Monthly market update

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Takeaways

- The ongoing banking crisis is the result of several macroeconomic factors, including rapidly rising interest rates, tightening liquidity conditions and a slowing economy.
- While the financial system has stabilized in recent weeks, many of these underlying issues are unresolved, including continued pressure on long-term yields, shrinking deposits and reduced bank profitability.
- Investors should view these events with a broad perspective and carefully consider the safety and yield of their deposits.

Market update

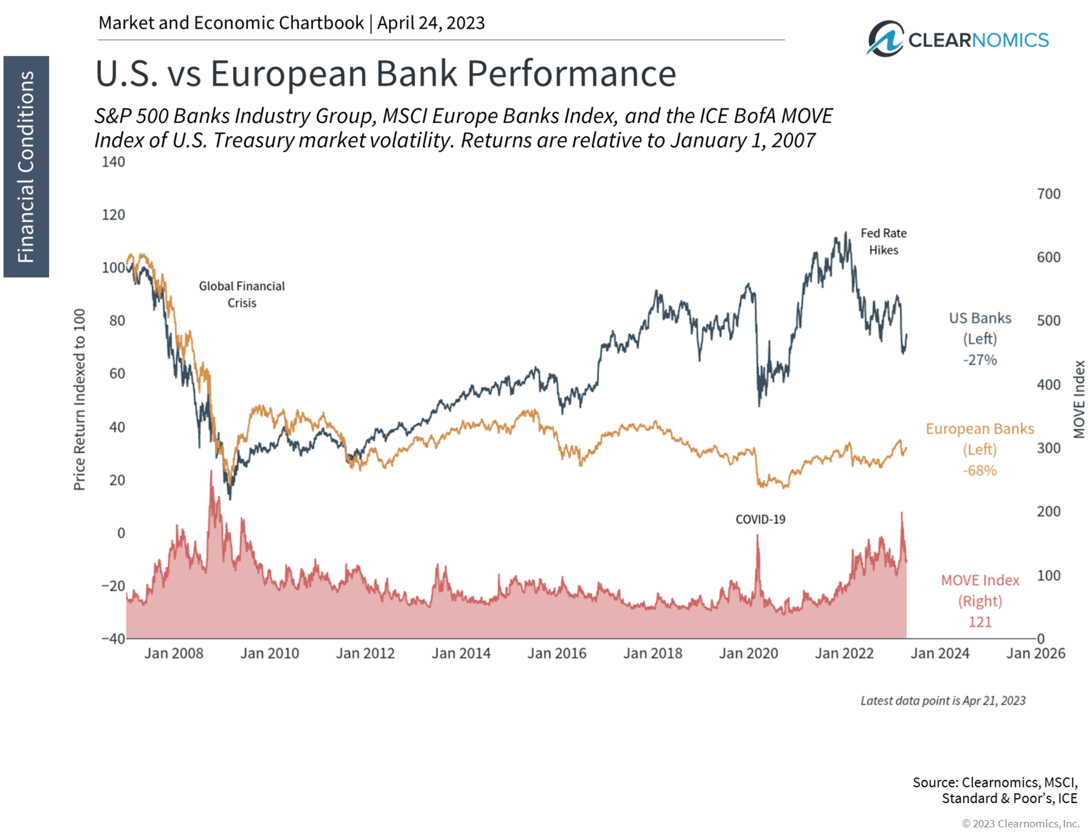
This update is provided in partnership with Clearnomics, a market insights platform for asset and wealth managers. Our goal is to help you stay abreast of ever-changing markets by putting current conditions into the context of economic and market history. Every monthly update will address key issues clients are asking about and share real-time insights you can use with your clients. The updates will also provide practical historical stress-testing scenarios to help you explore potential outcomes for portfolios in the current environment.

The ongoing banking crisis continues to raise concerns over the economy and financial system. The situation is still evolving but there’s plenty of speculation as to what might come next. When it comes to investing, it's more important than ever to stay level-headed and focus on the big picture. What should long-term investors know about these bank failures and what do they reveal about the financial system?

The collapse of Silicon Valley Bank (SVB) in March was the first FDIC-insured bank failure since 2020 and the second largest in history. This was followed two days later by the failure of Signature Bank, the third largest in history.

Chart 1

U.S. and European bank performance



Sources: Clearnomics, MSCI, Standard & Poor's, ICE

Just a few weeks earlier, these two publicly traded companies had the 14th and 18th largest market capitalizations among U.S. banks, respectively. Runs on these banks also spread to Europe and led regulators to broker Credit Suisse's sale to UBS. Fortunately, the situation has calmed in the intervening weeks.

From a market and economic perspective, the main question is whether there's wider systemic risk to the financial system. This episode reveals that these banks grew too aggressively and with too little risk management as tech valuations rose and crypto prices rallied over the past several years.

While this worked well in a bull market, the reversal of these trends over the past 12 months made these institutions vulnerable to classic bank runs.

Deposits grew rapidly during the pandemic

It's no secret that the Fed loosened monetary policy dramatically during the pandemic to support the financial system. The central bank also engaged in large-scale asset purchases and emergency funding programs that increased the Fed's balance sheet to nearly $9 trillion, up from its pre-pandemic peak of $4.5 trillion. This monetary stimulus was accompanied by the largest budget deficit as a share of GDP since World War II and included the Paycheck Protection Program, stimulus checks and other programs. These policies dramatically increased the supply of money and, when paired with low market interest rates, led to a surge in deposits across both small and large banks.

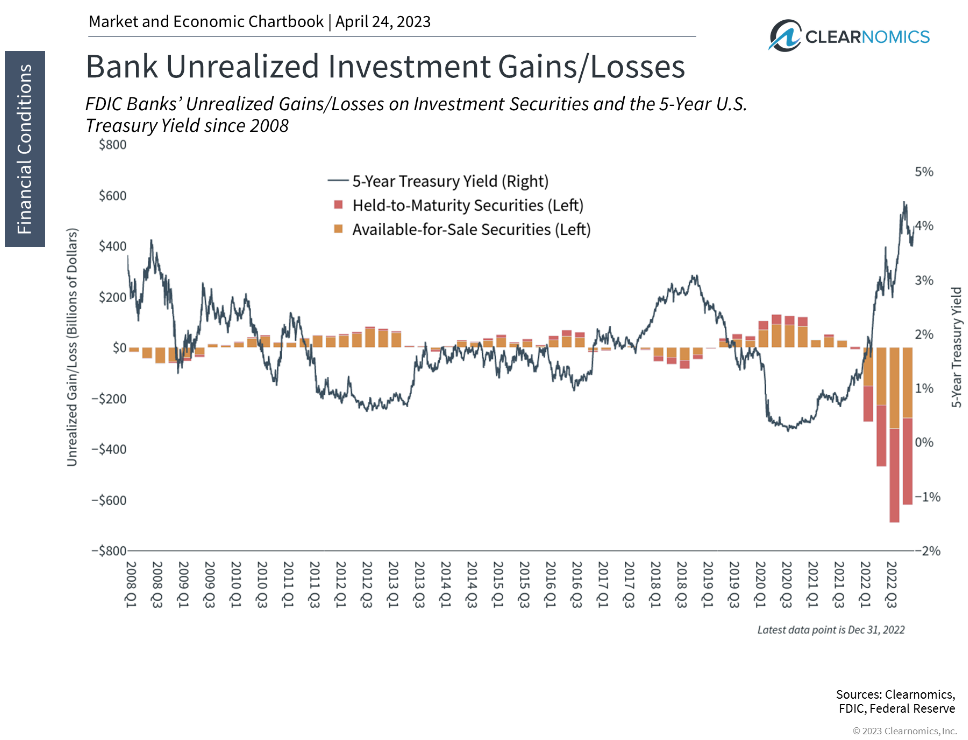
However, the dynamics have reversed over the past year as interest rates have risen, the Fed has tightened, depositors have sought higher yields, and economic conditions have deteriorated. Large banks (the 25 largest by assets), saw their deposits decline at the fastest rate among financial institutions of all sizes, while small banks experienced flat deposit growth. Recent FDIC data show that the average national deposit rate for savings accounts is less than 0.4% while a one-month Treasury bill yields 4.7%. This has led many to reconsider their allocation between cash and other yield-generating products. Please see our April Asset Allocation and Performance research notes for additional details.

Unrealized losses are weighing down bank balance sheets

Compounding these issues, rapidly rising interest rates and Fed rate hikes over the past year created financial stress on bank balance sheets. Bonds had their worst performance in history in 2022, driving unrealized losses on investment assets including U.S. Treasuries, as shown in the following chart. Whether banks need to book these losses depends on how these securities are accounted for, but this worsens as banks face pressure on deposits. Thus, SVB and others found themselves with assets that were worth far less as rates rose.

Chart 2

FDIC bank unrealized gains/losses



Sources: Clearnomics, FDIC, Federal Reserve

SVB's concentration of tech and startup customers made it particularly vulnerable to a broad-based downturn in deposits as conditions deteriorated for that sector, just as Signature Bank was exposed to the slowdown in the crypto industry. SVB tried to plug this gap by raising fresh capital, but this backfired because it highlighted the liquidity and solvency issues SVB faced. Like shouting "fire" in a crowded theater, once there's the perception of solvency problems, a classic bank run can occur swiftly, which can then become a self-fulfilling prophecy.

The banking crisis that began in the U.S. then spread to Europe. Concerns over the solvency of Credit Suisse, Switzerland's second largest "global systemically important bank" (G-SIB), were due in no small part to the runs on U.S. banks. What made Credit Suisse vulnerable was that it had been plagued by reputational and financial difficulties over the past decade, including problems with its financial reporting, exposure to the failed companies Archegos and Greensill, a criminal conviction over money laundering and more. Swiss regulators stepped in and brokered a deal for UBS to buy Credit Suisse for only $3.25 billion.

Financial stability remains an ongoing concern

Moves by the Treasury, Fed, FDIC and Swiss regulators to backstop customer deposits across these banks have helped to prevent further contagion effects across the system over the past two months. At the same time, these actions do not directly address the underlying issue of impaired assets which depends on the quality of risk and asset/liability management at each bank. Fortunately, the risk that unrealized losses become a solvency issue is mitigated for larger, more diversified banks, which are less reliant on deposits, have a stronger deposit base and maintain higher amounts of capital. In fact, deposits have increased for the largest banks as depositors have sought safety.

The concern over small bank liquidity has eroded confidence in closely related sectors. While large banks make up the majority of total loans, small banks are key centers of economic activity. Within the commercial real estate (CRE) credit space, small banks account for 67% of the outstanding loans by dollar amount, compared to their overall share of loans of 37%. This could act as a drag on the CRE industry for months. More broadly, banks will face profitability pressures as they offer higher rates on deposits to retain and attract customers.

As the dust settles, falling deposits and stressed balance sheets in small and regional banks are the center of speculation surrounding financial stability. In the worst case, a credit crunch would add to the host of headwinds that the economy and areas such as commercial real estate are facing. On the other hand, the Fed is expected to pause its rate hikes later this year, and large banks have navigated the recent period well. As these events play out, investors ought to maintain a broader perspective on the causes of the banking crisis and what these causes may mean as the economy stabilizes this year.

Stress-testing scenarios:

History-driven simulation provides a principled, systematic way for advisors and investors to quantitatively stress test their portfolios based on these effects and understand the spectrum of likely outcomes. Please see our companion piece on Portfolio Performance for newly developed scenarios to model your portfolios. Please contact Addepar Research at research@addepar.com to model your portfolios through our new stress-testing capabilities. We'll continue to add new scenarios every month.

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