MARKET INSIGHTS

NAPLES GLOBAL ADVISORS

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Leverage can sting, cash flow can maim, but liquidity kills...

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Four years ago, the portfolio managers here at Naples Global Advisors made the decision to rotate the authoring of each quarter's "Market Insights" piece, giving our legacy literary geniuses (Michael and John) a long-overdue and well-deserved respite. When agreeing to write the insights piece for the first quarter from then on, I had no idea that the world was heading in a direction that would provide a consistent stream of crises and chaos for discussion. It seems as though these articles almost write themselves: 2019 Boeing airplane crashes and recalls, 2020 COVID, 2021 Meme Stocks, 2022 Ukrainian War and FAANG stock meltdown. Well, here we are again with our annual "once-in-a-generation" crisis. Mark Twain coined the phrase "history doesn't repeat itself, but it often does rhyme." I'd have to agree.

This time the crisis du jour is in the banking sector, and while most likely not a repeat of the Great Financial Crisis of 2008, we see some rhyming in the recent headlines. With the collapses of Silvergate Bank, Silicon Valley Bank (SVB), and Signature Bank, closely followed by the "forced marriage" of UBS and Credit Suisse, tensions flared rapidly in an arena where everything appeared fine just a few short weeks ago. Prior to the week of March 12th, most people had not heard of SVB, let alone understood the bank's size, role, and importance to the tech sector. And while the Federal Deposit Insurance Corporation (FDIC) receivership plan for SVB has seemingly "bailed out" deposit holders of the bank, investors face a different fate. The shock waves created by the failure of the $60 billion institution are reverberating out to most corners of the globe.

Alternatively, Credit Suisse has spent some time in the headlines over the past 20 years, and while some say that "any press is good press," that may not apply when the press is an endless stream of fines and lawsuits. Credit Suisse spent north of $11 BILLION[1] on fines since the year 2000—that's just shy of half a billion dollars per year! What's more surprising than the dramatic conclusion of their story is the fact that it took this long to conclude.

Industry-wide risk events typically have a common cause, and the current volatility in the banking sector seems to stem from the combination of two identifiable sources. The first and broader-spanning source of volatility in this case is the fallout from the rapid rise in interest rates throughout the past year. Banks, at their core, are interest rate matching, or "spread", entities. They pay an interest rate to depositors to "use money" which they then invest or loan out to creditors to receive interest payments. For reference, think of the interest you receive from a savings account versus the interest you pay on a mortgage or car loan. Simply put, the difference between the rate a bank pays for deposits and the rate a bank receives from loans is how they make money. Customer deposits are extremely liquid and short-term in nature—you can go to your bank and pull your cash out pretty readily when you make up your mind to do so. However, the loans made by banks to earn revenue are typically illiquid and longer-term in nature, spanning years or even decades. Interest rates have a direct, inverse relation to the value of assets on banking balance sheets, meaning that as interest rates go up, the value of the assets (i.e., bank loans)

go DOWN! As you can imagine, if you're a bank and your depositors panic because of a drop in the value of assets on your balance sheet, you could have a pretty big problem. Depositors fleeing a bank in excess of the bank's ability to raise liquidity is commonly known as a "bank run" and is not a new phenomenon—see the 1946 Christmas classic "It's A Wonderful Life" for some cinematic representation.

But why did this bank run only happen to a handful of banks when all banks are dealing with the same interest rate predicament? The second source of this risk event is what is currently making all the difference, and seemingly separating the survivors from the failures. This risk source is occasionally referred to as "mission drift," but in layman's terms can be called "losing focus." Banks in general require consistent and solid customer confidence to survive and thrive. The objective skill and brilliance required by banks to manage liquid and viable loan and investment portfolios with client deposits at risk, in addition to the discipline required to consistently exist within regulatory requirements, are perpetually epic undertakings. A strong argument can be made, for the banking sector in particular, that "it doesn't pay to get cute." A bank should, first and foremost, be laser focused on managing risk above all else. Unfortunately, more and more businesses (not just in banking) are straying from their core profit motive and business competency—in the end putting customers and investors at greater risk. This is a disturbing trend that SVB and Signature Bank fell victim to, but hopefully corrects itself in the long run. Yes, largely all banks in the industry are faced with the same interest rate issue, but it's the ones who allowed risk management and liquidity focus to lapse that are ending up in the headlines.

We continue to believe that this is not a repeat of 2008, for some simple but very important reasons. In 2008, banks extended too many risky real estate loans and held tenuous derivatives when housing prices collapsed. Large portions of the banking industry took immeasurable amounts of levered risk (they got cute…) and got punished for it. This time, a historically rapid interest rate shift is testing all banks' abilities to do their core jobs properly and is catching the poor operators asleep at the wheel. The most encouraging point is that the vast majority of the industry is doing its job correctly, and passing a rather rigorous risk test without much fanfare.

Every adversity is an opportunity for education, so what can we learn from this particular crisis? For starters, with banks back in focus, it's a good reminder that FDIC insurance for deposits is $250,000 per depositor per qualified bank.[2] Additionally, only checking accounts, savings accounts, money market deposit accounts, and certificates of deposit are covered. Maintaining balances exceeding insured deposits may not be the most prudent move. Additionally, not all banks are created equal, and size does not necessarily equate to quality. At Naples Global Advisors, we are always happy to provide objective feedback on the fundamental quality of a bank you may be considering for your banking needs; please just ask.

Especially during times of uncertainty, the greatest source of confidence and reassurance is often as simple as having a clear, actionable path forward. Our typical client meeting discussions cover a broad range of topics, and usually include personal liquidity management along with asset diversification, precisely for times like this. If you would find such a big picture discussion valuable, please call us so we can schedule a time to get together. The goal of all discussions is essentially the same: to provide guidance onto and along the path with the highest probability of long-term financial success. We're always here to help, but especially when our collective path hits a few bumps!

[1] "Credit-Suisse: Violation Tracker." *Credit-Suisse | Violation Tracker*, https://violationtracker.goodjobsfirst.org/parent/credit-suisse.
[2] "Deposit Insurance Faqs." *FDIC*, https://www.fdic.gov/resources/deposit-insurance/faq/.

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