A bank crisis with little running

Asset allocation research note | April 2023

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Takeaways

- During the first month of the bank crisis — from the collapse of Silicon Valley Bank (SVB) on March 10 through early April — private wealth investors only moderately adjusted their portfolios in reaction.
  - While one may have expected a 'rush to the door,' only 18% of uninsured deposits flowed out of regional[1] banks, showing these banking relationships remain sticky with private wealth clients.
  - Although the gap between bank rates and Treasury bills is currently the highest in generations, very little cash has moved out of banks and into cash securities. However, there are early indications that investors may now be starting to more substantially move into cash securities and money market funds to take advantage of the higher yields.
  - Investors added to their First Republic and PNC positions while selling Credit Suisse and M&T Bank Corporation.
- The effects of Fed tightening have passed through to private capital investment. In combination with a lack of credit creation more broadly, including from regional banks, this may present opportunities for investors with liquidity.

Introduction

Our 2023 Q1 Asset Allocation research note provides insight into how private wealth investors are adjusting their portfolios in light of the unfolding banking crisis. Interestingly, portfolios have not shifted all that much, suggesting that outside of a few high-profile examples the bank crisis has

[1] The Federal Reserve defines regional banking organizations as those with total assets between $10 billion and $100 billion.

occurred without a bank run. That said, we are now seeing a potential change in sentiment, which could have knock-on effects.

In the first section of this note, we focus on the flows of cash across regional banks, national banks and money market funds. Because bank runs weigh on profitability and valuations, in the second section we review flows within the banking sector itself. We finally reflect on how the actions of the Fed in raising rates coupled with stress on regional banks may impact credit creation in niche markets, a potential opportunity for investors with excess liquidity.

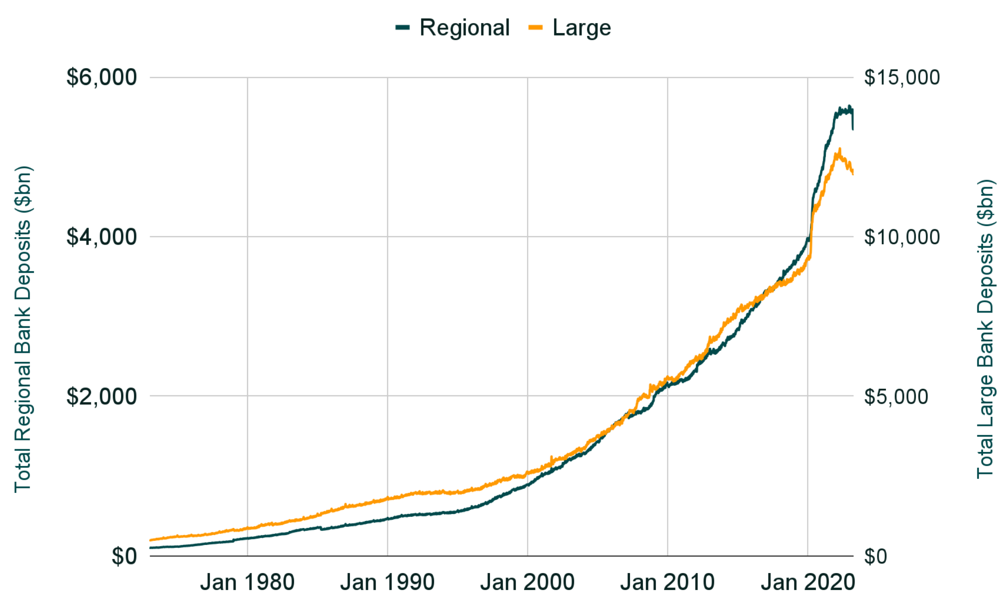
Bank crisis

Given extensive coverage of the run on Silicon Valley Bank (SVB) and its impact on cash markets, we provide the most relevant context of these macroeconomic dynamics. In response to the global pandemic, the Fed and Treasury doled out almost $5 trillion in stimulus to households and businesses. As Exhibit 1 shows, a significant amount of the stimulus ended up as deposits at banks.

Exhibit 1

Regional banks saw large inflows during the pandemic up until their largest monthly outflows in history in March

Total deposits at U.S. regional banks, billions of dollars, 1973–2023



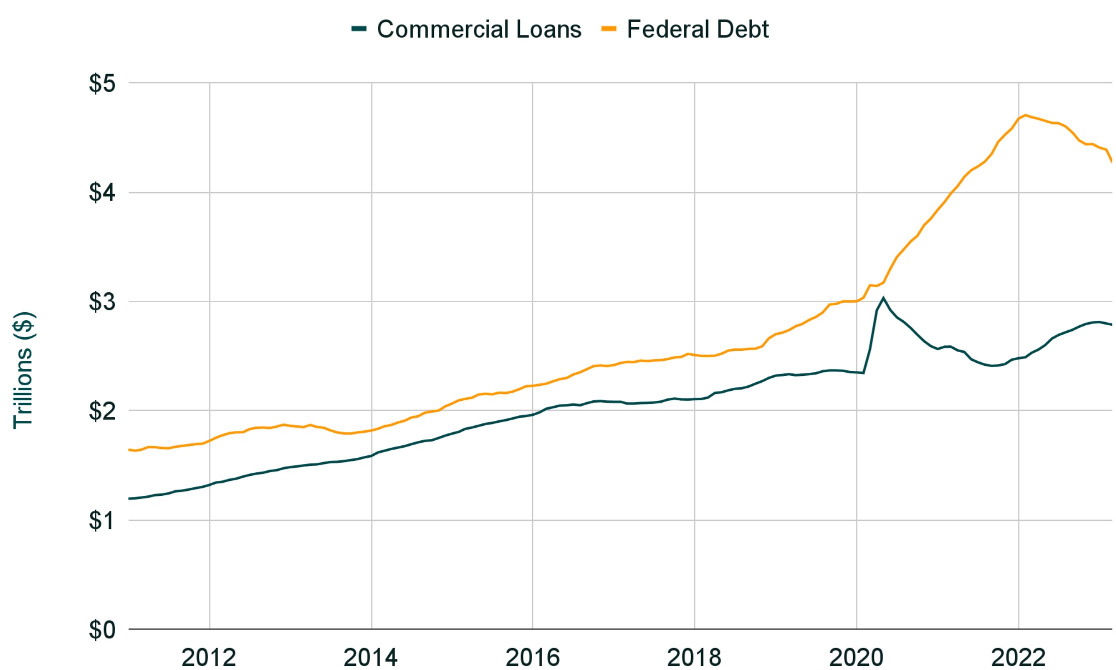
Source: Federal Reserve

At the same time, cash was returning basically zero interest, demand for credit remained effectively on hold, the Fed ran its program of quantitative easing to hold down long-term rates, and banks bought large amounts of Treasuries [see Exhibit 2].

Exhibit 2

U.S. commercial banks have invested heavily in Federal debt rather than loans since 2020

Commercial loans and government debt held by commercial banks, trillions of dollars, 2011–2023



*Federal debt is defined as the combined Treasury and Agency debt held by U.S. commercial banks.
Source: Federal Reserve

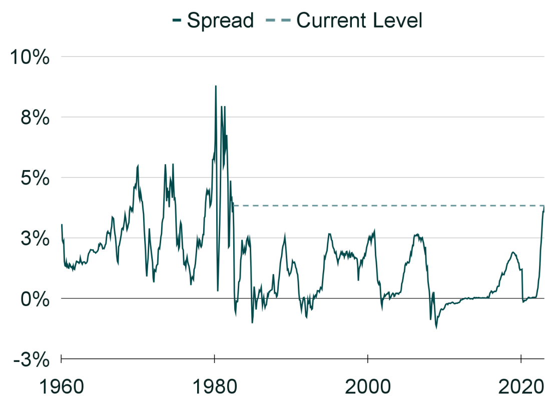
When interest rates rose throughout 2022, banks continued to offer low rates on deposits despite mounting risk of the depository base shrinking. What an investor could get from putting money in a bank versus investing in T-Bills either directly or through money market funds diverged to levels not seen in generations. **Yields on depository instruments have barely moved, despite the Fed raising interest rates in 2022. As Exhibit 3 shows, this has led to the largest spread that banks have been able to earn since the early 1980s.**

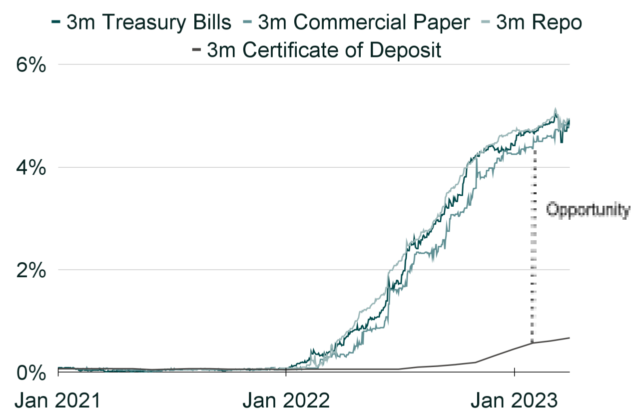
Exhibit 3

Banks are earning their highest spreads in decades while short-term rates are rising dramatically

Spread between banks' cost of deposits and 3m Treasury bills, percent, 1960–2023

Daily Treasury bill, commercial paper, U.S. repo and certification of deposit yields, Jan. 2021–March 2023





Source: Refinitiv, Bloomberg "Money Market Funds Are Surging in Popularity", Bridgewater Associates

In contrast to the rates dynamic described above, the average high-net-worth (HNW) investor generally responds to movement of the stock market, not cash yields[2]. Exhibit 4 looks at how the HNW investor typically trades cash. On a portfolio-weighted basis, we show flows into liquid risky assets against flows into cash in the context of equity market returns.

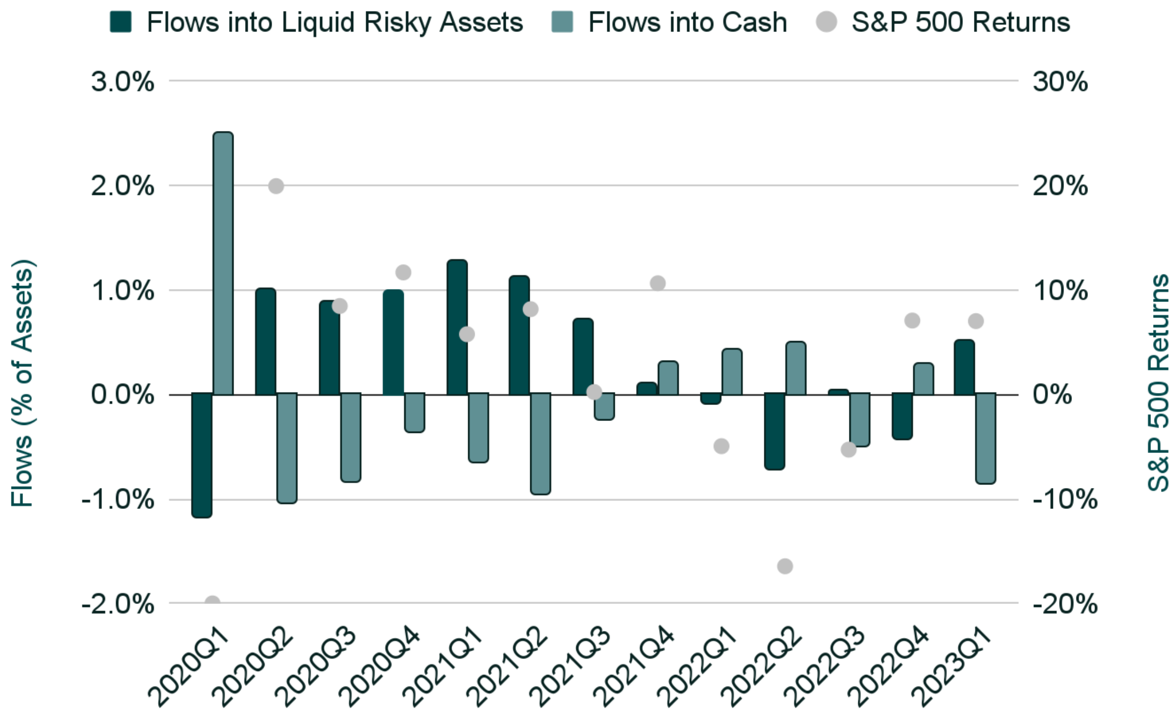
As can be seen, flows in and out of cash have historically been connected with the performance of liquid risky markets. When equity markets rally, investors tend to move money out of cash and into risky assets. When equity markets sell off, the reverse happens and investors tend to move money into cash. Due to the 2022 sell-off in equity markets, the average investor added 70 bps of deposits in 2022. This was fully reversed in the first quarter of 2023.

[2] See our Flows ARB for further information on this topic.

Exhibit 4

Capital flowed out of typical time deposit accounts in Q1 2023

Flows (% of total assets) into liquid risky assets against S&P 500 returns, percent, 2020Q1–2023Q1



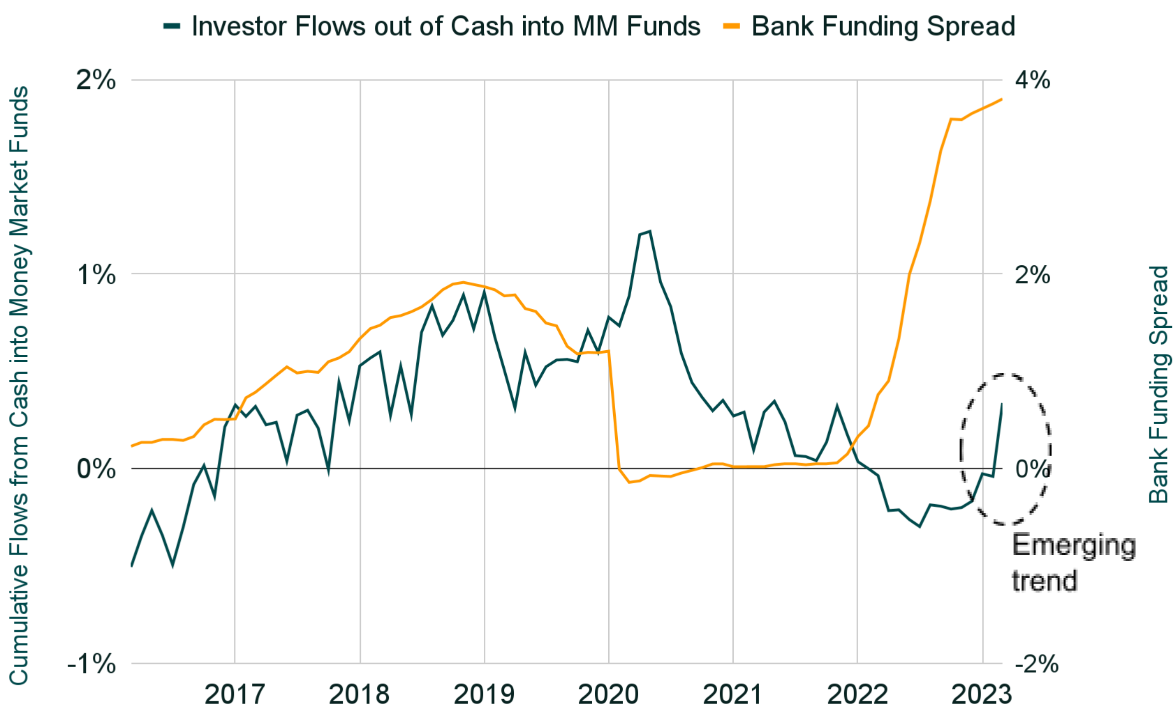
Source: Addepar

At the aggregate dollar level, investors have historically only slightly responded to pricing of cash. One can see small and lagged moves into cash securities when investors are provided a better yield over the operational ease benefits of holding deposits. In Exhibit 5, we show the spread of bank funding costs to T-bills against investor flows out of cash and into money market funds. As the chart suggests, flows quite modestly tend to move more into money market funds when they pay a relatively better yield. These movements appear to be quite slow, muted and lagging the pricing of cash. **Despite this lag, it appears that investors are now quickly shifting funds from cash to money market funds in March 2023, although the cash pricing gap is the widest in a generation.**

Exhibit 5

Investors have been slow to move cash into money market funds despite the high opportunity cost

Money market fund and cash flows, percent of total assets, Jan. 2022–March 2023



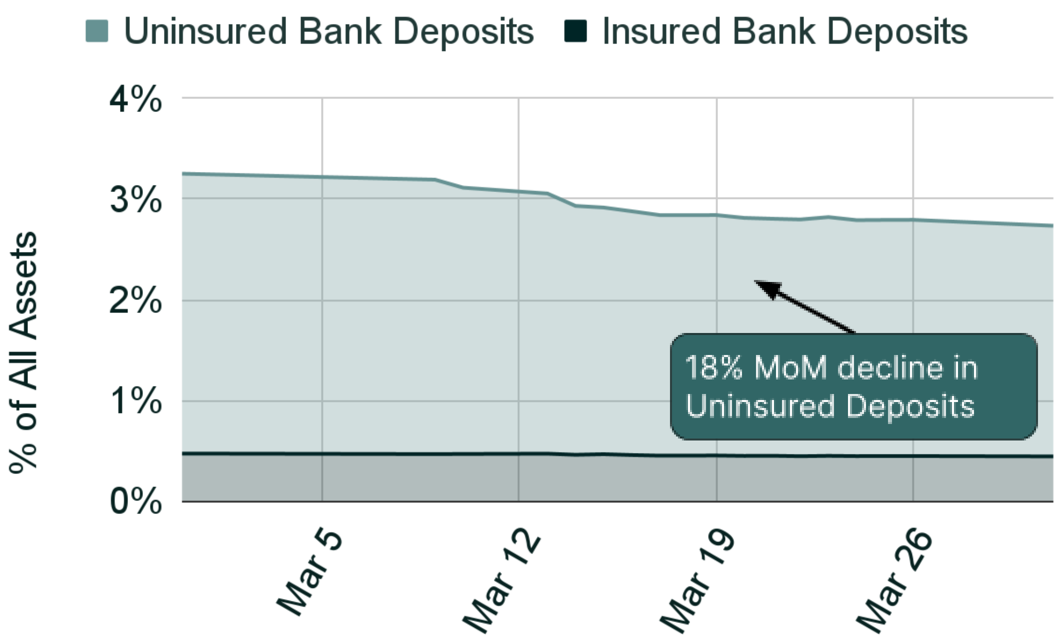
* Bank funding spread: Rate on the 3m Treasury bill net of the cost that banks pay on their deposits.
Source: Addepar

In addition to the relative pricing of cash, bank deposit insurance is an important consideration for large deposits. **Our research shows that movement out of uninsured deposits have been moderate in March and not indicative of a 'rush to the door.'** This contrasts with media reports, although we continue to closely monitor the dynamics. Exhibit 6 shows that uninsured deposits, typically stable, declined 18% in mid-March.

Exhibit 6

Investors pulled approximately 18% of their non-insured deposits during March

Total bank deposits and insured bank deposits, March 2023



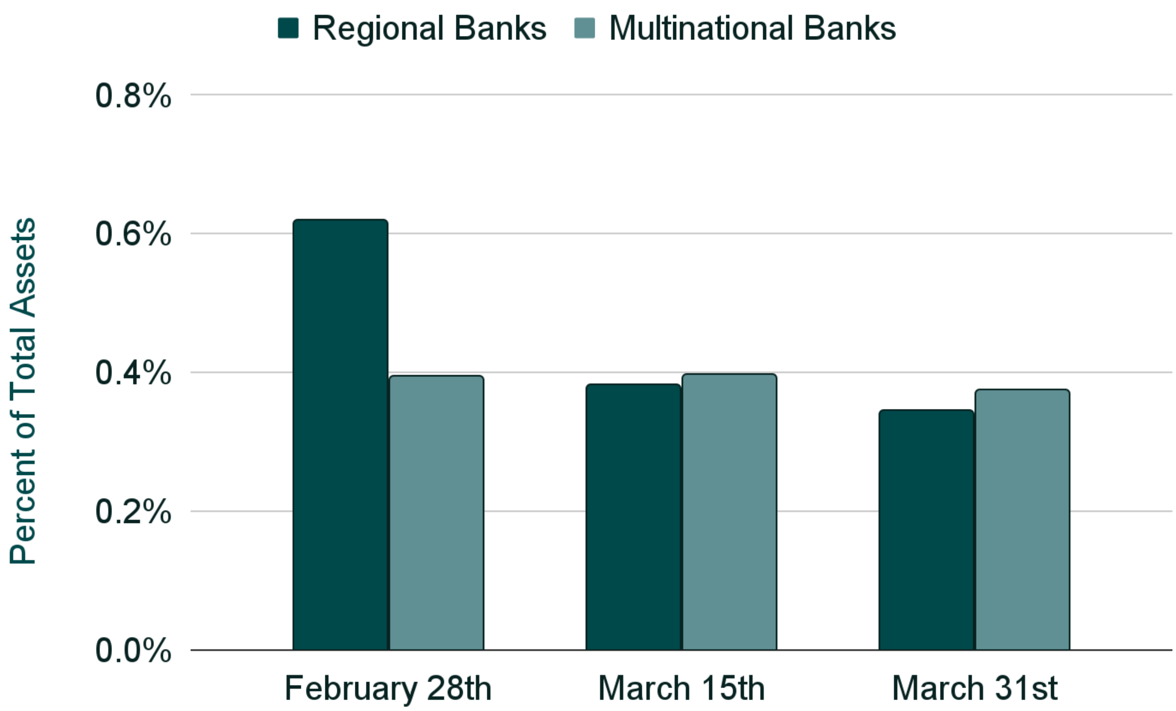
Source: Addepar

To add color, Exhibit 7 shows that **these outflows were primarily from regional banks, and primarily occurred during the first half of March** during the depth of Silicon Valley Bank's and Signature Bank's troubles. Notably, this capital did not end up as deposits at larger banks.

Exhibit 7

Time deposits were reallocated away from regional banks in the first half of March

Percentage of bank time deposits held in regional and multinational banks, February vs. March 2023



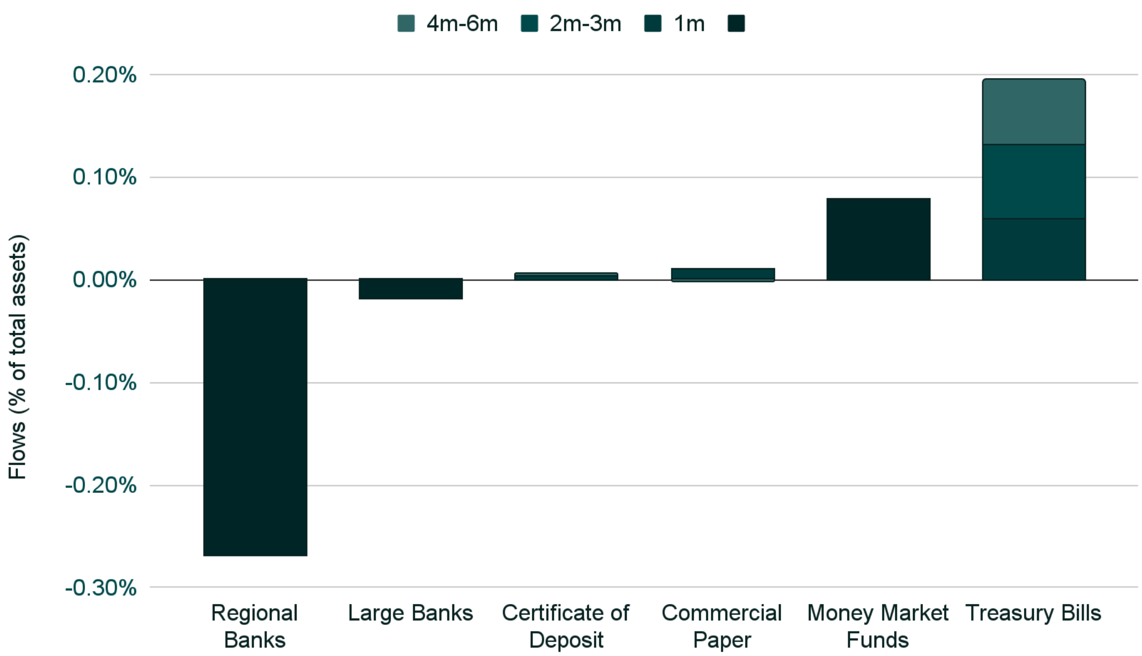
Source: Addepar

Instead, the capital left the banking sector in general and ended up in securities. **As Exhibit 8 shows, deposits moved out of regional banks and into money market funds and Treasury bills. However, as mentioned previously, the aggregate flows are modest to date.**

Exhibit 8

Cash that flowed out of regional banks primarily flowed into Treasury bills and money market funds

Flows, percentage of total assets, February 28 to March 31, 2023



Source: Addepar

Stepping back, it's quite surprising to see how minimally investors' cash strategies respond to changes in market conditions. Beyond earning a better return, most institutional investors would agree that T-bills are safer than deposits given their well-defined ownership (while deposits get aggregated and lent out).

The relatively muted shift from deposits is also surprising because investing in T-bills has become so much easier with the advent of new investment technology. Perhaps this is because so much of the economy was built up during the low-interest-rate environment post the financial crisis that private wealth investors didn't develop cash management expertise (and companies formed during this time didn't build a Treasury function). This seems like a continued opportunity for investment managers.

Banking flows

The banking industry, particularly regional banks, are in a challenging position. On the liability side, banks need to offer higher rates or replace deposits with other sources of more expensive capital. On the asset side, rising long-term interest rates are generating unrealized losses. The likelihood of a bank becoming stressed is dependent upon how much of its business has relied on buying long-duration assets (Treasuries and mortgages) funded by cheap, less sticky deposits.

In Exhibit 9, we align where private wealth investors have a view relative to the market's. **Notably, it appears that private wealth investors are buying the dip on First Republic Bank and PNC relative to a significant market sell-off in these stocks. We also see moderate outflows from Credit Suisse and M&T Bank Corporation.**

Exhibit 9

Private wealth investors were slow to react to rapidly changing regional bank price movements

March 2023 net flows as a percentage of total holdings by investors in regional + distressed banks against equity market returns, percent

	Relative flows	Gross flows	March return
Credit Suisse	-0.97%	1.20%	-71%
M&T Bank Corporation	-0.73%	1.10%	-22%
First Horizon Corporation	-0.55%	0.63%	-28%
Truist Financial Corporation	-0.47%	2.32%	-27%
Citizens Financial Group Inc.	-0.34%	0.52%	-27%
Cullen/Frost Bankers Inc.	0.18%	0.28%	-20%
Columbia Banking System Inc.	0.18%	0.22%	-28%
Amerant Bancorp Inc. Class A	0.22%	0.22%	-23%
PNC Financial Services Group Inc.	0.67%	2.10%	-20%
First Republic Bank	1.25%	2.64%	-89%

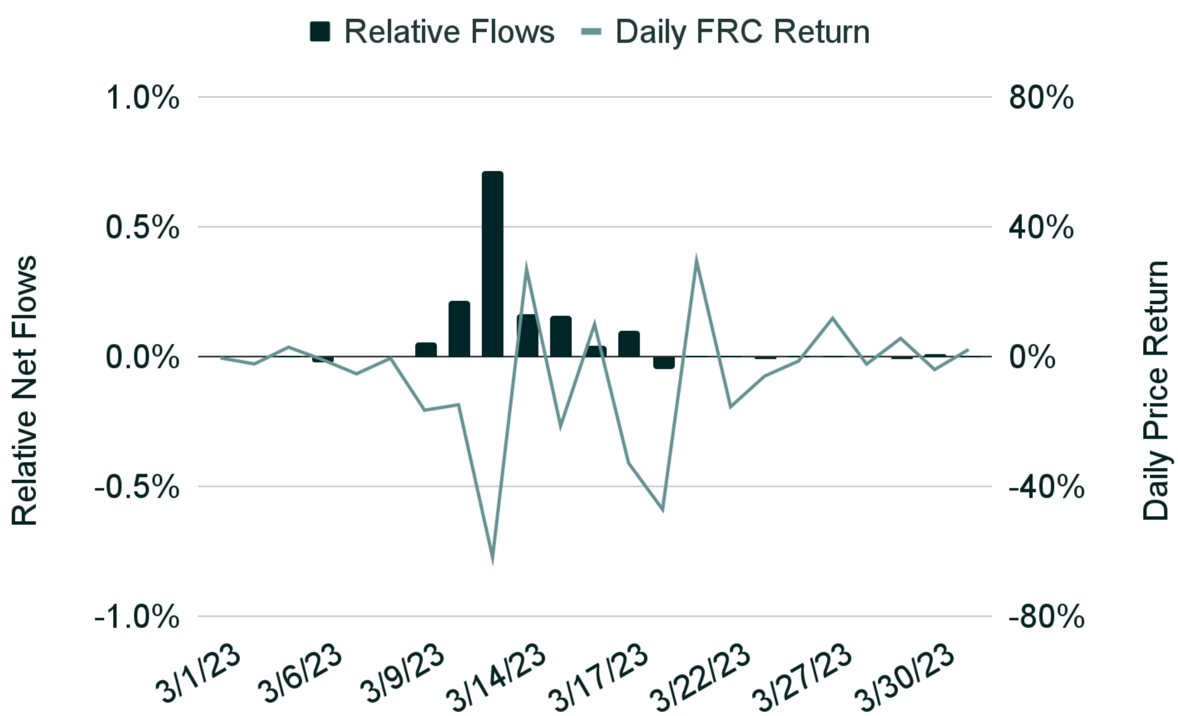
Source: Addepar

First Republic Bank (FRB) offers an interesting case study into investor behavior regarding their regional bank investments during March 2023. In the figure below, we plot net investor flows against daily price movements in FRB's stock. In the beginning of the banking crisis, investors saw the fall in prices as an investment opportunity and bought the dip. They continued to buy throughout the month. Please reach out for our Addepar Research Brief on flows for additional information.

Exhibit 10

Private wealth investors were slow to react to rapidly changing regional bank price movements

March 2023 net flows as a percentage of total holdings by investors in regional + distressed banks against equity market returns, percent



Source: Addepar

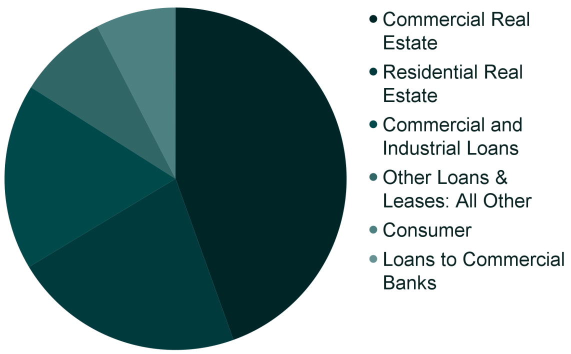
Emerging investment opportunity?

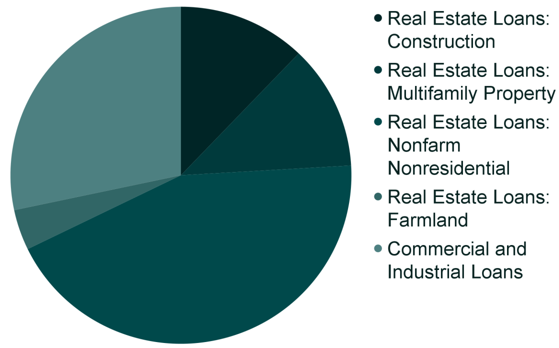
Regional banks play a hugely important role in credit creation for niche markets. They're a primary lender to real projects for small companies, as shown in Exhibit 11. Should high interest rates persist and the banking crisis deepen, then real fixed investment projects — an important component of the economy — could be hit quite hard. **Investors with liquidity, whether through private capital or by investing in large national banks, could potentially help fill this gap and find new investment opportunities.**

Exhibit 11

Commercial and industrial lending makes up over half of regional bank loans

Left: Regional bank lending, percent of total lending, March 29, 2023
Right: Regional bank aggregate commercial lending, percent of all lending, March 29, 2023





Source: Federal Reserve

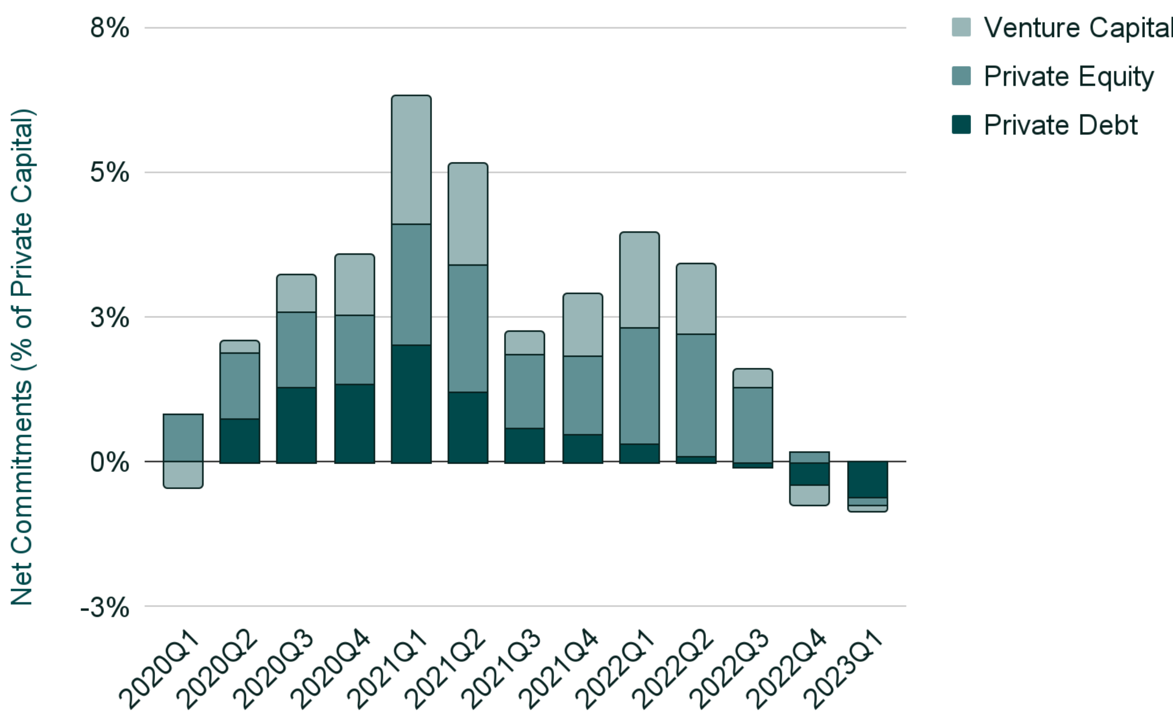
Investors with excess liquidity may find quality niche opportunities that aren't being funded through traditional banking channels should credit remain tight, particularly in markets serviced by regional banks.

Exhibit 12 below shows quarterly net commitments to private capital funds. This measure, which is defined as the total dollars entering funds minus the total dollars exiting them, provides a gauge for the level of investment opportunities that private capital is acting upon. **After a very strong 2020 through the first half of 2022, net commitments to private capital funds have trailed off and become negative in aggregate over the past six months.** This has been led by divestiture from private debt funds in particular.

Exhibit 12

Alternatives continue to see more redemptions and distributions than commitments in Q1 2023

Net commitments, percent, 2020Q1–2023Q1



Source: Addepar

Conclusion

We've examined how investors have adjusted their portfolios in light of the unfolding banking crisis. While moves in cash have been modest to date, at this stage most investors are now examining and improving their cash management practices. The slow response in cash management along with modest flows in bank stocks has been surprising in relation to high fixed income market volatility, large money market flows and the extensive media coverage. We will continue to report back to you on investors' response to these evolving dynamics.

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