MONTHLY UPDATE

CARY STREET PARTNERS

MARCH 21, 2023

The Fed is Starting to Break Banks

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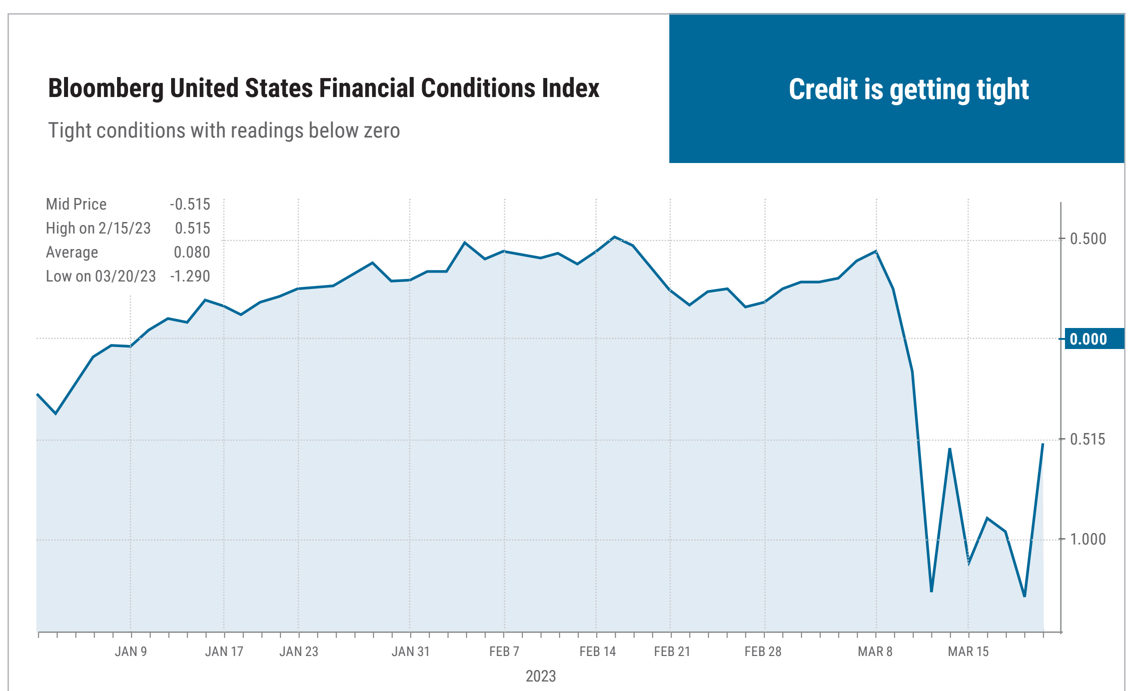
There is an expression on Wall Street that the "Fed raises rates until something breaks." Well, something broke in March: Silicon Valley Bank and Signature Bank failed, and a host of regional banks came under stress, First Republic being the poster child of the latter group. The rapid and dramatic rise in the Federal Reserve's short-term overnight lending rate, Fed funds, has put balance sheet pressure on banks that failed to hedge rate risk. This exposure is best summarized as a bank borrowing at short maturities (deposits) and buying long maturities (bonds and loans). Rising rates have punished the value of long maturities over the last 12 to 18 months, while the cost of short-term borrowing has escalated. As this balance sheet pressure became evident, primarily in regional banks, scared depositors quickly initiated a run on Silicon Valley, resulting in rapid insolvency. Regulators quickly extended guarantees to depositors as the bank failed to stem further runs. Despite these efforts, fear spread to the rest of the regional bank sector as depositors quickly moved deposits to either large money center banks or Treasury-backed money funds. As a meaningful yardstick of stress, in the week ending March 15th, banks borrowed a record $153 billion from the Federal Reserve discount window, the long-standing source of liquidity for banks in need of operating funds.

Adding fuel to the fire, Credit Suisse, a weak link in the European banking chain, also came under pressure culminating in its acquisition by UBS in a deal engineered by Swiss authorities. The Credit Suisse situation is arguably more systemically important as it is deeply entwined in the global financial network. The upshot of all this drama has been increased volatility, as seen in CBOE Volatility Index (VIX) pricing, and a flight to safety in the Treasury market. Yields plummeted since last month as Treasury bond prices increased, making long and short-duration Treasuries the beneficiary of this stressed market. Bond yield and price move opposite. Treasuries, leaning into long duration, along with income-producing hedge strategies, were among our portfolio diversification recommendations in the 2023 Market Outlook. They remain as recommendations along with balanced value and growth positioning in equities.

The additional fallout of bank stress is that a pause in the Federal Reserve's rate increase campaign may come sooner than previously thought. Financial conditions have tightened significantly, which leads to tighter credit. Tight financial conditions, tight credit, bank runs, plummeting rents (which make up 40% of the CPI), falling commodity prices, zero container ships offshore in California, and most of all, negative money supply growth support a viewpoint of dis-inflation, maybe not all the way to 2% but significantly lower than the current 6%. The only thing supporting a sticky, high-inflation viewpoint is a tight labor market—the Phillips Curve[1] is a dubious and backward-looking inflation indicator, although wage inputs are important. That said, the Fed is reactive and likely waits for further improved inflation prints before pausing.



Source: Bloomberg

[1]*The Phillips Curve is an economic theory that essentially states that low unemployment leads to higher inflation.*

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