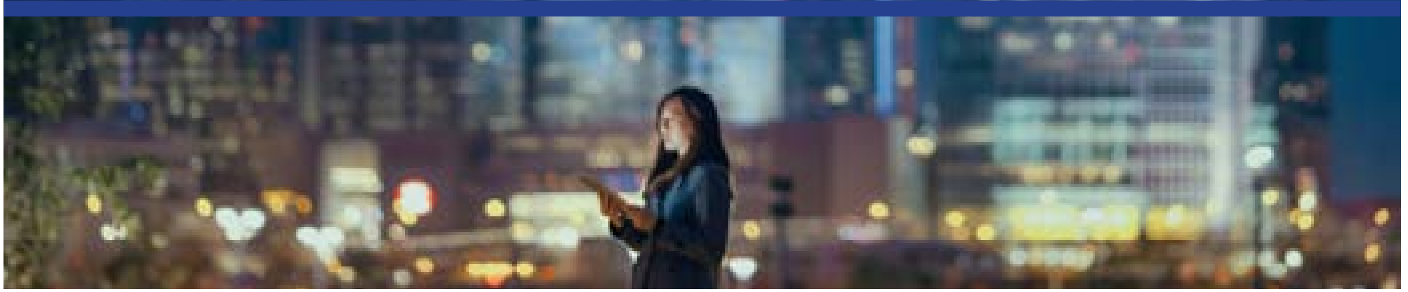

March 19, 2023

CIO Strategy Bulletin

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Unintended Consequences

- Confidence is the life blood of the banking system and critical to the economy's performance. Once a financial institution loses the confidence of its customers, it becomes vulnerable. This past week, we saw what a lack of confidence looks like in internet time.
- The Fed's abrupt and rapid reversal of monetary policy set the stage for the recent tumult. Responding to the pandemic shock, fiscal authorities borrowed and spent a record stimulus in 2020 and 2021, and maintained a zero-rate environment after expanding money supply by a record amount in 2020. To tame the inflation that ensued, the Fed raised rates 450 basis points – more quickly than ever before – while also slashing its bond portfolio.
- This reversal of policy and abandonment of incremental action in 2022 saw the worst combined stock and bond market performance since 1931. The fact that banks have $620 billion in aggregate mark-to-market losses on their securities portfolios is, in part, a reflection of the Fed's actions.
- In our view, the US banking system will stabilize when the US government provides clear and unambiguous support for the system as a whole. The longer it takes for the government to provide clear guidance in support of depositors and the wider banking system, the less safe many depositors will feel.
- We think it likely that the US economy will show an output contraction around midyear, though timing of the particular quarter it will bottom cannot be precisely determined. Once labor markets shift to net contraction, the Fed will likely begin to reverse course. These views leave us significantly overweight US Treasuries and defensive industries such as large-cap pharmaceuticals along with strong dividend growers in equities markets.
- A silver lining amidst the present banking uncertainties is that we are likely in the final stretches of the bear market. Asset markets are now more likely to quickly price the economic weakness to come with the Fed recognizing this as well. Just as asset prices fell in 2022 when economic growth and profits rose, history suggests markets can find a bottom in the trough of an economic contraction.

Unintended Consequences

Confidence.

Confidence is the life's blood of the banking system and is critical to the economy's performance. Once a financial institution loses the confidence of its customers, it becomes vulnerable. This past week, we have seen what a lack of confidence looks like in internet time. Within days, we saw the failure of two large banking institutions. Unlike in 2008, the speed of information has impacted the speed of depositor actions to the point where regulators had to act intraday to announce bank closings.

This past week, a consortium of US banks deposited $30 billion at First Republic. Overseas, Credit Suisse borrowed $54 billion in central bank funding to ensure it had sufficient liquidity. Yet, both are considering strategic options this weekend to regain the confidence of markets.

A Loss of Confidence.

When there are a sufficient number of events like bank failures or forced mergers between institutions, depositor and investor anxiety – the antithesis of confidence – can become endemic. We have already seen the price of regional bank shares in the US fall by 30% since March 1.

On March 15, bond rating agency Moody's cut its outlook on the US banking system to negative due to a "rapidly deteriorating operating environment." Moody's issued its warning *after* US regulators had stepped in to ensure the safety of depositors and promised to provide substantial liquidity to banks faced with deposit outflows.

Driven by news of unrealized losses in "Held to Maturity" bond portfolios, uninsured, non-retail depositors of banks rapidly sought safer options for their assets. This immediately impacts the liquidity, funding, and capital of affected banks. In turn, many other banks sought to reassure their depositors that they were safe – and most are – but a wider financial contagion was evident across markets by week's end.

While US authorities announced a backstop lending program for banks ("Bank Term Funding Program") that will help them avoid taking mark-to-market losses on US Treasury and agency securities, it appears the Fed will press on this week with raising US borrowing costs in a way that contributed to this banking-led tightening of financial conditions. If so, we cannot rule out that this will contribute to a further lack of confidence.

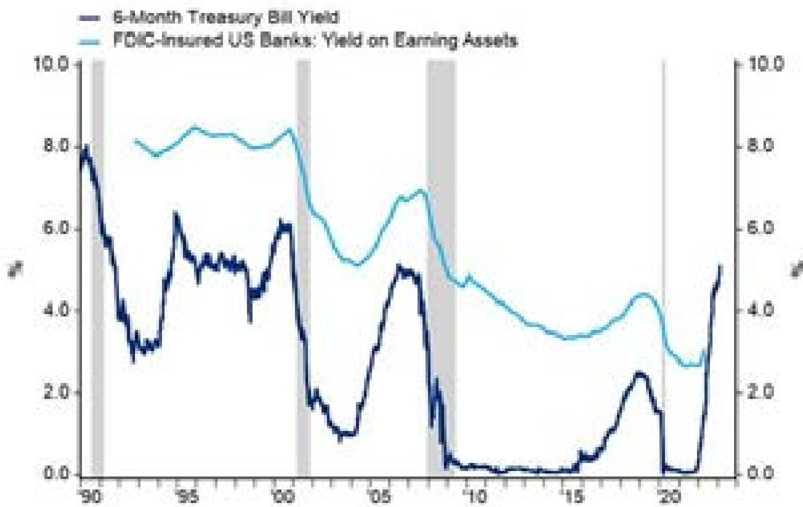
Preconditions for a Crisis

The Fed's abrupt and rapid reversal of monetary policy set the stage for today's unfolding events. In an effort to generate a full recovery from the COVID shock, fiscal authorities borrowed and spent a record stimulus in both 2020 and 2021. Even as US growth boomed in 2021, the Fed maintained a zero-rate interest environment after expanding the money supply by a record annual amount in 2020.

Then, to fight inflation caused, in part, by excessive stimulus, the Fed reversed course and raised rates 450 basis points, more quickly than ever before while also reducing its bond portfolio at a rapid pace. They have committed to maintaining these policies until their target of 2% inflation is in sight.

This reversal of policy and abandonment of incremental action in 2022 saw the worst combined stock and bond market performance since 1931. The fact that banks have $620 billion in aggregate mark-to-market losses on their securities portfolios is, in part, a reflection of the Fed's actions. Among the various macroeconomic bank stress tests conducted by the Fed, none included a higher rate "shock." As we showed in last weekend's CIO Bulletin, FDIC data showed that the interest rate paid on US Treasury bills rose for the first time above the yield held on bank balance sheets (**Figure 1**, available data begin in 1993).

Figure 1: US bank yield on assets vs 6-month Treasury bill rate



Source: Haver Analytics as of March 10, 2023. Grey areas note recessions.

Insufficient Initial Steps

A week ago, the FDIC, Federal Reserve and Treasury Department stepped in to ensure that all depositors of Silicon Valley Bank and Signature Bank – both insured and uninsured – would have "full access to all of their money starting Monday, March 13th." By doing so, the agencies prevented thousands of companies from having immediate payroll and payments issues.

They implied that all depositors at regulated US banks would not be subject to default. Further, the government said there would be no losses to taxpayers and the Deposit Insurance Fund's protection of uninsured depositors would be recovered by a special assessment on banks. Markets and the public were relieved by this apparent display of massive support.

But are all US bank depositors safe? Of any size? Is there, in fact, unlimited deposit insurance, if only during this period of massive instability? That remains unclear. On Thursday, March 16, Treasury Secretary Yellen told senators that government support for uninsured deposits will not be extended to every failed bank, only those that posed systemic risks to the financial system. This led to more deposit flows to larger institutions, increasing uncertainty.

The Need for Unambiguous Support

When the eurozone faced a rolling debt crisis in late 2011, Mario Draghi, the newly appointed European Central Bank president famously said, "the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough.[1]" His statement and promise to have the ECB make "unlimited" purchases of eurozone member bonds caused the borrowing costs of stressed members to fall and led, ultimately, to the stability of markets and the preservation of the euro.

As we illustrated in last week's CIO Bulletin, the US banking system does, in fact, have far higher equity capital than in the previous banking crisis (**Figure 2**). Its lending to support the economy and purchases of government bonds over the past three years does not represent a high-level credit risk. But bank runs and investor panic need not follow facts or reason.

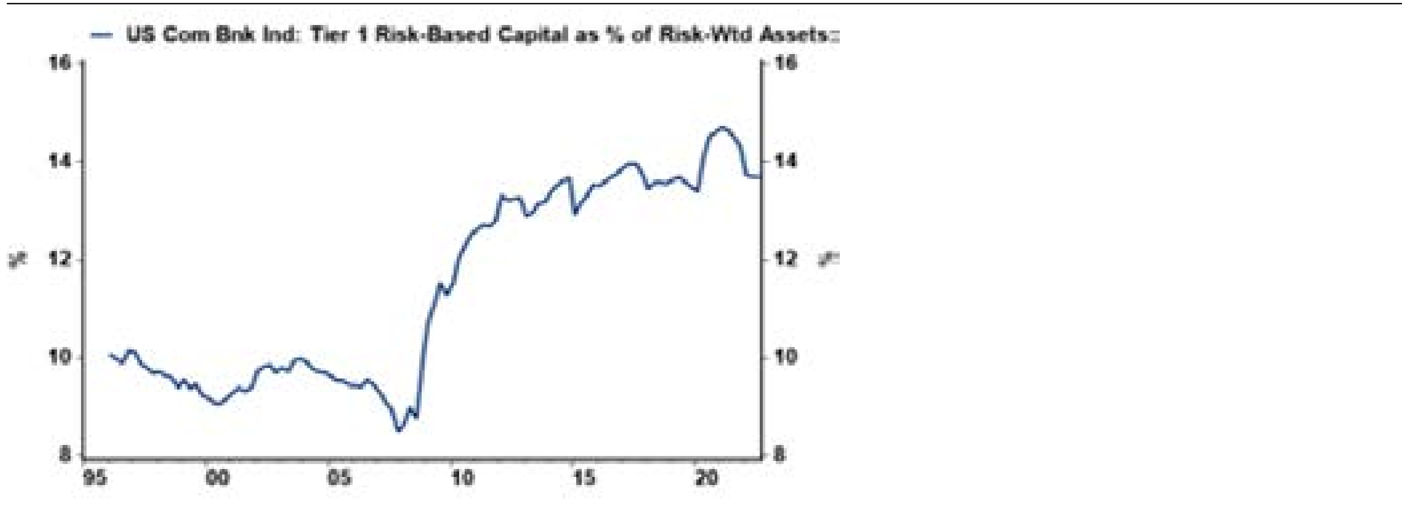
In our view, the US banking system will stabilize when the US government provides clear and unambiguous support for the system *as a whole*. The longer it takes for the government to provide clear guidance in support of depositors and the wider banking system, the less safe many depositors will feel. And when the government appears to backtrack, the time it will take to establish stability will increase.

While providing funding for banks by allowing borrowing against their assets without haircuts was bold, having depositors completely reassured as to the safety of their funds is essential. There are both bold and conservative approaches to achieving this, but speed may prove of the essence.

[1] Speech by Mario Draghi at the Global Investment Conference in London, July 2012.

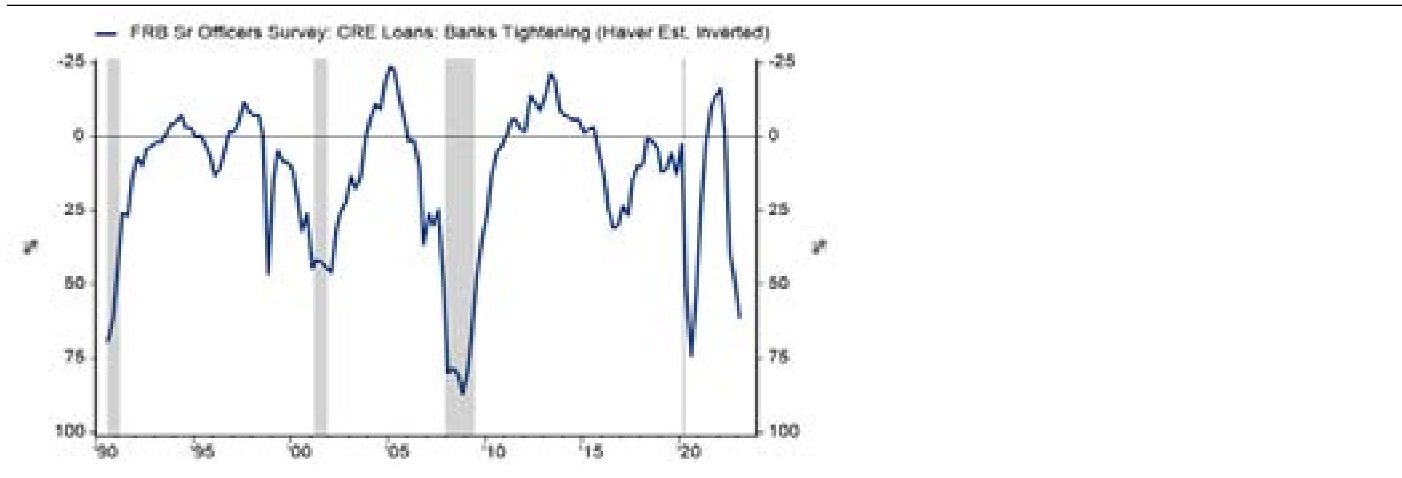
As for the Fed, we believe the inverted US yield curve and sharp tightening of bank lending standards before this shocking banking news is indicative of effectively tight monetary policy (**Figure 3**). As we've shown previously, it takes two years before the effects of monetary tightening are clearly seen in inflation data. Weaker inflation readings are only a matter of time. In tightening further now, the Fed should consider how much easing will be required down the road if there's a further loss of confidence.

Figure 2: US bank tier-1 capital as % of risk-weighted assets



Source: Haver Analytics as of March 9, 2023.

Figure 3: Net % tightening lending standards for commercial real estate



Source: Haver Analytics as of March 10, 2023. Grey areas note recessions. Survey is the Federal Reserve Board senior loan officer opinion survey on bank lending practices and notes the percentage of domestic banks tightening standards for commercial real estate loans.

Implications for Depositors and Regulation

Regardless of the timing of the end of 2023's banking emergency, there are several impacts that will extend to the broader economy with delayed, but negative implications. The rates banks will need to pay for deposits will rise while US Treasury rates will fall. Borrowing costs for companies and individuals will rise, as well. Market liquidity will be reduced.

The behavior of bank depositors will likely change and their awareness of available rates from other sources will become a part of their "buying process", as will considerations of relative safety. All of this will put pressure on bank

profitability over the coming year or longer. And in the meantime, there will likely be more banking consolidation and less credit expansion.

There will be changes to regulations. Remember, Silicon Valley Bank had an A1 credit rating and a tier 1 risk-based capital ratio of 15.4%, according to its latest filings. It was also considered a “category 4” bank that didn’t have to disclose its liquidity and funding ratios like larger banks.

Implications for the Economy

While US employment gains have been stronger than we expected in the early months of 2023, we continue to believe the extreme Fed tightening cycle is sure to apply the brakes, and not evenly. Less well-capitalized firms (cash-burning small caps) and industries under secular pressure (such as office real estate) would likely be the first to show cracks.

Looking at data that shows market changes in rates and equities since December 16, 2022, all markets do not appear to reflect the full impact of Fed tightening and the banking turmoil. Whereas rates have receded, especially in the front end of the curve, equity indices are above their prior levels. The 2-year Treasury yield, which peaked at 5.05% a few weeks ago, is now 3.80% (**Figure 4**).

Figure 4: Treasury yields and equity levels today vs late 2022

		17-Mar	3-Mar	16-Dec	*Change since Dec 2022*
US Treasury Yields (%)	2yr	3.84	4.06	4.10	*(0.34)*
	3yr	3.71	4.60	3.91	*(0.19)*
	5yr	3.50	4.25	3.62	*(0.12)*
	7yr	3.49	4.14	3.58	*(0.09)*
	10yr	3.43	3.95	3.48	*(0.05)*
	30yr	3.62	3.88	3.55	*0.07*
Equity Indices	S&P 500	3917	4046	3852	*2%*
	Nasdaq 100	12520	12291	11244	*11%*
	Euro Stoxx 50	4065	4295	3804	*7%*

Source: Bloomberg as of March 18, 2023. The indexes are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results.

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Five Answers to Frequently Asked Questions

Q: How could a healthy banking system have bank failures and runs on deposits?

A: Just because the overall banking system has seen a marked increase in equity and sharp reduction in risky lending since 2008 doesn't mean every institution was managed prudently. As we discussed in our March 12 CIO Bulletin, there are vast differences between banks that might make some more fundamentally vulnerable in certain circumstances. Some have low levels of retail deposits. Others have made the bulk of their loans to a single industry or geography. Some economists ignore these distinctions and speak only of the aggregate strength or weakness of the banking system.

Importantly, depositor and investor attitudes and anxiety can be a powerful force for the economy, whether there is a rational basis for them or not. Banks work in the economy by meeting credit demand for periods that differ from those providing funding through deposits. If the majority of a bank's depositors – the lenders to a bank – demand immediate repayment, it would threaten the solvency of nearly any bank.

So-called contagion occurs when investors (in this instance, depositors) fear that others will withdraw their deposits and act similarly without an assessment of the specific situation. This is why the banking system has macro-level safeguards, such as deposit insurance and access to central bank funding if lenders cut off a bank out of "contagious" fear.

Q: How could the Fed still raise interest rates under present circumstances?

We suspect that Fed policymakers believe that regulatory action to support confidence in the banking system will allow them to press on with a rate hike at their next meeting. While we think the Fed, Treasury and FDIC have so far limited contagion risk, the impact of rapid rate hikes on bank balance sheets and reduced Fed lending (Quantitative Tightening) is one of the factors underlying a loss of confidence in the banking system.

Credit is fundamental to how the US economy performs. Tightening monetary policy works through the banks. As **Figure 5** shows, banks sharply tightened lending standards for Commercial and Industrial Loans even before the SVB news, though high yield credit spreads have remained tight. We think that further Fed tightening and more cautious lending may reduce the availability of bank credit in the economy in 2023.

Figure 5: Share of US banks tightening lending standards for Commercial and Industrial Loans vs US high yield credit spread over US Treasury

Source: Haver Analytics as of March 14, 2023.

Q: If the Treasury, FDIC and Fed successfully navigate this crisis, does that alter our pessimistic view for the US economy in 2023?

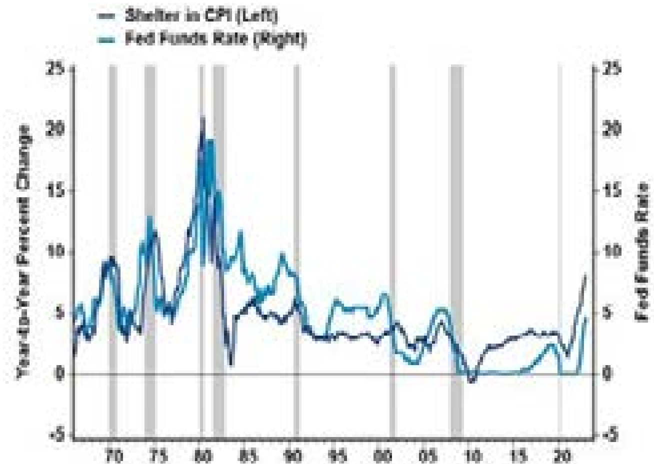
We expect US authorities to take whatever action is needed to protect depositors and the stability of the banking system, even if there are subsequent bank failures. Assessing the end point for the turmoil is difficult to do in real time. Broadly speaking, we don't believe the US or European banking systems face great systemic risk. Yet, we did not count on a banking emergency when forecasting a mild recession this year.

In our view, the move from dramatic stimulus to restraint in macroeconomic policy (monetary and fiscal) in the past few years threatens to turn one shock (Covid) into two recessions. The past impact of Fed policy rate increases seems likely to sink key components of the labor market looking ahead (**Figure 6**).

Financial turmoil might cause this restraint to be larger and, therefore, the peak Fed funds rate would be lower. Markets are now convinced the Fed will take risk management considerations into account and not resume tightening at a pace larger than 25 basis points this coming week. However, the Fed's stated goals are to make backward-looking inflation lower. This takes time when their own policy tool has the effect of boosting a key component of inflation – shelter costs (see **Figure 7** and this week's Data Watch).

Figure 6: Mortgage purchase application volumes vs employment in residential construction and real estate brokerage firms

Figure 7: Fed Funds rate vs CPI for shelter



Source: Haver Analytics as of Jan. 18, 2023. Note: grey areas are recessions.

Q: What does it mean for the Swiss central bank to provide 50 billion francs in loans to Credit Suisse?

Credit Suisse's common equity has fallen for 16 years since peaking in 2007. The slow decline in this particular financial institution has given its counterparties plenty of notice. We think the loans from the Swiss central bank will slow down the difficulties faced by Credit Suisse – deemed a globally important bank – but not curtail them. It can assure investors and clients there will be a lender to the bank if others balk -- and not at pricing that would cripple the bank. However, this is *not* a capital infusion (equity), so it doesn't help the bank offset losses if it has them.

News over the weekend suggest several US and European firms are considering investments in parts of Credit Suisse. A possible merger with another Swiss bank is also in the press.

Q: Where will we look for potential opportunities amid market disruption?

It might be too soon now, but we expect market volatility and a fast-evolving business cycle to present us with potential opportunities to add to equities this year. When we do move to add risk – once the Fed has shifted toward easing – our first steps will likely focus on three broad groups of stocks: rate victims, global firms with strong balance sheets, and secular growth themes:

- **Rate victims**: So-called long duration equities were the biggest victims in 2022 as interest rates rose sharply across the world (**Figure 8**). With the market quickly moving to price a lower Fed funds terminal rate and a much more imminent cutting cycle, these same growth-oriented assets could see their shares bottom before value cyclicals like industrials.
- **Global firms with strong balance sheets**: We have written recently about the potential for non-US shares to outperform the US in the coming cycle. Compelling relative valuation coupled with an over-valued US dollar make for an interesting entry point with a multiyear time horizon. But as we've seen with the European banking sector in successive waves of crisis in the past 15 years, not all global shares are created equal. Indeed, European and Asian commodities, technology, and consumer discretionary names will likely see much stronger long-run earnings tailwinds than more regulated and less dynamic sectors like financials and utilities. Even more so than our allocations in the US market, we'll likely take an active approach when choosing among international investment options.

- **Secular growth themes**: We will also consider thematic trends when selecting from the universe of growth shares. Leading themes of the last cycle, like social media and smartphones, have seen winning firms evolve into more mature businesses, which will mean more moderate sales and profit growth going forward. We therefore look to the next generation of technological advancement, in areas like AI, robotics, and cutting-edge computing, as a likelier source for market-beating growth in the next decade. Other less tech-oriented themes like clean energy infrastructure, advancements in battery technology, and biologics research are also likely to experience strong secular tailwinds. Further near-term market volatility could present us with attractive entry points across many of these themes.

Figure 8: Global share prices vs EPS

Figure 9: S&P 500 vs Nasdaq and 10-year real yield

Source: Bloomberg as of March 16, 2023. The indexes are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results.

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Bond rating equivalence

Alpha and/or numeric symbols used to give indications of relative credit quality. In the municipal market, these designations are published by the rating services. Internal ratings are also used by other market participants to indicate credit quality.

Bond credit quality ratings	Rating agencies		
Credit risk	**Moody's[1]**	**Standard and Poor's[2]**	**Fitch Ratings[2]**
Investment Grade			
Highest quality	Aaa	AAA	AAA
High quality (very strong)	Aa	AA	AA
Upper medium grade (Strong)	A	A	A
Medium grade	Baa	BBB	BBB
Not Investment Grade			
Lower medium grade (somewhat speculative)	Ba	BB	BB
Low grade (speculative)	B	B	B
Poor quality (may default)	Caa	CCC	CCC
Most speculative	Ca	CC	CC
No interest being paid or bankruptcy petition filed	C	D	C
In default	C	D	D

1 The ratings from Aa to Ca by Moody's may be modified by the addition of a 1, 2, or 3 to show relative standing within the category.
2 The ratings from AA to CC by Standard and Poor's and Fitch Ratings may be modified by the addition of a plus or a minus to show relative standing within the category.

(MLP's) - Energy Related MLPs May Exhibit High Volatility. While not historically very volatile, in certain market environments Energy Related MLPS may exhibit high volatility.

Changes in Regulatory or Tax Treatment of Energy Related MLPs. If the IRS changes the current tax treatment of the master limited partnerships included in the Basket of Energy Related MLPs thereby subjecting them to higher rates of taxation, or if other regulatory authorities enact regulations which negatively affect the ability of the master limited partnerships to generate income or distribute dividends to holders of common units, the return on the Notes, if any, could be dramatically reduced. Investment in a basket of Energy Related MLPs may expose the investor to concentration risk due to industry, geographical, political, and regulatory concentration.

Mortgage-backed securities ("MBS"), which include collateralized mortgage obligations ("CMOs"), also referred to as real estate mortgage investment conduits ("REMICs"), may not be suitable for all investors. There is the possibility of early return of principal due to mortgage

prepayments, which can reduce expected yield and result in reinvestment risk. Conversely, return of principal may be slower than initial prepayment speed assumptions, extending the average life of the security up to its listed maturity date (also referred to as extension risk).

Additionally, the underlying collateral supporting non-Agency MBS may default on principal and interest payments. In certain cases, this could cause the income stream of the security to decline and result in loss of principal. Further, an insufficient level of credit support may result in a downgrade of a mortgage bond's credit rating and lead to a higher probability of principal loss and increased price volatility. Investments in subordinated MBS involve greater credit risk of default than the senior classes of the same issue. Default risk may be pronounced in cases where the MBS security is secured by, or evidencing an interest in, a relatively small or less diverse pool of underlying mortgage loans.

MBS are also sensitive to interest rate changes which can negatively impact the market value of the security. During times of heightened volatility, MBS can experience greater levels of illiquidity and larger price movements. Price volatility may also occur from other factors including, but not limited to, prepayments, future prepayment expectations, credit concerns, underlying collateral performance and technical changes in the market.

Alternative investments referenced in this report are speculative and entail significant risks that can include losses due to leveraging or other speculative investment practices, lack of liquidity, volatility of returns, restrictions on transferring interests in the fund, potential lack of diversification, absence of information regarding valuations and pricing, complex tax structures and delays in tax reporting, less regulation and higher fees than mutual funds and advisor risk.

Asset allocation does not assure a profit or protect against a loss in declining financial markets.

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