



MassMutual

Market Update
March 14, 2023

"Gradually, then suddenly."

This brilliant phrase originally came from "The Sun Also Rises," by Ernest Hemingway, to describe the two ways of becoming bankrupt. Much to Hemingway's chagrin, it also has been used to describe the downfall of individual relationships, the personal budget, and more recently, the collapse of Silicon Valley Bank (SVB)¹.

What follows is an attempt to provide clarity on what has occurred and what we believe is likely to occur. For those who would prefer a statement of clarity upfront, let me start by saying I believe a 2008-like crisis is unlikely.

With that, let us begin.

Section 1: What Has Occurred

Banking, at its core, is a fairly simple business. Banks receive deposits (mostly in the form of cash) from depositors, and try to generate income from those deposits by lending them out. Some banks do very conservative and simple things like mortgages and car loans, and other banks do more nuanced and occasionally risky things like lend deposits to businesses with little to no assets.

SVB was, up until very recently, a bank that was generally admired for its ability to sit in the middle of the tech epicenter and finance some of the most innovative and adaptive tech businesses in recent years.

Founded in 1983, the bank was essentially designed to lend to those with generally different business models than those which appeal to the more traditional banking system.

Accordingly, and with a tailwind of ample levels of liquidity (like cash) slushing around the economy, SVB grew to become the 16th largest bank in the United States.

And yet, as I write this update, SVB has been overtaken by regulators and is under government control.

What went wrong?

We'll get there, but first, let's review the timing:

- On Wednesday, March 8, the management of the bank abruptly decided to mark to market some long-duration bonds and surprised investors with news that it needed to raise \$2.25 billion to shore up its balance sheet. What this essentially means is that the bank held some bonds that had gone down in value, and suddenly decided to realize that value. This decision is certainly receiving some scrutiny.
- On Thursday, March 9, SVB's chief executive officer held a call discussing a desire to raise additional capital. As you might have guessed, this call did not go particularly well.

¹ Note. For purposes of brevity, I am referencing Silicon Valley Bank, Signature Bank and Silvergate Bank collectively as the stories are quite similar, and related.

- That same day, several large incubator and venture capital firms encouraged their clients and relationships to withdraw their cash from SVB. This is essentially the same as yelling “fire” in a crowded theatre and generally doesn’t end well.
- Unfortunately, the confluence of these events resulted in requests of \$42 billion of withdrawals, causing a negative cash balance of \$958 million at the end of March 9.
- With that negative cash balance now confirmed, on Friday, March 10, regulators stepped in, took over the bank, and seized all deposits—resulting in the largest bank failure since 2008.
- After the takeover, the question remained of how to treat those that had lost access to their deposits at the bank (where a significant amount of the concern existed). Accordingly, on Sunday, March 12, a joint statement was issued by the Secretary of the Treasury Janet Yellen, Federal Reserve Chairman Jerome Powell, and Federal Deposit Insurance Corporation (FDIC) Chairman Martin Gruenberg that clarified that all depositors at SVB would be fully protected and have access to their accounts beginning Monday, March 13².
- That same day (Sunday, March 12), Signature Bank—which is smaller—but had similar exposure, also was shuttered with a similar outcome.
- On Monday, March 13, all SVB clients (including commercial clients) gained access to capital when the former bank’s assets, including both insured and uninsured deposits, were transferred to a newly created bridge bank.

If the narrative that a well-respected bank could go from existing in a reasonable place to out of business in short order is causing you to scratch your head, you aren’t alone.

And yet...there is much more here than meets the eye.

Two main points: let us 1) zoom in, and then, 2) zoom out.

Zoom In

With the benefit of hindsight, SVB, made four key decisions that were perhaps unwise:

1. The bank made a business out of lending large amounts of money to borrowers with a) very few assets, and b) very little income,
2. The bank lent large amounts of money to borrowers who all spoke to each other and did so quickly and frequently,
3. The bank was very focused on the more challenging corners of the market (crypto and early-stage tech)—corners that often struggle when liquidity disappears from the market.
4. There is significant evidence that the bank had gaps in its risk management (as a more notable example, SVB had no one in the role of head of risk management for nearly a year³).

² <https://www.fdic.gov/news/press-releases/2023/pr23019.html>

³ <https://fortune.com/2023/03/10/silicon-valley-bank-chief-risk-officer/>

It is, of course, unclear if having better risk management would have resulted in better asset to liability matching (one of SVB's main problems), but it is unlikely to have made things worse.

Zoom Out

Perhaps more importantly, let us also zoom out and review why this occurred now.

Warren Buffet, the business magnate, investor, and philanthropist, once said, "You don't find out who's swimming naked until the tide goes out." I think that's a fairly appropriate description of what has occurred.

The important back-drop to the banking issues last week is that the Federal Reserve has been removing dollars from the financial ecosystem by raising rates. As rates go up, the lower probability projects and companies become less viable, while those initiatives that are funded become more expensive. Credit, in other words, is both harder to come by and more expensive to obtain.

Everyone from public companies, to banks, to private companies, to individuals, must be more cautious and thoughtful about the dollars they have and those they want to have. By design, that dynamic results in fewer speculative deals at the margin, which hurts many of the clients that SVB (and its brethren) had been targeting for years. Ergo, easy money is now more difficult money...and cracks begin to show.

And yet...

Section 2: Volatility & Bated Breath

If we zoom out even further, most indicators do not predict a crisis on the horizon. Yes, inflation has been high, but pressures continue to abate, and the momentum has clearly stalled. The job market is remarkably strong. Leverage levels are relatively low. Cash balances are high, for both consumers and businesses. Said another way, while the withdrawal of liquidity is clearly going to cause problems (many of which are, as of yet, unclear), the economy still has plenty of positives...and we see SVB as more idiosyncratic than symptomatic.

From an asset perspective, we believe the risk-off assets (treasuries, cash equivalents, metals, etc.) will continue to have strength over the near-term, while risk-on assets (equities, crypto, and the like) will demonstrate meaningful volatility.

Given the large and rapid government intervention, particularly on the regulatory side, we also believe that bank assets will likely attract more scrutiny in the future and there will be increased pressure for FDIC changes.

Does this mean that investors should change their portfolios? No, generally not. Even if we knew the future (which we don't), as we have shown over and over, the large benefits of investing come from the power of compounding...not in the power of timing the market (which is close to impossible). This is a wonderful time to ensure a plan is in place, however, and it's always the right time to find ways to mitigate taxes and expenses. It's also a great reminder of the benefit of periodically reviewing the locations of your accounts, the protections in place, and the safety of the organization where your accounts are held.

It is also worth noting that more than 400 banks failed between 2008 and 2012, and yet markets continued to function and incentives continued to provide opportunities for those who remained focused on the long term. While we certainly can't predict the future, and recognize this is a difficult market to navigate, we remain focused on what we can control.

As always, we remain at your service, and watching closely.

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