The Soundness of the Banking System

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It is often said that the Federal Reserve (Fed) tightens until something breaks. In fact, history is peppered with examples of financial accidents caused by past Fed tightening cycles—Orange County's default (1994), the collapse of Long Term Capital (1998), the bursting tech bubble (2000) and the housing crash (2008). That is why the market has been concerned about the Fed, particularly as the it has raised interest rates at the fastest pace in over 40 years and the full impact—which occurs with a lag—has yet to be seen. Last week's sudden collapse of Silvergate Capital and Friday's failure of Silicon Valley Bank sent shockwaves through the markets, driving the S&P 500 down -4.5%, sending US Treasury yields sharply lower, and wiping out nearly $300 billion market capitalization in the S&P 500 financial sector. The biggest question for investors: are the recent failures manageable events or is there a significant risk of financial contagion that could have downside economic implications?

Before we delve into these questions, let's review what led to demise of Silvergate Capital and SVB Financial, the parent of Silicon Valley Bank. The two banks had a lot in common:

- **Niche Banks |** Both banks were niche players that benefited enormously from areas of the market that flourished during the pandemic tech boom. Silicon Valley Bank catered to venture capital firms and tech start-ups. Silvergate Capital was a major banking partner for the crypto industry.

- **Concentration Risk |** The lack of diverse deposit bases and their concentrated loan books left both banks in a vulnerable position. Once venture capital funds started to struggle to raise capital, liquidity tightened as new deposit flow slowed dramatically. In fact, the bank's clientele started to draw down their deposits at an accelerating pace while they waited for the venture market to recover. The banks were unprepared for this. In addition, with so many companies having large deposits at the bank in excess of $250,000, the vast majority of the deposits were uninsured.

- **The Pace of Interest Rate Moves |** The speed of the Fed's rate hikes over the last year caught the banks by surprise. This exposed a huge mismatch between their assets (investments) and liabilities (deposits), and they were negatively impacted on both fronts. Deposits were getting more expensive to attract as short-term interest rates rose. Meanwhile, as their assets were invested in safe, liquid, high quality Treasurys and mortgages, these long duration bonds were sitting on huge mark-to-market losses due to the sharp rate increases over the last year. For reference, the 10-year Treasury yield increased 237 basis points over the last year alone. When the banks needed to raise cash to meet client deposit withdrawals, they were forced to sell these long duration securities at a loss that reduced their capital base. To be clear, this was not like the Great Financial Crisis where lax lending standards and leverage exacerbated losses. This was a mismatch of asset and liabilities where interest rate moves caught them off guard.

- **Social Media Mania |** The proliferation of social media likely accelerated the failure of Silicon Valley Bank and Silvergate Capital. The speed at which they collapsed felt much like the meme stock mania of late, where investor psychology and rapid-response money flows drive the fate of the company. The hysteria-induced bank run caused clients to withdraw a staggering $42 billion of deposits from Silicon Valley last Thursday, sealing its fate the next morning.

Where Do We Stand Today?

Silicon Valley Bank was taken over by the FDIC on Friday, leaving many tech companies and start-ups scrambling to make payroll and wondering about the fate of their uninsured deposits (above the FDIC's $250,000 threshold) over the weekend. In addition, the third bank in a week, Signature Bank, failed yesterday.

The Government Reaction to Stabilize Markets:

- **New Facility |** To prevent further financial contagion and to ensure public confidence in the banking system, the Fed, Treasury and FDIC introduced a new loan facility—the Bank Term Lending Program (BTLP)—on Sunday evening. This emergency facility will provide loans up to a period of 12 months to help banking institutions access capital when needed. One important dynamic of this facility is that banks can pledge their bonds (that are enduring unrealized losses) as collateral

and receive the par value of those investments as a loan. This helps avoid banks selling their investments at depressed levels.

- **Full Depositor Access |** The Fed, Treasury and FDIC announced they will be making the depositors of Silicon Valley Bank and Signature Bank whole as they will be able to access their full deposits as of today.

- **Restoring Confidence in Banking |** These swift actions should arrest concerns that there may be other banks lurking in the shadows with similar hidden risks. At a minimum, it should help reduce the potential of significant outflows of bank deposits at some institutions.

Implications for the Fed and the Economy?

The failure of SVB is a true game changer for the Fed and could change not only the narrative from the central bank but has the potential for changing the path as well as the direction of interest rates, depending on how these events play out in the coming days, weeks, and months. For now, the probability of a March increase in the federal funds rate is less certain than it was last week and the end result will depend on the evolution of this crisis up until the Federal Open Market Committee (FOMC) meeting on March 21-22. Despite current uncertainty, we still believe that the Fed will raise rates by 25bps next week as bringing down inflationary pressures remain a priority.

Although the characteristics of the failed banks are highly particular to their niche markets as we mentioned above and should not create systemwide contagion, bank runs are unpredictable. However, the central bank, that is, the Fed, remains as the "lender of last resort" and will be ready to backstop any potential run against the banking system. The Fed has already created the BTLP program to inject liquidity for banks that need it and will continue to assess the risks to the system and provide resources as the system needs them.

For the US economy, the potential effects are less clear, as they will depend on how the current crisis evolves over time and what the Fed decides to do with interest rates. We will continue to monitor the events and make the necessary changes to our forecast.

Implications for the Fixed Income Market?

The collapse of Silicon Valley Bank and the new Bank Term Lending program are game changers. The creation of the Bank Term Lending Program should relax concerns about broader financial contagion. However, it also shows that the Fed is becoming increasingly concerned about financial stability risks in the wake of the three bank failures over the last week.

While Chairman Powell opened the door for a potential 50 basis point rate hike during his testimony to Congress last week, the recent strains in the financial sector have taken this off the table for now. Market expectations for the peak fed funds rate continue to whip around—climbing to a cycle high of 5.7% after Powell's hawkish testimony early last week to ~5.1% as of this morning. Rate cuts by year end are once again a possibility. While past crises have historically led to easier monetary policy, the Fed does not have the same flexibility today with inflation remaining elevated. But it does tell you that the Fed will need to tread carefully from here.

Meanwhile, the SVB crisis sparked a huge flight to quality across the entire yield curve, sending the 2-year Treasury yield down ~90 basis points from a peak above 5% last week and the 10-year to 2-year spread reversing some of its extreme inversion. These moves highly suggest that the market thinks the Fed may be done and a recession could be nearing. This does not bode well for lower-quality credits like high yield bonds. Our preference remains for higher quality bonds. It also suggests that the cyclical peak for yields is likely in.

Implications for the Equity Market?

Patience remains a virtue as we reiterate our 4,400 2023 year-end target on the S&P 500 that has held through multiple narrative shifts in the first quarter. The year started with a soft-landing narrative with the Fed pausing and eventually cutting, then to a no landing with heightened inflation and higher rates and now to a banking crisis. While we've held steady with our 4,400 target, this most recent narrative shift does not cause us to change our long-term optimistic view on the equity market. Why?

- **Don't Fight the Fed |** This banking crisis has likely caused the Fed to rethink the aggressiveness of further interest rate hikes moving forward. For example, rather than the debate of 0.50% or 0.25% at the March 21-22 meeting, the debate will be staying on hold versus 0.25%. The increase in potential financial market instability should cause the Fed to modify their views moving forward. Historically, the end of a tightening cycle is a positive catalyst for the equity market.

- **Lower Interest Rates |** Lower short-term interest rates (as the Fed ends its tightening cycle soon) and lower long-term interest rates (as we believe the 10-year

Treasury yield has peaked) should be positive for the equity market. This is positive for equities for many reasons, including lower funding costs and higher potential multiples. In addition, these lower rates should provide a boost for growth stocks.

- **Contagion Risk Limited, But Not Zero |** Outside of the Financials sector we expect the impact of this crisis to be minimal given the backstop of uninsured depositors. Within Financials we favor larger higher quality institutions over smaller regional banks. There remains the risk that some smaller regional banks could struggle from potential deposit outflows. This crisis also highlighted the need for continued competitive deposit rates that may strain profitability in the sector. More regulation and increased oversight will also potentially hamper earnings growth for these regional banks.

- **Restate $215 Earnings Forecast |** Assuming no contagion, our 2023 earnings forecast for the S&P 500 remains unchanged. If anything, the early year strength of the economy, the weakening dollar and cost cutting of companies leads to upside risk to that forecast.

The equity market is likely to be volatile in the near term as the market sifts through the potential impact of this recent banking crisis. But for long-term investors, prudence and keeping a long-term perspective are paramount in avoiding emotionally driven portfolio changes.

Bottom Line

The recent failure of three banks is an unfortunate result of the rapid rise in interest rates to combat the unprecedented rise we have seen in inflation. The quick response from regulators and the creation of a lending facility should limit the contagion fall-out to the broader economy and financial markets. The silver lining may be that the Fed moves more slowly in raising interest rates and may potentially end its tightening cycle earlier which should be a positive for the economy and both the fixed income and equity markets. As this is a very fluid situation, we will continue to provide necessary updates as needed.

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