Comerica Wealth Management

March 13, 2023

Weekly Market Update:
Bank Volatility

Executive Summary

The collision of extreme fiscal and monetary policies has finally arrived, with the victims being investors in banks with narrowly focused deposit, lending, and securities portfolio strategies.

To be sure, the collapse last week of Silicon Valley Bank (SVB), Silvergate Capital, and now, Signature Bank, highlights the troubling confluence of emergency pandemic related spending, a surge in deposits, tighter monetary policy, and a plunge in confidence.

Key Takeaways

- Unfortunately, markets have not yet proved discerning, and the leading indexes for banks and regional banks have come under significant pressure in recent days.
- While we would like to think the worst is behind us, experience tells us otherwise. It is conceivable that some of the banks currently under the most pressure may find the FDIC at their doorstep in the coming days and weeks.
- Yet, we do not view these developments as systemic contagion, like the experience of the Great Financial Crisis (GFC) in 2008 and 2009.
- Over the past 15 years, the banking industry has been on a journey of stress testing, higher capital ratios, and restructuring with lower risk and less leverage, thereby more insulated from economic and market risks.
- In addition, regulators have stepped up in this crisis to support depositors of the failed banks. The Federal Reserve created a new Bank Term Funding Program that will offer loans for up to one year to banks in return for high quality collateral, like U.S. Treasuries. In addition, the central bank has eased terms for banks seeking loans at its discount window.
- Though financials large and small will likely remain under pressure in the near -term, we suspect that investors will eventually become more discerning, and look for opportunities with banks, large and small, with depressed prices and broader lending, deposit, and investment strategies than the niche players that have either failed or remain under significant pressure.

We maintain our Market Weight preference for the Financial Services sector, which makes up about 12.0% of the S&P 500® Index. Our base case has warned of a retest of the October lows, and these developments may provide the catalyst. Yet, we believe the combination of regulatory support and increased awareness of most broadly diversified banking models within the Financial Services sector will enable the banking industry, and the equity market, to eventually find support and price in recovery.

Our fair value estimate for the S&P 500® Index remains in the range of 4,100 to 4,200 – yet this move is unlikely to be linear.

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Bank Volatility

To be sure, the collapse last week of Silicon Valley Bank (SVB), Silvergate Capital, and now, Signature Bank, highlights the troubling confluence of emergency pandemic related spending, a surge in deposits, tighter monetary policy, and a plunge in confidence.

Pandemic related fiscal measures saw bank deposits in the U.S. surge by approximately $5 trillion between 2020 and 2021, with weak loan demand resulting in approximately 20.0% of that amount being lent out. The rest was invested in U.S. Treasury and government sponsored mortgage-backed securities or held as cash. Accounting rules state that banks must designate securities held as either “available for sale” (AFS) or “held to maturity” (HTM). Selling HTM securities is complicated, given “marked to market” pricing requirements, which can accelerate the need for a capital raise.

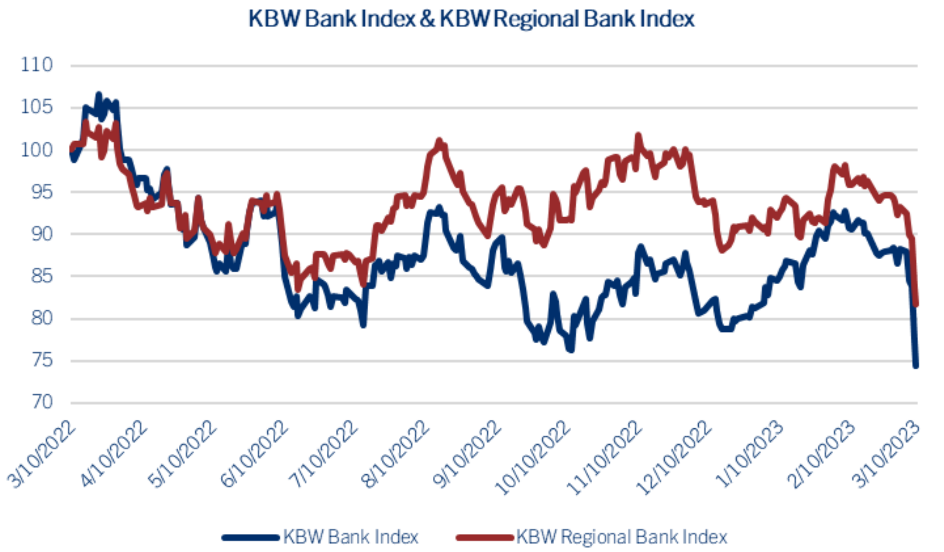
The massive amount of liquidity invested by banks came under pressure last year once the Federal Reserve began raising interest rates. This resulted in “unrealized losses” in the securities books for these institutions, complicating their ability to respond to the funding requests of depositors.

SVB was unique in that it relied extensively on HTM treatment for its growing securities portfolio. In addition, it had a narrow lending and deposit focus catering almost exclusively to venture capital and technology firms. SVB experienced sudden and overwhelming pressure once depositors wanted their money back and was forced to sell securities at a loss to meet depositor demand for funds. Consequently, inadequate liquidity and insolvency quickly resulted, and the Federal Deposit Insurance Corp. (FDIC) took control of SVB midday on Friday, leading to the second largest bank failure in history. Silvergate Capital failed last Wednesday, and we wake up Monday morning to discover that Signature Bank was also taken over by the FDIC.

Not surprisingly, these developments have led to a surge in market volatility. Stock prices plunged and U.S. Treasuries caught a safe-haven bid. As is typical, traders quickly circled those other financial institutions with similarly narrow focused business models and an HTM emphasis on their securities portfolios.

Bank Volatility (continued)

Unfortunately, markets have not yet proved discerning, and the leading indexes for banks and regional banks have come under significant pressure in recent days. See chart: KBW and Regional.



Source: Bloomberg L.P.

While we would like to think the worst is behind us, experience tells us otherwise. It is conceivable that some of the banks with narrowly focused business models may find the FDIC at their doorstep in the coming days and weeks.

Yet, we do not view these developments as systemic contagion, like the experience of the Great Financial Crisis (GFC) in 2008 and 2009.

Bank regulation and stress testing over the past 15 years has resulted in fortified balance sheets, improved capital positions, and stringent lending standards all aimed at the prevention of systemic risk. Of course, unforeseen events like a global pandemic and emergency fiscal spending of more than $6 trillion with an expanded Fed balance sheet of greater than $8 trillion leads to unchartered territory, resulting in imbalances, particularly for narrowly focused financial institutions. But investors should keep in mind that despite the near-term volatility affecting the industry, most regionals and "big" banks have strong balance sheets, healthy income statements and diversified deposit and lending activities, suggesting the current crisis is idiosyncratic and not systemic.

When viewed through the lens of "systemic importance" many of the larger U.S. regional banks, though sitting on unrealized losses, have much lower deposit betas (interest rate risk) and lower deposit outflow risk than SVB. The group's net interest margins remain high and possess large reserves with "available-for-sale" holdings that can be used as additional sources of liquidity, should they become necessary. Moreover, the largest U.S. "big" banks also hold large unrealized gains/losses positions, but the impact of this is not likely to be more than an earnings drag given their regional and business line diversification, low deposit betas, allocation to reserves, broad trading assets, and primarily "available-for-sale" holdings.

Regulatory Support

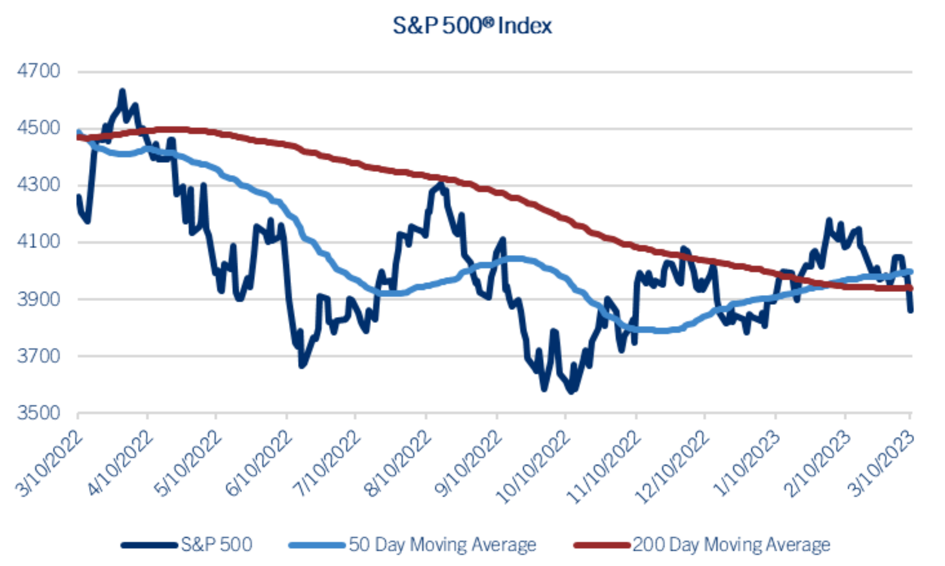
Over the past 15 years, the banking industry has been on a journey of stress testing, higher capital ratios, and restructuring with lower risk and less leverage, thereby more insulated from economic and market risks.

In addition, regulators have stepped up in this crisis to support depositors of the failed banks. The Federal Reserve created a new Bank Term Funding Program that will offer loans for up to one year to banks in return for high quality collateral, like U.S. Treasuries. In addition, the central bank has eased terms for banks seeking loans at its discount window.

An old Wall Street adage claims that "the Fed always raises rates until something breaks." While the crypto sell-off and collapse of FTX were prime candidates, the economy and financial markets kept moving. Perhaps fallout from the SVB collapse over the next few weeks will change the Fed's tune. Though we do not expect a rate cut, it is possible we learn of a reduction in the amount of quantitative tightening in the weeks and months ahead. In the meantime, economic activity and inflation remain too high for the central bank's taste, and at a minimum, these events likely remove the threat of a 50-basis point hike at the Fed's next policy meeting on March 21st and 22nd.

Market Response

We continue to favor a “barbell risk” sector strategy emphasizing Health Care and Energy. Though financials large and small will likely remain under pressure in the near-term, we suspect that investors will eventually become more discerning, and look for opportunities with banks, large and small, with depressed prices and broader lending, deposit, and investment strategies than the niche players that have either failed or remain under significant pressure. U.S. Treasuries will likely experience further safe-haven demand in the coming days and weeks. We maintain our Market Weight preference for the Financial Services sector, which makes up about 12.0% of the S&P 500® Index. **See chart: S&P 500® Index.**



Source: Bloomberg L.P.

Speaking of the S&P 500®, the Index closed below the important 3,900 level on Friday, which represented not only a big round number, but also represents a break below the rising trend line that had offered support throughout the bear market rally that began last October. Downside risks should prevail with the combination of fundamental concerns and a lack of technical support.

As a result, we expect further near-term pressure on stocks. Our base case has warned of a retest of the October lows, and these developments may provide the catalyst. Yet, we believe the combination of regulatory support and increased awareness of most broadly diversified banking models within the Financial Services sector will enable the banking industry, and the equity market as a whole, to eventually find support and price in recovery. Our fair value estimate for the S&P 500® Index remains in the range of 4,100 to 4,200 – yet this move is unlikely to be linear.

Be well and stay safe!