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Banks Matter

Global Markets and Regions

	1st QTR	2023 YTD
US	7.7%	7.7%
Developed Europe	10.70%	10.70%
Asia	5.10%	5.10%
Emerging Markets	4.20%	4.20%

US Markets

	1st QTR	2023 YTD
Dow 30	0.90%	0.90%
Large Cap Cos.	7.43%	7.43%
Mid. Cap Cos.	3.77%	3.77%
Small Cap Cos.	2.60%	2.60%
Bonds	3.24%	3.24%

Silicon Valley Bank, whose name highlights the technology capital of the world, disappeared last month. Well, it didn't really disappear, the shareholder's value disappeared. It will cease to operate as Silicon Valley Bank, as their assets and operations will be subsumed at huge losses by other banks as the FDIC and bank regulators step in to facilitate the cleanup. Several other banks suffered the same fate as the ensuing panic and rapid withdrawal of funds by depositors spread. The stock market has responded negatively as this new threat to the economy has taken center stage. The Federal Reserve's inflation fighting interest rate policy has been "credited" with a large share of the blame.

Markets have been occupied over the last year digesting a number of other issues, as the Bear Market we have been experiencing has made clear. This particular crisis was not supposed to happen. The bank had been given a clean bill of health by auditors just a few weeks prior to the crisis. Banking regulations and practices made in the wake of the Great Financial Crisis of 2008 were supposed to prevent these types of systemic financial events.

This series of bank failures may turn out to be an isolated event precipitated by poor decisions by a select group of bank managers unprepared for what just happened. Regulatory responses may be effective in containing the negative contagious effects. We'll have to wait and see.

The Federal Reserve has raised interest rates in an unprecedented manner over the last year trying to contain sky rocketing inflation. Higher short-term interest rates undermine banks core profit mechanism of making long term loans, home mortgages, car loans, commercial real estate, etc., against deposits. Money market funds that 6-8 months ago were paying interest indistinguishable from deposit and savings accounts are now paying 2-4%. When depositors pull funds to seek higher interest rates elsewhere, the banks are hurt. When depositors concerned about bank safety panic and pull large amounts of funds out in a matter of days or hours, banks can “disappear”.

The Federal Reserve has been very active in trying to control inflation with these rapid interest rate increases and additional activities to withdraw excess liquidity from the economy. Inflation is the result of too much money in the economy, but it has many causes. A lot of blame has been attributed to the flood of Covid relief monies created during the Pandemic.

The Federal Reserve’s monetary control tools are effective in reducing inflation by slowing down economic activity and getting inflation back into balance. There is a delicate balancing act so as not to throw the economy into a hard recession. Markets and investors do not respond well to recessions. But there are also unintended consequences and they can “break things”, in this case a few banks. Financial crises can really slow the economy down. Outsized market consequences can be the result.

The Federal Reserve’s inflation fighting actions have been generally effective so far in bringing down inflation without igniting a severe recession. The economy has been slowing down. Housing construction activity and sales have been slowing down. Auto sales have slowed down. Employment activity has been slowing down. Overall wage growth has been slowing. Corporate earnings growth has been slowing. We are entering first quarter earnings season and more evidence of activity slowing down is expected. Activity hasn’t collapsed. Markets have been responding to this slow down over the last year. Maybe the task can be completed without too much more pain.

Markets are cyclical and tend to repeat themselves in how cycles play out. We’ve seen adverse markets like this before. The Dot-Com bubble market decline in 2000 was facilitated by the Federal Reserve trying to control the easy credit that facilitated excess investment in and lending to companies with suspect sales and no discernible revenue streams. They incentivized lending until they didn’t and a market debacle followed. The Great Financial Crisis of 2008 was caused by Federal Reserve trying to control the easy credit that facilitated the faulty lending that had inflated the housing market and banking system. The Federal Reserve incentivized lending until they didn’t and a market debacle followed.

Today the Federal reserve is trying to clean up all of the excess liquidity and spending created during the Covid crisis. Markets are reacting with a lot of volatility, to where the economy presently finds itself as a result of that process. We are part way through the journey. Let’s hope that the Federal Reserve is up to the task and can complete the it without “breaking” much else.