Monthly Market Review & Outlook
4/11/2023

Banking Crisis Averted but Economic Questions Increase

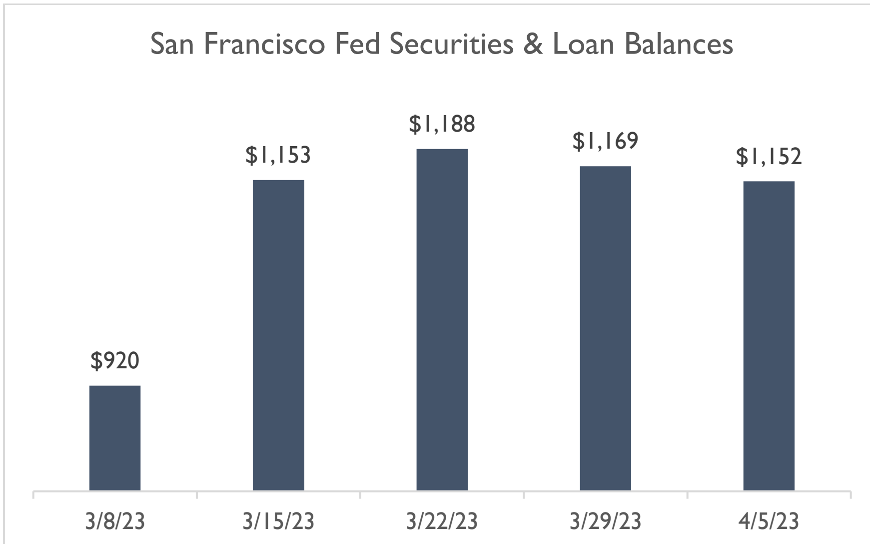
The events surrounding the failure of Silicon Valley Bank and Signature Bank – the second and third largest banks to ever fail in this country – during the last month were the center of attention. To that end, we published two research pieces and provided webinars with our assessment of the situation and, most importantly, reassurance that client assets at Charles Schwab were/are safe. We also delved into the details driving Silicon Valley Bank's collapse and made the case why their failure was an isolated incident of poor interest rate risk management in our Monthly Strategy webinar, which is worth watching. (Replay link: Monthly Strategy Update - Banking Crisis Averted but Economic Questions Increase - YouTube)

At the root of the recent banking turmoil is interest rate risk management. All banks face three critical business risks: credit, liquidity and interest rate. Proper credit risk management ensures that borrowers can pay back their loans. Liquidity risk management ensures that the bank can meet depositors' withdrawal requests. Interest rate management ensures that as interest rates change the yields on assets (i.e., securities and loans) continue to exceed the cost of the bank's liabilities (i.e., deposits).

In short, Silicon Valley Bank utterly failed at interest rate management which created significant pressure on profitability. The epic surge in interest rates last year - thanks to the Fed's aggressive actions - exposed Silicon Valley Bank's mismanagement. Losses in their securities portfolios grew so large that depositors became concerned about the safety of their money and began to withdraw. One unique feature of Silicon Valley Bank was the concentrated and sophisticated nature of their depositors who were generally venture capitalists and the companies whom they had funded. It only took a few texts from a few influential people to get the "run" on Silicon Valley's deposits going and the proverbial snowball effect ensued. According to the Wall Street Journal, nearly one-third of the bank's deposits were withdrawn on June 9th after the bank failed to raise enough equity to bolster capital and assuage depositor concerns. The next day the FDIC placed the bank in receivership.

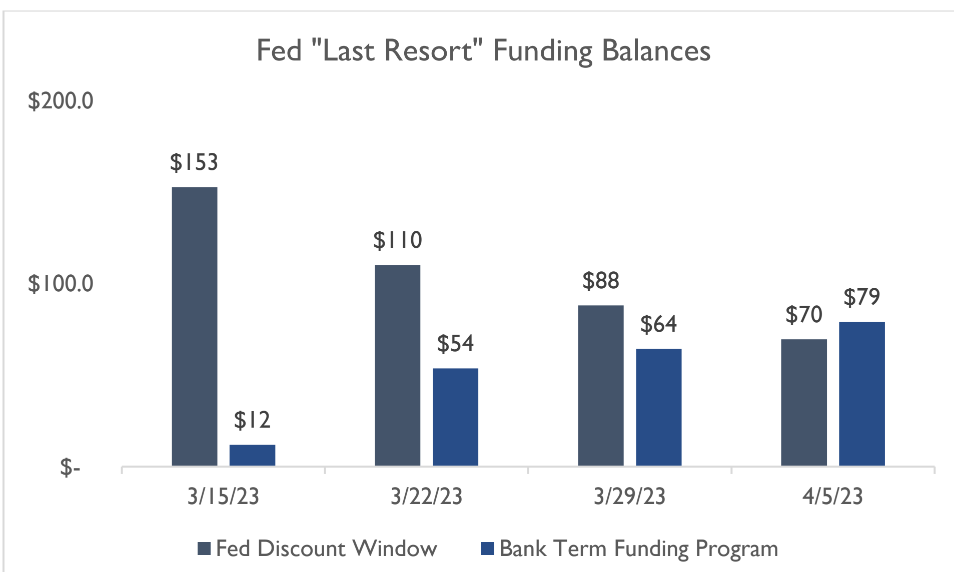
In response to Silicon Valley's failure, the Fed rolled out a new funding facility (the Bank Term Funding Program or BTFP) that enables banks to use the face value of their securities holdings as collateral for loans adding another source of liquidity for any bank facing a run-on deposit. This facility in addition to the Fed window and Federal Home Loan Bank ("FHLB") loans (which are last resort funding sources) provide an effective backstop that in our view greatly diminishes the risk of a systemwide crisis in depositor confidence.

Supporting evidence for this conclusion is available in the Fed's H.4.1 report which provides a weekly snapshot into changes in the Federal Reserve banks' balance sheets. From this data, it is possible to see if banks are using the Fed's "last resort" facilities to access desperately needed liquidity. The first observation is that the banking system stress was almost entirely in the San Francisco Fed's region (this region includes Silicon Valley, First Republic and PacWest…all experienced deposits runs to some degree). The localized nature of the banking stress is a clear indicator of no broader deposit run contagion.



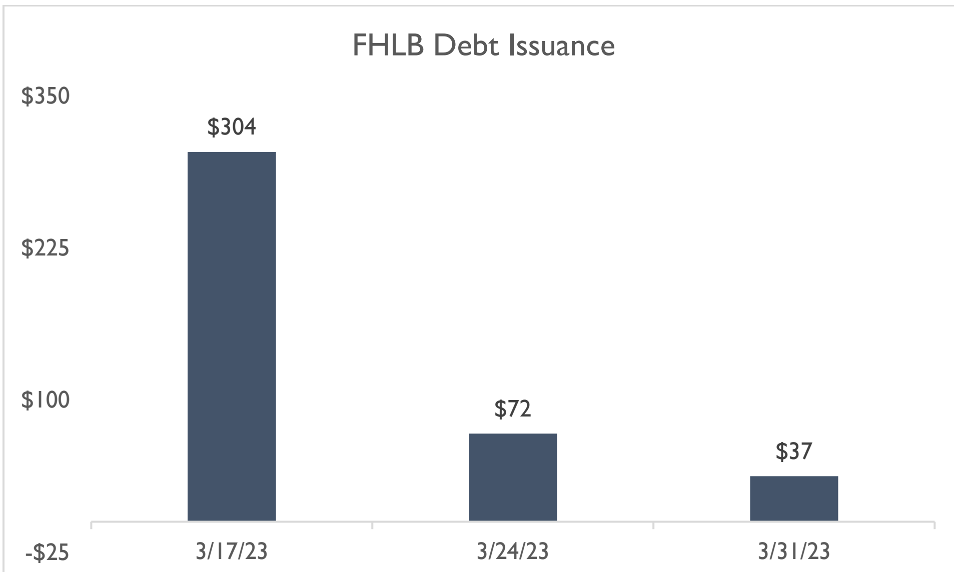
Source: The Federal Reserve

The second observation from this data strongly suggests that the liquidity stress caused by deposit runs has significantly declined. The graph below shows the declining use of the Fed's discount window, which is meant for emergency, last-ditch liquidity. We can also observe that the Fed's new BTFP facility has lent out $79 billion dollars over the past four weeks but the growth in borrowing seems to be slowing. Both are good signs that calm is returning to the system.



Source: The Federal Reserve

Another data point that suggests the banking turmoil is coming to a swift end can be inferred from FHLB's debt issuance. The FHLB system represents a collection of federally guaranteed banks. The sole purpose of the FHLB is to lend money to banks that need additional liquidity. It is very similar to the new BTFP save for tighter collateral requirements. The FHLB has received little use until now because banks typically would just sell some of their securities to meet liquidity needs. However, today those securities possess unrealized losses, so banks are less willing to crystallize those losses and damage their capital base. Thus, banks have increasingly turned to the FHLB to borrow against their securities portfolio to obtain liquidity. When a bank asks the FHLB for a loan (i.e., cash), the FHLB bank must issue debt – generally in the overnight or term repo markets – to obtain the cash for the bank. So, the amount of FHLB borrowing implies how much loan demand there is from banks. According to a recent Bloomberg article, FHLB debt issuance has fallen sharply implying that banks are not banging on FHLB's doors asking for liquidity. Another very good sign that the run on deposits has died down.



Source: Bloomberg, 4/10/23

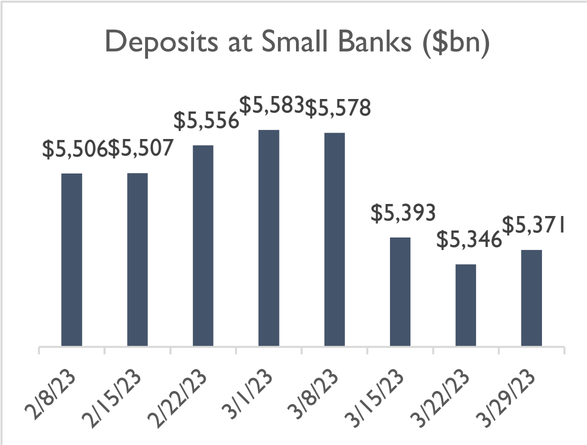
What Does this Mean for the Economy?

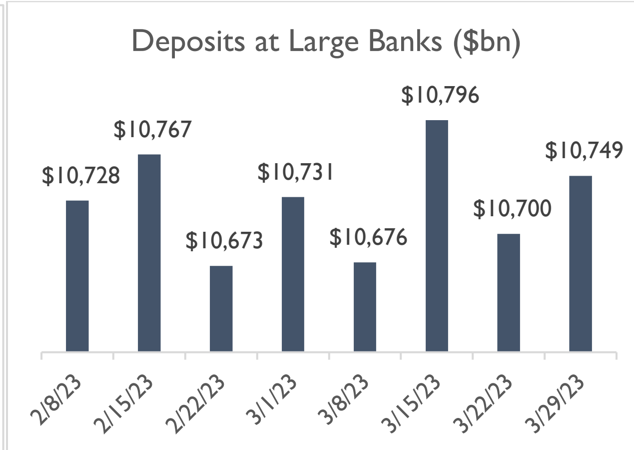
While the liquidity crunch for banks appears to have abated, it has left a mark that could impact banks' willingness to lend. The banking turmoil has caused banks to pull back a bit on lending, according to the latest H.8 report from the Fed. If banks continue to reign in lending this could put additional pressure on the economy. Time will tell.

We will be monitoring loan growth data very closely as the weeks go by to gain greater insight into the direction of the overall economy. Bank loans are like oxygen for the economy. Without it, the economy is at greater risk of recession. Importantly, the amount a bank can lend is largely dependent on the size of their deposit base. From the graph below, it is evident that Small Banks[1] lost almost 4% of their deposit base as a result of the recent turmoil. This will impact the ability of Small Banks to lend. Fortunately, Big Banks experienced very little change in their deposit

[1] The Federal Reserve distinguishes Big Banks as the 25 largest U.S. banks by assets and Small Banks as all other banks.

bases, which should support future loan growth. Nevertheless, banks may simply decide to tighten their credit underwriting, so this data will be closely watched going forward.





Source: The Federal Reserve

Market Outlook

The equity market has been remarkably resilient despite the recent banking turmoil and has recouped all related losses. The S&P 500 is now up approximately 7% for the year while the Nasdaq is up over 15% continuing its recovery after a difficult 2022. The S&P 500 index is now trading at a forward price-to-earnings ratio ("PE") of 18x – slightly elevated relative to history and somewhat concerning in light of our increasingly gloomy economic forecast.

However, this observation misses an important underlying trend: lopsided performance. Apple, Microsoft, Alphabet, Amazon, Nvidia and Meta account for nearly all of the index' gains this year despite comprising only 22% of the index. The six stocks collectively also carry a 25x PE, which is much higher than the rest of the index members that collectively trade at a 16x PE. In other words, if you strip out these six names the market is trading at a more reasonable valuation.

Despite frustratingly high interest rate volatility, the bond market has also recovered from the recent bank-driven pullback. The US Aggregate Bond Index is up 3.3% for the year and has provided portfolios with a measure of safety.

Looking ahead, the first quarter earnings season is about to commence, and we enter with some hesitation. Last earnings season proved to be better than feared and we hope this quarter is similar as expectations seem fairly low. However, there is a reasonable chance that the recent banking turmoil could weigh on earnings outlooks. If earnings expectations are broadly set lower, the market could experience a short-term correction.

Conclusion

With the banking turmoil in the rear-view mirror, we return our gaze to economic data and whether tighter lending standards will persist. Gauging the impact this could have on the economy is difficult, so we remain comfortable with our conservative portfolio positioning. Fixed income has generally played its expected role this year and we continue to believe that as inflation fades interest rate volatility will decline creating an excellent market for fixed income. Further, should the economy worsen, high quality bonds will likely outperform stocks. As for stocks, we are finding more and more value. Many stocks have experienced significant unjustified corrections that we are cautiously accumulating. Our 2023 mantra ("Be Patient") continues to guide our investment process.

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Definitions

The **S&P 500 Index** consists of 500 stocks chosen for market size, liquidity, and industry group representation. It is a market-value weighted index (stock price times number of shares outstanding), with each stock's weight in the Index proportionate to it market value.

The **Nasdaq Composite Index** is a market cap-weighted index, representing the value of all stocks listed on the Nasdaq Stock Market. The composition of the Nasdaq Composite is a mix of long-established companies that have been on the exchange since inception, to IPO newcomers, companies that grew from OTC exchanges or switched from other exchanges.

The **Dow Jones Industrial Average** is a price-weighted average of 30 blue-chip stocks that are generally the leaders in their industry. It has been a widely followed indicator of the stock market since October 1, 1928.

U.S. Treasury securities are guaranteed as to the timely payment of principal and interest if held to maturity. Investment options are neither issued nor guaranteed by the U.S. government.

The **Bloomberg Aggregate Bond Index** represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities.

The **Bloomberg U.S. Investment Grade Corporate Bond Index** covers U.S. dollar denominated, investment-grade, fixed ratee or step up, taxable securities sold by industrial, utility and financial issuers. It includes publicly issued U.S. corporate and foreign debentures and secured notes that meet specified maturity, liquidity and quality requirements. Securities included in the index must have at lease 1 year until final maturity and be rated investment-grade (Baa3/BBB-/BBB+) or better using the middle rating of Moody's, S&P, and Fitch.

The **Bloomberg US High Yield Index** covers the USD-denominated, non-investment grade, fixed-rate, taxable corporate bond market. Securities are classified as high-yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below. A small number of unrated bonds are included in the index. The index excludes emerging markets debt.

The **Bloomberg Commodity Index** is comprised of futures contracts and is designed to be a highly liquid and diversified benchmark for commodity as an asset class.

The **Bloomberg U.S. Mortgage-Backed Securities Index** tracks fixed-rate agency mortgage-backed pass-through securities guaranteed by Ginnie Mae, Fannie Mae and Freddie Mac.