the Connection

A Quarterly Review 1st Quarter 2023

FINANCIAL HARMONIC RESONANCE

We had hoped to write about something inspiring. The news cycle has been so negative. Partisan politics, debt ceiling debates, war with both China and Russia and impending economic doom have taken over the media cycle. We wanted to counter that with some interesting technologies that have recently been pushed from theoretical to actual. However, the recent bank collapses need an explanation.

Three major banks collapsed. Two were a surprise, one not so much. The bank that didn't surprise us was Credit Suisse. Credit Suisse was facing scrutiny from Archegos Capital, Greensill and other hedge fund failures already. Unlike the other two banks (Silicon Valley and Signature bank), Credit Suisse was on the ropes long before interest rates started to rise. Silicon Valley and Signature bank were different, but ultimately the three bank failures were caused by a three-year process – which sadly our central governments were key to.

First– The Pandemic. When governments started writing checks to keep businesses afloat (PPP here in the U.S.), employers were suddenly awash with cash. Where did that cash go – to banks. Bank deposits at regional banks went way up, just from the business cash. That was the first cash infusion into mid-sized banks ill-equipped to handle it. It was not the last.

Second, zero interest rates drove speculative investment. As everyone reached out to get a return above 0%, speculative assets went up the most. What does speculative mean? To a large extent this meant over investment in IPO's, secondary stock offerings and Crypto-assets. When We-Work asked for cash for its expansion plans, not only did they get the cash they needed, but they got more cash than they could spend. All this corporate cash from stock offerings ended up at regional banks. Second cash infusion into banks that couldn't lend it fast enough.

Third, unemployment benefits were extended indefinitely. People were getting flush with cash from the government, and they were leaving the cash in their bank accounts. They didn't need to spend it because nothing was open. By the beginning of 2022, Silicon Valley bank had grown its deposit base by around 300%. That was not abnormal, most banks grew their deposit bases at an absurd rate.

Fourth, the banks needed to put the money to work. There wasn't enough demand to underwrite mortgages or business loans – most capital needs were already met by mid-2021. They had nowhere to put the assets, and instead of parking it at the Fed for 0.2%, they decided to buy longer dated treasuries. These treasuries were considered by bank regulators to be tier 1 capital. Tier 1 capital expansion meant that banks looked well reserved against any collapse. Also, sticking $100bn dollars in ten-year treasuries made the bank an extra $1bn of income, whereas parked at the Fed it was only $100-200mn. No brainer –make a billion dollars a year per hundred billion in deposits.

The problem with that was 2022. Let's recap what happened from 2020-2022. The government gives everybody tons of money. People and businesses don't need the money, so they park it at regional banks. Banks don't need the money, so they park it back at the government by buying treasury bonds. Global Inflation and the end of the Pandemic makes central banks leery. Central banks begin to hike rates. As these rate hikes occur, the easy money that had been locked up in long dated treasuries now begins to depreciate. The ten-year treasuries that were held at banks had a very low coupon (let's say 1%). As interest rates rise, equivalent ten-year treasuries now yield 3.75%.

This drives down the price of the 1% treasuries by about 20%. Regional bank holdings in long-dated treasuries are now worth 80 cents per dollar purchased. That isn't the end of it though.

The world re-opens, and suddenly businesses and people need money again. Depositors withdraw funds to meet daily needs. Banks start to sell their liquid instruments to meet the cash needs, but those instruments are selling at a discount. The banks suddenly have an asset base that is 20% lower than what it was a year ago, yet that asset base still has to cover the same amount of deposits. No problem if the deposits stay at the bank. The first fracture happened when businesses had to spend their cash because of new payroll expansion, global inflation, and business investment (specifically away from China into other countries). The second happened as businesses and individuals get smart and pull money from their deposit accounts earning them zero into short term treasuries earning over 3%. As the deposit base shrinks, banks sell treasuries to cover the deposits, which in turn leads to banks taking massive losses on treasuries. What looked like a no brainer, locking up cash at 1% for 10 years in hindsight was a bad investment. This cycle drops two regional banks: One exposed to Crypto expansion and contraction (Signature Bank); the other exposed to speculative technology expansion and contraction (Silicon Valley Bank). As this mess unfolds, the weakest global bank, Credit Suisse, finally topples as well.

Everything from 2020 until now can be pinned to government intervention. There are two factors that play into massive government intervention. Murphy's law, anything that can go wrong will go wrong; and the law of unintended consequences – not only will things go wrong, but they will also go wrong where you least expect them. Central governments flooded everything with cheap cash. When the cash caused problems, they made that cash expensive to hold onto (opportunity cost). When central governments started to course correct with interest rate hikes, that directly caused the assets that banks held in reserve to depreciate. We were all lucky that it was only three banks – JPM, Citi, Wells Fargo, Bank of America, and Goldman along with other major global banks were limited by deposit regulations, they could not get much bigger by law. Otherwise, who knows what mess we would be in.

THE ACT OF GIVING

Below is an updated list of some organizations our clients are helping today.

All Local Food Banks
www.sfmfoodbank.org
www.shfb.org
www.foodbankccs.org
www.refb.org

Bloom Marin
www.bloom.org

Maya's Music Therapy
www.mayasmusic.org

Frien*ds of the Urban Forest*
www.fuf.net

Guide Dogs for *the Blind*
www.guidedogs.com

Doctors without Borders
www.doctorswithoutborders.org

The Nature *Conservancy*
www.nature.org

National Kidney Foundation
www.kidney.org

Guide Dogs of America
www.guidedogsofamerica.com

Golden Gate National Parks Conservancy
www.parkconservancy.org

Fine Arts Museums of San Francisco
www.famsf.org

Canine Companions for Independence
www.cci.org

Alzheimer's Association
www.alz.org

The Foundation for Rotary International
www.therotaryfoundation.org

Wildcare
www.wildcarebayarea.org

Homeward Bound of Marin
www.hbofm.org

Vivalon
www.vivalon.org

FINCA
www.finca.org

Sonoma Land Trust
www.sonomalandtrust.org

Friends of the Earth
www.foe.org

The American Friends Service Committee
www.afsc.org

Amnesty International
www.amnestyusa.org

Eastside College Prep
www.eastside.org

Northern Sierra Partnership
www.nothernsierrapartnership.org

American Bird Conservancy
www.abcbirds.org

The Cornell Lab of Ornithology
www.birds.cornell.edu

Mono Lake Committee
www.monolake.org

California Trout
www.caltrout.org

Tahoe Rim Trail
www.tahoerimtrail.org

Ocean Conservancy
www.oceanconservancy.org

Global Fund for Women
www.globalfundforwomen.org

Marin Agricultural Land Trust
www.malt.org

Walk to End Alzheimer's – San Francisco, CA
www.act.alz.org/sanfrancisco2019

UCSF Foundation – Sarcoma Research
www.giving.ucsf.edu

If you would like to go paperless, please contact Barbara 415-797-6003 or bcorley@gencappm.com