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Situation analysis

March 13, 2023

Capital markets gauge financial sector contagion risk

Global capital markets continue to weigh if actual and perceived liquidity issues within specific banks will have broader implications across asset classes. With Silicon Valley Bank and Signature Bank failing in recent days, investors are anxious to understand if other financial institutions are vulnerable or if risks are more contained. Asset prices remain volatile across stocks, bonds, currencies and commodities, and this paper will frame the issues and discuss our outlook. U.S. Bank is a depository banking institution, so the scope of this paper is limited to investment implications on behalf of our investing clients.

Background

Totaling more than $200 billion in assets, Silicon Valley Bank's failure is the second largest in history behind Washington Mutual's 2008 collapse, and Signature Bank is the third largest, with assets exceeding $110 billion. While bank failures involve idiosyncrasies germane to each institution, Silicon Valley Bank's and Signature's demise appear to be liquidity-based, where depositors seeking cash overwhelmed each institution's ability to convert loans and securities to cash. The mismatch between depositors seeking funds and each institution's ability to produce those funds led to both bank's closings.

Banks take on deposits, which are liabilities on a bank's balance sheet, and use those deposits to make loans and buy bonds, which are assets on a bank's balance sheet. The difference between assets and liabilities is known as equity — a bank holds assets exceeding their liabilities as an equity cushion. The equity cushion's makeup and nature are important, and banks typically will hold traditionally safe securities like government and government agency bonds. However, with the U.S. Federal Reserve's sharp increases in interest rates over the past year, bond values have fallen, adversely impacting equity cushions.

Banks can take steps to shore up those equity cushions by raising additional equity capital or through other means, but investors and bank customers may not look favorably upon steps taken. Investors may sell a specific bank's stock or bonds, impacting sentiment. Depositors may learn of pressure on a specific bank's stock or bonds and in turn grow wary of their deposits and look to withdraw and seek safety elsewhere. This negative feedback loop can remain contained within a bank or a handful of banks or can spread and become a more systemic issue.

Over the weekend, a joint statement from the Treasury Department, Federal Reserve (Fed) and the Federal Deposit Insurance Company (FDIC) sought to quell systemic risk concerns. The joint statement announced easier loan terms through the Fed's main lending facility, a new Federal Reserve program to provide loans to banks at favorable terms, a resolution to fully protect all Silicon Valley Bank and Signature depositors and, perhaps most importantly, an assertion that the Federal Reserve's new program is large enough to protect all U.S. deposits.

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Outlook and market implications

The current environment remains fluid. While the Silicon Valley Bank and Signature fallout appear to be contained to a few institutions, banking sector stock and bond volatility throughout Monday reflect a market still seeking clarity on broader implications, despite this weekend's joint announcement. Investors had been focused on a heavy economic data calendar this week, including domestic consumer and producer inflation, retail sales, home construction and industrial production alongside Chinese industrial production, retail sales and infrastructure spending figures plus a European Central Bank meeting on interest rate policy. The Federal Reserve concludes a critical interest rate policy meeting a week from Wednesday; prior to the Silicon Valley Bank and Signature issues, markets had anticipated either a 0.25% or 0.5% interest rate increase. As of Monday, markets are split between no interest rate increase or at most a 0.25% hike.

We continue to have a more cautious outlook toward riskier asset classes in the current environment. One of the risks we have cited throughout the Federal Reserve's abrupt interest rate policy shift is liquidity; one year ago, government bonds maturing six months forward yielded 0.77%, and in the middle of last week, they yielded 5.25%. Such a dramatic yield increase has had implications for consumer and business borrowings as well as asset values across stocks, bonds, currencies and commodities, and the longer interest rates remain elevated, the more adjustments and recalibrations are necessary within the real economy. Adding in concerns about specific financial institutions can lead to more foundational concerns, but currently we view those concerns as premature.

As always, the investor pendulum between excessive optimism and caution can swing too far in either direction, and the current capital market environment offers opportunities for investors to remain engaged with their financial plan for individual investors and investment policy statements for our institutional clients. Please do not hesitate to contact us if we can answer questions about the current investment climate or engage on your specific situation. We will continue to keep you apprised as events unfold and we thank you for your trust.

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Equity securities are subject to stock market fluctuations that occur in response to economic and business developments. International investing involves special risks, including foreign taxation, currency risks, risks associated with possible differences in financial standards and other risks associated with future political and economic developments. Investing in emerging markets may involve greater risks than investing in more developed countries. In addition, concentration of investments in a single region may result in greater volatility. Investing in fixed income securities are subject to various risks, including changes in interest rates, credit quality, market valuations, liquidity, prepayments, early redemption, corporate events, tax ramifications and other factors. Investment in debt securities typically decrease in value when interest rates rise. This risk is usually greater for longer-term debt securities. Investments in lower-rated and non-rated securities present a greater risk of loss to principal and interest than higher-rated securities. Investments in high yield bonds offer the potential for high current income and attractive total return, but involve certain risks. Changes in economic conditions or other circumstances may adversely affect a bond issuer's ability to make principal and interest payments. The municipal bond market is volatile and can be significantly affected by adverse tax, legislative or political changes and the financial condition of the issues of municipal securities. Interest rate increases can cause the price of a bond to decrease. Income on municipal bonds is free from federal taxes, but may be subject to the federal alternative minimum tax (AMT), state and local taxes. There are special risks associated with investments in real assets such as commodities and real estate securities. For commodities, risks may include market price fluctuations, regulatory changes, interest rate changes, credit risk, economic changes and the impact of adverse political or financial factors. Investments in real estate securities can be subject to fluctuations in the value of the underlying properties, the effect of economic conditions on real estate values, changes in interest rates and risks related to renting properties (such as rental defaults).

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