The Navigator

March 2023

Down in the Valley to Pray

In more than my 25 years of this business, I have witnessed many bank bankruptcies, but I have never seen a bank that collapsed due to a bank run and certainty not at the speed of Silicon Valley Bank. More often, many bank bankruptcies stemmed from the impairment of their assets chiefly loans to the consumers, corporates or proprietary investments. These three types of bankruptcies have different resolution duration and magnitude of recovery. A corporate loans instigated bankruptcies typically last the shortest and have reasonable recovery rates. Consumer loans bankruptcies are often the most long-drawn, while blow-ups in proprietary investments are often debilitating and immediate. But a liquidity run bankruptcies is one of crisis of confidence and I will surely learn many important lessons from the demise of Silicon Valley Bank and Signature Bank in months to come especially asset-liability management (ALM).

Silicon Valley Bank (SVB) is a truly a textbox study of what a poorly conceived ALM should look like, but still the extent of mismanagement is quite unbelievable. It even operated without a Chief Risk Officer from April 2022-Jan 2023. From 2019-2022, SVB grew its deposit base by 180%, the fastest pace amongst all the banks in the US, surpassing the industry growth rate of 60%. Furthermore, its deposit mix was amongst the most concentrated with 93% of deposits coming from corporate customers, aka VC/PE funds and their investee companies. Corporate deposits are most sensitive to rates. Whichever bank that offers corporates slightly higher bps, the corporates will move funds over. Hence, corporate deposits are considered the flightiest deposits, while retail and asset/wealth management deposits are stickier. This is in sharp contrast to the GSIB (Globally Systemically Important Banks) which has actively managed their source of deposit funding. For eg, Bank of America has a good deposit funding base consisting of 28%/54%/17% of corporate/retail/asset and wealth management deposits. JP Morgan is evenly spread at 42%/48%/10%. Furthermore, SVB's vulnerable deposit mix is aggravated by the fact it has higher concentration of large corporate accounts with more than 97% of its deposit accounts have balance of $250,000 or more, with an average balance of $4.2mn in contrast to the closest comparison, First Republic Bank, that has 63% of

its deposits with less than $500,000. SVB has more than 52% of its deposits coming from PE/VC sector as well. Truly an amazing dereliction of proper liability management.

Supercharged deposit growth, super flaky deposit base

US BANK DEPOSIT GROWTH 2022 VS. 2019

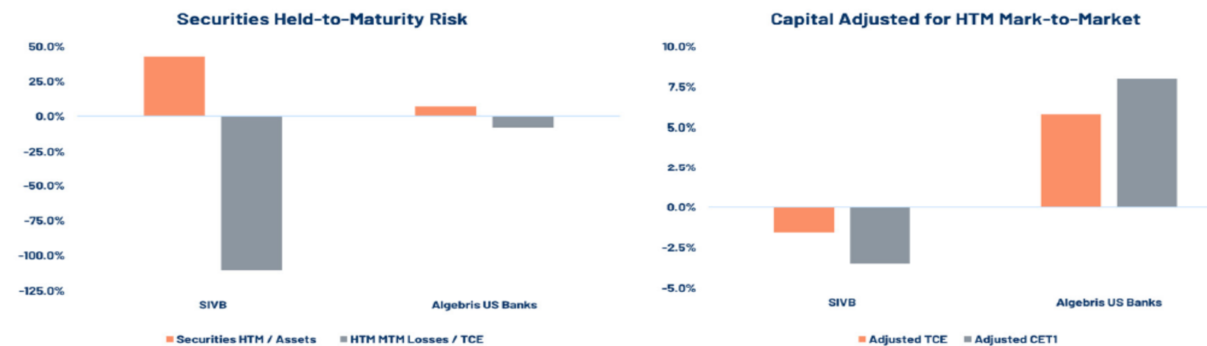
SVB: A CLEAR OUTLIER

Source: S&P Global, Algebris Investments. Data as of 31.12.2022.

But you cannot fault SVB for having lousy assets. It has total assets of $211bn at the end of last year of which 63% are in liquid assets of either cash ($13bn) or short-term investments consisting mainly of US government bonds ($91bn are held to maturity and $29bn held as for sales). Commercial loans are $72bn. However, the unintended consequence of trigger-happy Fed has wrought significant mark-to-market unrealized losses on its US government bonds holdings. This is again where its poor management of assets is exposed. With 57% of its asset is US government bonds, the risk of unrealized losses on its supposedly held-to-maturity holdings was so large in the last quarter and if they were sold, would have wiped out 124% of total common equity! Even its held-for-sales bond holdings registered -4% mark-to-market loss in contrast to the bank holdings of our alternative capital fund manager which have far less impact than SVB on both fronts.

Never seen such a bad ALM before

SVB: OUTSIZED MARK-TO-MARKET RISK

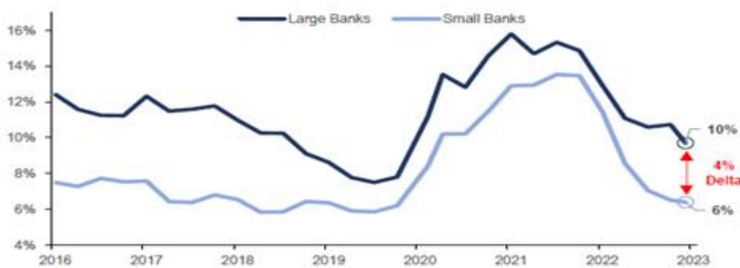


Source: S&P Global, Algebris Investments. Data as of 31.12.2022.

As of this morning, the Fed, Treasury Department, and the FDIC have already announced their rescue plans and we shall not delve further, CNBC: Regulators unveil plan to stem damage from SVB collapse, but instead will focus to ascertain if there will be contagion within the financial systems. Aside from the this morning announcement of the establishment of the Bank Term Funding Program by the Fed and a $25bn Exchange Fund from the Treasury department to prevent short-term contagion, we would argue that SVB and Signature Bank (SB) do not pose a systemic risk. Banks like SVB, SB, First Republic and Western Alliance have total assets of $592bn or just <3% of total systems assets. JPM alone has asset base 6x larger than the four banks combined. The large banks have far larger liquidity buffer than SVB and SB. On average, the large banks holds 4ppt more in reserve to total assets than the smaller banks. Liquidity coverage ratio is well above 100% for the GSIBs and for the record, SVB alongside SB and First Republic have cleverly orchestrated themselves out of Fed's supervision to maintain this critical ratio. The larger banks' liquidity is also not as stretched with its loans-deposit ratio at 59% in contrast to small banks 80%, and they have a better spread of deposit mix as well. Lastly, large banks are well capitalized with CET1 ratio as of 4Q22 at 12.1%, 5ppt above regulatory requirement.

Look the same, but ain't the same

US commercial banks' reserves-to-assets



Source: Federal Reserve and J.P. Morgan calculations. Large Banks is defined as the top 25 banks in the US. Reserves is defined as Vault cash, cash items in process of collection, balances due from depository institutions, and balances due from Federal Reserve Banks.

Liquidity coverage ratio, 4Q22

BAC	120%
C	118%
JPM	112%
PNC	107%
TFC	112%
USB	122%
WFC	122%
Median	**118%**

Average deposit mix by client type, 4Q22

	Corporate	Retail	AM/WM	Other
BAC	28%	54%	17%	1%
C	62%	8%	24%	6%
CFG	29%	65%	NA	5%
FITB [1]	37%	53%	8%	2%
JPM	42%	48%	10%	0%
PNC	34%	60%	6%	0%
RF	29%	63%	7%	2%
TFC	35%	59%	NA	6%
USB	34%	43%	21%	2%
WFC	24%	63%	10%	3%
Median	**34%**	**57%**	**10%**	**2%**
SVB	93%	0%	7%	1%
SBNY [2]	100%	0%	0%	0%

Source: Company reports and J.P. Morgan calculations. [1] as of 3Q22. [2] Reflects period end deposit mix.

Loan-to-deposit ratios, quarterly average

	4Q22	1Q23 QTD
Large Banks	59%	60%
Small Banks	80%	82%

Covenant Capital has no dealings with SVB or SB nor First Republic and Western Alliance. We have asked our custodians this morning and they have all reverted they have no exposures to SVB or SB. In terms of the companies we own across mandates, the impact is immaterial. We have a blockchain PE fund manager that has direct and indirect exposure in SVB and SB, but they have informed us their exposure within the firm is immaterial and will not affect their operation and are not aware of any of their portfolio of companies that will have material issues.

Global search company	We are not concerned with direct exposure, but we recognize that advertisers, cloud customers, developers, and others in our ecosystem likely have some exposure to SVB
Global e-commerce company	we are not concerned with direct exposure, but we recognize that third-party sellers, cloud customers, advertisers, and others in our ecosystem likely have some exposure to SVB
Leading crypto exchange	4% deposits in SB but all will be covered in FDIC original scheme.

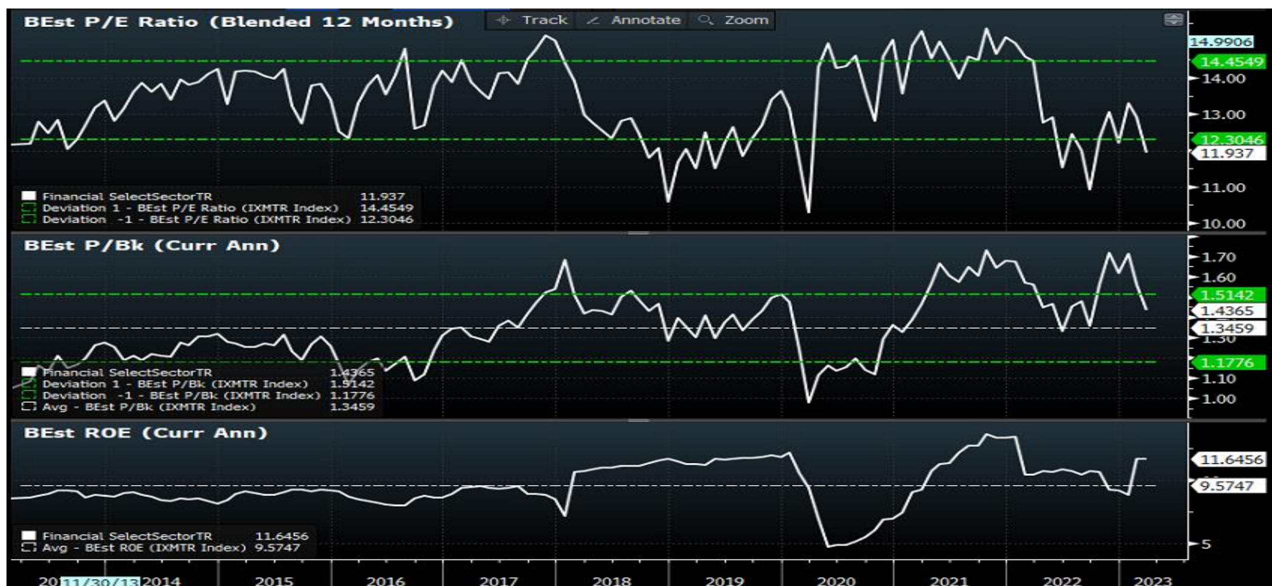
We have exposure in the GSIB banks but we believe this shakeout will be beneficial to them as deposits will flee to them given their higher capital adequacy and better managed ALM. The US Financial Index ETF is now trading at 11x forward PE, 1.3x P/B, 2yrs EPS is forecast to grow at CAGR of 7%, generates ROE of 11-12%, and pays dividend of 2.6%. It looks attractive trading below its -1sd ten-year PE band, and is at the average of its ten-year average PB band, but generated 2ppt higher ROE that the same period. We also own a fund manager specializing in the alternative capital instruments of financial institutions. We are confident in their holdings as they own mostly in systematically important global banks and bulk of their portfolio are in additional tier-1 of the capital structure.

Holdings of our alternative capital fund manager

Top 10 Bond Issuers by Exposure

Name	Total	Name	Total
Barclays	9%	Caixabank	5%
Intesa Sanpaolo	8%	BNP Paribas	5%
Unicredit	7%	Société Générale	5%
Deutsche Bank	7%	Lloyds Banking Group	4%
Santander	6%	Natwest	4%

The US Financials ETF is attractively valued with large banks benefitting from the flight to quality



Asset Allocation Strategy

This is our quick read on market implications and ensuing asset allocation strategies.

Rates (our view is unchanged with US10 trading within 3.5% to 4.0% throughout the year): Market has gone ahead of itself at the start of last week on the back on payrolls and entourage of Fed speakers sounding the hawkish bells. Before this debacle and as late as Thursday, market was pricing the possibility of terminal rate of 6% versus our view of 5.25-5.5%. Market also pushed out first cut from January to April versus our view a first cut could come in December or January. Short of a disastrous CPI on tomorrow, if the Fed would raise by 50bps instead of 25bps, it would be absolutely tone-deaf on their part. We are sticking to our views another 2 more 25bps hikes or at best 3, but US10 yield to trend lower even as Fed fund rates increases.

Fixed income (no change either): Stay in high grade, recession risk is still high. Not forgetting investment-grade debt has longer duration hence will benefit more than high-yield debt as yields fall besides the attendant lower historical default rate but higher recovery rate of IG versus HY

Equities (still underweight): While we like the fact that earnings expectations have been materially recalibrated falling for 9 months now and revised down by 10% since its peak back in June last year and is now within historical norm associated with a recession, valuation is a major stumbling block. Short-end rates is now 4.5% but SPX earnings yield is 5.7% and dividend yield is less than 2% makes it uncompelling from a cross-asset valuation point of view on the back of negative EPS growth for this year.

FX (not quite sure): The interplay between flight to safety to USD in the short-term versus the diverging path of interest rate trajectories between the Fed vs ECB/BOJ, which is medium term bearish, makes it a tough call to be long or short the USD. Just keeping FX exposures neutral to clients' reference currency.

Cash: Still holding 10% cash.

Featured Picture/Quote: Victory is sweet, even it is for the moment.

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