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PRIVATE WEALTH

The Week Ahead

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March 13, 2023

Week of
March 13, 2023

Bank Run Fears Trump Fear of Higher Rates

As we near the Ides of March, there are widespread concerns that cracks are beginning to show in the U.S. financial system. But are we facing a historic turning point? We believe no.

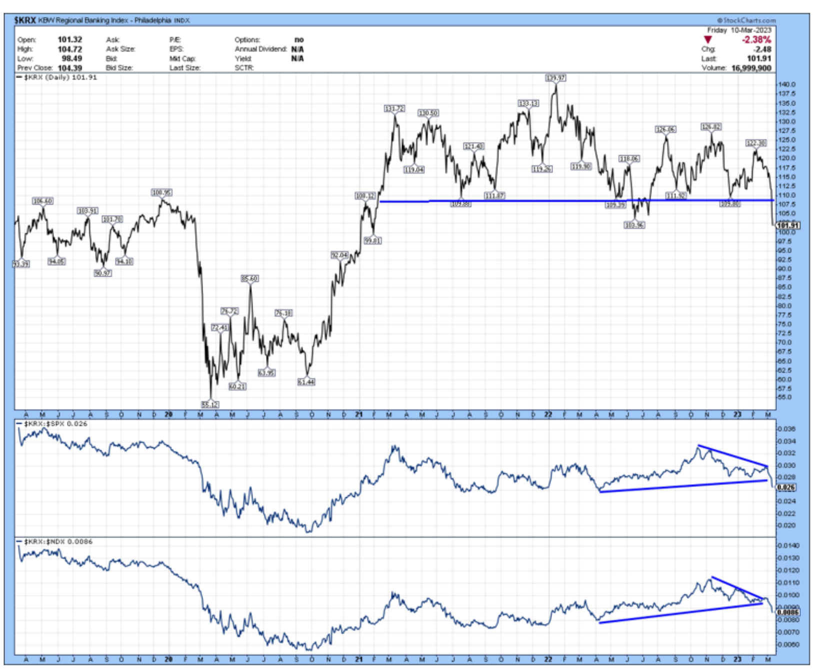
Last Thursday, concerns emerged on the credit risk of Silicon Valley Bank (SVB), and fear of a run on that bank spread like a contagion to other banks, particularly to the regional banks. This wave came on the heels of fears caused by the voluntary shutdown of Silvergate Bank, operated by Silvergate Capital Bank (SI), which was heavily leveraged to the crypto market.

Higher interest rates now appear to be having an impact on a select area of the financial system. We must emphasize that the major commercial banks are heavily regulated and monitored and are required to have a solid capital base that satisfies Federal Reserve stress tests. These banks also have a more diversified business mix (unlike SVB and Silvergate). But these banks' stocks were hit last Thursday and Friday in sympathy.

The regional banks have broken down technically, indicating the likelihood these stocks are going to remain under pressure. The big banks are also under pressure – but not as bad as the regionals. The silver lining of last week's action was a positive diversification created by a flight to safety as the Treasury market saw rates falling on both the short and long ends.

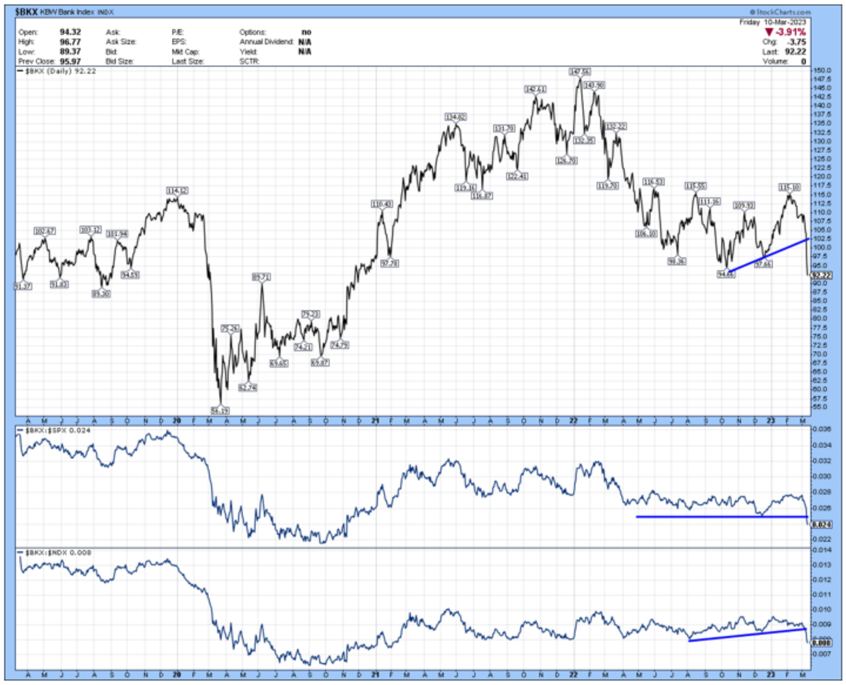
This is a time for patience not panic as deposits are safe with the Fed backstopping this banking crisis. Historically, when policy makers begin to panic you are near the lows of the market. But do expect volatility to continue as the market digests what all this means.

KBW Regional Banking Index (KRX)



Source: StockCharts.com, March 10, 2023

KBW Bank Index (KBX)



2023

What Happened to SVB

What we saw last week was an old-fashioned run on a bank. Some are calling this a digital run as this all started with a tweet. Back in the 1800s, long before regulations, bank failures were common. But let's look at modern history. SVB Financial Group (SIVB), parent company of Silicon Valley Bank, which was well known as a start-up lender for technology and healthcare companies, failed last Friday. This is the largest bank to fail since the 2008 financial crisis when Washington Mutual went under. The collapse of SVB, following the closure of Silvergate Bank by Silvergate Capital (SI), left billions of dollars belonging to companies and investors stranded.

California banking regulators closed Silicon Valley Bank and appointed the Federal Deposit Insurance Corporation (FDIC) as receiver for later disposition of its assets.

Based in Santa Clara, SVB was ranked as the 16th biggest bank in the U.S. at the end of 2022, with about $209 billion in assets according to the Federal Reserve. The main office and all branches of Silicon Valley Bank reopen today and all depositors will have full access to deposits.

The process for accessing the uninsured deposits is more complicated. The FDIC has said uninsured deposits will receive a dividend within a week, covering an undetermined amount of their money and a "receivership certificate for the remaining amount of their uninsured funds." (Note: deposits up to $250,000 are insured by the FDIC.) "As the FDIC sells the assets of Silicon Valley Bank, future dividend payments may be made to uninsured depositors," said the regulator. Restoring confidence is key to the markets.

So, What Sparked The Run?

It is important to note that SVB had an unusual concentration in deposits from a specific client base. SVB had a concentration of start-up companies in the areas of technology and healthcare. Peter Thiel of Founders Fund, a San Francisco-based venture capital firm investing in companies building revolutionary technologies, was advising his firm's portfolio companies to pull money from SVB as a precaution last Thursday – that triggered a panic and a run on the bank began.

U.S. venture capital-backed companies raised $330 billion in 2021 almost double the previous year. SVB took in tens of billions of dollars from its clients and parked them into longer dated Treasuries. As interest rates rose the sharpest in history, losses began to amount in SVB's Treasury portfolio.

As cash lending from the VC community dried up, many of SVB's clients began to withdraw deposits as more demand for cash was needed. According to Bloomberg, "Severe losses on the long-term bonds purchased during the rapid deposit growth had mark-to-market losses in excess of $15 billion at the end of 2022 for securities held to maturity, almost equivalent to its equity base of $16.2 billion." These losses referenced reflect unrealized losses on the balance sheet at the end of 2022. It should be noted that only one analyst on Wall Street had a sell recommendation on the stock out of 26 who covered SVB's stock prior to this event occurring.

According to news reports a week prior, Moody's Investors Services – a credit rating agency – notified SVB that with the bank's unrealized losses the risk was a credit downgrade and potentially more than one level. This put the bank in a tough spot. To shore up its balance sheet, it would need to offload a large portion of its bond investments to increase liquidity. So, the bank along with its advisor Goldman Sachs Group, decided to sell the portfolio – for a realized loss of $1.8 billion, according to CNBC. SVB also announced a $2.25 billion equity raise last Wednesday and this started the panic.

Despite these efforts, Moody's still downgraded the company one notch, as did the S&P credit agency. Reassurances from SVB were not enough to stop a run – and with the run on the bank beginning, the equity raise was canceled, and the bank looked for a buyer – a strategy that also failed.

Depositors withdrew more than $42 billion by the end of the day Thursday, setting up the second largest bank failure in U.S. history. (Largest was Washington Mutual in 2008, bought by JPMorgan Chase for $1.9 billion.)

Here's an important take from Credit Insights: "... this, from SVB's 10-K, is not a liquidity risk factor we typically see in bank 10-Ks (emphasis ours): 'Much of the recent deposit growth was driven by our clients across all segments obtaining liquidity through liquidity events, such as IPOs, secondary offerings, SPAC fundraising, venture capital investments, acquisitions and other fundraising activities—which during 2021 and early 2022 were at notably high levels....our level of deposits also depends on whether clients determine to keep proceeds from liquidity events and other funds in deposit products with us (as opposed to off-balance sheet products, such as thirdparty money market funds). Although clients have historically retained a significant portion of their funds on our balance sheet, clients began to move more funds off balance sheet in the second half of 2022."

Credit Insights summarizes the events at SVB as: "Our initial take is that the issues at SVB are idiosyncratic based on its business model and especially its funding profile and are not a reflection of broader banking system issues. The situation says more about "SV" than "B", that is, more about the dynamics playing out in the Silicon Valley VC investing ecosystem than it does about the banking industry as a whole."

There was no choice but for the regulators to step in on Friday.

Silicon Valley Bank Customers to Have Access to All Money and Signature Bank Depositers to be Made Whole

Late Sunday night, the Treasury Department, Federal Reserve and Federal Deposit Insurance Corporation announced:

"Today we are taking decisive actions to protect the U.S. economy by strengthening public confidence in our banking system. This step will ensure that the U.S. banking system continues to perform its vital roles of protecting deposits and providing access to credit to households and businesses in a manner that promotes strong and sustainable economic growth. After receiving a recommendation from the boards of the FDIC and the Federal Reserve, and consulting with the President, Secretary Yellen approved actions enabling the FDIC to complete its resolution of Silicon Valley Bank, Santa Clara, California, in a manner that fully protects all depositors.

Depositors will have access to all of their money starting Monday, March 13. No losses associated with the resolution of Silicon Valley Bank will be borne by the taxpayer. We are also announcing a similar systemic risk exception for Signature Bank, New York, New York, which was closed today by its state chartering authority. All depositors of this institution will be made whole. As with the resolution of Silicon Valley Bank, no losses will be borne by the taxpayer. Shareholders and certain unsecured debtholders will not be protected. Senior management has also been removed. Any losses to the Deposit Insurance Fund to support uninsured depositors will be recovered by a special assessment on banks, as required by law. Finally, the Federal Reserve Board on Sunday announced it will make available additional funding to eligible depository institutions to help assure banks have the ability to meet the needs of all their depositors. The U.S. banking system remains resilient and on a solid foundation, in large part due to reforms that were made after the financial crisis that ensured better safeguards for the banking industry. Those reforms combined with today's actions demonstrate our commitment to take the necessary steps to ensure that depositors' savings remain safe."

Monday morning, it was announced that in the UK, HSBC Holdings Plc was acquiring the UK arm of Silicon Valley Bank.

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What the Fed Will Be Providing

The Fed also announced a new "Bank Term Funding Program" that offers one-year loans to banks under easier terms than it typically provides. $25 billion is available. The central bank also relaxed terms for lending through its discount window, its main direct lending facility. Bloomberg reported that "under the new US program, which provides loans of up to one year, collateral will be valued at par, or 100 cents on the dollar. That means banks can get bigger loans than usual for bonds, reducing the pressure to generate cash by selling securities whose prices have tumbled."

Important Context for the SVB Failure

The FDIC estimated that U.S. banks had a combined $620 billion in unrealized losses on securities in 4Q22. The Bank of St. Louis recently wrote, "For many banks these unrealized losses will stay on paper. But many others may face actual losses if they have to sell securities for liquidity or other reasons."

We must remember that the big banks are subject to annual stress tests administered by the Federal Reserve to ensure they have sufficient capital to withstand market and economic shocks. Large banks also have a very diversified business model and are not concentrated like Silicon Valley Bank or Silvergate.

Back in 2018, some of the regulations were relaxed for smaller banks (those below $250 billion), as they were not deemed as having systemic risk. There are current fears that any deposits that are not insured in other smaller banks will get withdrawn creating additional runs on banks.

If history is a guide, when a financial crisis arises, the Federal Reserve steps in and provides liquidity and, if necessary, lowers rates. Remember: the role of the Central Bank is to be the lender of last resort. Given the current inflation concerns the Fed will likely attempt all measures of assistance – without lowering interest rates. But if all this is not enough, the Fed will most likely consider a rate cut. As of Monday morning, the markets are betting on less Fed with the Fed Funds futures market pricing in a peak rate falling from 5.69% on last Wednesday to 4.82% today or a drop of 87 basis points. Monday morning former Fed Vice Chair Roger Ferguson said on CNBC that a 50 basis points hike is off the table, maybe a 25 basis point hike but early to say, but if markets remain fragile a pause will be on the table.

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In Other News

Initial Jobless Claims Up – A Positive

Jobless claims have risen to 211,000, coming in above 195,000 – a level last seen in December. The bond market took this data as a positive and rates responded positively. Yields on the 2-year Treasury ticked up to 5.08% the day prior the jobless claims announcement but fell to 4.87% on the claims data release. Since the banking crisis, these rates have continued to fall. We expect the Fed to view this data as a positive, but the upward trend needs to continue.

Weekly Initial Jobless Claims

Source: Bloomberg, March 12, 2023

Jobs – Not as Bad as Feared

Last week, non-farm payroll and private payrolls came in higher than expected but the unemployment rate went up to 3.6% from 3.4% which had been a 53-year low. Meanwhile, average hourly wages came in lower than expected (year-over-year 4.6%, down from 4.7%). Initially the market acted favorably to this data, but with the events escalating with SVB, the market went down sharply.

S&P 500

The S&P 500 broke short-term support levels as the events of SVB unfolded on Friday. The target range of next support is 3800-3700. When a crisis like this happens, you are typically near the last leg of the bear market. Bear markets in a secular bull market are great buying opportunities but are challenging because the news at the time is just not good.

The U.S. has been through many crisis events, including the Continental Illinois bank failure in 1984, which was the seventh largest bank at the time, the crash of 1987, the S&L Loan crisis in the 1980s & 1990s, Russia's default bringing Long Term Capital Management (LTCM) down, the Great Financial Crisis of 2008 & 2009 and the European debt crisis of 2012. There have been many events that felt bad but were resolved – though resolutions can take time. This is a time for patience not panic as deposits are safe with the Fed backstopping this banking crisis. Historically, when policy makers begin to panic you are near the lows of the market. But do expect volatility to continue as the market digests what all this means.

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S&P 500 Index

Source: StockCharts.com, March 10, 2023

Russell 2000 Index Feels Brunt of Regional Bank Decline

With regional banks taking a huge hit last Friday as SVB was shut down by the FDIC, there was panic and other regional banks were sold off sharply, taking the Russell 2000 small cap index down almost 3%. Small caps do have the best valuations in the market and have been favored. As this banking crisis is worked through, small cap stocks are at risk of remaining under pressure and underperform large cap stocks as this index has many of the small banks in it.

iShares Russell 2000 ETF (IWM)

Source: StockCharts.com, March 10, 2023

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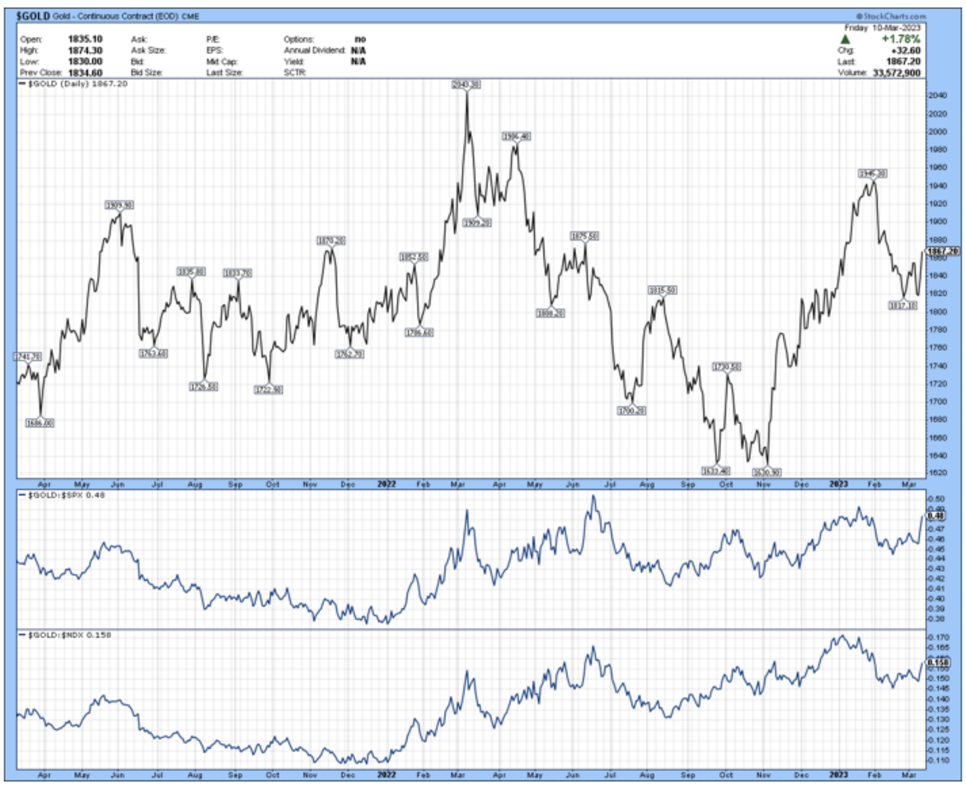
Gold Shining On Through

Gold is traditionally a market hedge outside of cash during a crisis but does not have a yield. With cash having a yield near 5%, many would prefer cash as a hedge. Given the recent events, we took a look at how gold is performing. Gold is performing as expected during a crisis: rising and outperforming the markets. Gold is likely to continue to rise until the crisis in the banks has ebbed. The potential technical trading range is up to $1940-$1960, a break above this level would suggest a move to $2000. We don't see much of panic to gold at this time.

Gold



Source: StockCharts.com, March 10, 2023

Volatility Spikes

Volatility, as seen in the VIX volatility index (VIX), is picking up given the stress in the market from the SVB failure and its ripple effects. The VIX had a big spike on Friday, hitting near 29. As fallout from the failure of SVB continues and depending on if the Fed continues to raise interest rates, volatility could continue to remain elevated.

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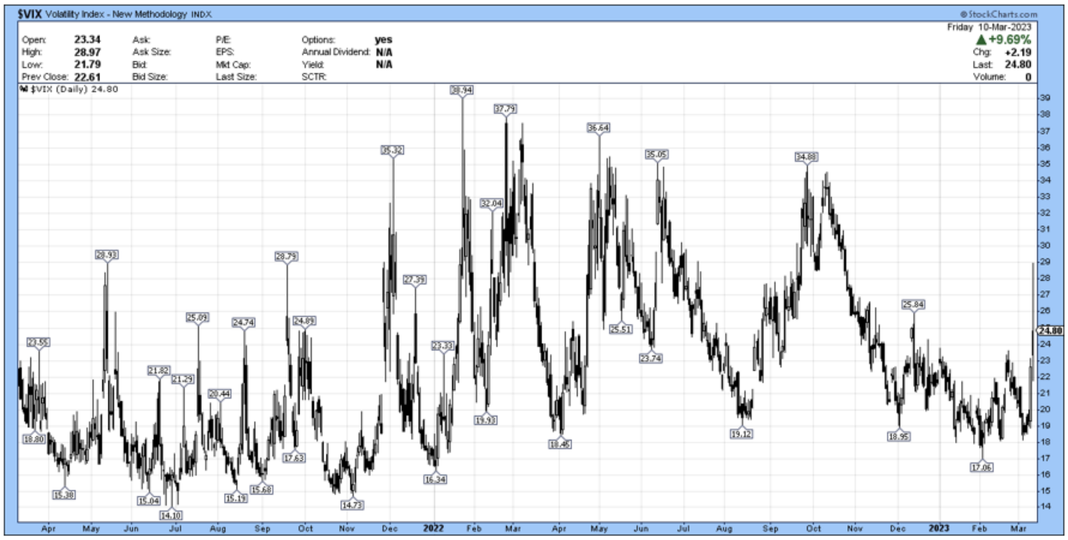
VIX Volatility Index



Source: StockCharts.com, March 10, 2023

Uncertainty: You Can Bank on It

This is the week that SVB's failure might derail expectations for the Fed's next move

SVB and its aftermath will dominate headlines this week, but the war on inflation will continue. This is the week the Ides will be upon us, and as I've said, it could be a dangerous week. All eyes will be on CPI (Tuesday) and PPI (Wednesday) data, which we would typically look to as an augur for the Fed's impending rate hike (March 22). But now, we'll have to add the SVB fallout into the mix. Keep your eyes open, but above all, remain patient.

Programming Note

Please tune in on Tuesday, March 14th for Mary Ann Bartel's appearance on FOX Business with Maria Bartiromo at 7:00 a.m. ET.

Calendar

Mon.

Earnings: **GitLab, Ko**diak Sciences

Tue.

6:00 a.m. NFIB Optimism index
8:30 a.m. Consumer price index, Real hourly earnings
Earnings: Caleres, Guess?, IHS Holding, Lennar, SentinelOne, StoneCo

Wed.

8:30 a.m. Retail sales, Producer price index, Empire State manufacturing
10:00 a.m. Homebuilders' survey
Earnings: Adobe, Array Technologies, Ebix, Five Below, Franco-Nevada, Oatly Group, Proterra, The Children's Place, UiPath, ZTO Express

Thu.

8:30 a.m. Initial jobless claims, Import price index, Housing starts, Building permits, Philadelphia Fed manufacturing
Earnings: Academy Sports + Outdoors, Designer Brands, Dollar General, Fedex, G-III Apparel, Hello Group, Jabil, Signet Jewelers, Titan Machinery, Traeger, Williams-Sonoma, Yamana Gold

Fri.

9:15 a.m. Industrial production, Capacity utilization
10:00 a.m. Algonquin Power & Utilities, Ballard Power

Source: MarketWatch Kiplinger

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