THE WEEKLY BEACON **MARCH 17, 2023**

We will be giving some macro economic market updates on a weekly basis. No equity recommendations will be given in this commentary, and we encourage you to contact us if you have questions regarding any observations.

MacNicol & Associates
Asset Management

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BEACONS OF THE WEEK

The two main purposes of a Lighthouse are to serve as a navigational aid and to warn ships (Investors) of dangerous areas. It is like a traffic sign on the sea.

Panmure Island Lighthouse,
Prince Edward Island

PEI's oldest wooden lighthouse and Heritage site. Climb to the lantern, take in spectacular views. The lighthouse has been a symbol of the local fishing and farming community of Panmure Island for over 150 years.

Sombrero Key Light, *Vaca Key, Marathon, Florida*

The lighthouse was put in service in 1858, automated in 1960, and was deactivated in 2015. The foundation is iron pilings with disks, and the tower is a skeletal octagonal pyramid of cast iron. It is a 142-foot (43 m) tall red painted tower.

**Feel free to send us your photos of Lighthouses to be featured in our weekly market observations. **

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Silicon Valley Bank (SVB) defaults

We are sure you heard about Silicon Valley Bank this week. The bank which traded on the Nasdaq under the ticker SIVB was the news story of the week and perhaps the year. This will take a bit to explain so buckle up.

Silicon Valley Bank was founded in 1983 and IPO'd in 1987. Last Friday the FIDC announced that it had taken over the bank and assets would be sold to cover depositors. This is the largest bank failure since the Financial Crisis and 2nd largest U.S. bank failure.

SVB shares dropped 65% last Thursday:

Shares traded at $41 before they were halted in pre-market trading early Friday. SVB's market cap was $30 billion just a year ago and $17 billion as of March 1st.

SVB had over $209 billion in customer deposits at the time of its failure. Washington Mutual which failed in 2008 was the only bank larger on record to fail with roughly $309 billion in assets.

First, we need to explore what a bank does (and how they earn money).

Banks are supposed to take your money, pay a rate to you then loan out your money at a higher rate than the one they pay you. The spread is their profit and a major stream of revenue for most banks. They also earn revenue through service fees and advisory fees and other fees.

So, before we get into why SVB failed and what has happened since let us get into who they are.

SVB is a bank that operates in the financial services industry. At the time of its failure, it was the 16th largest bank in the U.S.

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SVB's headquarters are in Silicon Valley and its focus is providing services to start-ups. Since its founding, they believed the start-up world had been underserved and mismanaged in terms of loans. Start-ups usually do not earn revenue in the early days despite their need for capital. SVB helped structure loans that solved this industry's shortcomings. As of December 31, 2022, 56% of its loan portfolio were loans to venture capital firms and private equity firms, secured by their limited partner commitments and used to make investments in private companies, 14% of its loans were mortgages to high-net-worth individuals, and 24% of its loans were to technology and health care companies. For years SVB has been the choice for start-ups and venture capitalists (VCs) needing funding, advisory, or banking needs.

SVB offered commercial and private banking services through its bank side and its subsidiaries offered asset management, private wealth management, M&A advisory, venture capital, and private equity investment. Essentially, they were a full-service bank that supported tech companies and their employees.

Why did they fail?

In short, Silicon Valley Bank (SVB) collapsed due to a liquidity crisis better known as a bank run. SVB did not have enough liquid assets to cover customer withdrawals. As we are sure you know, bank runs cause panic and the media multiples said panic which eventually causes a crisis:

As investors heard about this bank run, SVB's stock price collapsed. The collapse in equity wiped out billions in shareholder equity. Hopefully, you did not own this stock in your RRSP or IRA…..

The bank run was essentially caused by a few start-ups and venture capital investors wanting their capital for various reasons leading to mass withdrawals and panic accelerating SVB's issues.

Peter Thiel, a prominent venture capitalist told his founders to withdraw money from SVB as did several other venture firms. Thiel's firm completely withdrew all funds from SVB by Thursday. Thiel reportedly told his founders to withdraw all funds from SVB after some founders reportedly faced pushback from SVB when trying to withdraw their money. Thiel and his firm saw this as a red flag and got all money out of SVB. Other venture firms also withdrew money from SVB but kept some money in to maintain a relationship with the bank. Many founders could not retrieve their funds due to the bank run and

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collapse of the bank. Thiel's firm led this collapse and has not announced why they had their suspicions but perhaps he looked at their balance sheet or was tipped off by something or heard about the upcoming Moody's downgrade (credit rating).

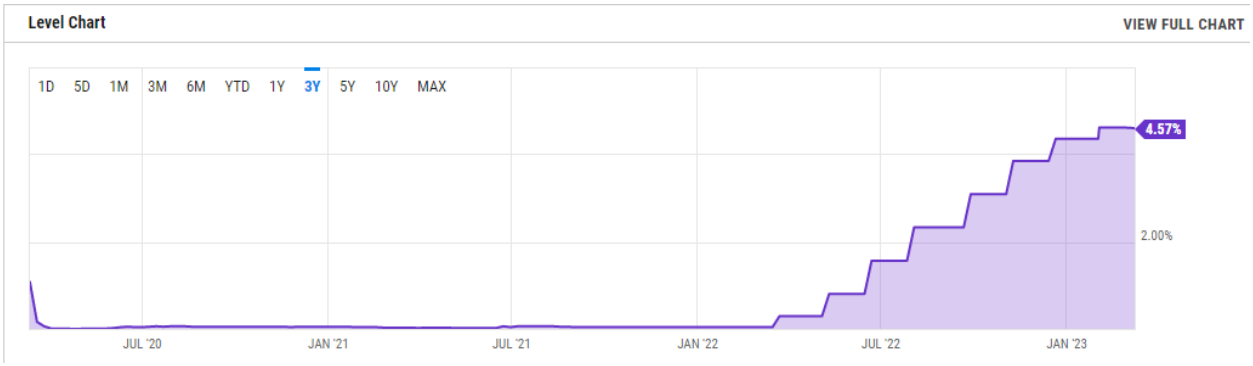
Many are blaming Thiel for the bank's collapse and ignoring SVB's mismanagement of its balance sheet. Thiel and other venture capitalists may have caused panic, but they did not create this issue.

On Thursday approximately $42 billion was withdrawn from SVB, the largest bank run in U.S. history. These withdrawals were not middle-class folk, or mom-and-pop shops lining up, they were billionaires and start-ups phoning in to transfer their money out of SVB. This bank run differs from any bank run in history due to the customer base and amount of money in 1 day.

So why was there panic to withdraw from SVB in the first place?

SVB incurred large losses following the FED raising interest rates in 2022. Fixed-income products had their worst year in decades (in terms of returns), and this had negative impacts on individual investors as well as banks like SVB.

Here is the U.S. FED Funds Rate over the last 3 years.



We all know why this happened so we will not dive into that.

As interest rates increase, bond prices decrease, and bondholders are negatively impacted.

Back to SVB.

SVB had $189.2 Billion in deposits by the end of 2021 up massively from $61 Billion at the end of 2019 (As of last week deposits sat around $209 Billion).

As deposits exponentially grew, they could not grow their loan book at the same rate. This denied them a chance at creating that spread where their profit comes from. Instead, they bought $80 Billion in Mortgage-Backed Securities (MBS) and long-duration government bonds. 97% of these MBS had durations over 10 years and their average yield was 1.56%. So why is this a problem?

As the FED raised rates, the value of these MBS collapsed (which covered customer deposits), and as customers withdrew funds, SVB was forced to sell $21 Billion in securities for a $1.8 Billion loss.

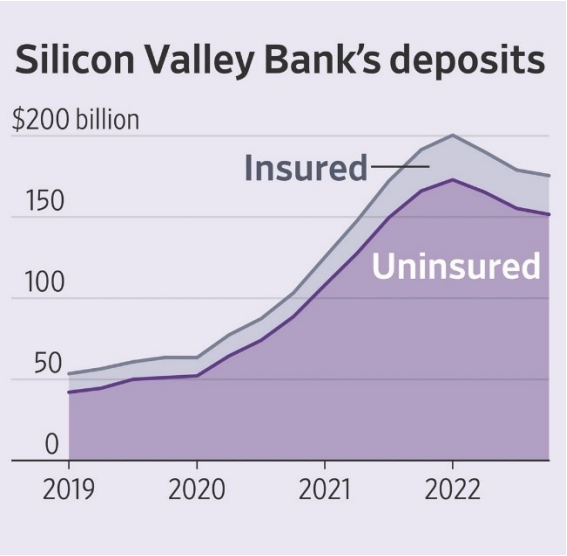
To meet their capital requirements they announced a $2.25 Billion debt and equity issuance. This was a huge surprise as investors thought they had enough short-term liquidity to cover withdrawals and maintain the capital requirements imposed by the regulators. These MBS and bonds were categorized in the balance sheet as long-term investments, but they needed the money immediately, so they sold them for 80 cents on the dollar and lost money (if they held them to maturity, they would recover their entire principal). They could not wait and had to realize their losses.

So how did they allow this to happen? The bank essentially was positioned for rates to stay close to 0%. The bank completely ignored interest rates, inflation, and other macroeconomic indicators risks, no hedges were out in place and the mismatch between assets and liabilities caused the bank to fail. In other words, this was a complete failure from the risk management department since any other competent risk management department would have protected the bank against those risks.

Getting back to SVB's customer deposits……why did they grow so quickly in 2021? Most of SVB's depositors were start-ups and technology companies that are funded by venture capitalists and private equity firms. Their deposits accelerated in 2021 as venture capitalists poured money into the industry, a symptom of easy money (cheap rates, and stimulus). Essentially every technology start-up got a cheque. In 2022 that money dried up and start-ups were forced to tap their reserves as VCs were investing less money, this caused more and more withdrawals at the bank eventually wiping out most of the bank's liquid assets.

So, after the bank defaulted due to a bank run, regulators took control of the bank (Friday). Regulators faced a major dilemma. They could not just sell all the bank's assets and return customer deposits ($209 billion) due to the bank's assets having a market value below customer deposits. The other unfortunate thing is that even though SVB accounts are insured by the FDIC (The Federal Deposit Insurance Corporation is a U.S. government corporation supplying deposit insurance to depositors in American commercial banks and savings banks.), the FDIC only covers up to $250,000 per account.

Since the majority of the clients were businesses with accounts greater than $250,000 most of SVB's deposits were not insured at their time of default:



As most deposits were not covered by insurance, many wondered what the government would do and if they would step in. Would it be a bailout? Would they help facilitate a buyout from a larger bank? or would they just liquidate the bank giving depositors 80 cents on the dollar for their deposits?

A bailout is extremely unpopular to the public, especially after what happened in 2008, and doing nothing would cause consumers to question the U.S. banking system and would screw depositors in the process.

Most of SVBs depository clients were start-ups and technology companies and their accounts help them conduct business (make payroll, pay for services, pay for office space). Obviously, this presents a MAJOR problem for said companies and the money that backs them……

The VCs who back the companies who were using SVB were showing their true colors last weekend. They were panicking and fearful for their investments. These investors were worried that their companies could not access their accounts (in which they invested), which would impact the value of their investments. Numerous VCs flocked to TV, and social media to voice their opinion and offer a solution. They made broad statements that this would set the technology industry back by decades and claimed that it would reduce investment in this space significantly eventually leading to slower economic development.

VCs David Sacks and Jason Calacanis (cohosts of the All in Podcast with SPAC King Chamath Palihapitiya) essentially begged the federal government for a bailout over the weekend on Twitter and across numerous news outlets. The two who are prominent VCs, highlighted the risks of the government not stepping in, highlighting unemployment rates, stunting growth in the sector, and numerous other factors. Other VCs shared similar thoughts as they believed the federal government needed to insure all SVB clients had access to all their deposits. Sacks and Calacanis also stated that their idea differed from 2008's bailout as they would not bail out shareholders, debtors, and executives. They wanted the government to bail out customers of SBV which some of their portfolio companies used.

Bill Ackman, a billionaire, and hedge fund investor advocated for similar moves. He cited that markets needed stability and that the government should ensure all deposits at regional banks (as well as other large financial institutions). He highlighted that this is essential for the lifespans of these smaller banks and if the government did not step in, the biggest 5-6 banks would end up monopolizing the entire industry decreasing competitiveness and eventually hurting consumers.

Ackman also advocated for investors to buy U.S. Regional Banks on Monday which had traded off significantly since the SVB news.

Sounds like Ackman had some exposure to U.S. Regional Banks.

We are not sure why Sacks, Calacanis, Ackman, and other investors began to publicly panic, you would have to ask them. Perhaps they did believe the banking system needed stability and they believed this was the best way to do it, it's just hard to ignore that they all have large positions in companies connected to SVB or in SVB's sector.

On Sunday the FED announced they would insure all customer deposits giving Ackman and VCs exactly what they wanted:

WASHINGTON, March 12 (Reuters) - New policies adopted on Sunday by U.S. banking regulators will "wipe out" equity and bondholders in Silicon Valley Bank (SIVB.O) and Signature Bank (SBNY.O) of New York while protecting all customer deposits, a senior U.S. Treasury official said.

Both the Treasury and Biden Administration said this move will cost taxpayers $0. The jury is still out on that one. We do not know how this process will happen but expect the federal government to front the difference in SVB's liquidated assets and customer deposits and take on the debt securities that SVB own to maturity to recoup their investment. The one place taxpayers will pay is real returns as the quoted rates on SVBs debt securities (MBS yielding 1.56%) are well below inflation. However, banks could also pay the difference through the Deposit Insurance Fund.

Separately, the FED said it was launching a Bank Term Funding Program that would make additional funding available to banks to meet the needs of their depositors.

Beyond that, this essentially introduces a moral hazard and potentially encourages banks to act as they please and live like it's the Wild West.

New legislation will need to be created to prevent this from happening again. Banks should not prioritize bottom-line income (and its shareholders) at the expense of their depositors.

VCs and their portfolio companies were the most affected by SVB collapsing and the government is bailing them out. The median U.S. bank account has $5,300 in it (Charlie Bilello) and the average U.S. transaction account holds $42,000 in it (JP Morgan Chase). Any deposit account that holds $250,000 or more is likely a corporate account backed by VCs or the personal account of someone very wealthy.

Perhaps the solution for the FDIC is to raise their covered insurance limit. However, that will cost every person more. Perhaps the real solution is a direct fee that could be charged to accounts that need that added insurance. We are not in the business of driving policy and do not follow banking regulations but feel our suggestion is easy to implement and would help.

After SVB failed, Signature Bank defaulted on Sunday. Signature Bank is the 3rd largest U.S. bank to fail.

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Largest U.S. Bank Failures

Bank	City	State	Year	Assets at time of failure
Washington Mutual	Seattle	Washington	2008	$307 billion
Silicon Valley Bank	Santa Clara	California	2023	$209 billion
Signature Bank	New York	New York	2023	$118 billion
Continental Illinois National Bank and Trust	Chicago	Illinois	1984	$40.0 billion
First RepublicBank Corporation	Dallas	Texas	1988	$32.5 billion
IndyMac	Pasadena	California	2008	$32 billion
American Savings and Loan	Stockton	California	1988	$30.2 billion
Colonial Bank	Montgomery	Alabama	2009	$25 billion
Bank of New England	Boston	Massachusetts	1991	$21.7 billion
MCorp	Dallas	Texas	1989	$18.5 billion
FBOP Corp banking subsidiaries	Oak Park	Illinois	2009	$18.4 billion
Gibraltar Savings and Loan	Simi Valley	California	1989	$15.1 billion
First City National Bank	Houston	Texas	1988	$13.0 billion
Guaranty Bank	Austin	Texas	2009	$13.0 billion
Downey Savings and Loan	Newport Beach	California	2008	$12.8 billion
BankUnited FSB	Coral Gables	Florida	2009	$12.8 billion
HomeFed Bank	San Diego	California	1992	$12.2 billion
AmTrust Bank	Cleveland	Ohio	2009	$12.0 billion
WesternBank	Mayaguez	Puerto Rico	2010	$11.9 billion
United Commercial Bank	San Francisco	California	2009	$11.2 billion
Southeast Bank	Miami	Florida	1991	$10.5 billion

CREATIVE PLANNING @CharlieBilello

Signature Bank was a New York-based full-service commercial bank. Like SVB depositors, all Signature depositors will be covered by the government's bailout. As of December 31st, Signature had $110.4 billion in total assets and $88.6 billion in deposits. Equity and bondholders of Signature bank will be wiped out by the bank's default. Signature Bank's customer base included numerous cryptocurrency firms including Coinbase and Paxos.

Signature Bank's stock price plummeted last week due to contagion fears from SVB.

Regulatory filings show that more than $79 billion, or approximately 90% of Signature Bank's deposits were uninsured at the end of last year.

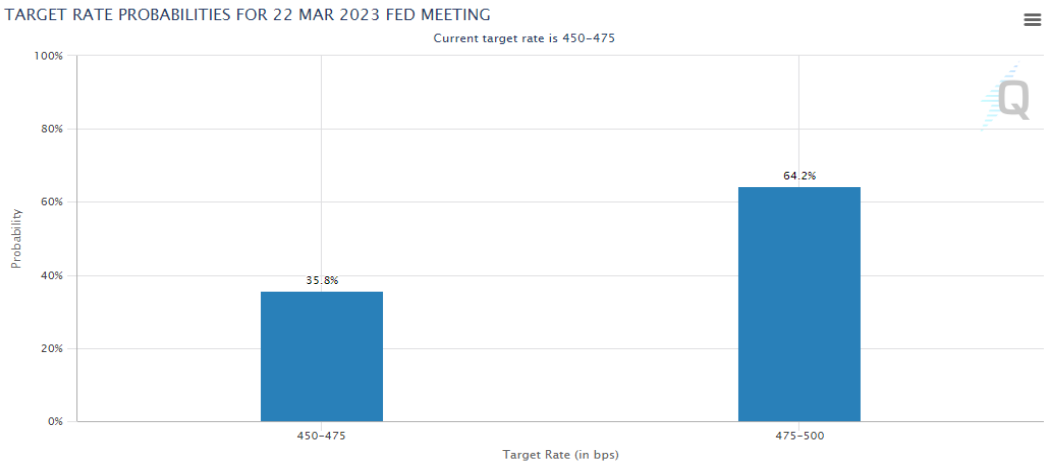
Carnage was not limited to SVB and Signature Bank, First Republic bank dropped 62% on Monday, Western Alliance Bancorporation was down 47%, and PacWest Bancorp was down 21%.

This move by the government will hopefully create stability across financial markets during this period of uncertainty. The major issue with this move by the government is this does not incentivize regional

banks to clean up their acts, it also proves they are willing to bail everything out. The one area where improvement could come is shareholder and debtholder due diligence. Equity and debt holders were wiped out, this will encourage more due diligence by investors even in "safe" sectors like financials.

Instability across the economy and financial markets also has led to some major changes when it comes to analysts predicting what the FED will do.

Just a week ago analysts were projecting a 0.5% interest rate increase, fast forward to Monday and the consensus states that the FED will raise rates by 0.25%, and 35% of analysts believe the FED will pause its interest rate increases. The FED's next meeting is next week.



Even the big boys believe a pause is coming:

U.S. Markets

1 minute read · March 12, 2023 11:02 PM EDT · Last Updated 16 hours ago

Goldman analysts no longer expect Fed rate hike in March after SVB failure

Reuters

Market expectations have completely pivoted in the last 2 weeks when it comes to when the FED will pause – then cut:

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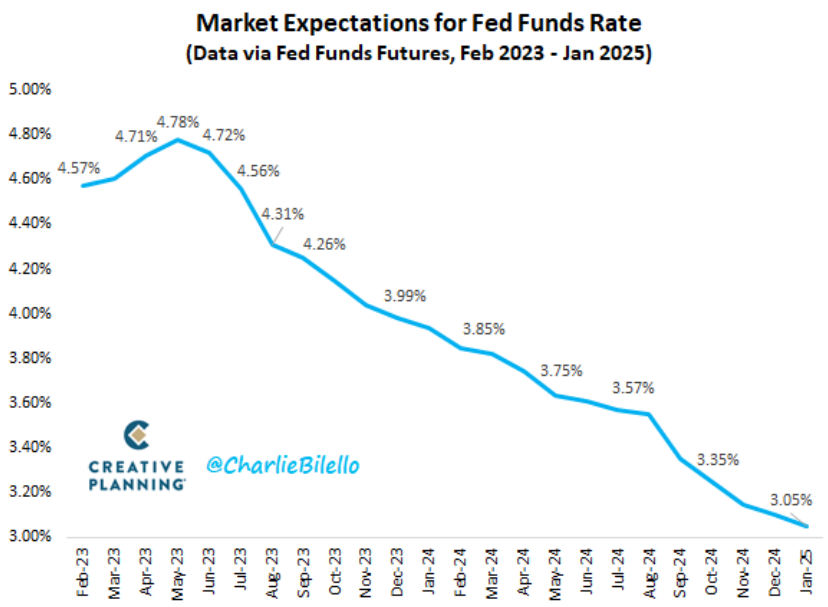

Is this investors being optimistic or is this investors understanding this is a problem that the FED created and they have no way out but to cut rates?

This move by the government to backstop all depositors could have inflationary effects and could be the reason why the FED decides to increase their target inflation rate. The FED could potentially increase its target inflation rate from 2% to 3%.

As expected, Jim Cramer recommended Silicon Valley Bank just one month before it defaulted. On February 8th's edition of Mad Money:

The reverse Cramer never fails.

Forbes even named Silicon Valley Bank one of America's best banks just a week before it failed.

It seems everything Forbes touches also turns to dust (or fraud).

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We will continue to follow the situation.

MacNicol clients have zero exposure to U.S. regional banks and the MacNicol Emergence Fund which invests in private companies had no exposure to Silicon Valley Bank.

Opposing view to what the government did

SVB was bailed out, all depositors will be made full. The venture world can breathe a sigh of relief (for now). Even though many VCs and notable investors like Bill Ackman begged for the FED to step in, not all industry professionals agree with this move.

Ken Griffin, CEO and Founder of Citadel LLC, a multinational hedge fund, and Citadel Securities, a market maker completely disagreed with what the federal government did to backstop Silicon Valley Bank.

The billionaires claimed that "U.S. capitalism is breaking down before our eyes." Griffin went on to say there is a loss of financial discipline with the government bailing out depositors in full.

While we think depositors did no wrong and should not have risk when choosing a bank, the government is intervening in capitalism when they backstop bad business decisions. If the government stops everything from failing, then they are proving quality does not matter.

Griffin claimed that the economy could face this storm and that these companies were very small. He also said losses to depositors would be very minimal and would be immaterial to most clients. He said these consequences would drive home the point that risk management matters.

While Griffin gives some great points that counter the government's move, he has changed the rules when it best suited him (and his company). Citadel reportedly assisted in the restriction of trading on certain platforms during the short squeezes of 2021 when stocks like GameStop and AMC Entertainment surged on retail interest. Everyone has an agenda.

However, if we do not let things fail as a society, nothing will get better. We think there are benefits to what the government did but also major negatives. Bailing out poor management is a slippery slope that we should steer clear of.

February inflation

Inflation came in right at consensus estimates for the year ending February 29th, 2023. The CPI ticked in a 6% down from 6.4% in January.

Just two weeks ago this would be the biggest news across markets but with what has gone on in the banking sector over the last week, it was almost an afterthought.

This was the eighth consecutive month that CPI decreased. This is also the lowest annual inflation rate since September 2021. As we expected most goods have dropped in price which is helping the CPI drop. However, as we expected services inflation is leading the way. Services inflation ticked up 0.1% to increase 0.8% in February. It’s up 8.1% year over year.

Producer prices also came in lower than analysts expected. Perhaps this cycle of inflation is on its way out. The producer price index fell 0.1% for February, below the estimate for a 0.3% increase. On a 12-month basis, the index increased 4.6%, well below the downwardly revised 5.7% level from the previous month.

Here is the U.S. PPI over the last 25 years:

Even though the PPI has retreated, it is still higher now than it was at any point between 2010 and 2020.

Twilight zone

Now that the government backstopped SVB depositors in full, it appears to be the safest place for high-net-worth individuals to store their cash. If you hold less than $250,000 in a chequing account, it does not matter what bank you are at as you are fully insured but if you hold more then that SVB could be a consideration. The government has guaranteed depositors money and has yet to announce a cut-off date for that guarantee which is quite weird. It's weird because some VCs and SVB's new leadership team are encouraging customers to open accounts, they are also encouraging customers who withdrew their funds to bring them back to SVB.

Venture capitalist Sheel Mohnot is encouraged by SVB and encouraging his portfolio companies to use the bank as it’s fully guaranteed by the federal government:

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It gets worse, the new CEO said the company is fully open for business, which means the company will be giving out new loans and taking in new deposits and it looks like (for now) all deposits even if they are new will fully be guaranteed. This guarantee also means depositors do not even have to look at the loans the bank is giving out, no matter the credit quality as even if they are bottom-of-the-barrel crap, depositors will get their money back.

Here is the letter the new SVB CEO sent around:

svb FDIC

Dear Clients:

Yesterday I shared the news that I was appointed as the CEO of Silicon Valley Bridge Bank, N.A. We are doing everything we can to rebuild, win back your confidence, and continue supporting the innovation economy. We recognize the past few days have been an extremely challenging time, and we are grateful for your patience.

We are open for business and are hard at work bringing all systems and solutions back online to support you. We are making new loans and fully honoring existing credit facilities.

The number one thing you can do to support the future of this institution is to help us rebuild our deposit base, both by leaving deposits with Silicon Valley Bridge Bank and transferring back deposits that left over the last several days.

As stated in yesterday's announcement, **depositors have full access to their money and both new and existing deposits are fully protected by the FDIC**. This action by FDIC effectively means that deposits held with SVB are among the safest of any bank or institution in the country.

If you, your portfolio companies, or your firm moved funds within the past week, please consider moving some of them back as part of a secure deposit diversification strategy. We are also open for business for any new customers. We are actively opening new accounts of all sizes and making new loans.

Please reach out to your SVB team with any questions. We will be sharing more updates as we continue our work to support the innovation economy.

Thank you.

Tim Mayopoulos, CEO
Silicon Valley Bridge Bank, N.A.

We are truly in the twilight zone.

What happens to shareholders and debtors if the company does not shut down? Is there a guarantee from the government unlimited? We have no idea but are glad we had no exposure to SVB.

Fears reignited

On Tuesday, investors seemed pleased with what the government had done to guarantee deposits. Markets moved in the right direction and even regional banks which had plummeted in the two previous sessions rebounded quite substantially. All that fear returned on Wednesday.

European banking giant Credit Suisse is the reason. The lending giant is back in the news for all the wrong reasons. Credit Suisse's largest shareholder announced that they would not invest any more money into them. Saudi National Bank Chairman Ammar Al Khudairy told the media outlet that taking a stake of more than 10% in Credit Suisse would trigger regulatory complications.

Credit Suisse shares dropped 24% on the news to a new 52-week low. Credit Suisse shares are now down 76% over the last year and are at their lowest price ever.

The comments by SNB's chair come only weeks after Credit Suisse's former top shareholder, the Chicago-based investment firm Harris Associates, revealed it had dumped its entire stake in the lender in recent months.
Credit Suisse reported a net loss of 7.3 billion Swiss Francs ($7.85 billion USD) for 2023.

Bond yields for Credit Suisse surged on this news. The once-safe investment is now trading at distressed levels.

Credit Suisse has close to $578 billion in assets. Credit Suisse was the 45th largest bank in the world in terms of assets (as of Dec 31, 2021).

Credit Suisse has reportedly reached out to the Swiss National Bank for some assistance. The U.S. Federal Reserve announced that they were monitoring the situation and looking at what exposure they may have with Credit Suisse. Many are looking to the Swiss National Bank to provide some stability to Credit Suisse to help the global economy find some stability.

This edition of *The Weekly Beacon* was our longest yet, but we felt it was needed to explain some major events unfolding in front of our eyes. Although financials are not the most interesting sector to look at, it is important to monitor especially in turbulent times.

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March 17, 2023

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