A Very Normal Quarter with a Bank Run

April 2023

There was a bank run… In 2023! So, of course that's what this newsletter is going to be about. Let's take a few minutes to talk about the role banking plays in our economy and see if there's any perspective we can take away from this round of chaos.

A cornerstone concept of our modern economy and the banking industry is what's called fractional reserve banking. Families and businesses deposit cash at a bank and then that bank turns around and lends *most* of that money out to individuals and businesses seeking cash for various needs. This allows the bank to make a profit on the spread between what they pay depositors in interest and what they collect in interest from the loans they make. However, fractional reserve banking isn't just a bank-enrichment enterprise. This is a collective good for the broader economy, as well. The loans that are made to individuals are often used to buy or improve houses and land. Businesses use loan proceeds to invest in new equipment or hire workers to grow and expand the products and services they offer. Absent these loans, homeownership would be unattainable for the overwhelming majority of individuals and business formation and innovation would grind to a halt.

Look, most of us have a negative view of the banking industry for various scandals and nefarious dealings over the past 15 years, along with being one of the primary culprits of the Great Financial Crisis at the end of 2000's. Despite this, modern banking is not a parasitic blight on the economy. It is an essential component of production and innovation. There are bankers that are good at their jobs and bankers that are bad at their jobs – just like any other industry. What went wrong with Silicon Valley Bank is primarily a failure of risk management. From what we can observe, they did a poor job of matching short-term liabilities with long-term assets. On its own, that problem may not have been enough to cause a bank failure. However, it turned out their client base was very sector-concentrated and the same macro-influences (rising interest rates) that created insolvency for Silicon Valley Bank also led to problems with their clients' businesses that required them to draw on their cash reserves at exactly the time when SVB would struggle to meet those liabilities. Furthermore, those clients were very connected professionally and socially to each other, so the whispers or instability quickly led a full-blown bank run.

As we sit here a few weeks removed from the crisis, it seems as though worries over a total banking sector collapse are unfounded. Despite 94% of deposits at Silicon Valley Bank falling in excess of the FDIC deposit limits[1], all depositors were made whole due to emergency actions by The Federal Reserve. No depositor has lost so much as a penny in an FDIC-insured bank since the FDIC was established in 1933. While there is no guarantee that uninsured deposits will be made whole in the future, a precedent has been set by The Fed with its actions.

Now, most of us don't have more than $250,000 in bank accounts, but what about our brokerage and retirement accounts? I've seen a few articles within the less-reputable corners of the financial advice world that call for "*institutional diversification"* of investment assets. Let's nip that in the bud from the

start. There is no reason to diversify investment assets across different custodians and brokerages over fears of a 'brokerage run'.

Unlike banks, brokerages do not engage in fractional reserve banking. There is an SEC Rule that prevents firms from using customer assets to finance their own businesses. A bank run, as we understand them for traditional banks, cannot happen with a brokerage. If every investor who owned shares in Apple suddenly wanted to pull their shares out of a brokerage, they should be able to do it. Those shares of Apple aren't off in other places financing the activities of others.

Additionally, brokerage assets are subject to SIPC protection, which works similarly to FDIC coverage at a bank. SIPC offers protection of up to $500,000 of securities with a sub-limit of $250,000 on cash assets. This coverage would kick in if assets were missing in the event of fraud or misappropriation by the brokerage firm.

From anecdotal experience, there is more risk created from spreading assets around for two reasons:

1) Strategic Inconsistency – It will always be more difficult to maintain a strategic allocation as more steps are added to accomplish the same result. As assets inevitably drift from strategic targets, it is challenging to monitor and correct that variance if there are assets at Vanguard, Fidelity, Schwab, and E-Trade, as opposed to just one brokerage.

2) Losing Track of Assets – The amount of times we have come across individuals that 'forgot' they had money at one institution or 'found' money they had previously forgotten about, has been alarming. Even the most diligent recordkeepers often leave a mess for their heirs to navigate after they're gone if they choose to use a handful of custodians as opposed to consolidating assets in one place.

All this is to suggest that there is *not* material risk to institutional consolidation and there are benefits to keeping your investments in one place.

Inflation Corner

While it can be argued that the actions of the Fed over the past year directly led to the banking panic – with which I'd agree – let's also look at the other side of the coin. The impetus behind The Federal Reserve's interest rate hiking campaign has always been to curb inflation. Last June, we hit a high of 9.06% annualized inflation. Since then, inflation has steadily receded[2].

June 2022	9.06%
July 2022	8.52%
August 2022	8.26%
September 2022	8.20%
October 2022	7.75%
November 2022	7.11%
December 2022	6.45%
January 2023	6.41%
February 2023	6.04%
March 2023	4.98%

There's still a bit further to go before we return to the sub-3% inflation we had been accustomed to over the previous 15 years, but the trend is certainly encouraging.

Last summer, as inflation was peaking, we discussed the market expectations for forward inflation. By observing the yield spread between nominal treasuries and inflation-protected treasuries, we can effectively determine what the market thinks inflation is going to be over various periods. Based on the data as of the middle of April, the 5-year spread is 2.39% and the 10-year spread is 2.31%[3]. This tells us that the market is expecting annualized inflation of 2.39% over the next five years and 2.31% over the next ten years.

If it were obvious that actual inflation was likely to be materially higher or lower than these spreads, a tremendous amount of money could be made by trading these two instruments. There are billions of market participants always looking for an edge, so if there was money to be made from betting on high inflation, prices would quickly adjust and reflect a higher expectation for future inflation. As always, we don't know what we don't know. But, the information we do have suggests that the baseline expectation is that inflation is likely to moderate in the near-term and stay relatively low throughout the next decade.

A frequent question we've been fielding over the past several months is: "Are you still using 3% inflation for financial plans?" The answer is yes, and we still believe that errs on the conservative-side of planning assumptions. Now, we do recognize the risk higher inflation poses to our clients' financial well-being. We stress-test financial plans to see how they would turn out in the event inflation exceeds expectations.

Broadly, clients that derive a significant portion of their income from fixed sources that receive cost-of-living adjustments, such as Social Security and/or COLA-linked pensions, have less to worry about when it comes to higher-than-expected inflation. Clients that rely more on their investment assets or have pensions that do not receive inflation step-ups, bear more risk when facing down sustained high inflation.

Regardless of the flavor of risk that will inevitably pop-up, we are here to help you navigate these currents and keep things in perspective. We wish you a pleasant and bountiful Spring.

[1] *Salmon, Felix. "Why failed Silicon Valley Bank was an outlier." Axios. March 15, 2023.*

[2] *Source: FRED CPI for All Urban Consumers as of 4/13/2023.*

[3] *Source: US Treasury Department Interest Rate Stastistics; Daily Treasury Par Yield Curve Rates; Daily Treasury Par Real Yield Curve Rates as of 4/14/2023.*

Past performance is no guarantee of future results.

This newsletter contains general information that may not be suitable for everyone. The information contained herein should not be construed as personalized investment advice. Past performance is no guarantee of future results. There is no guarantee that the views and opinions expressed in this newsletter will come to pass. Investing in the stock market involves gains and losses and may not be suitable for all investors. Information presented herein is subject to change without notice and should not be considered as a solicitation to buy or sell any security. Investment advisory services offered through Ferguson-Johnson Wealth Management, a registered investment adviser.