Convergence Commentary

March 2023 Market Recap

Quick Hits:

- Most stocks went up in March despite concerns surrounding the collapse of Silicon Valley Bank, Silvergate, and Signature Bank and the potential for more small banks to experience similar issues.
- The Fed hiked rates by 25 basis points, but their primary goal may have shifted from price stability to financial system stability.
- Inflation came in line with expectations despite concerns it was ramping back up after the January report came in hotter than expected.

Market-Moving Highlights

Markets were rattled on March 9th when Silicon Valley Bank, the 16th largest bank in the country, collapsed. The collapse was a multilayered issue, but the root cause of it boils down to the mismanagement of risk by the bank. Like any business, a bank's balance sheet consists of assets, liabilities, and equity. A bank's assets include any fixed income product such as a treasury or loan earning interest for the bank, while its liabilities include the deposits of customers. When a customer adds money to their bank account, the bank takes that money and uses it to make loans, and in return, pays the customer interest. The treasury notes on the balance sheet of SVB that were purchased a few years back at lower interest rates declined significantly in value as the Fed increased interest rates to fight inflation. Why were the treasury bills on the balance sheet worth less? The prices of all bonds purchased prior to the Fed's interest rate hiking cycle have declined because an investor can now purchase bonds that offer a higher yield, making older bonds with lower yields less advantageous to own. In addition, SVB's customer loan base consisted largely of technology startup companies that have struggled to raise capital since the start of 2022.

This led to these companies being forced to draw down their deposits, so the bank's liquidity came under pressure in response to higher risk loans and market values of the treasury bills on the balance sheet declining, so bank customers withdrawing funds increasingly put pressure on the bank to meet its liabilities. Once the concerns around SVB's liquidity became public

knowledge after the bank announced they were selling new shares to enhance liquidity, depositors panicked and a bank run ensued, which ultimately led to the collapse of the bank. Luckily, the government responded quickly by insuring deposits at SVB and injecting liquidity into the financial system, as there was a serious concern about more bank runs and a deposit flight to safety to the biggest banks in the country. In addition to SVB, Signature Bank and Silvergate also failed around the same time due to similar issues. This series of bank runs sparked memories of the 2008 Great Financial Crisis. So far, the damage from the collapse of these three banks is dwarfed by what happened in 2008 and the issues that arose during the Great Financial Crisis were far more severe and involved far riskier practices by some of the biggest banks in the United States. While there is certainly still elevated risk in the market as a result of multiple regional bank collapses, it looks as though the issues SVB, Signature Bank, and Silvergate had that resulted in them ceasing to exist are not systemic issues. However, there is the possibility that other banks will experience similar issues in the future given the rapid increase in interest rates.

The Fed raised rates by 25 basis points after briefly discussing a 50 basis point hike before the collapse of SVB. After the bank collapses that were at least partially a result of higher rates, the market initially priced in no rate hike, but ultimately, things settled down once the Fed held their meeting to discuss hiking rates. Hiking 25 basis points allowed them to get closer to their target on the federal funds rate and it gave the market confidence that the regional bank scare is behind us. If they did not hike, it could have signaled to the market that the Fed was panicking about the situation, and a 50-point hike was clearly not appropriate given the circumstances.

After CPI came in hotter than expected for January, the report for February fell in line with the expected 0.4% increase. The annual print came in at 6.0%. Once again, the increase in prices was driven by the shelter component. While inflation has been higher than initially thought to start 2023, we have noted in the past that shelter is the component of inflation that prevents CPI from falling more quickly, but the lagged data effect will reverse that at some point in 2023. In addition, as a result of the regional bank crisis, credit availability will be much tighter, which has a ripple effect on the economy. Tighter credit slows the economy by making it more difficult for businesses to obtain loans to fuel growth, and eventually should help cool inflation.

Index Performance

Index	1 Month	YTD	1 Year	5 Year
S&P 500	3.67%	7.50%	(7.73%)	11.19%
Nasdaq Composite	6.78%	17.05%	(13.28%)	12.60%
Russell 2000	(4.78%)	2.74%	(11.61%)	4.71%
MSCI ACWI ex US	2.55%	7.00%	(4.56%)	2.97%
Bloomberg US Aggregate Bond	2.54%	2.96%	(4.78%)	0.91%

The major indexes still posted positive returns in March despite the banking crisis, with the exception of the Russell 2000. The Russell 2000 has a large allocation to regional banks, so it was impacted by the situation more than the other indices. The Nasdaq continued to lead, as it has throughout the start of 2023. With the first quarter of the year now complete, the Nasdaq is up over 17%. The Nasdaq does not have exposure to financials, so it was not impacted as much as the other indexes. The resilience of the indexes was impressive given the circumstances. A quick response by the government and a lack of real contagion so far helped calm markets. The effects of the banking crisis include a less hawkish Fed and indicate the end of the hiking cycle is closer than the market was pricing in before the SVB collapse, which is a positive for stocks.

S&P 500 Sector Highlights & Commentary

Best-Performing Sectors		Worst-Performing Sectors	
Technology	10.86%	Financials	(9.55%)
Communication Services	8.65%	Real Estate	(1.48%)
Utilities	4.90%	Materials	(1.01%)

Technology and communication services were beneficiaries of the concerns surrounding financials. Big companies within these sectors like Apple, Microsoft, and Google were viewed as companies that are not impacted by the bank crisis, so a "flight to safety" effect took place. The rapid decline in interest rates throughout the month also helped technology, communication services, and utilities, as all are interest rate-sensitive sectors. Meanwhile, it is no surprise financials were the worst-performing sector by far given the set of circumstances it faced with the collapse of three banks. Aside from financials, all other sectors held up quite well, with 7 sectors seeing positive months despite the turmoil.

What to Watch in April

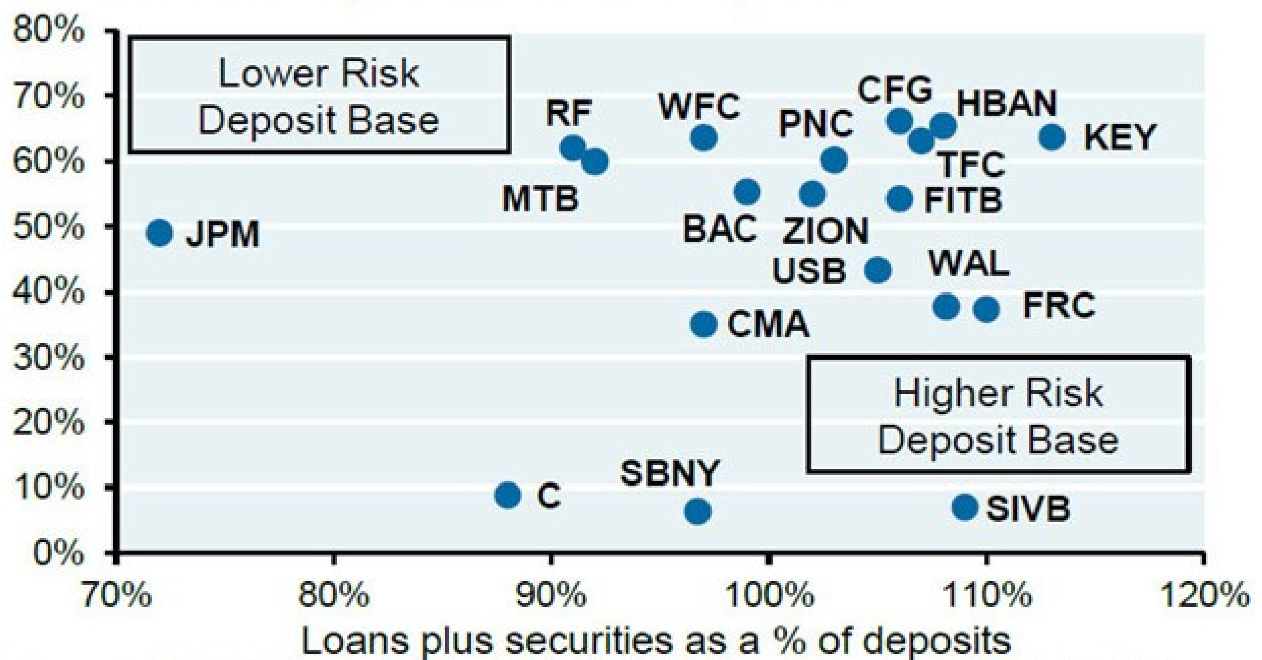
The banking crisis seems to have subsided and the market is reacting as if we have avoided the worst of it. However, the status of other banks and the financial system in general will continue to be monitored closely.

With the first quarter now behind us, earnings reports will start to be released. How strong earnings are will provide more clarity on if the economy can avoid a recession in the short run.

Market Wrap

The collapse of SVB and the subsequent banking crisis was something investors have not seen since 2008. In fact, SVB was the second biggest in the history of the United States. While the comparisons are obvious between SVB, Silvergate, and Signature Bank and the collapses of 2008, the circumstances are quite different. In 2008, the banks that collapsed were a result of the

housing bubble and subprime mortgages. The collapse of these three banks was a result of the market value of treasuries on their balance sheet and the mismanagement of the bank's liquidity. As a result, more bank regulations are likely so a similar situation does not happen again. In the chart below, you can see that Silicon Valley Bank (SIVB) had the riskiest deposit base of all major banks by a wide margin. In our view, this makes the issues that plagued SVB unlikely to become systemic and came about as a result of poor management by SVB. If the issues were likely to become systemic, the market would not have rebounded as strongly as it has. However, there is still the possibility of more issues within the banking sector that could arise as a result of higher interest rates.



Sources

https://mergersandinquisitions.com/silicon-valley-bank/

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