White Paper Report
Decoding the Chaos in the Banking Industry

Last year, investors were forced to quickly absorb the Federal Reserve's unwinding of a decade of easy monetary policy through a rapid repricing in risk assets and the worst annual performance for bonds on record (as measured by the Bloomberg Aggregate Index). Now as the Federal Reserve is in the middle of its most aggressive tightening cycle since the 1980s, their actions are filtering into other areas of the economy. The most prominent recent sector to feel the negative effect of interest rates at the highest level since 2007 has been the banking sector. Regularly, news outlets have been covering details of banks "on the brink," capital infusions and government intervention.

In this white paper we will address how recent events have unraveled into a situation that feels like a game of dominoes. We emphasize that in our view, this is not another 2008-2009 crisis where the banks nearly took down the global economy. We will outline what has changed from an economic perspective because of the recent events. In addition, we will discuss how the current events impact our portfolio positioning and opportunities we expect to arise out of the most recent dilemma.

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Past performance is not indicative of future returns

Explaining the *Why* Regarding the Recent Banking Downfall

The lifeline of a bank is deposits. Banks pay depositors a small rate of return for them to keep their money at the bank. In turn, banks lend that money at a higher interest rate. Over the past year the Fed has been aggressively raising short term rates. As a result, depositors haved looked elsewhere for safe short-term investments that offered more yield than what they were offered as a deposit rate at a bank (e.g., Treasury bills, money market mutual funds). As a result, small, mid and even large cap banks have lost deposits. This weakens a bank's stability.

Additional cracks started to surface with the implosion of the cryptocurrency market in 2H22. This exposed what we have long feared in this unregulated market: fraud, the lack of transparency, careless accounting practices and ultimately many crypto currency exchanges failing, the most widely known was FTX.

In addition to cryptocurrency and other speculative investments, many investments that relied on low interest rates for funding began to deteriorate (e.g., tech start ups and Venture Capital). The small banks that catered to these businesses saw the value of these assets on their balance sheets deteriorate.

What happens when the assets on a bank's balance sheet get notably weaker? In many cases, customers panic and want to withdraw their deposits. To satisfy the withdrawals, banks may be forced to sell even good assets. In the case of Silicon Valley Bank, they were forced to sell the safest of safe investments, U.S. Treasuries. However, because interest rates had risen so much in 2022 and the long duration characteristics (yields go up and prices fall) of their bond holdings, the value of these bonds had also fallen sharply. This created a viscous cycle and ultimately a run on the bank. Quickly the FDIC took them over in the largest bank failure since Washington Mutual in 2008.

This has spiraled into a collapse of confidence in many banks that not only hold or cater to these speculative investments/companies but also those that have a large amount of uninsured deposits and those that have not managed the interest rate risk in their long maturity Treasury portfolios appropriately. Typically, the FDIC insures up to $250K per depositor at a bank. Customers grew weary of balances in banks above that level and investors started filtering through all the regional and niche banks' balance sheets to find the weakest links. Unfortunately, the negative news loop can be detrimental for the banking sector. Especially with the age of financial technology where money can move in an instant. Many banks simply could not keep up with customer withdrawals. We have seen capital infusions from the biggest banks (e.g., JPMorgan Chase, Bank of America, Wells Fargo) to some regionals (e.g., First Republic) and government intervention to calm the markets.

The largest has been the collapse and ultimate takeover of Credit Suisse, a Swiss bank founded in 1856. Their demise differed from some of the U.S. regionals but the response by investors was the same, pull money quickly. Credit Suisse became a target because of scandals, management turnover, billions of dollars in losses, a lack of long-term strategic planning and ultimately the deterioration in confidence.

When the **Federal Reserve started raising interest rates to combat inflation** it came at the expense of many assets that relied on easy money to fuel their momentum.

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This is *NOT* 2008 - 2009

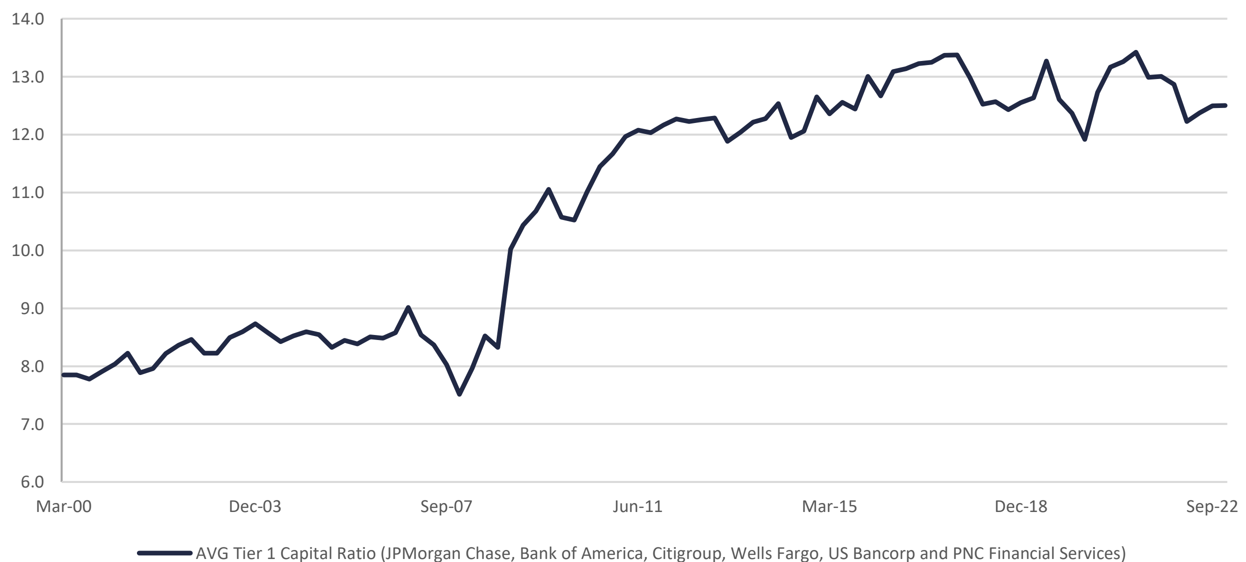
We believe the current banking turmoil is different than the crisis in 2008-2009 that nearly brought down the banking system. However, we also acknowledge that the fear investors feel is real. First, the major banks in the U.S. and the world have faced increased regulatory standards in the aftermath of the financial crisis in 2008-2009 to avoid another "too big to fail" scenario. The tier 1 capital ratios, which measure assets to their risk-weighted assets, of the biggest U.S. banks are significantly higher than levels leading up to 2008-2009**(Chart 1).**

In addition, banks with assets of $50 billion or more face some level of regular stress testing of their balance sheets by the Federal Reserve to guarantee their stability. Second, 2008-2009 was the result of excess leverage, assets with no valuation, and a collapse of counterparty confidence. While some of these regional banks became too concentrated on speculative investments (e.g., Signature Bank, Silicon Valley Bank) they also held safe investments in their portfolios. This has been a mismanagement of duration risk, not credit risk.

Chart 1

Big Banks Much Stronger Now than in 2008 – 2009

Data is as of 4Q22. Tier 1 Capital Ratio is the ratio of equity capital and reserves to its risk weighted assets. Source: Bloomberg Finance LP, Verdence Capital Advisors.



Impact on the Economic Outlook

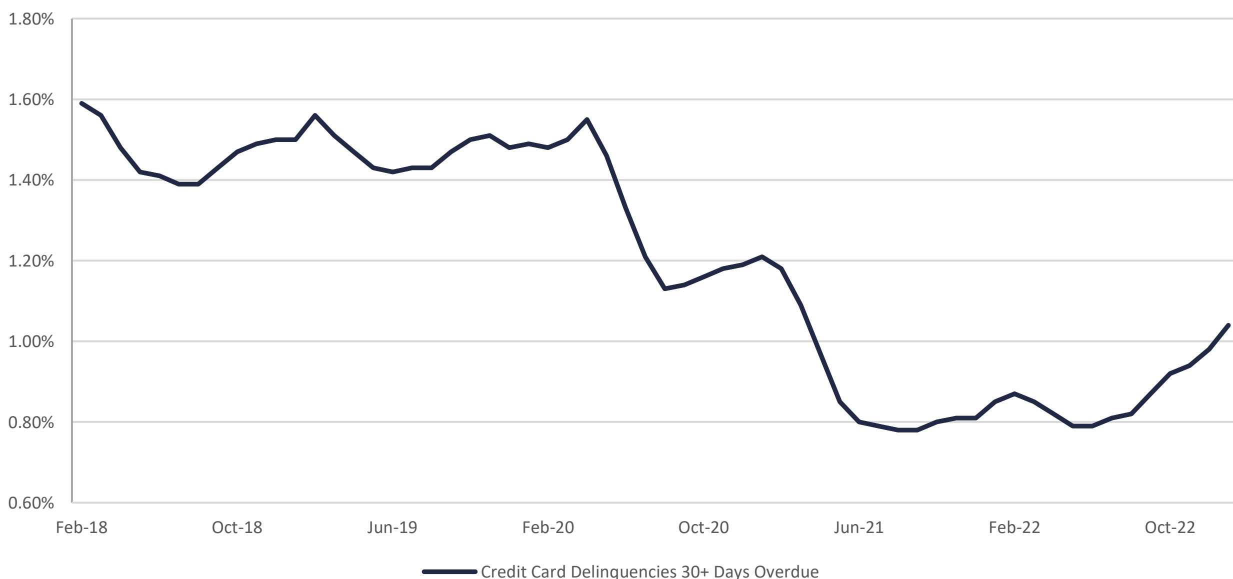
Unfortunately, the add-on effect of a banking crisis means tighter financial conditions and/or less bank lending, regardless of the stability of the bank. No bank wants to be the next victim in a negative news loop that causes a run on their bank. Many small businesses and Americans rely on small and mid-size banks for loans, so this is going to weigh on economic growth and likely hiring. Currently, we do not know what that magnitude may be. In addition, the lagged effects of the most aggressive tightening cycle since the early 1980s are starting to show up in economic data. Manufacturing is in contraction territory. The consumer is getting squeezed by rising prices. Credit card debt is growing at a double-digit pace on an annual basis and the average credit card rate is at a record high (more than 20%). Delinquencies are rising on things like credit cards and auto loans. **(Chart 2).** This, combined with the recent banking turmoil, leads us to believe that the ability of the Federal Reserve to orchestrate a soft landing without a recession over the next 12 months is slim.

In addition, the Fed is caught between taming inflation, which remains stubbornly high, and maintaining the stability of the banking system. While a pullback in lending and likely recession in economic growth can be disinflationary, the Fed has limitations on how much they can ease up on their tightening cycle without further stoking inflation. Contrary to the current market pricing, we do not think rate cuts are on the table for this year. Instead, we think the Fed will raise once more (May 3) and maintain a wait and see approach thereafter.

Chart 2

Consumers Getting Squeezed by Higher Rates

Data is as of January 2023. Source: Bloomberg Finance LP, Verdence Capital Advisors.



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Do Recent Events Impact Portfolio Positioning?

In 4Q22, we witnessed a strong rally in many areas of the global equity market (e.g., growth, tech) as investors priced in the end of the Fed tightening cycle and soft landing for the economy. As a result, we reduced risk by cutting our overweight to global equities due to our expectation that the optimism was getting overdone, believing that volatility would likely emerge and our outlook for 2023 economic growth was weaker than consensus. We entered 2023 with all our portfolios, regardless of risk tolerance, overweight cash compared to their strategic benchmarks.

While we remain optimistic long term about global equities, we believe it is prudent to further reduce our global equity exposure given recent developments. We think valuations do not reflect the unknown banking risks, refinancing risks (e.g., commercial real estate), the risk of policy error and likely earnings downgrades in the face of lower economic growth. In addition, while we believe the regional banking crisis will be an isolated incident there are other areas of the economy that can be challenged by the pullback in lending. Specifically, small businesses, commercial real estate and credit markets that rely on low rates and credit availability to refinance debt. This may negatively impact some of our largest over-weights in our global equity exposure (e.g., small, and midcap stocks).

With an extra layer of dry powder, we can look at additional pullbacks in the equity market as long-term opportunities, especially as the economy weakens and earnings get more realistic. We do not believe in a significant underweight in equities because, history tells us that in the long run, equities offer better price appreciation than bonds and some areas of the global equity market are not expensively priced (e.g., developed international). We also believe that an active approach to investing at this point is the most beneficial as opposed to indexing. Given the wide dispersion in valuations there is ample opportunity for active managers to capitalize on the current weakness across select sectors and issuers.

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Opportunities That Should Arise from Recent Turmoil

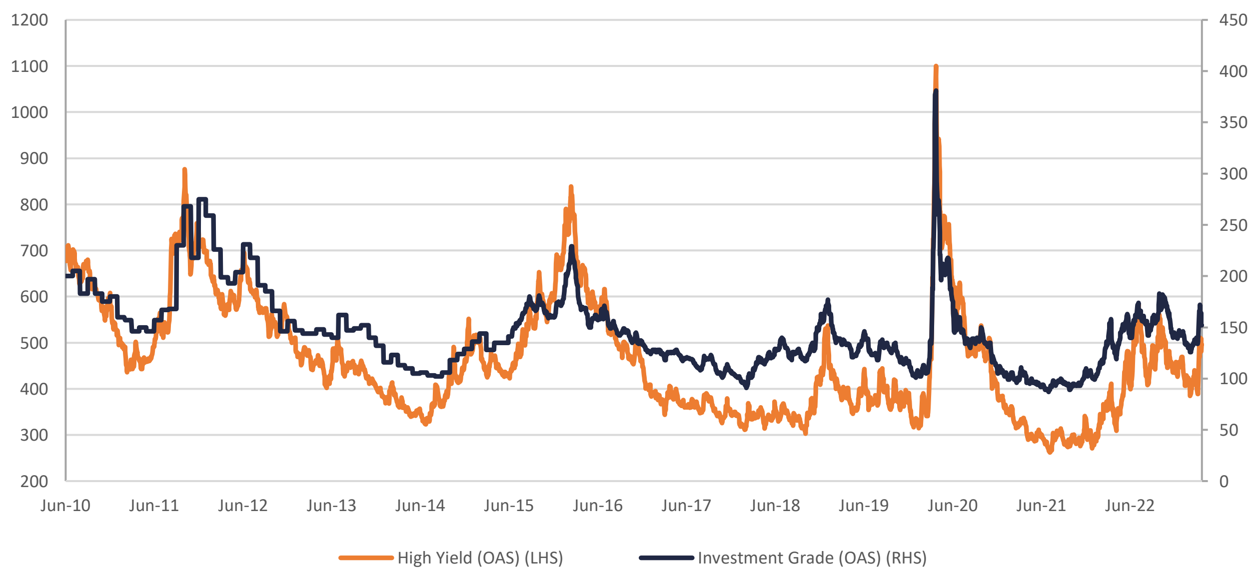
The area that we think may present the biggest opportunity this year is within fixed income. We have been underweight both investment grade and high yield credit for some time because we do not think the extra yield investors are earning over the safety of Treasuries (aka spreads) is enough to warrant the risk. However, with overall yields now higher, fixed income in general looks more attractive than it has in years. While we do not expect the same type of long-term price appreciation that stocks can offer, we do think there may be a good opportunity to add safe investment grade or even high yield corporate bonds at the right price. Currently, we are patiently awaiting attractive prices for credit, which currently do not reflect the economic weakness or chance of a pick-up in defaults. **(Chart 3).**

Lastly, the expected economic weakness has caused a further sell-off in commodities. In fact, crude oil is down ~40% from its June 2022 peak and when the economy recovers, we do not see a fundamental change to the supply/demand imbalance that should keep oil prices higher than current levels. We are actively looking for opportunities within commodities but with a well-diversified approach.

Chart 3

Credit Not Reflecting Risks Yet

Data is as of March 22, 2023. OAS stands for option adjusted spread. Source: Bloomberg Finance LP, Verdence Capital Advisors.



Our View

As with most of the historical market disrupting events, we think that additional regulation and oversight will roll out in response. In addition, we expect further consolidation in the regional banking system and investors will likely absorb additional negative headlines in the near term. A run on a bank can happen rapidly and with little to no warning. Unfortunately, clearing out excesses in the economy is part of every long-term economic cycle, and indirectly the goal of Federal Reserve tightening cycles. This is to assure long-term stability in the economy. We have witnessed froth, greed, delusion, and a fear of missing out overtake disciplined due diligence from investors and prudent risk management at the corporate level over the past decade of easy monetary policy (e.g., bitcoin, NFTs, select venture capital). The rapid unwind of this extraordinarily easy money policy was not expected to come without pain.

Fortunately, we think recent events may help do some of the work for the Fed to reduce inflationary pressures, but they are not done yet. As a result, growth will continue to be challenged and additional disruptions are likely (e.g., defaults). We believe having an extra cushion of cash in portfolios will prove beneficial as history also tells us in times like this, opportunities often present themselves, at the right prices. We will continue to assess the economic environment and look for opportunities as they present themselves.

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