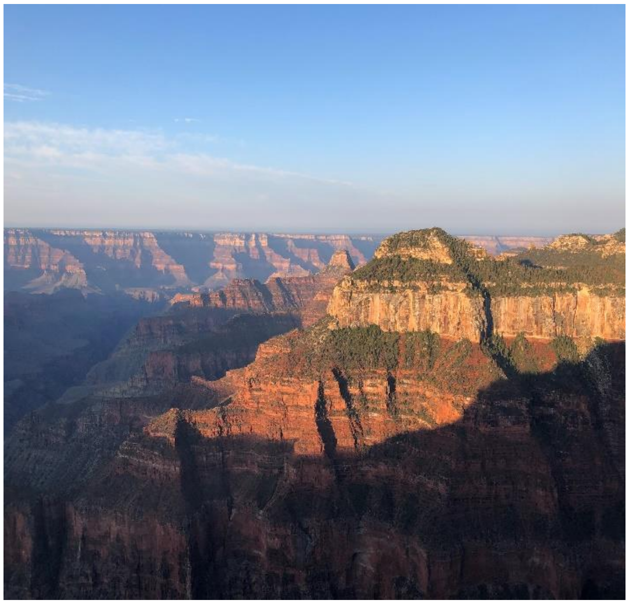
Highlights and Insights

March 13, 2023

Benefit Financial Services Group ║ 1643 E. Bethany Home Road, Phoenix, AZ 85016 ║ Phone: 602-997-8882 ║ www.bfsg-az.com



Inside This Issue

The Ides of March

The February jobs report last week was completely overshadowed by the collapse of SVB Financial Group (SVB). Within 2 days of attempting to issue a $2.5B stock issuance to shore up declining liquidity, the bank faced an unprecedented runoff in deposits, leading to the swift takeover by the Federal Deposit Insurance Corp (FDIC). This was the largest bank failure in the U.S. since the financial crisis. Bank stocks ended the week sharply lower in what was a sell first and ask-questions-later reaction. We have a further report below discussing the factors that led to the SVB failure and the consequences for Fed Policy and interest rates.

SVB was operating in a niche marketplace, which didn't stop the market from speculating on connections to larger and more important banks, whose liquidity and capital ratios are well above regulatory standards. Our current view is that the SVB collapse was based on company-specific or "idiosyncratic" factors, and the panic selling in financials is overblown. The one positive consequence has been that market expectations of an outsized 50 bp rise in the Federal funds rate in March have diminished.

Getting to the February Jobs report[1], the 311,000 monthly increase in payroll workers was stronger than the expected 225,000, as the economy was thought to be still running above expectations, threatening higher inflation. Stocks and bonds sold off as it was interpreted as leading the Federal Reserve to increase the Federal funds rate by 50bps in March vs. the expected 25bps.But looking behind the curtain presents a different picture of the February report.

The employment data for December and January were revised down by 35,000, making the February net gain 277,000, well within the standard error of such data and closer to the 225,000 expected. And private payrolls were revised down by 94,000 to 265,000. The message is that economy is still growing while gains in employment are slowing.

Average hourly earnings were ahead only 0.2% last month, the smallest of any month this year, and 4.6% from a year ago. Together with a 0.1% decline in hours worked, this resulted in **total wages** also ahead by just **0.2**% in the month, **the smallest monthly increase in 2 years**.

And by the way, the labor force expanded by 419,000 workers, exceeding the 277,000 in payroll jobs gain. This pushed the unemployment rate up from 3.4% to 3.6%, as the supply of labor outstripped demand, and kept wage growth in check. The takeaway? This report was not inflationary at all.

Speaking of inflation, The Federal Reserve Bank of Cleveland's "Nowcast"[2] for the personal consumption expenditures price index (PCE), which is the Fed's preferred inflation measure, is expected to fall to 4.5% in March, from 5.2% in February. The peak was 7% in June 2022. That would be a sizable decline in nine months, as it took 18 months to rise from 2% to 7%. This is happening with low unemployment, and less than 5% wage gains, before an expected further slowdown in employment as the massive rate hikes by the Fed over the past 12 months work their way through the economy.

In the meantime, the stock and bond markets will continue to be choppy and volatile, as the repercussions of the Silicon Valley Bank liquidation are assessed by the markets and the Fed. What the February employment has actually highlighted is that continued disinflation and recession-lite growth are likely to become more reflected in the Wall Street rhetoric but more importantly in market valuations.

Thomas J. Steffanci, PhD - Senior Portfolio Manager

Sources:

[1] https://www.bls.gov/news.release/empsit.nr0.htm

[2] https://www.clevelandfed.org/indicators-and-data/median-pce-inflation

A Primer on What Happened to Silicon Valley Bank (SVB)

Regulators have long warned that the end of very low interest rates could cause sudden disruptions in the banking system. When Silicon Valley Bank (SVB) failed last week in the face of a funding crunch, there was a swift selloff in bank stocks reflecting worries that the ripple effects of interest-rate hikes would be contagious to many other banks.

What Happened to SVB?

As the only publicly traded bank focused on Silicon Valley and new tech ventures, SVB was deeply embedded in the US startup scene. According to its 10-K, it did business with nearly half of all US venture capital-backed startups and 40% of US venture-backed tech and health-care companies that went public last year such as Shopify, VC firm Andreessen Horowitz, and cybersecurity firm CrowdStrike Holdings.

On March 8, its parent company, to stem deposit outflows, SVB_Financial Group, announced it had sold $21 billion of securities from its portfolio at a loss of $1.8 billion and planned to issue $2.25 billion in new shares to shore up its finances. Investors were unnerved, especially prominent venture capitalists who reportedly had their portfolio businesses pull their cash from SVB. By March 10, the effort to raise new equity failed, and the bank was put into receivership by the Federal Deposit Insurance Corp (FDIC).

What does that mean for SVB's Clients and Depositors?

The FDIC created a new bank, the Deposit Insurance National Bank of Santa Clara, to hold the assets of SVB. All depositors—not just those with $250,000 or less in their accounts — would have access to their money by March 13. Receivership usually means a bank's deposits will be directly assumed by another healthy bank or paid directly by the FDIC. This latter option was approved over the weekend for all depositors.

Could a buyer emerge?

It's possible. It might involve selling the company's assets piecemeal or as a whole, according to Bloomberg, citing a person familiar with the matter who said the goal is to complete a deal by Monday.

In the depths of the global financial crisis 15 years ago, US regulators set a precedent by arranging the distressed sales of Bear Stearns Co. and Merrill Lynch & Co. to JPMorgan Chase and Bank of America, respectively. But those failed banks were considered systemically important because of their debt obligations to other banks; it's not clear that SVB would get the same treatment.

Why did SVB prove so vulnerable?

Several factors came together to cause its distress. Some of those are unique to SVB, while others are the source of broader worries about the banking system as a whole.

Behind most of them are the rapid interest-rate increases that were pushed through over the last year by the Federal Reserve to fight inflation. These policies hit SVB especially hard, given the sharp downturn in the incubating tech companies that had been the source of its rapid asset and deposit growth. Few banks had such a concentrated client base. As venture capital dried up, SVB's clients tapped their deposits to withdraw cash they needed to operate.

What acerbated the bank's problems was their purchase of long-term bonds with the huge influx of deposits in 2021 and 2022 as venture capital activity waned. Its investment portfolio had swelled to more than half its total assets, far above the norm. When interest rates rose, the prices of those bonds declined sharply, and their sales created a $1.8B realized loss and a big capital drain.

Why are there fears of contagion?

For one thing, SVB's problems coincided with the abrupt shutdown of Silvergate Capital Corp., though the two cases are mostly unrelated.

At Silvergate, the issue was a run on deposits that began last year, when clients — cryptocurrency ventures, primarily — withdrew cash to weather the collapse of the FTX digital-asset exchange. But the withdrawals forced asset sales, creating capital losses as with SVB, leading Silvergate to announce plans to wind down operations and liquidate.

Even before SVB's woes became public, bank stocks were declining as mid-sized banks warned about mounting pressure to raise deposit rates, as money market yields were three to four times the interest on deposits. That pressure hits regional banks the hardest. They can either raise their own rates, cutting into profits, or face the prospect of a scramble to shore up their funding base if depositors leave. It is too early to assess the likelihood of that contagion, though last week's price declines of small and midsized banks reflected that perceived likelihood.

Did anyone see this coming?

Concern had been mounting about the impact of rising rates on bank balance sheets. While rate increases buoy banks' revenue in the short term, they also force them to write down the value of assets they hold. In all, US banks had booked $620 billion in unrealized bond losses at the end of last year, according to filings with the FDIC. The agency noted in February that those paper losses meaningfully reduced the reported equity capital of the banking industry. But as recently as January, SVB Chief Financial Officer, Daniel Beck, told investors there wasn't "any desire" for a wholesale change in the bank's bond portfolio, according to Bloomberg. That all changed this month.

What impact will this have on Fed Policy?

It will most likely change the trajectory of their interest rate increases in the near term in order to assess the risks of contagion. Whereas the market projected a good chance of a 50bp rise in the federal funds rate this month, that expectation has dropped to 30% as of Friday. As is historically the case with Federal Reserve tightening cycles, they underestimate the impact of their policies on bank liquidity especially as the yield curve is deeply negative and react too late in moderating their policy. And, with the impact of QT largely unknown, the chance of another policy mistake is more elevated.

Source:

Adapted and Expanded from Bloomberg "Quick Take" March 10, 2023:
https://www.bloomberg.com/news/articles/2023-03-10/why-svb-was-hit-by-a-bank-run-and-where-it-could-lead-quicktake?utm_source=website&utm_medium