Q1 2023: Volatile Markets & Banking Sector Turmoil

By Peak Trust Company's Chief Investment Officer, Lisa Russell, CFA. May | 2023

HIGHLIGHTS

- Both U.S. and international equity markets rallied in the last few days of March to end the month (and the quarter) with positive returns.
- As long-term interest rates stabilized, U.S. bonds recovered most of February's losses, ending the quarter at January's month-end levels.
- Despite a barrage of economic and policy news, the quarter will be remembered mainly for the failures of Silicon Valley Bank and Signature Bank.
- Recent bank failures are more a symptom of the Fed's rapid rate hiking cycle than a systemic solvency risk, but these failures are leading to a sharp contraction in lending that could increase the risks of a recession.

Overview

It certainly hasn't been a quiet start to 2023. Markets started the year on a strong note as both stocks and bonds ended January with decidedly positive returns. However, since then, things have taken an interesting turn. In February, most of the gains that stocks and bonds had made since the start of the year were wiped out. In fact, February was the fifth-worst monthly decline for bonds since 1993. On March 10, Silicon Valley Bank (SVB), the 16th-largest bank in the U.S., collapsed—the second-largest bank failure in U.S. history. Two days later, Signature Bank, the 29th-largest U.S. bank, closed as customers rushed to withdraw deposits. The speed at which these banks collapsed was unprecedented, a point captured well in a comment from Morgan Stanley CEO James Gorman:

> *"… with the click of an iPhone, $42 billion left one bank in one day. To give you a sense of the order of magnitude, in the financial crisis of 2008, one bank lost $17 billion in a week, so the rate of withdrawal was 20 times what it was then."*

These sentiments were echoed by Federal Reserve Chair Jerome Powell: "The question we were all asking ourselves over that first weekend was, 'How did this happen?'"

It happened partly because banks were not offering competitive deposit rates relative to short-term U.S. Treasury rates. As a result, depositors started shifting their money out of bank deposits and into Treasuries while the value of many banks' assets were declining (also due to higher interest rates). Large banks typically have enough reserves to withstand these shifts, but smaller and more specialized banks struggled to cope with such large drops in their deposit levels, especially when their investments were simultaneously sputtering. Even with these industry-wide headwinds, the largest culprit—at least in the case of SVB—was poor risk management. Throughout March, deposit withdrawals from commercial domestic banks totaled almost $400 billion, while $367 billion flowed into Treasury money markets.

March 17 marked the one-year anniversary of the Fed's first rate hike of the current hiking cycle. Although it is slowly easing, inflation remains well above the Fed's 2% target. Throughout the past quarter, a strong labor market and robust spending rates continued to thwart the Fed's efforts to slow the economy enough to get inflation under control. To date, there are few signs that the labor market is easing. The unemployment rate has remained steady at 3.5%. This most recent rate hike, which happened despite signs that higher interest rates were starting to destabilize key parts of the economy, highlights the policy predicament that the Fed has put itself in. By waiting too long to address inflation, which started spiking in early 2022, the Fed must now decide between two crucial mandates: price stability or financial stability. There is no viable path to fix both simultaneously.

Threats

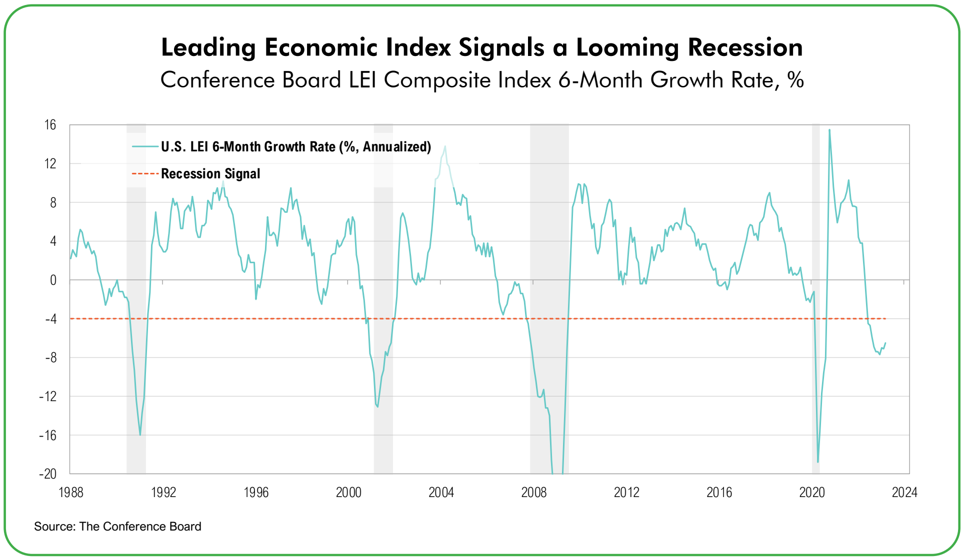
Another threat that is emerging slowly, yet inexorably and potentially more significantly, is the U.S. consumer may be running out of spending dollars. This is significant because the U.S. is a consumer-driven economy. In fact, consumer spending accounts for more than 67% of U.S. economic activity. During the height of the Covid-19 pandemic, government stimulus checks helped U.S. consumers amass more than $2 trillion in excess savings. As the pandemic lifted, consumers began burning through their savings, and demand skyrocketed, lifting the economy out of recession. Buoyed by stimulus checks and cheap credit, consumers continued to spend, even as inflation hit 40-year highs in June 2022. Today, the easy money that bolstered consumer spending over the past two years is dwindling, yet inflation remains stubbornly high. This combination of higher interest rates, reduced fiscal stimulus, and a nascent economic slowdown is slowly, but surely, depleting pandemic-era savings.

This trend is evident in changes in the U.S. savings rate. In June 2022, when inflation reached a four-decade high of 9.1%, the personal saving rate dropped to 2.7%—the lowest level since 2007. As inflation has slowly moderated, the savings rate has crept upwards to 4.6%. While a notable improvement, the rate still remains well below the average savings rate of 8.9% since 1959. Wages have also not kept pace with inflation, as real wage growth has been negative since March 2021. This is the longest period of negative wage growth on record surpassing the second-longest period from April 2011 to June 2012.

Even before the financial market turmoil caused by the collapse of SVB and Signature Bank, a key gauge of consumer sentiment in the U.S. fell for the first time in four months. The University of Michigan's Consumer Sentiment Index for March dropped from 67 to 63. Data from the same survey reveals that consumers are increasingly anticipating a recession and a sharp weakening in one-year business conditions. Yet for now, consumers are continuing to spend. Revolving consumer credit reached an all-time high of $1.2 trillion in February, a year-over-year increase of 15%. Credit card delinquencies also started ticking upwards in June 2022, and given that average credit card rates now surpass 20%, these delinquencies will likely continue.

The rapid increase in credit card debt speaks to the precarious situation of the U.S. consumer. With the Fed still hiking rates and the consumer continuing to get squeezed by the higher cost of living, it seems like only a matter of time before the money runs out. Tighter lending standards may also mean that businesses will also have less access to credit. Throughout the first quarter of the year, approximately 44% of domestic banks in the U.S. tightened their lending standards for commercial and industrial loans to companies. The chart below shows that loan standards were tightening even before the collapses of SVB and Signature Bank. Since SVB's collapse, loan growth has been further curtailed. Over the past two weeks ending March 31, commercial real estate loans from U.S. banks declined by a record $40 billion, and loans and leases declined by a record $100 billion—the largest two-week changes since 1975.

Recession Watch



Although no one can accurately predict if and when a recession will start, leading economic indicators can offer useful insights. Over the first quarter of 2023, the Treasury yield curve—proxied by the difference in yield between the 2-year and 10-year Treasury notes—remained inverted. On average, it takes about 14 months from the initial point of inversion until a recession hits. Since 1956, an inverted yield curve has correctly predicted a recession within 14 months 90% of the time, with the only exception being in 1998, when the yield curve briefly inverted before correcting itself. At the end of March 2022, almost exactly one year ago, the yield curve inverted. We are now entering the 13th month from the initial point of inversion.

Similarly, the Conference Board's Leading Economic Index (LEI), which is used to forecast future economic activity, has been signaling a looming recession since July 2022. Since 1988, the LEI has dropped below zero over a six-month period on 10 occasions. On five of those occasions, the LEI dropped below -4%—signaling a recession every time. In May 2021, the LEI's six-month change dropped below zero, triggering a recession warning. On June 30, 2022, the index dropped below -4%.

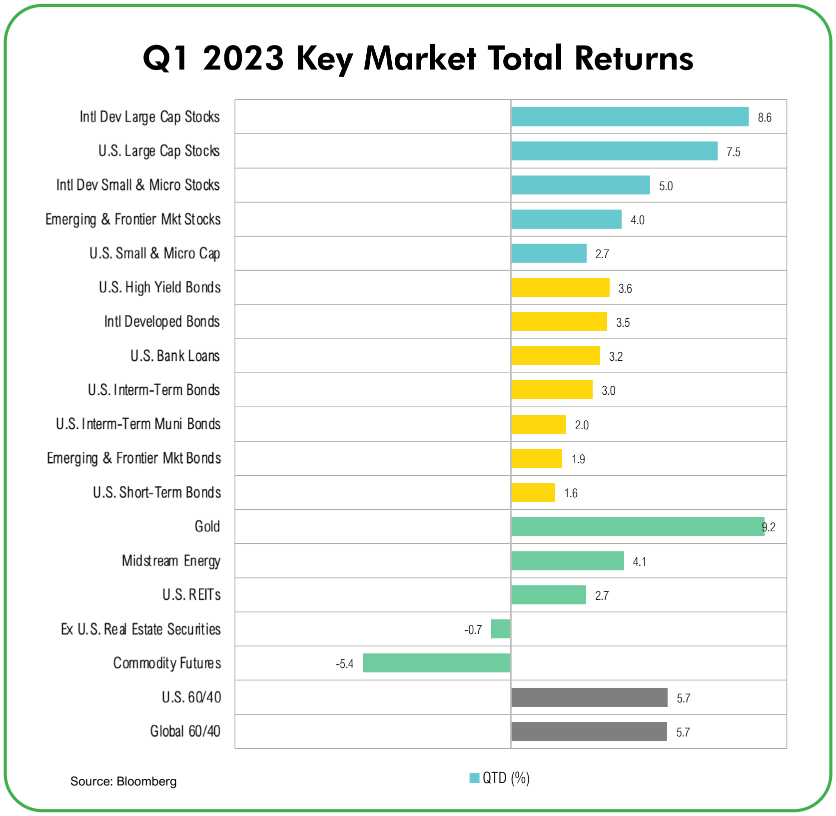
To add even more intrigue, on January 26, 2023 the U.S. Treasury Department officially hit its statutory borrowing limit, otherwise known as the debt ceiling. So far, the Treasury Department has been able to improve liquidity by activating extraordinary accounting measures, but estimates indicate that it could run out of funds by July. While the U.S. certainly has the resources to raise the debt ceiling, it's unclear by how much the ceiling will be raised or what political tradeoffs will be required to reach such an agreement. Notably, the MOVE Index (which measures implied volatility in the U.S. Treasury market) also remains elevated to levels of volatility not seen since the Global Financial Crisis in 2009.

Markets

Both U.S. and international equity markets rallied in the last few days of March to end the month (and the first quarter) in positive territory. The MSCI EAFE Index ended the quarter up 8.6%, and the S&P 500 posted a respectable 7.5% gain. As longer-term interest rates stabilized, fixed income markets recovered most of the losses incurred throughout February and ended the quarter at January-end levels. The Bloomberg U.S. Aggregate Bond Index closed the quarter up 3.0%.

When we look under the covers in the U.S markets, growth continued to outperform value by a large margin, which was a trend we started seeing in the 4th quarter of 2022. In fact, the Nasdaq 100, which represents a high growth index, returned 20.77% on the quarter, while the Dow Jones Industrials, which is more value oriented, returned only 0.93%. The S&P 500, which is a market-cap weighted index, returned 7.5%. Eight stocks represented 80% of the returns, while the other 482 represented only 20%.

Commodities have taken a breather as the Bloomberg Commodity Index returned -5.36%. Whether China is reopening or not has been a major factor. Gold has bucked the trend with a return of 8.11% YTD and still sits at multi-year highs. Flight to safety and a lower dollar are the main drivers for gold prices.



Looking Forward

Recent bank failures are more of a symptom of the Fed's rapid rate hiking cycle than systemic solvency risk, but they are causing a sharp contraction in lending, which could contribute to triggering a recession.

Due to persistently high inflation, the Fed has continued to hike interest rates, which has stressed the banking system and slowed the economy. To make matters worse, the Fed Funds futures markets currently projects a 70% chance that the Fed will raise interest rates an additional 25 basis points (to 5.25%) at the May 3 FOMC meeting. Beyond that, predictions begin to shift, and markets anticipate a Fed pause, followed by rate cuts before the end of 2023.

Although there is no predefined path for policies or markets, we remain focused on downside risks. If we are wrong and the economic backdrop is stronger than current data suggests, we will still likely participate in any upside, but to a muted degree. Higher fixed income rates are giving us an opportunity to extend duration in portfolios at attractive levels. Given our cautious stance, gold is an asset class worth holding in portfolios as well. As always, we will remain diversified and nimble.

About Lisa

Lisa Russell started with Peak Trust Company in 2003 and currently serves as Chief Investment Officer. Lisa brings over 25 years of investment experience to the Peak team. She specializes in designing unique investment programs for high-net-worth clients and trust accounts. She is highly attuned to the tax consequences of investment actions.

Lisa holds a Master of Business Administration in Finance from Emory University and a Bachelor of Science in Business Administration from the University of Southern California. Lisa holds the designation of Chartered Financial Analyst (CFA), and is a member of the CFA Institute and the CFA Society of Seattle.

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