A letter for clients on recent bank turmoil

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The fall of Silicon Valley Bank on Friday (March 10) and the concerns of further contagion in the banking sector that followed on Monday took many people by surprise. While the sudden unwinding of SVB and Signature Bank of New York was astonishing to witness, it is also an unintended consequence of interest rates rising faster and higher than expected, primarily due to the Federal Reserve's moves to tighten monetary policy over the last year.

I would like to reassure you as a client that we are monitoring conditions in the financial markets closely and are committed to our defensive strategies to help you weather this recent type of volatility. As an investor, this episode of market turmoil underscores the value of owning quality companies in your portfolio. Our strategies are not overly exposed to the financial sector, but we do count JPMorganChase as one of our holdings, for the very reason that we view the largest U.S. bank as a quality company that manages risk well. News reports on SVB's demise make it apparent that risk management at the company was quite poor; the bank had exposure to longer-term Treasuries at low yields, which fell in value as interest rates rose considerably last year.

This moment presents a good opportunity to reiterate the inverse relationship between bonds and interest rates. Bond values appreciate when rates go down and fall when rates go up (as they did last year). For an example, a bank bought a 10-year Treasury note two years ago with an interest rate around 1.5%. If the bank had to sell this bond today, it would get less than it paid for it two years ago. That's because an investor looking at 10-year Treasuries today could find one at a higher yield (around 4.0% as of last week.) The bank would have to discount the selling price of their 10-year bond in order to make it attractive to the investor. A position in long-term bonds may not necessarily be bad if the bank could hold those bonds to maturity. In the case of SVB, it did leave them vulnerable to a classic run on deposits, which required the bank to sell their bond positions at a significant loss in order to return cash to depositors.

This is also a good reminder that there is risk in bond investing. Bonds are traditionally lower risk than stocks, but they are not risk free. U.S. Treasuries are often held up as the "risk free" standard, but that risk is related to repayment of investors' capital, not to changes in interest rates. Even government-issued bonds lose value when interest rate rise. In fact, longer-term bonds can be more volatile than shorter-term bonds in times of rising interest rates, which makes SVB's decision to hold a stake in longer-term bonds questionable because interest rates would eventually and inevitably rise from their previously low levels.

Many investors are wondering what will happen next. Will this be a contained event? Is there another shoe to drop? Is this a sign of a systemic problem? The wind-down of SVB and Signature does expose the potential fragility of regional banks, which do not tend to have the same capital requirements of larger "systemically important" banks. It also looks more likely that the Fed will have to ease up or even pause the pace of rate increases in the near term. This comes after Fed Chair Jerome Powell talked up higher rate hikes just last week to fight stubborn inflation.

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What would easing monetary policy at a time of rampant inflation mean for economy? There's the possibility for the economy to slow down organically, as banks try to shore up risk by scaling back lending. Companies would have less capital to invest, which would in turn dry up investment, reduce business activity and impact employment. This could potentially affect the technology sector and startup community. But as a silver living, an economic slowdown would lower inflation, leaving the banking sector to do the Fed's work for it.

There are many moving parts at present, which makes it hard to be certain where these events may lead. At these times, investing with a disciplined strategy focused on quality companies can help see you through periods of uncertainty and volatility. You can be assured we are staying aware of developments in the markets and economy as they occur. This is part of the value you receive from us as a professional wealth advisor.

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