THE
COOK REPORT

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INSIDE THIS ISSUE:

BANKS!

The first quarter of 2023 began on a positive note with strong employment numbers and modest economic growth demonstrating a resilient economy in the face of high inflation and the Federal Reserve's aggressive monetary tightening to combat it. Recession fears began to moderate as some analysts discussed a "no-landing" situation in which economic growth continued while inflation remained high.

Such talk quickly dissipated in early March when issues at Silicon Valley Bank (SVB) led to its eventual failure and sparked wider concerns about the banking sector. In this edition of *The Cook Report*, we review the basic mechanics of how banks operate, explore the SVB failure more closely, and look ahead to potential outcomes.

BANKING 101

To better understand recent news, it is useful to revisit how banks operate. On a simple level, banks perform a vital role in efficiently allocating capital in the financial system. In return for providing a place for individuals and businesses to store their money, banks in turn lend out a portion of those deposits to help finance other areas where capital is needed. In return for the loans, banks charge interest, a portion of which is returned to depositors with the remainder staying with the bank as profit. This is known as fractional reserve banking.

At any given time, banks do not have reserves to meet 100% of depositor withdrawals. The assumption is that depositors usually only need a small portion of their money and in the meantime can allow the balance of their funds to help create growth in the economy. For example, a mortgage allows a family that does not have the full sale price in cash to purchase a home and spread the payments out over time, paying interest to the lender. If banks were required to keep 100% of their deposits ready for withdrawal, mortgages would not be possible and far fewer families would be in homes today.

In situations where a bank's cash on hand is less than the amounts being withdrawn, banks can meet that demand in multiple ways. Notably, they can borrow funds from other banks, paying interest to those banks for the loans. The interest rate in this case is set by the Federal Reserve and is known as the Fed funds rate. The Fed funds rate is the rate that has been rapidly increasing over the past many months in the fight against inflation.

Banks can also invest in assets such as U.S. treasuries and agency mortgage-backed securities. These assets can be sold as well to meet withdrawal demand. Banks use a combination of reserves, borrowing, and asset liquidation to meet customer withdrawal needs.

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BANKS! (cont.)

SILICON VALLEY BANK

Silicon Valley Bank had a highly concentrated customer base of tech companies, many of which were in the start-up phase of their growth and relied on debt financing from business loans, as well as venture capital and private equity capital infusions to meet their payrolls and operating expenses. As interest rates began to rise and some of these financing instruments became more expensive or dried up, the companies had to pull more out of their accounts at SVB to meet expenses.

In short, SVB had to liquidate a significant amount of assets at a loss to meet the unexpected withdrawal demand. It had the assets to meet the withdrawals in normal circumstances, but got caught out by interest rate and duration risk. When interest rates rise, the underlying value of the fixed income instrument decreases in value. If they were able to hold the assets until maturity, there wouldn't have been a loss. However, SVB didn't anticipate the increase in withdrawals and had to sell some of its assets. When the losses were announced, SVB's credit rating was downgraded, which caused a steep decline in its stock price and led more depositors to lose faith that they would be able to access their assets. On March 10th, a day after customers attempted to withdraw $42 billion from their accounts, the Federal Deposit Insurance Corporation (FDIC) put the bank into receivership.

Over the next weekend, the Treasury Department, FDIC, and Federal Reserve announced emergency measures to stop the panic, including a loan facility that will allow banks to hold declining assets to maturity rather than booking losses. It was also announced that all depositors would have access to their money.

WHAT HAPPENS MOVING FORWARD?

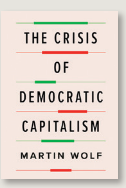
For now, it appears that the emergency measures deployed to reassure depositors have been successful. Most depositors are already covered by FDIC deposit insurance, which covers up to $250,00.00 per individual at each qualified institution for each qualified account. This means that if you have $250,000.00 in savings accounts at five different banks, your deposits are insured (all $1.25 million). Or if you have $250,000.00 in three different types of qualified accounts at the same bank, your deposits are also insured ($750,000.00). Big banks—those seen as "too big to fail"—have benefited from large inflows of deposits at the expense of small and mid-size banks.

The Fed's continued interest rate increases, notably an additional 0.25% at the end of March (to a range of 4.75%-5.0%) will place more scrutiny on bank balance sheets, loan books, and assets as financial conditions tighten. Many analysts see the Fed pausing its interest rate increases, a position which was bolstered with the release of moderating inflation numbers on the final day of March.

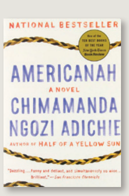
Volatility remains in equity and fixed income markets, with discussion of a looming recession back in vogue. The bottom line is that it is going to take more time for the stimulative policies of recent years to work their way out of the economy. Long-term investors will need to remain patient and continue to prioritize asset diversification in their long-term holdings to contain the short-term fallout of large-scale mismanagement by a few institutions.

We hope you enjoy the increased warmth and sun as Spring transitions into Summer!

READER'S CORNER



The Crisis of Democratic Capitalism by Martin Wolf (Penguin Press, New York, 2023) who is associate editor and chief economics commentator at the *Financial Times*, London, is a superb chronicling of the relationship between politics and economics, particularly the success of market capitalism and democratic principles. He makes the case that the success of democratic capitalism is threatened by forces eroding the practice and legitimacy of democratic capitalism, in the face of autocratic capitalism, most identified with China.



Americanah by Chimamanda Ngozi Adichie (Vintage Books, New York, 2014), features a Nigerian woman who emigrates to the United States and is confronted with what it means to be black for the first time. Over time, she becomes known for her blog exploring race in America from the perspective of a Non-American Black. After many years and becoming a U.S. citizen, she returns to Nigeria, finding it, too, has changed in the interim.

IN THE NEWS

- "You Could Live to 100. The Trick Is Not Running Out of Money," by Andrew Welsch (*Barrons*, February 10, 2023) makes a convincing case that many of us will have a likelihood of living longer than we expect and what we need to do to prepare for it.
- "Who Is Going to Police the New World Trading System?," by Greg Ip (*The Wall Street Journal*, January 14, 2023) suggests stress in the current Western oriented policies being challenged by China and Russia.
- "The Wall Street Journal Tax Guide 2023," by Laura Saunders, Richard Rubin and Ashlea Ebeling (*The Wall Street Journal*, March 6, 2023) is a great primer for preparing for this year's taxes, due next year!
- "Here Comes The 60-Year Career," by Carol Hymowitz (*The Wall Street Journal*, February 12, 2023) acknowledges that 85 may become the new 65!