No Easy Decisions

By James M. Walden, CFA

DASHBOARD

- Business Cycle (red)
- Valuation (green)
- Trend (yellow)

Recent banking turmoil has created the need to make some tough decisions.

By now, everyone is familiar with the collapse of Silicon Valley Bank (SVB). The bank fell from a classic run-on-the-bank made much worse by management missteps. Like many banks, SVB benefited from a spike in customer deposits created by all the Covid stimulus put into the system. Instead of keeping those deposits safe in cash and short-term bonds with relatively low interest-rate risk, SVB made the bad decision to buy an outsized amount of long-term bonds at generation-low interest rates.

As the Fed increased rates over the past year, yields on safe, short-term bonds became more attractive for savers than the deposit yields offered by SVB and other banks. Importantly, SVB was uniquely reliant on the venture-capital industry for its customer base, which was undergoing turbulence. Most other banks rely on a greater proportion of stickier retail depositors.

As customers withdrew deposits, SVB was forced to sell bond investments at a loss to raise cash. (Remember, as interest rates go up, bond prices go down.) Further, almost 90% of SVB's customer deposits were above the FDIC-guaranteed limit of $250,000, greatly exacerbating the problem as panic among SVB's depositors spread. All this ultimately led to SVB's insolvency.

We think it's highly unlikely that this will lead to another Global Financial Crisis. The failure of SVB, that of Signature Bank days later, and the shotgun marriage between Swiss banks USB and Credit Suisse were largely driven by issues specific to them.

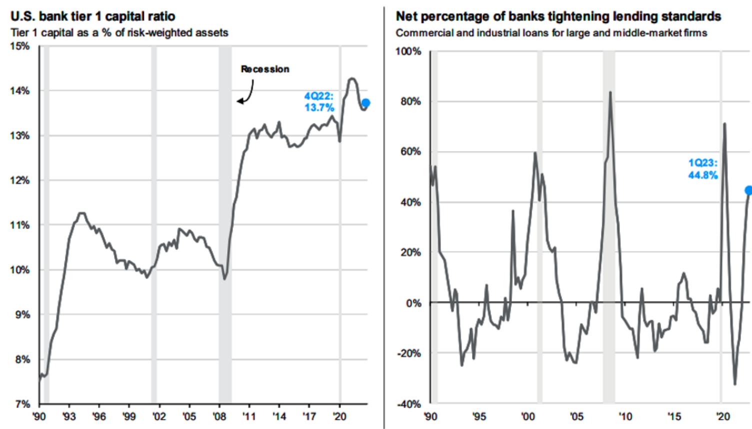
Importantly, the finances of large global banks (those deemed "systemically important") are in much better shape than in 2007, and they all regularly undergo rigorous "stress tests." The left panel in the exhibit on Page 2 highlights U.S. banks' tier 1 capital ratio. It's a measure of their equity capital and reserves relative to their risk-weight assets and indicates their financial strength.

It's currently around the highest it's been in more than 30 years. And just as importantly, federal regulators stepped in quickly with the troubled banks by guaranteeing all deposits and providing a mechanism for other institutions to receive cash to meet deposit outflows, so they wouldn't have to sell bonds at a loss.

However, there will likely be some lingering fallout for banks and another economic headwind. To prevent further deposit outflows, banks may have to raise their deposit rates to be more competitive. Or they may have to access more-expensive funding elsewhere to meet deposit-withdrawal demands. Both could lead to lower bank profitability.

And as small and regional banks, in particular, work to manage their cash, they may be increasingly discerning in their lending. (Bank lending standards had already been tightening—see the right panel in the exhibit.) The result is potentially less funding available for commercial real-estate and industrial projects, an outsized part of their lending activity. Whatever the odds were of a near-term recession, they're probably higher now.

Exhibit: Bank Capitalization and Lending Sentiment



Source: Bloomberg, Federal Deposit Insurance Corporation, Federal Reserve, J.P. Morgan Asset Management, Clayton Wealth Partners.

All this puts the Federal Reserve at a crossroads. The Fed has made progress in reducing inflation, but it isn't yet at the Fed's 2% target. Continuing to raise rates could help the Fed get there and more quickly. But this could make the current banking environment worse, as higher rates on short-term government securities would make current bank deposit rates even less attractive.

If the Fed cuts rates, it could alleviate pressure on the banks. But the potential downside is that with lower rates, the Fed loses momentum in its fight against inflation.

We still believe now is not the time to take on undue risk. We remain positioned defensively across most client portfolios.

Bullish

- Significant pent-up consumer demand
- Reasonable equity valuations
- The most attractive yields for fixed income in years
- Fed progress toward reducing inflation
- China's lifting of Covid restrictions, which could provide a lift to its economy

Bearish

- Slowing global economic growth with recession pressures mounting
- Deterioration in leading indicators of unemployment, such as a lower number of job openings and average weekly hours of employees and higher initial jobless claims
- Wall Street is cutting estimates of corporate profits
- Ongoing deterioration in housing
- Tightening by the Fed and other global central banks
- Russia-Ukraine war and other geopolitical concerns

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As Partner & Chief Investment Officer, James Walden strives to maximize our clients' long-term, risk-adjusted portfolio returns. This includes determining strategic and tactical asset allocations, as well as specific investment analysis and prudent rebalancing. Jim is also a partner and management team member. His expertise includes advanced investment research and valuation, and he is passionate about his role in helping clients reach and exceed their financial goals.

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