Regional Bank Weakness

March 13th, 2023

We've had two banking failures over the last week. What does it mean?

Over the last week, both Silicon Valley Bank (SVB) and Signature Bank (SBNY) collapsed due to their inability to meet customer deposit withdrawal requests.

In broad strokes, both banks were undone by the same challenge: classic bank runs. Their customers, whether crypto exchanges (SBNY) or tech startups (SVB) are facing broad pressure thanks to weakening financial conditions. This environment had led to declining deposits and rising cash withdrawals at a time when the markets were battering bank investments. The resulting cash squeeze made each bank sell investments at deep discounts and realize substantial losses. (Note: this is called "forced selling" and is something we believe is paramount to avoid in client portfolios.)

Over the weekend, regulators seized SBNY two days after shutting down SVB. A joint announcement was made by the Treasury, Federal Reserve, and FDIC that all depositors at both SVB and SBNY would be made whole, along with establishing a new liquidity facility for depositories. They added that any losses to the FDIC's Deposit Insurance Fund to support depositors who exceeded the $250,000-protected limit "will be recovered by a special assessment on banks, as required by law." The new liquidity program, the Bank Term Funding Program, will make advances up to the value of pledged collateral. This announcement has essentially calmed markets for now, with most indices reporting modest returns on Monday.
In the Treasury market, the flight to safety has been incredibly pronounced, as the 2-year yield is down nearly .50% this morning after falling .29% on Friday and .20% Thursday. What's remarkable about these declines is that they came just after the 2-year yield topped 5% for the first time since June 2007. The last time the 2-year yield dropped more than this in a three-day span was just after the 1987 crash.

What is also notable is the shift in expectations for future interest rate hikes. Only a week ago, comments from Fed Chair Powell shifted market expectations for the Fed Funds rate in March from a .25% hike to a .50% hike. The last few days' events have not only taken a .50% hike off the table, but the market isn't even sure there will be a .25% hike. As of Monday afternoon, futures markets were only pricing in a 65% chance of a .25% hike at the March FOMC meeting.

Mark Twain is reputed to have said, “History doesn't repeat itself, but it does often rhyme.” Keeping this proverb in mind, we analyze the potential for other regional banks to fail and compare the current environment to the Great Financial Crisis (GFC) of ‘08. Currently, First Republic Bank (FRC) is potentially susceptible to the same forces that cratered SVB and SBNY. That said, the Fed's actions over the weekend imply that the government will cover additional liquidity issues, and we view further bank failures as having a minimal impact. We don’t foresee a repeat of ‘08. Contagion risk has marginally increased for smaller banks, but overall, the threat to the financial system appears low. For larger, better-capitalized banks – such as (JPM), (BofA), (WFC), and (Citi) – default risk remains low. Each large bank is subject to regulatory oversight and leverage constraints directly resulting from the GFC. This group may benefit from the current environment through increased customer deposits and additional business as customers move to safe havens.

In client portfolios, we have minimal exposure to the bank industry, owning a handful of small positions in JPM and no equity exposure to regional banking stocks. Looking ahead, we are focused on how interest expectations evolve. The timing and magnitude of further rate hikes will have the largest impact on market returns over the summer. The FOMC will hold its March meeting on the 21-22nd. This meeting will be the next opportunity for an interest rate hike. The decision by the Fed and commentary around the meeting may create investment opportunities as investors adjust their future expectations.

Thank you for your confidence and partnership. Please reach out to us directly with comments and questions.

Sincerely,

Jim and Mike