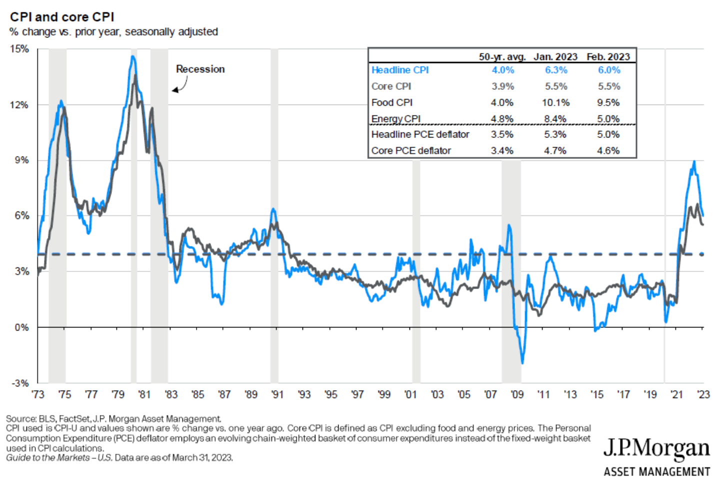
Q1 2023 Commentary

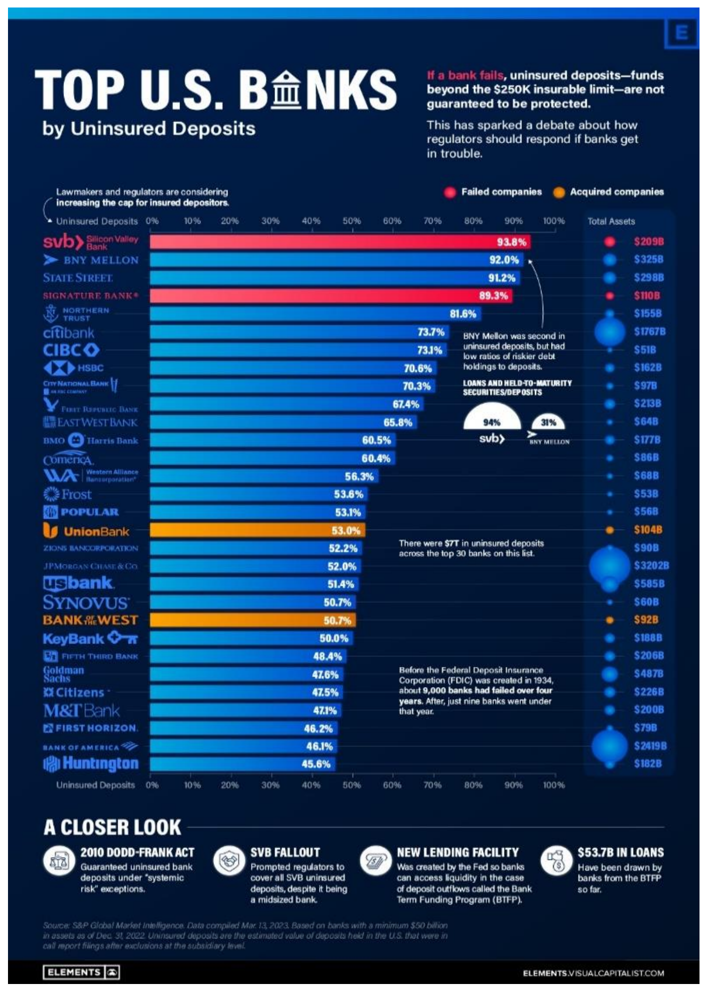
Did Silicon Valley Bank Help the Federal Reserve?

The first quarter of 2023 ended with the Federal Reserve continuing to tap the brakes on the U.S. Economy to fight the persistant inflationary pressures. As the chart below shows, the inflation rate on the heels of an *all-gas-and-no-brakes* policy (easy money, low-interest rate) created historic 40-year high inflation.



In our previous commentaries and webcasts, we discussed the coming inflation problem as early as February 2021. The late-to-the-game Federal Reserve finally conceded the inflation problem in the fall of 2021, and began tapping the brakes on the economy with raises in the Federal Funds interbank lending rate. The Fed Funds rate began their tightening campaign in April of 2022, and continued rising from nearly 0% to 5% by March 2023.

Most analysts, economists, and the market forces appeared to believe that the economy was not slowing fast enough to tame inflation sufficiently. The consensus was that Fed Funds rate increases were on tap for most of 2023, and the two-year U.S. Treasury kept pace, hitting 5.1% on March 9th of this year. Flash forward one week, and the Silicon Valley Bank (SVB) failure hit the news wire. A wave of panic that the entire banking sector was in peril hit markets as speculation began to boil. After a period of reflection, cooler heads and analysis prevailed as it became apparent that the poor management of the SVB and a few others were isolated and not an industry-wide contagion.



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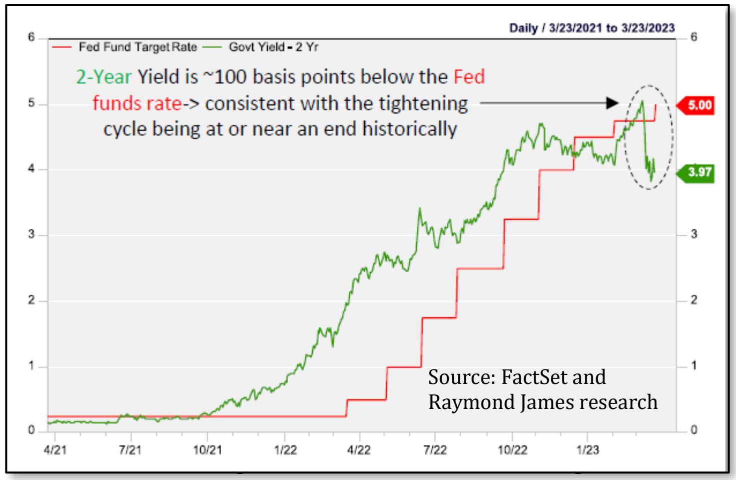
Bank customer protection through the FDIC is capped at $250,000 per account holder. The vulnerability of banks for having a large percentage of depositors unprotected is a serious problem. As the chart above shows, nearly 94% of SVB depositors were unprotected. That is poor risk management which led to the failure, as a demand for funds from a single or a few large deposit holders can create a run on bank liquidity. As an aside, Raymond James bank staggers –or waterfalls– deposits into many $250,000 traunches to eliminate this excess deposit risk.

Even though the SVB, First Rebublic, and Credit Suisse liquidity crises seemed to be unique, a fear and knee-jerk reaction for all banks became the mode for defensive action. The result has been one of credit tightening and scrutiny for all banks. This action is constricting to the economy, and has the same effect as further interest rate raises by the Fed and regulation by the government. The desired slowdown of the economy to fight inflation by Chairman Powell of the Federal Reserve was now given a hand by the SVB failure and resulting market fear!

That one week and banking crisis event sent an immediate and dramatic shock to the interest rate and economic outlook. The chances of a recession, even if mild, were now increased for later in 2023. The two-year and ten-year U.S. Treasury bond yields collapsed dramatically as the outlook and narrative changed from several more rate increases coming, to possibly only one more rate increase, and the possibility of rate drops later in the year was now on the table. The chart below depicts the rapid decline (green line) in the two-year note compared to the Fed Funds rate.



The equity market celebrated briefly with the prospect that the rate hikes may be close to ending, but now the focus is on the economy. How bad will the predicted recession be? We see some relief from higher interest rates in sight, but can our economic slowdown provide a goldilocks landing? Just cool enough to continue the inflation fight, but not so cold that the resilient jobs and company earnings are crushed. The jury is out, and the situation is ever-changing with new data.

We appreciate your continued confidence and trust!

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