Weekly Investment Insights

March 11, 2024

Key Takeaways:

- Quits rate falls to lowest level since August 2020.
- Fed's Beige Book shows consumers more sensitive to prices.
- U.S. economy adds more jobs than expected.
- Large-cap growth leads U.S. equities lower.
- Yields retreat as investors digest employment data.
- Natural gas prices surge, leading commodity gains.

Weekly Economic Recap –

Job Growth Remains Robust

The ISM Services Index decreased slightly in February but remained in expansion territory (a reading above 50) for the 14th consecutive month. The employment component dipped back into contraction territory (a reading below 50). However, new orders and broad-based business activity rose.

U.S. job openings as reported by the JOLTS report were higher than consensus estimates in January (8.86 million vs. 8.85 million est.) as employers still have strong demand for workers. The current ratio of openings to unemployed held steady around 1.4:1. Those leaving their jobs volunarily (i.e., quits rate) fell to the lowest level since August 2020.

The Fed released their Beige Book, which indicated the U.S. economy continued to expand at a modest pace since earlier in the year, but consumers are starting to become "increasingly sensitive to price changes." Districts reported labor markets continuing to ease amid improvements in labor availability and employee retention.

The U.S. trade deficit widened by the most since April as the value of imports increased to the highest level in a year. Capital goods and motor vehicle prices on the imports side contributed the most to the rise.

The U.S. economy added more jobs than expected (275K vs. 200K est.) in February. However, the unemployment rate rose (to 3.9%) to the highest level since January 2022 as more people entered the labor force.

Average hourly earnings increased less than expected (0.1% vs. 0.3% est.) in February, while the YoY change decreased slightly to 4.3% (from 4.5%).

Weekly Market Recap –

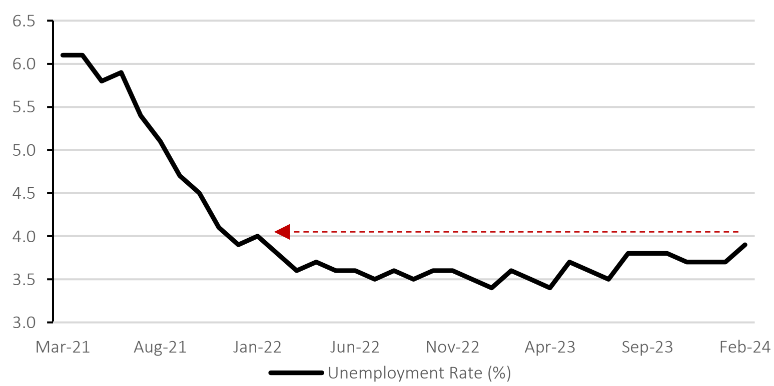
U.S. Markets Underperform as Large-Cap Growth Trade Stalls

Equities: The MSCI AC World Index was higher for the seventh straight week driven by international equity markets, which broadly outperformed U.S. markets. The rally in technology stocks stalled which sent the S&P 500 and Russell 1000 Growth lower for the week. Europe and Japan led the gains in the developed international space.

Fixed Income: The Bloomberg Barclays Aggregate Index was higher for the third straight week as Treasury yields fell as investors digested employment data in the U.S. All areas of fixed income markets were higher for the week driven by investment grade corporates and emerging market bonds.

Commodities/FX: The Bloomberg Commodity Index was higher for the second straight week. Natural gas prices surged by the most since October as production cuts took place amid warmer temperatures. Gold prices were higher for the third straight week as investors weigh the likelihood of Fed rate cuts.

Unemployment Rate Jumps to Highest Level in Two Years



Footnotes: Data is as of February 2024.
Data Source: FactSet Research, Verdence Capital Advisors

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Past performance is not indicative of future returns

Key Takeaways:

- One year since collapse of Silicon Valley Bank (SVB).
- Regional banks have still not recovered deposit base.
- Lending standards remain tight.
- Commercial real estate risk major concern.
- Run on banks are unpredictable and even harder to control.

Regional Banking Sector One Year After SVB Collapse

On March 10, 2023, Silicon Valley Bank (SVB) became the second largest bank failure in U.S. history (behind Washington Mutual in 2008). Its collapse crippled the regional banking sector and we quickly witnessesd the downfall of two more banks (i.e. Signature Bank two days later and First Republic in May 2023).

Just to recap, SVB'S failure was attributed to several factors. The Fed's aggressive tightening cycle resulted in the value of the risk free Treasuries that SVB held to substantially decline. Second, SVB was a major bank for tech start ups. In 2022, the tech sector struggled due to high interest and inflation rates. As these companies continued to tap SVB for deposits, the bank was forced to sell their depressed Treasuries to meet withdrawals. This put the bank's balance sheet into question, a run on the bank occurred and ultimately the bank failed. This spread to other regional banks and in total, five banks failed in 2023 amounting to nearly $550 billion of assets, the largest ever in American history. In this weekly, we dive deeper into the current state of the regional banking system after a tumultuos year and why we can not say the regional banks are out of the woods.

- **Current state of the regional banking system:** Since SVB's collapse the S&P 500 Regional Banking Index has underperformed the larger S&P 500 Diversified Bank Index by over 3000 bps. From the time SVB collapsed to the end of March 2023, small banks in the U.S. lost ~$220 billion worth of deposits. They have not recovered that base with deposits still below pre-SVB levels. Banks (both small and large) have been forced to tighten lending standards due to concern over their balance sheets. While there has been some easing in recent months, lending conditions remain tighter than the historical average.

- **Regional banks may not be out of the woods:** Aside from rising interest rates and less lending ability, small and regional banks still face the crisis in the commercial real estate market. According to a report by the National Bureau of Economic Research, the decline in commercial real estate values may result in "$80 to $160 billion in bank losses" and put anywhere "from dozens to more than 300 regional banks at risk of failing."[1] Last week we saw a consortium of investors rescue New York Community Bank after its shares dropped over 70% and got downgraded to junk status. Its exposure to commercial and residential real estate led to its demise. In addition, according to Morgan Stanley, there is ~$1.5 trillion worth of commercial real estate debt that needs to be refinanced before the end of 2025.

The Bottom Line:

We believe the biggest risk to regional banks is in their exposure to commercial real estate debt. The enormous amount of debt that needs to be refinanced will need to be refinanced at higher rates. It will also need to be refinanced in a fundamentally weak environment. At the end of 4Q23 U.S. office vacancy rates hit a record high (~20%), surpassing some of the weakest times in commercial real estate's history (1986 and 1991).[2] Unfortunately banks, due to the nature of their business (deposits are their lifeline), can see their solvency evaporate in a matter of days when negative news sparks a run on the bank. It is nearly impossible to predict and even harder to control. We think we could see more consolidation/mergers in this space as we work our way through the enormous amount of debt that needs to be refinanced.

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