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The Fed's Boomerang

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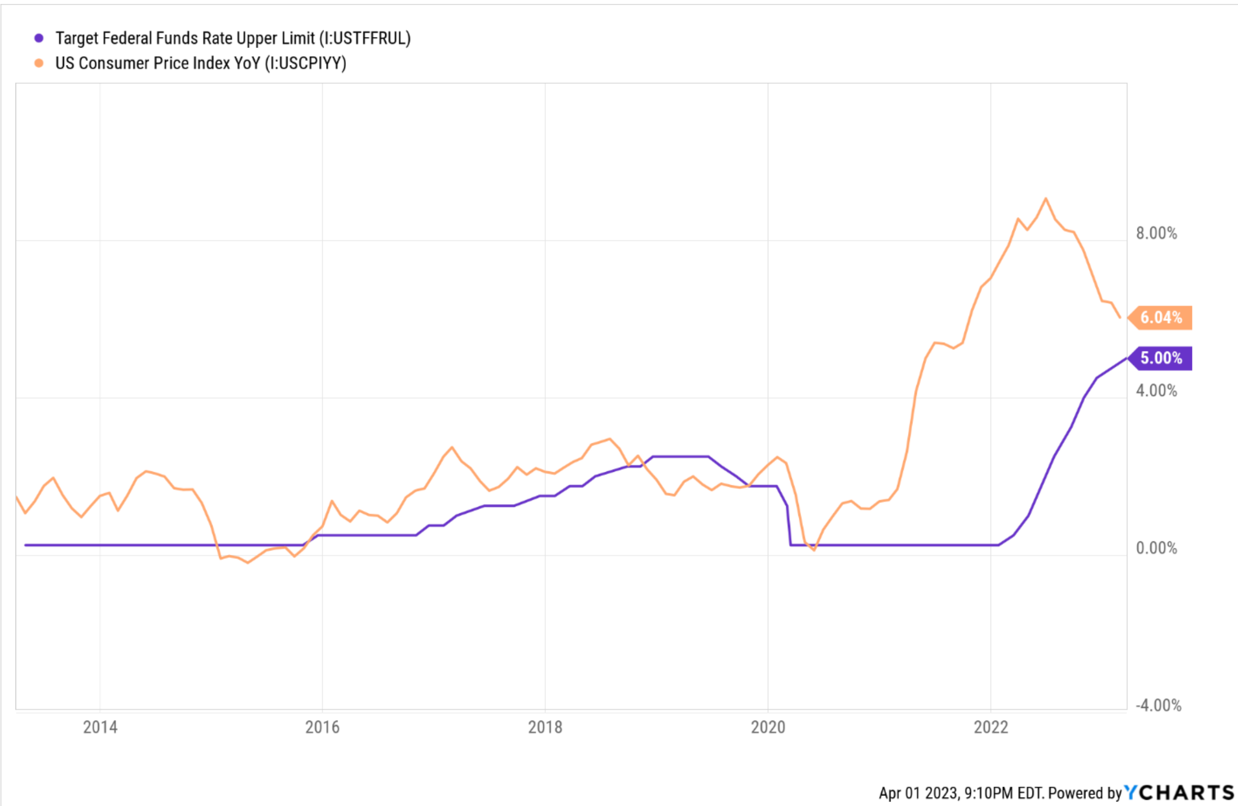
After many years of ultra-low interest rates, the Federal Reserve decided to raise interest rates and close the gap between the inflation rate. The consequences are now reverberating through the financial system.

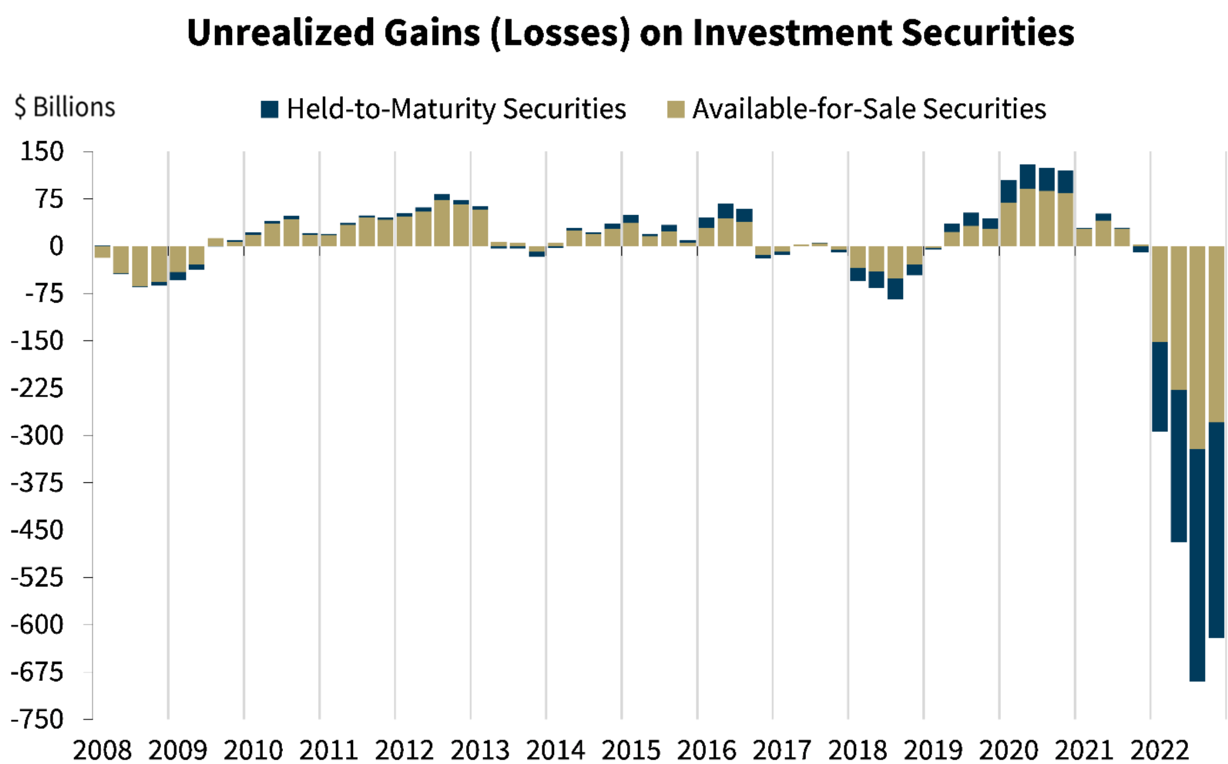


There are two categories for investment securities on a bank's balance sheet: 1) "available for sale" which are marked to current market value, and 2) "held to maturity" which are shown at cost with amortization to maturity of any premium or discount. On the basis of its reported balance sheet for the fourth quarter, Silicon Valley Bank (SVB) had adequate capital. However, in the parenthetical disclosure for its $91.3 billion of held to maturity securities, SVB showed a market value that was $15.1 billion lower than the amortized cost. Adjusting to current market value for its investment securities would reduce the bank's capital from $16.3 billion to $1.1 billion. At the end of 2022, SVB had $173.1 billion of deposits and more than 85% of those deposits were over the FDIC limit and uninsured. Naturally, a run on the bank ensued.

On March 10, the news of the Silicon Valley Bank failure emerged. On March 12, a joint statement was issued by Secretary of the Treasury Janet Yellen, Federal Reserve Board Chair Jerome Powell, and FDIC Chairman Martin Gruenberg. The announcement stated that all depositors of Silicon Valley Bank and Signature Bank of New York would be fully protected. The FDIC deposit coverage above the $250,000 limit was justified by them on the basis of a systemic risk exception, which would most likely be true of any large bank.

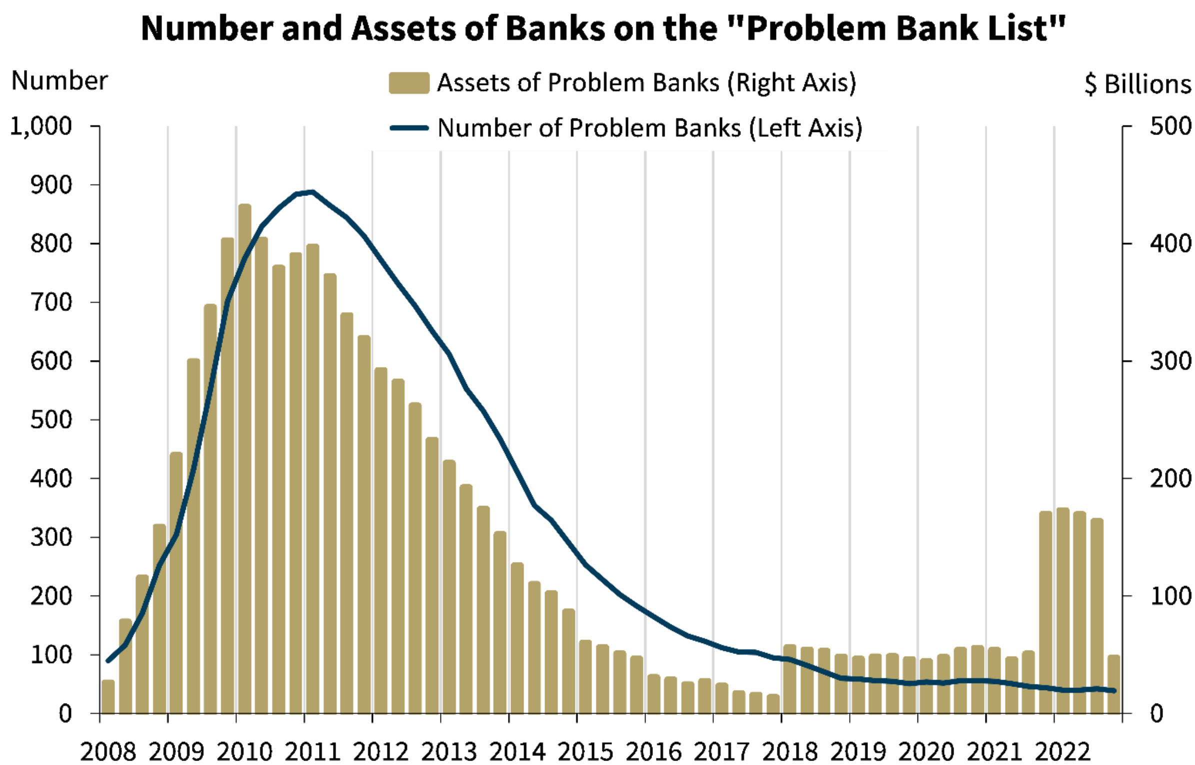
Concerns were then raised by another San Francisco Bay Area bank, First Republic Bank (FRC). In an attempt to calm depositors, five major US banks deposited $30 billion at FRC. Nevertheless, FRC's stock price has declined by 89% during the month of March.

At the end of February, the FDIC released its fourth quarter 2022 review of the banking industry. As interest rates rose during 2022, the unrealized losses on investment securities held by banks expanded to $620 billion.



Source: FDIC.
Note: Insured Call Report filers only.

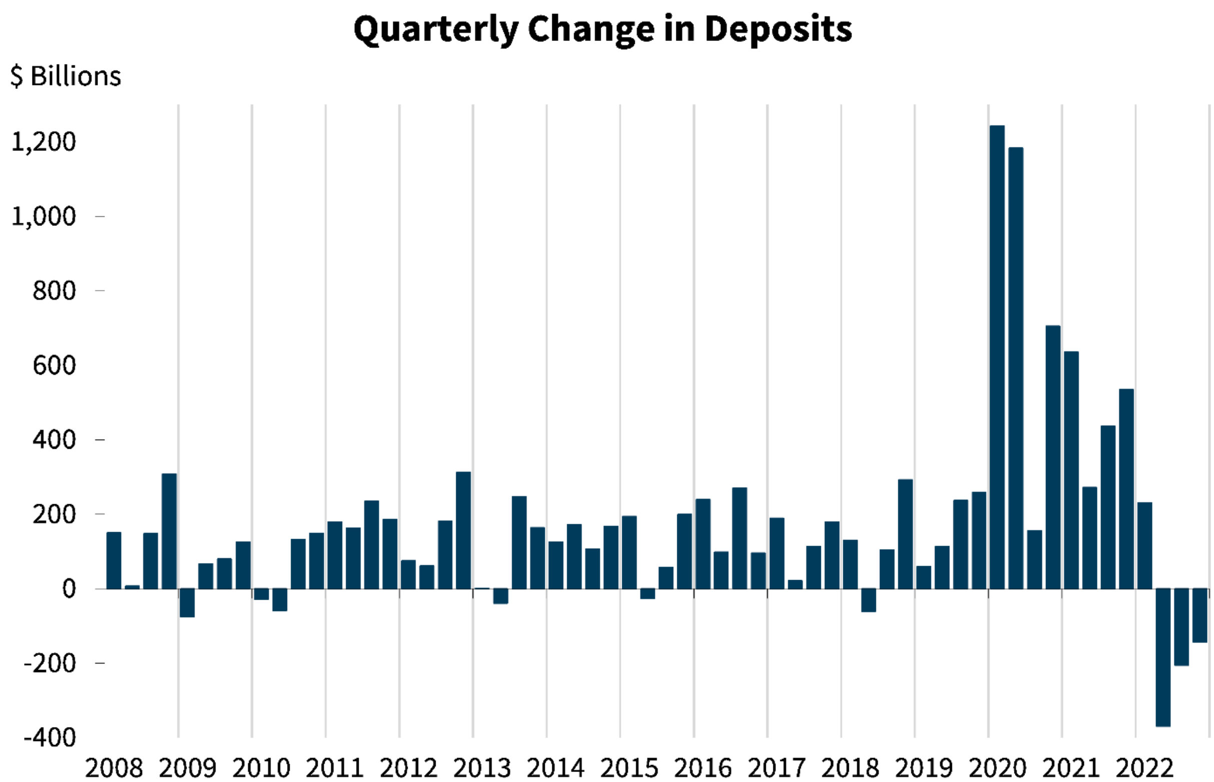
As of the end of 2022, the FDIC had a short list of problem banks, but this will change by the end of the first quarter.



Source: FDIC.
Note: The asset values of insured financial institutions on the problem bank list are what were on record as of the last day of the quarter.

In spite of the higher interest rates in the bond market, banks have not increased interest rates on deposit accounts very much. As a result, some depositors have realized that they can earn 4-5% on short-term US Treasury bills or other fixed income securities. So why leave money in a bank deposit account where it can earn very little interest income? Banks will soon be raising interest rates on deposits if they want to stem the outflow of deposits. They are also likely to tighten credit standards on loans to provide more liquidity and improve capital ratios on their balance sheets.

The Federal Reserve Banks (Fed) are facing the same circumstances as the commercial banks. As of March 29, 2023, the Fed held outright $7.93 trillion of securities. The vast majority of these securities have a lower market price than they did when purchased. However, the Fed assumes that all securities are held to maturity and does not disclose unrealized losses. Furthermore, the Fed currently pays interest of 4.90% on deposits by commercial banks at the Fed, which is higher than the interest rate that the Fed is receiving on some securities.



Source: FDIC.

In the meantime, two headlines from ZeroHedge reflect how the world is changing:

- France Buys 65,000 Tons of LNG from China in First Ever Yuan-Denominated Trade.
- China and Brazil Strike Deal to Ditch the US Dollar. "The deal… will enable China…and Brazil, the biggest economy in Latin America, to conduct their massive trade which amounts to $150 billion per year, and financial transactions directly, exchanging yuan for reals and vice versa instead of going through the US dollar."

The outlook for precious metals remains very favorable.

If you have any questions or comments, please contact me.

Sincerely,
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