Highland Capital
MANAGEMENT, LLC

Market Update

March 23, 2023

Thoughts on the Current Banking Dislocation (Not a Crisis)

The events that began around March 9th resulting in the subsequent failures of Silicon Valley Bank and Signature Bank have been rapidly evolving daily, and to call them “fluid” would be an understatement. Credit Suisse has been absorbed over the weekend by UBS, and Signature Bank in New York is being sold. Those events seem to have provided some stability in markets. You will notice that we chose our words carefully and used the word dislocation rather than crisis. Having been through the 2008-2009 financial crisis, the structure, transparency, and quality of bank assets and portfolios is dramatically different today. It’s much stronger. The regulation that resulted from the previous financial crisis has resulted in more resilient banking organizations, with more and better capital, reserves, and liquidity. While we hesitate to use the word idiosyncratic too loosely, the issues at Silicon Valley Bank and Signature Bank were somewhat unique. These were banks with high levels of uninsured deposits. The US banking system is a fractional reserve system, meaning that banks take in deposits, hold a percentage of that back as reserves, and lend or invest the balance to provide credit to the economy for growth. As a result, banks never have enough liquidity on a single day to be able to handle a massive amount of deposit outflows. In other words, confidence is a vital part of the system, and when large numbers of uninsured investors at these banks lost confidence and felt the need to withdraw their deposits, these banks didn’t have the liquidity to meet those demands (that’s why they are called demand deposits). The response by the FDIC to these events was to provide an implied guarantee to all bank depositors. The FED also implemented a lending facility that allows banks to use securities in their portfolios to be pledged at full value so that banks can access additional liquidity should it be needed to meet depositors’ demand. These actions should alleviate depositors’ concerns.

Another issue you have likely heard is that banks have big losses (on paper) in their bond portfolios due to the rise in interest rates. That is true but with a caveat. The bonds are predominantly government guaranteed bonds (no credit risk) and will mature at 100% of value (no losses) if they are held to maturity. If banks don't have to meet huge demands for deposit withdrawals, the bonds will be held, and the losses will never be realized. The FED lending facility mentioned earlier lets the bank use those assets at their maturity values, recognizing that these assets are money good.

The Fed raised interest rates by another 25 basis points at their meeting yesterday and changed the wording in their statement to "some additional policy firming may be appropriate". Our interpretation is that there may or may not be more rate increases coming, but any moves will be dictated by economic data (is economy weakening or maintaining resilience) and how quickly inflation is trending lower. In effect, yesterday could have been the beginning of a Fed pause, but without explicitly stating it. The data will determine. The Fed also acknowledged that the extension of credit will tighten due to the banking issues, and this will also serve to slow the economy. So while the Fed only raised the Fed Funds rate by 25 basis points, they may have in a sense hiked by 50 basis points if you consider the additional tightening caused by tighter lending standards.

Considering the recent events our team at Highland has been busy reviewing our holdings on both the equity and fixed income sides and will take appropriate actions when needed. We recognize that you may have questions and we are always available to discuss any concerns you have, so please feel free to reach out.

Regards,
The Team at Highland Capital

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