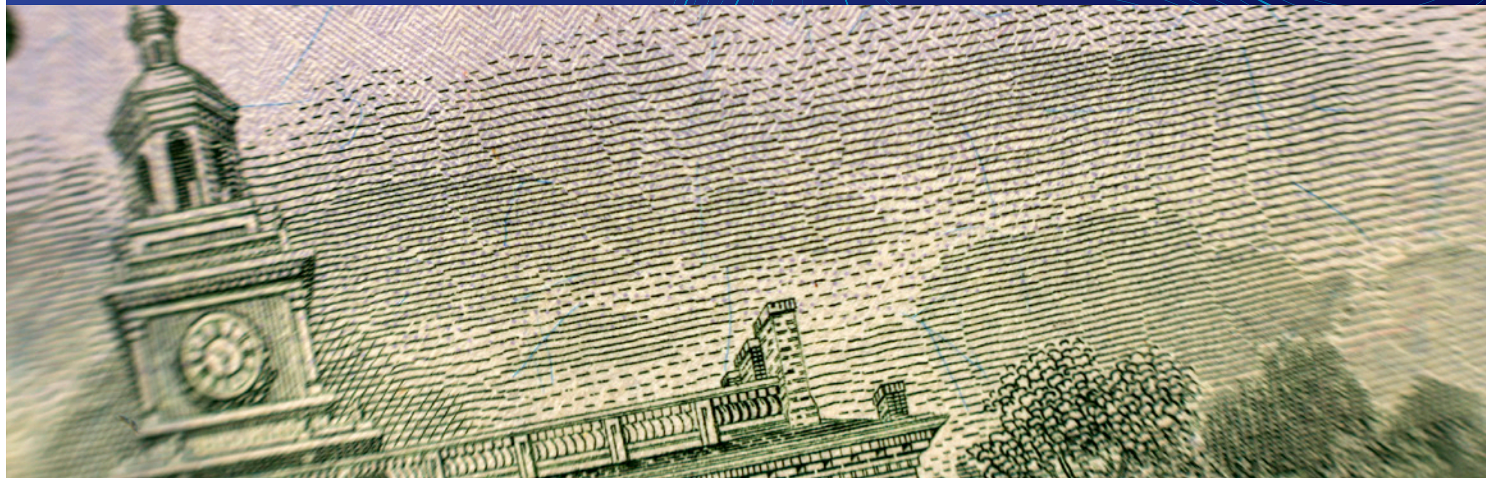

US Bank Failures: Will Cracks Turn into Chasms?

After a long period of relative calm in the US banking system, the back-to-back failures of Silicon Valley Bank (SVB) and Signature Bank—the second- and third-largest bank failures in the country's history—have depositors and markets on edge.

Looking to shore up confidence in the system and prevent the infection from spreading, a coterie of US authorities—including the Federal Reserve, Treasury and Federal Deposit Insurance Corporation—intervened over the weekend. As of March 13, these measures appear to have been at least partially successful. Though market volatility remains elevated, the selloff in broad equity indexes has abated for now. Regional bank stocks have not been as fortunate; the S&P Regional Banks Select Industry Index opened Monday morning down more than 14%, and trading was halted in several stocks during the day. In contrast, perceived "safe havens" like gold and US Treasuries have rallied.[1]

Contagion is a difficult thing to predict, and we won't attempt to do so here. That said, the idiosyncratic nature of these bank failures and the intervention of US authorities suggest that containment may be the likely outcome of this episode. While some observers may hear echoes of 2008 in recent headlines, the magnitude of and reason for last week's failures point to something less far-reaching—which is not to say that broad-based fallout from these events is not possible. Further, these failures highlight the pronounced vulnerabilities inherent in today's financial system and the potential for unintended consequences as policy-makers attempt to unwind years of highly accommodative monetary policy. They also underscore why the Global Value team seeks to build resilient portfolios through rigorous security selection and thoughtful diversification, often complemented by a strategic allocation to gold as a potential hedge against extreme market events.

KEY TAKEAWAYS

- The impact of the recent midsized bank failures appears to be contained for now, though the episode highlights the vulnerabilities inherent in today's financial system.
- Portfolios managed by the Global Value team had no direct exposure to Silicon Valley Bank or Signature Bank.
- Given our focus on trying to avoid the permanent impairment of capital, the Global Value team has long sought to build resilience in our portfolios through rigorous security selection and thoughtful diversification.
- Our philosophy is to hold gold as a potential hedge against extreme market events, and the metal has provided stability during the recent tumult.

Views expressed are as of March 13, 2023.

1. Source: FactSet; data as of March 13, 2023.

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Bank Failures Highlight Cracks in the System

Despite being little known outside of its customer base of venture capital-backed tech names, Silicon Valley Bank (SVB) grew to be the 16th largest bank in the US. The bank's deposits nearly doubled over the course of 2021 in conjunction with a massive increase in venture capital investment, and by the end of the year it had nearly $190 billion on its books. With more deposit assets than it could profitably lend out given rock-bottom interest rates, SVB sought to boost profits through an investment portfolio focused on longer-term agency mortgage-backed securities.[2] While these highly rated securities carried minimal credit risk, their long durations made them susceptible to rising interest rates.

> US regulators took extraordinary action over the weekend to protect customer deposits in the two failed banks and to bolster wavering confidence in the nation's banking system.

The beginning of the end for SVB likely can be traced back to the early-2022 commencement of fed fund rate hikes. Rising interest rates weighed on the venture capital investment that fueled SVB's rapid growth, and its customer base was now burning cash rather than hoarding it. More impactful, however, was that rising interest rates were punishing the extensive long-dated fixed-rate bond holdings in SVB's portfolio.

A press release issued by SVB on Wednesday, March 8, set the end game into motion. The bank reported that it had sold $21 billion of securities from its investment portfolio for an after-tax loss of $1.8 billion and planned to issue $2.25 billion of new shares, ostensibly to plug the hole these sales left in its balance sheet.[3] Prominent venture capitalists advised their clients to pull their money from the banks, and the run was on. On March 10, SVB was closed by California authorities and the FDIC was appointed as receiver. While SVB depositors with balances under the $250,000 insurance threshold were expected to have access to their funds within days, the fate of larger deposits was murky.[4]

This lack of clarity raised concerns about the safety of bank deposits in general and produced runs at other banks deemed vulnerable in the uncertain environment. Among these were crypto-focused Signature Bank, which had nearly $90 billion in deposits at the end of 2022. Signature lacked the bond-portfolio overhang of SVB, but its concentration of clients in the digital-asset world appeared to undermine confidence in its ability to continue meeting its obligations amid increasing risk aversion in the bank space. Signature was shuttered on March 12.[5]

That same day, US regulators announced extraordinary action to protect customer deposits in these two banks and to bolster wavering confidence in the nation's banking system. The FDIC vowed to fully protect all SVB and Signature depositors, including those with accounts in excess of its $250,000 insurance ceiling; notably, such accounts represent more than 90% of depositors at both banks, which made them particularly susceptible to bank runs.[6] The Fed introduced a new Bank Term Funding Program that offers short-term loans against collateral valued at par, which is intended to reduce the pressure on banks to sell bonds in order to meet their cash needs. The central bank also eased lending terms through its discount window.[7] While these measures provided relief to equity markets in general, bank stocks continued to struggle into the new week due at least in part to the ambiguity that persists around the programs.

2. Source: *Wall Street Journal;* data as of March 12, 2023.
3. Source: Silicon Valley Bank; data as of March 8, 2023.
4. Source: Federal Deposit Insurance Corporation; data as of March 10, 2023.
5. Source: Federal Deposit Insurance Corporation; data as of March 12, 2023.
6. Source: Bloomberg; data as of March 13, 2023.
7. Source: Federal Reserve; as of March 12, 2023.

Seeking Resilience Through Selectivity and Diversification

First Eagle's Global Value team previously has expressed concern about the potential risk of a financial accident emerging somewhere in the system. We saw a number of burgeoning threats materialize in 2022; all ultimately failed to inflict widespread damage, and we are hopeful that the current tumult in the banking sector will play out with similarly limited systemic impact. At the same time, however, the periodic emergence of such events may suggest a broader set of troubling tectonics shifting underneath the surface.

Given our focus on avoiding the permanent impairment of capital, the Global Value team has long sought to build resilience in our portfolios from the bottom up. This has meant searching for companies with track records of stability in the face of market volatility and macroeconomic weakness, with pricing power that can be exploited in inflationary environments, with scarce assets and strong capital structures that may serve as a buffer against rising interest rates, and with prudent management teams. This also has meant investing in such companies only when we can do so at what we believe to be "margin of safety" to our estimate of intrinsic value.[8] While we have seen broad dislocation across financial stocks over the past week, we are confident that our investment philosophy and process will help mitigate the worst of the downside—and may potentially reveal attractive buying opportunities in names undeservedly caught up in the downdraft.

We are also mindful of the importance of diversification as a guiding investment principle, and our portfolios represent carefully curated and balanced collections of businesses we believe have strong competitive positions in a variety of industries and geographic markets. Our benchmark-agnostic perspective supports our disciplined approach to business selection, enabling thoughtful diversification rather than index-tracking and helping to ensure we are providing clients with truly differentiated investment solutions. Many of our portfolios have a strategic allocation to gold as a potential hedge against adverse market developments, and the metal has performed as we would expect during the current period of uncertainty.

> Portfolios managed by the Global Value team had no direct exposure to Silicon Valley Bank or Signature Bank.

8. First Eagle defines "margin of safety" as the difference between a company's market price and our estimate of its intrinsic value. "Intrinsic value" is based on our judgment of what a prudent and rational business buyer would pay in cash for all of a company in normal markets.

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The principal risk of investing in value stocks is that the price of the security may not approach its anticipated value or may decline in value.

Investment in gold and gold related investments present certain risks, and returns on gold related investments have traditionally been more volatile than investments in broader equity or debt markets.

Securities that invest in bonds are subject to interest-rate risk and can lose principal value when interest rates rise. Bonds are also subject to credit risk, in which the bond issuer may fail to pay interest and principal in a timely manner, or that negative perception of the issuer's ability to make such payments may cause the price of that bond to decline.

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Income generation and dividends are not guaranteed. All investments involve the risk of loss. If dividend paying stocks in the portfolio stop paying or reduce dividends, the portfolio's ability to generate income will be adversely affected.

Diversification is a strategy that involves allocating assets to a variety of investments with the intention to help manage risk.

Federal funds rate is the interest rate at which depository institutions (banks and credit unions) lend reserve balances to other depository institutions overnight on an uncollateralized basis.

Mortgage-backed securities (MBS) are financial instruments collateralized by a pool of mortgages.

Volatility is a statistical measure of the degree to which the return of a portfolio or individual security deviates from its mean over time.

Indexes are unmanaged, and one cannot invest directly in an index.

MSCI EAFE Index measures the performance of large and midcap securities across 21 developed markets countries around the world excluding the US and Canada.

MSCI World Index measures the performance of large and midcap securities across 23 developed markets countries.

S&P 500 Index is a widely recognized unmanaged index including a representative sample of 500 leading companies in leading sectors of the US economy. Although the S&P 500 Index focuses on the large cap segment of the market, with approximately 80% coverage of US equities, it is also considered a proxy for the total market.

S&P Regional Banks Select Industry Index measures the performance of stocks in the S&P Total Market Index that are classified as regional banks in the global industry classification standard (GICS).

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