CORBETT ROAD
WEALTH MANAGEMENT

MACRO MUSINGS

March 15, 2023

Bank Failures Elicit Government Action

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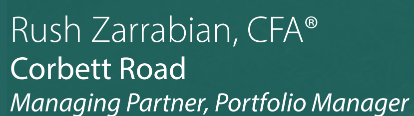

SUMMARY

- The **macro**cast™ score suggests the probability of a recessionary bear market remains elevated. **micro**cast™ shifted to a neutral allocation as the market rally began losing momentum, and the signal continues to reflect the uncertainty and volatility present in current market conditions.
- The banks that have failed over the past week were among the riskiest financial institutions, given their outsized exposure to clientele in the tech industry. Still, the collapse of these banks highlights the consequences of the Fed's rapid shift in monetary policy. Following a multi-year period of zero interest rate policy, the Fed has increased interest rates at a historic pace bring down inflation. The speed of this tightening and the sharp draining of liquidity creates stress on the financial system.
- Markets have been quick to adjust their rate hike expectations in the fallout from these failures. Fed Funds futures are now pricing in a 25 bp rate hike next week, and even the possibility of no action at all. If the turmoil in the banking sector continues, the Fed may pause raising rates for the foreseeable future.

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FIRST BANK FAILURES SINCE 2020...
MORE TO COME?

On Friday, March 10th, the Federal Deposit Insurance Corporation (FDIC) shut down Silicon Valley Bank(SVB). After realizing losses tied to their bond investments, the bank's parent company sought to raise capital on Wednesday, startling investors and triggering a selloff in the stock's price. The deal quickly fell apart, and within 48 hours, the bank was seized by regulators.

SVB was not a small institution. SVB, as well as Signature Bank, which was shut down on Sunday, were among the 25 largest US banks in terms of assets (table from LPL):

By The Numbers - Top 25 Publicly Traded U.S. Banking Institutions
Unique deposit and business exposures contributed to troubles for SIBV and SBNY

	Name	State	Total Asets ($mil)	Unrealized Gain/(Loss) ($mil)	Total Deposits ($mil)	Deposit Growth YoY (%)	Total Equity ($mil)	Earning Assets ($mil)	FDIC Tot. Securities ($mil)	Securities as a % of Earning Assets	Securities as a % of Tot. Deposits	Securities as a % of Tot. Assets	Unrealized Loss as a % of Tot. Equity	Tier 1 Capital Ratio (%)
1	JPMORGAN CHASE & CO	NY	$ 3,665,743	$ (17,026)	$ 2,340,179	-5.0	$ 292,332	$ 3,190,226	$ 631,229	19.8%	27.0%	17.2%	-5.8%	14.9
2	BANK OF AMERICA CORP	NC	$ 3,051,375	$ (16,083)	$ 1,930,341	-4.6	$ 273,197	$ 2,678,988	$ 853,651	31.9%	44.2%	28.0%	-5.9%	13
3	CITIGROUP INC	NY	$ 2,416,676	$ (7,952)	$ 1,365,954	3.7	$ 201,838	$ 2,173,652	$ 514,469	23.7%	37.7%	21.3%	-3.9%	14.8
4	WELLS FARGO & CO	CA	$ 1,881,016	$ (11,590)	$ 1,383,985	-6.6	$ 181,875	$ 1,652,380	$ 410,738	24.9%	29.7%	21.8%	-6.4%	12.11
5	GOLDMAN SACHS GROUP INC	NY	$ 1,441,799	$ (2,126)	$ 386,665	5.3	$ 117,189	$ 1,106,896	$ 100,581	9.1%	26.0%	7.0%	-1.8%	16.6
6	MORGAN STANLEY	NY	$ 1,180,231	$ (4,437)	$ 356,646	-0.6	$ 101,231	$ 1,071,386	$ 159,965	14.9%	44.9%	13.6%	-4.4%	17.2
7	US BANCORP	MN	$ 674,805	$ (13,187)	$ 524,976	15.1	$ 51,232	$ 544,587	$ 161,650	29.7%	30.8%	24.0%	-25.7%	9.8
8	PNC FINANCIAL SERVICES GROUP	PA	$ 557,263	$ (13,419)	$ 436,282	-4.6	$ 45,812	$ 493,689	$ 139,341	28.2%	31.9%	25.0%	-29.3%	10.4
9	TRUIST FINANCIAL CORP	NC	$ 555,255	$ (10,542)	$ 413,495	-0.7	$ 60,537	$ 481,077	$ 129,514	26.9%	31.3%	23.3%	-17.4%	10.5
10	BANK OF NEW YORK MELLON COR	NY	$ 405,783	$ (2,913)	$ 278,970	-12.7	$ 40,850	$ 257,628	$ 142,816	55.4%	51.2%	35.2%	-7.1%	14.4
11	STATE STREET CORP	MA	$ 301,450	$ (955)	$ 235,464	-7.7	$ 25,191	$ 244,887	$ 105,279	43.0%	44.7%	34.9%	-3.8%	15.4
12	CITIZENS FINANCIAL GROUP	RI	$ 226,733	$ (3,870)	$ 180,724	17.1	$ 23,690	$ 200,846	$ 33,841	16.8%	18.7%	14.9%	-16.3%	11.1
13	FIRST REPUBLIC BANK/CA	CA	$ 212,639	$ (300)	$ 176,437	12.9	$ 17,446	$ 198,587	N/A	N/A	N/A	N/A	N/A	11.56
14	SVB FINANCIAL GROUP	CA	$ 211,793	$ (2,580)	$ 173,109	-8.5	$ 16,295	$ 194,304	$ 117,396	60.4%	67.8%	55.4%	-15.8%	15.44
15	FIFTH THIRD BANCORP	OH	$ 207,452	$ (6,331)	$ 163,690	-3.3	$ 17,327	$ 183,077	$ 50,632	27.7%	30.9%	24.4%	-36.5%	10.52
16	M & T BANK CORP	NY	$ 200,730	$ (722)	$ 163,515	24.3	$ 25,318	$ 181,855	$ 24,281	13.4%	14.8%	12.1%	-2.9%	11.79
17	KEYCORP	OH	$ 189,813	$ (5,704)	$ 142,595	-6.5	$ 13,454	$ 172,753	$ 47,827	27.7%	33.5%	25.2%	-42.4%	10.6
18	HUNTINGTON BANCSHARES INC	OH	$ 182,906	$ (3,544)	$ 147,914	3.2	$ 17,769	$ 166,522	$ 40,474	24.3%	27.4%	22.1%	-20.0%	10.99
19	REGIONS FINANCIAL CORP	AL	$ 155,220	$ (3,692)	$ 131,743	-5.3	$ 15,951	$ 135,327	$ 28,734	21.2%	21.8%	18.5%	-23.2%	10.9
20	NORTHERN TRUST CORP	IL	$ 155,037	$ (1,471)	$ 123,932	-22.5	$ 11,260	$ 137,798	$ 51,700	37.5%	41.7%	33.3%	-13.1%	12.5
21	SIGNATURE BANK	NY	$ 110,364	$ (2,232)	$ 88,590	-16.5	$ 8,013	$ 101,894	N/A	N/A	N/A	N/A	N/A	11.2
22	FIRST CITIZENS BCSHS -CL A	NC	$ 109,298	$ (730)	$ 89,408	73.9	$ 9,662	$ 95,140	$ 19,272	20.3%	21.6%	17.6%	-7.6%	11.06
23	NEW YORK COMMUNITY BANCOR	NY	$ 90,144	$ (599)	$ 58,721	67.5	$ 8,824	$ 80,457	$ 9,060	11.3%	15.4%	10.1%	-6.8%	9.78
24	ZIONS BANCORP NA	UT	$ 89,545	$ (3,033)	$ 71,652	-13.5	$ 4,893	$ 84,063	N/A	N/A	N/A	N/A	N/A	10.5
25	COMERICA INC	TX	$ 85,406	$ (2,903)	$ 71,397	-13.3	$ 5,181	$ 75,816	$ 19,012	25.1%	26.6%	22.3%	-56.1%	10.5

Source: LPL Research, Bloomberg 3/12/2023
Company data is as of 12/31/2022
Past performance is no guarantee of future results

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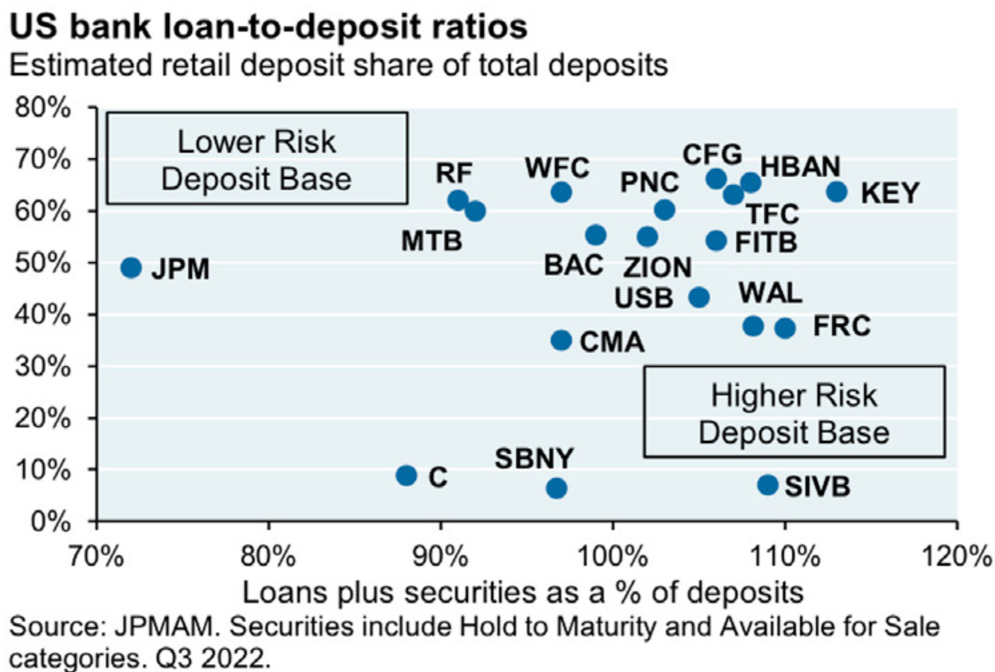
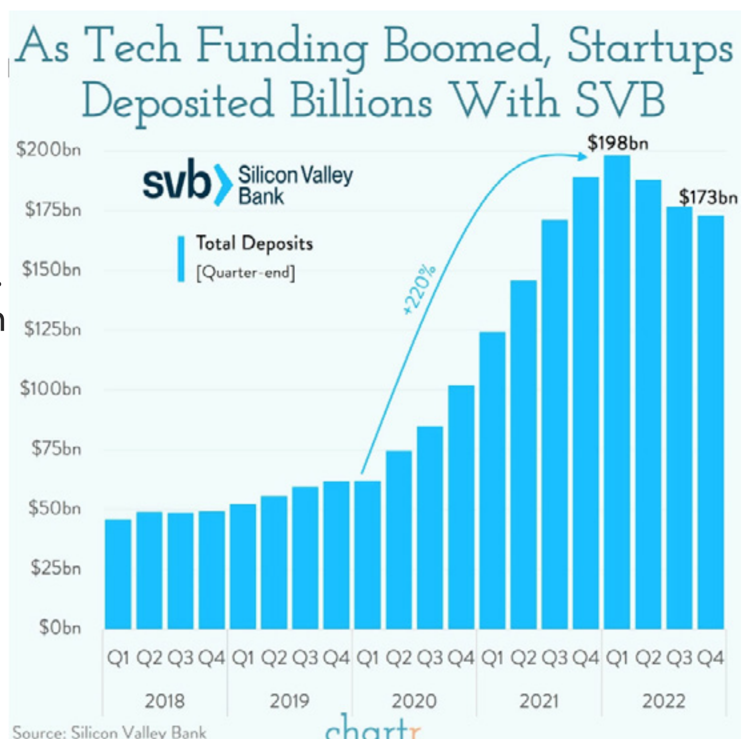
Banks failures have occurred throughout history, but Silicon Valley Bank is a particularly high-profile case. It is the first bank to fail since October 2020, and it is the largest bank, in terms of deposits, to go belly up since Washington Mutual collapsed in 2008. Perhaps, most notably, however, is SVB's outsized exposure to startups in the riskier tech and biotech space. Relative to the average bank, the bank's parent company, SVB Financial Group, had a riskier and more concentrated deposit base (chart from JPMorgan):



With SVB's client base largely made up of riskier startups, the bank's performance became closely tied to the path and direction of monetary policy. In the midst of the pandemic, the Fed's easy monetary policy helped to fuel a boom in new tech companies, ballooning SVB's deposit base. Then, as the Fed shifted to a more hawkish policy stance and raised interest rates, growth in the startup sector slowed and deposits began to decline as SVB's clients withdrew cash to cover expenses. The boom-bust pattern is highlighted in the chart to the right (from Chartr):



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When rates were low and deposits rising, the bank was thriving, flush with non-interest-bearing deposits that it was able to invest in higher yielding assets. The bank's investment portfolio grew, but then, as the Fed embarked on their massive rate hike campaign in 2022, SVB quickly accumulated losses on their long-term bond investments, just as its main clientele started burning cash to fund their businesses. To cover the outflow of deposits, the bank was forced to realize losses on their investments to raise liquidity.

Recognizing the stress the bank was under, many of SVB's biggest clients were encouraged by their venture capital partners to withdraw their money, resulting in a devastating bank run on Thursday and Friday that doomed the company.

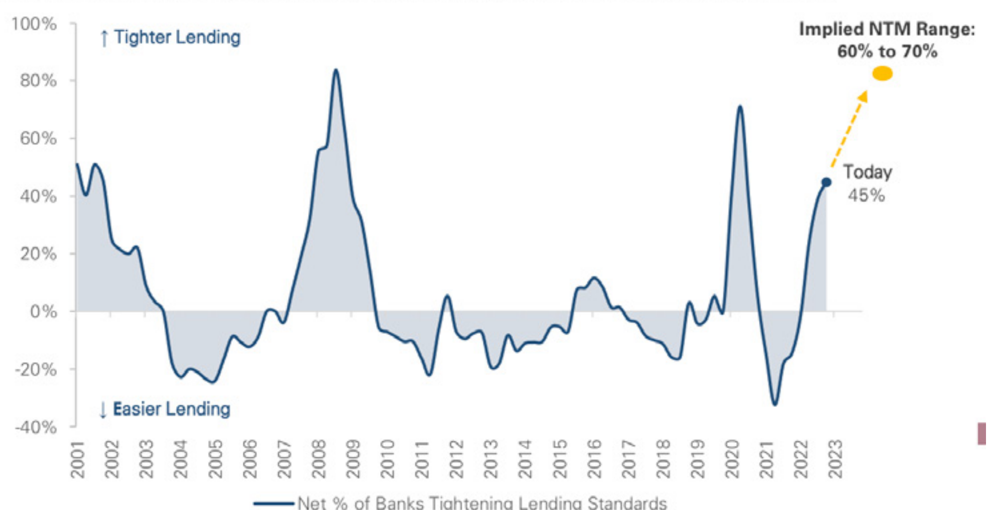
The Fed's aggressive rate hikes clearly played a part in the collapse of SVB, but it should be noted that bank failures occur whether the Fed is raising rates or not. Between 2009 and 2015, the Fed did not raise interest rates once and executed multiple Quantitative Easing campaigns. Despite loose monetary policy during this period, 490 banks still failed.

While SVB and Signature Bank made poor managerial decisions and were unique in their heavily concentrated exposure to the tech sector, their demise is a cautionary tale of the impact of tighter monetary policy and highlights the risks currently in the market.

BANK FAILURES COULD CAUSE FURTHER TIGHTENING OF **LENDING STANDARDS**

Last month, we highlighted that banks were tightening lending standards, and historically, that led to recession. The bank failures over the past week are likely to lead to further tightening. Why? Even banks with solid balance sheets and better risk management are not going to want to take on additional risk under the heightened scrutiny of wary investors. Even the appearance of weakness could damage the bank's sustainability.

We think last week's events make this forecast of tighter lending standards more probable (chart from MarketDesk):



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Further, we will be keeping an eye on credit spreads, which are a key component of **macro**cast™. Credit spreads measure the difference in yield between treasuries and corporate bonds and reflect the level of perceived credit risk by fixed income investors. Spreads tend to widen during periods of banking system stress and when there is uncertainty in the sustainability of corporate earnings. Despite the market selloff, the contraction in earnings estimates, and numerous rate hikes, credit spreads have been remarkably resilient over the past year, but that could change, in light of recent events.

THE FED MAY PAUSE HIKES UNTIL THEY CAN **ASSESS THE DAMAGE**

While the Federal Reserve took emergency measures to stem off further bank crises, the big question is how these events impact the path and pace of rate hikes going forward.

The bond market was quick to price in a major policy shift. Last week, the two-year Treasury yield, which reflects the market's forecast of the Fed Funds rate over the next two years, reached 5%, the highest rate since 2007. Since then, it has plummeted down to 4%. That is a huge move in just a few days and may signal a possible inflection point in Fed policy.

Still, Fed officials remain uneasy about inflation levels and aren't yet confident inflation will fall back to their 2% target rate, thanks to robust labor market conditions.

Given the turmoil in the banking sector, market participants now expect a rate hike of 25 bps next week, down from the 50 bp rate hike expected a week ago. While the Fed may slow their pace of tightening, or even opt for a pause, we believe inflation must fall further or labor market conditions weaken before we can be sure this interest rate hiking cycle is finally over.

In summary, a combination of the tech boom, poor risk management, and the aggressive tightening of monetary policy contributed to the failures of Silicon Valley Bank and Signature Bank. While the Federal Reserve and Treasury department responded quickly to prevent further damage, we expect the shock from the failures to lead to further tightening of lending standards and wider credit spreads. All else equal, this increases the risk of a recession later this year, but the key question will be how the Fed adjusts its policy path. As new data flows into our models, we will continue to look to **macro**cast™ and **micro**cast™ for guidance through this market cycle.

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WEALTH MANAGEMENT

TAX FILING DEADLINE IS RIGHT AROUND THE CORNER

April 18th

Don't forget to meet with your tax professional (if needed) or make your IRA contributions before the deadline.

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