March 17, 2023

MARKET SIGHT LINES

Three bank failures, and worries of more: What happened? Where are we now? What about the future?

By Michael O'Keeffe, *Chief Investment Officer*

While we must remain mindful of inflation and Federal Reserve (Fed) policy, investor focus has appropriately turned to real problems in the banking sector, the federal response, risks of a global credit crisis, and how all of this will affect consumer and business confidence, Fed policy, the global economy, and markets. What happened? What was the government's response? Where are we now? And what about the future?

In this week's Sight|Lines, we answer these questions and discuss what this turbulence in the market environment means for investors in 2023 and beyond.

THE TAKEAWAY: THREE BANKS FAILED, THE FED STEPPED IN, STOCKS FELL, AND RISK REMAINS ELEVATED.

In our 2023 outlook, we shared the idea that market volatility would remain elevated in the first half of 2023 as the lag effect of the historically tight monetary policy shift took hold. We discussed a weakening economy and the effects of higher rates, but a potential banking crisis was not at the top of our list of immediate concerns. Volatility is up across the capital markets this week on worries about the banking sector here and abroad. In summary:

- Three banks failed over the last week or so, raising concerns over investment practices present in other banks.
- Over last weekend, U.S. federal officials met, establishing facilities to help other U.S. banks avoid trouble.
- Stock markets have fallen, with increased volatility, as investors evaluate the related implications for the banking sector and markets more broadly going forward.
- Market interest rates have fallen on the anticipation that the Fed will halt rate hikes soon and even cut rates much earlier than has been expected.
- Meanwhile, outside the U.S. Credit Suisse Group AG exercised its option to raise up to 50 billion Swiss francs ($53.7 billion) from the Swiss National Bank to ally liquidity concerns.

We expect heightened volatility through midyear, but the prospect for relief in the second half remains.

IN-DEPTH: BANK FAILURES LEAD THE FED TO STEP IN AND PROVIDE A BACKSTOP; STOCKS FALL; INVESTORS RETHINK FED POLICY, AND RATES FALL; VOLATILITY IS UP WITH UNCERTAINTY AND WORRIES ABOUT MORE TROUBLE HERE AND ABROAD.

Investors and other market participants are assessing the banking troubles, the federal response, and where we go from here. Volatility jumped, stocks fell, and rates are down with the prospect of a less hawkish Fed. Going deeper:

- Three banks have failed in the last nine days, with shareholders severely impacted:
  - On March 8, Silvergate Capital announced a wind-down of operations and voluntary liquidation of its bank, given the challenges of major clients in the crypto space. Deposits will be repaid, according to the company's liquidation plan.
  - On March 10, Silicon Valley Bank (SIVB) was closed by authorities after an acceleration in deposit withdrawals forced the sale of assets with unrealized losses:
    - As of December 31, 2022, SIVB reported an unrealized loss of ~$16 billion. Absent a run on deposits, such positions, if held to maturity, would mature at par. But an early sale to fund withdrawals forced SIVB to book the losses, which the company could not absorb.
  - On March 12, authorities closed Signature Bank to prevent a systemic banking crisis after depositor withdrawals accelerated. Depositors will be made whole.
- Over last weekend, the FDIC, Treasury, and the Fed met, establishing facilities to help other U.S. banks avoid a full-blown banking crisis, which could be spurred by eroding public confidence:
  - They announced a "systemic risk exception" to make SIVB and Signature Bank depositors whole, "taking decisive actions to protect the U.S. economy by strengthening public confidence in our banking system."
  - To protect other banks, the Fed announced an additional funding program to "help assure banks have the ability to meet the needs of all their depositors."
- Markets reacted since the close on March 8:
  - Equities: VIX, a measure of volatility, jumped from 19.1 to 26.6; the S&P 500 has fallen -0.7%; and the KBW Regional Banking Index has fallen -12.3%.
  - Bonds: the 10-year Treasury yield has fallen from 3.99% to 3.48%; the Bloomberg Aggregate Bond Index is up 2.2%; and credit spreads have widened.
  - Fed futures now signal 0.25% rate hikes at the next two meetings, then rate cut in June. Before this trouble, futures implied a 0.5% hike next week, another 0.5% by June, and no cuts this year.
- Outside the U.S. Credit Suisse Group AG exercised its option to raise up to 50 billion Swiss francs ($53.7 billion) from the Swiss National Bank to allay liquidity concerns.

CONCLUSION

The environment is more uncertain, but the challenges of the last week have shaken business and consumer confidence, which will dampen demand and help cool inflation. Regardless, the Fed is likely to be less aggressive in its hawkish policy shift and may even be forced to cut as soon as June. While it seems a long way away, we continue to see relief in the second half of 2023, with this banking crisis hopefully behind us, greater clarity on the state of the economy and Fed policy, and an opportunity to turn back to the fundamentals and what could be the next bull market cycle.

Michael P. O'Keeffe, CFA
Chief Investment Officer
michael.okeeffe@stifel.com
www.stifelinsights.com

The information contained herein has been prepared from sources believed to be reliable but is not guaranteed by us and is not a complete summary or statement of all available data, nor is it considered an offer to buy or sell any securities referred to herein. Opinions expressed are subject to change without notice and do not take into account the particular investment objectives, financial situation, or needs of individual investors. There is no guarantee that the figures or opinions forecasted in this report will be realized or achieved. Employees of Stifel, Nicolaus & Company, Incorporated or its affiliates may, at times, release written or oral commentary, technical analysis, or trading strategies that differ from the opinions expressed within. Past performance is no guarantee of future results. Indices are unmanaged, do not reflect fees or expenses, and you cannot invest directly in an index.

Asset allocation and diversification do not ensure a profit and may not protect against loss. There are special considerations associated with international investing, including the risk of currency fluctuations and political and economic events. Investing in emerging markets may involve greater risk and volatility than investing in more developed countries. Due to their narrow focus, sector-based investments typically exhibit greater volatility. Small company stocks are typically more volatile and carry additional risks, since smaller companies generally are not as well established as larger companies. Property values can fall due to environmental, economic, or other reasons, and changes in interest rates can negatively impact the performance of real estate companies. When investing in bonds, it is important to note that as interest rates rise, bond prices will fall. The Standard & Poor's 500 index is a capitalization-weighted index that is generally considered representative of the U.S. large capitalization market. The Dow Jones Industrial Average (DJIA) is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange (NYSE) and the NASDAQ. The DJIA was invented by Charles Dow back in 1896. The MSCI EAFE index (Europe, Australasia, and the Far East) is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the U.S. and Canada. VIX is a trademarked ticker symbol for the Chicago Board Options Exchange Market Volatility Index, a popular measure of the implied volatility of S&P 500 index options.

Stifel, Nicolaus & Company, Incorporated | Member SIPC & NYSE | www.stifel.com

0323.5517343.1