We just wanted to let you know our take on what is happening with SVB in the United States, what we think it means for the markets, and how it may affect you. The impact on Canadian Banks should be limited as they are well funded, well diversified and well regulated.

Trust is what makes the banking industry function. Trust in financial regulations, in solid management and risk management. During the financial crisis in 2008, the world's Central Banks stepped in to shore up the banking system. This made the banking system much safer and systemically solid. The situation faced by SVB appears to stem from a lack of trust in one institution fueled by their mismanagement of risk.

When interest rates were lowered to historic lows, SVB was awash in deposits because they finance the higher risk technology companies in Silicon Valley who were able to borrow funds at very low rates to grow their businesses. The rates that these depositors received were driven by the U.S. Federal Reserve funds rate which is a variable rate driven by economic conditions. It is important to remember that deposits must be paid back on demand when the customer wants their funds. While the funds are held in the bank, interest is paid and this is a cost to the bank.

SVB's deposits arrived when variable interest rates offered by the Fed were extremely low. SVB received so much capital at that time because funds were easy to access for venture start up technology companies. Due to the sheer volume of deposits they received, they had difficulty finding alternative investments to earn revenues that would make a profit for the bank over the interest that they were paying out. Banks exist to make profits, so they moved away from their typical investments and looked to the fixed income market, buying what were deemed safe Government backed securities that paid fixed rates which were slightly higher than what SVB were paying out shorter term. These securities were longer term and needed to be held to maturity to earn the posted interest rate.

With interest rates rising at an historic pace driven by the U.S. Federal Reserve, the variable rate that SVB was paying skyrocketed while the fixed rate that they were receiving stayed the same. The income based on yield spreads that they were earning by holding longer term “safe” investments became a cost. In addition to this, the value of the longer-term fixed assets declined markedly. This meant that these invested funds went from an asset to a liability. This liability was not apparent because the longer-term assets held were still of value when they came to maturity, so they weren’t officially losses.

The problem occurred because with high interest rates, capital isn’t as liquid, and corporate customers need deposited cash to fund their operations. Because a great deal of the required cash that depositors need is locked up in longer term fixed income assets, they needed to be sold at a loss to fund short term liabilities. This created an unbalanced situation with SVB’s finances. Depositors don’t like uncertainty and perception caused panic to ensue. SVB tried to issue equity, but the damage was done, and the FDIC and the U.S. Treasury stepped in to guarantee the deposits to secure the faith in the U.S. regional banks.

What does this mean for the markets going forward?

Markets don’t like uncertainty and that is one of the reasons that we saw declines late last week. This situation will likely be contained, however some of the smaller US regional banks may face pressure as investors become nervous. The longer-term ramifications will impact capital that is loaned out to smaller companies and start-ups that need the ability to borrow capital to grow.

The central issue that will drive markets for the foreseeable future is the push and pull of inflation and recession. We remain in a highly fluid period that will be dependent on interest rates and the pace of hikes. Inflation is receding, however not at the pace that Central Banks were hoping for. The more aggressive they are, the more likely it is we face a recession. If they slow down inflation will remain stubborn. Markets will remain volatile while we sort this out, and the longer-term outlook is positive as the economy and employment remain stable.

For you, our clients, cash flow remains solid, and you are well diversified and positioned to face volatility as we look for opportunities.

If you have any questions, please do not hesitate to contact us.

Sincerely,

The Andras Group

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