Ropes Wealth Details Banks, Bonds, and Blowback From A Wild Week on Wall Street

Given the twists and turns of this past week, a daily email might have been more effective, or perhaps hourly to keep up. Sadly, there was much in the daily developments that is reminiscent of 2008, and yet so much is different as well. The main parallel is a systemic failure of the banking system, and regulators, to effectively oversee and manage risk. This time it was duration risk, otherwise known as interest rate risk, given a backdrop of sharply rising interest rates. In 2008, it was credit risk after a years-long binge on cheap credit and lax lending standards. The outcome feels eerily similar, though, and has everybody on edge as to what will happen next.

To recap in brief, at the end of last week Silicon Valley Bank, the 16th-largest bank in the U.S. and favorite lender to tech sector start-ups, failed after being forced to sell some of their invested U.S. Treasury portfolio. These positions were held at large losses thanks to rising interest rates. Their sales were prompted by a surge of withdrawals made at the behest of Peter Thiel of the Founders Fund and other prominent VC firms concerned over the bank's capital position. Without George Bailey offering his honeymoon money to depositors (flashback: It's A Wonderful Life) or the U.S. government backstopping all the banks circa 2008, Silicon Valley Bank was placed in receivership midday Friday and will remain so until the government finds a buyer(s). Meanwhile, Signature Bank, a New York-based bank with deep ties to real estate and legal industries but also crypto, was also placed into receivership by the end of the weekend.

Given the threat of crisis, the U.S. Treasury and Federal Reserve stepped in and exercised unusual powers to protect all depositors of these banks. Typically, individual depositors are only insured up to $250,000. The Fed also took the extraordinary step of extending the safety net by guaranteeing banks would have enough liquidity to meet all deposit needs (not just those below the $250,000 limit). They offered a new lending facility to shore up confidence in the banking system called the Bank Term Funding Program (BTFP). The BTFP allows banks to tender government collateral at par in exchange for a one-year loan. There is an estimated $2 trillion of capacity for this program.

But the BTFP fell short of stemming the crisis, and by Thursday afternoon, another intervention was made to help First Republic Bank stay afloat. In this rescue, the nation's biggest banks, which include JP Morgan, Citigroup, Bank of America, Wells Fargo, Goldman Sachs, Morgan Stanley, PNC, BNY Mellon, Truist, US Bancorp, and State Street deposited in varying amounts a sum total of $30 billion in deposits to First Republic to stabilize the battered California lender. The move was similar to the 1998 bailout of the hedge fund Long Term Capital Management, which had made a number of wrong-way bets that threatened the stability of the financial system. Then, Wall Street pumped $3.65 billion into the fund as a way to protect their own interests given a widening panic that could threaten more of them.

At press time, markets had mostly regained their footing in a wild week of trading that also delivered some meaningful economic news. On the inflation front, the Consumer Price Index (CPI) rose 0.4% in February and is now growing 6.0% year-over-year. While still high, this was good news as it was another month of decline in this critical measure. The core CPI, excluding food and energy, is growing at 5.5% year-over-year, only modestly down thanks to continued price inflation in airline fares, recreation prices and services, apparel, and rent. Used cars and trucks prices were the only downbeat category in the report. The Producer Price Index (PPI) report was more encouraging, with a slowdown in price growth to 5.7% with food and energy prices included, and 5.0% without.

In other data, following an exceptional January that was revised even higher to a 3.2% growth rate, retail sales pulled back some in February, but only by -0.4%. Sales were softer in autos, furniture, clothing, and restaurants, but higher in online and health and personal care. After posting the longest streak of declines since 2009, residential construction rose notably in February. The increase in building activity was broad-based and was led by construction of multifamily units. This could be an early indication that the worst may be over for the housing market, especially as homebuilder and homebuyer confidence improved again in March. The current drop in interest rates is also helping, though under the current crisis circumstances banks may tighten their lending standards as fears of contagion spread in the banking sector. As a result, the near-term outlook for the housing market is cloudy and the widening gap between mortgage applications to purchase a home and housing starts suggests there may be some more downside risk for residential construction.

While this banking crisis has the makings of a broader failure within the financial markets, the Fed appears convinced broader financial conditions remain “resilient and on a solid foundation” and are expected to still increase interest rates next week, likely by 25 basis points. Even so, fed funds futures currently imply the Fed will need to start cutting interest rates by June and will continue to do so until early next year. We shall see.

Liquidity is the most important building block of portfolio strategy, and it is times like these that demonstrate why. When markets confront challenges, the best way to avoid panic and to stay long-term focused is having enough reserves to make you feel confident that your cash needs are sufficiently provisioned so you can outlast that crisis. We started building those reserves in 2022 using short-term government bonds and have continued to prioritize liquidity in this market where valuations are not especially compelling and profits are in a down cycle. Diversification also remains crucial as notably global markets have had a better start to 2023 given the tailwind of a declining dollar and less aggressive central banks. It is not appropriate for us to join the chorus of those arguing these banks posed singular or isolated risks, as we know too well the interconnected, incestuous relationship of the global banking system. Likewise, it is not appropriate for us to yell “fire” in a crowded theater when our task is to strive to invest in the best quality securities arranged in such a way that preserves and grows via compounding that base of assets for your future. We are committed to you and your plan and welcome your personal updates as the best way to fine tune that plan in consideration of market conditions, not because of them.

“May your pockets be heavy and your heart be light. May good luck pursue you each morning and night.” Happy St. Patrick’s Day!

Thank you as always for your interest in our investment commentary. If you would like to speak personally with a member of our team at any time, please click **here**.

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