to support the economy over the pandemic were a core problem for Silicon Valley Bank. Its assets, including bonds, mortgage-backed securities and loans made to venture-backed companies, had mark-to-market losses in the face of rising rates.

Prior bank failures were often resolved by selling the failed bank to a healthy one. Typically, the healthy acquirer would cover the losses associated with the uninsured assets because they saw value in the clients the bank would acquire. In this instance, the rapid loss of confidence in SVB caused a bank run that did not allow sufficient time for such a process.

In our view, these recent events underscore the unanticipated weaknesses caused by the Federal Reserve's rapid rate rises, quantitative tightening and impatience with inflationary pressures.

Here are our observations:

- **US policymakers (the Fed, Treasury and FDIC) have drawn the line: Regulated banks will not default on deposits** The cost of making uninsured depositors of SVB and Signature Bank whole will be a levy on the banking industry. Avoiding a much wider panic is well worth this cost. While we expect this action will help stem a social-media age confidence crisis, it's not clear if the two banks are the sole institutions that will be resolved by regulators.
- Panic can be a very potent fundamental – when rational or otherwise. As we wrote in our initial Bulletin on SVB, **the overall US banking system is much more strongly capitalized than it was prior to 2008/2009**. This doesn't mean every bank has been wisely and prudently managed. And even if depositors are protected, it does not mean the same for bank equites or even unsecured credit.
- **Other actions taken by the Treasury and Fed will help banks**. A new one-year lending facility called the Bank Term Funding Program will allow banks to receive loans to bolster liquidity. An important feature is they will receive the credit for pledged Treasury and MBS at par, rather than a price that has potentially been deflated by Fed rate hikes of the past year. This is, of course, comparable to the price if held to maturity, and can limit mark-to-market losses for banks.
- Many have gone out of their way to note the highly unusual business model of SVB. This is true. Nonetheless, **US macroeconomic policies bear some of the blame for these events and which may not be the last**. Fiscal and monetary easing was drastic in 2020-2021 and Fed policy tightening in 2022 was equally drastic. Fed stress tests never included scenarios of surging policy rates.
- **Stemming an unexpected confidence crisis will not stop the US economy from slowing in the months ahead for reasons we discussed in our latest CIO Bulletin**. The shaky ground bank investors feel and the actual economic slowdown to come should help Fed officials see that their hiking cycle is nearing completion. This is even as they hope the latest liquidity boosting steps will allow them to keep monetary policy and regulatory policy separate.
- **Global markets took comfort in the action from policymakers. It followed a day of panic over potential default on a large bank's uninsured customers. Following the weekend's drama, our strategy remains the same**. We are underweight equities, particularly small and mid-cap firms with less balance sheet strength. We are overweight the most consistent dividend growers, who have the strongest balance sheet resources. We are overweight US Treasuries of all maturities at the expense of high yield credit. While the strongest categories of high yield borrowers have not been particularly impacted by the SMID bank news, we would expect a slowing economy to shift concerns from interest rates to credit in coming quarters.

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High quality (very strong)	Aa	AA	AA
Upper medium grade (Strong)	A	A	A
Medium grade	Baa	BBB	BBB
Not Investment Grade			
Lower medium grade (somewhat speculative)	Ba	BB	BB
Low grade (speculative)	B	B	B
Poor quality (may default)	Caa	CCC	CCC
Most speculative	Ca	CC	CC
No interest being paid or bankruptcy petition filed	C	D	C
In default	C	D	D

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