

Market Trends & Analysis

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Is this the start of a systemic banking failure?

What happened, and what may we expect?

Silicon Valley Bank's (SVB) failure occurred because of the Fed's most severe hiking cycle in history paired with bank-specific dynamics—namely where the bank chose to invest its money and the bank's high concentration to tech sector clients. So, does this mean we are headed toward a systemic banking system failure or another Lehman Brother's moment?

We do not believe so, particularly since most large banks are well capitalized and currently not under stress. That said, we do expect some things to change, especially for smaller banks. For instance, both the Treasury and Fed got things started by providing a new liquidity facility to all banks. The choices SVB made were not entirely unique, so other small banks with similar investment structures will see increased scrutiny. But keep in mind that with SVB client concentration also played a large role in their failure.

We do not foresee a systemic banking system failure—but envision increased scrutiny for smaller banks regarding investment structures.

Regarding our view on interest rates and recession, we believe the pressure is on for the Fed to slow or pause its hiking cycle in order to provide assurance to the market. The expected Fed Funds path has already changed dramatically, with interest rate cuts in the second half of 2023 implying more acceptance of a recession during this period.

Tying these events to economic and market outcomes

Our view has long been that the lagged impact of the Fed's tightening cycle was liable to slow the economy this year. In previous cycles, leverage in the housing, technology, or financial sector resulted in more painful recessions. This cycle's "excess" has been liquidity, and the inflation that it engenders.

Today, we are seeing a combination of slowing nominal growth, the lagged impact of tightening monetary and lending conditions, and now the uncertainty around potentially more restrictive bank lending standards. We believe this combination of factors makes recession a matter of when, not if.

Multi-Asset Solutions Team

We are New York Life Investments' specialists in multi-asset investing, assisting our partners in their pursuit of investment success.

The weekend's events effectively create three scenarios for the market

	Scenario 1 Easier financial conditions bring market upside... for now	Scenario 2 Steady as she goes towards recession (our base case)	Scenario 3 The canary in the coal mine
Description	<ul style="list-style-type: none"> • New government programs significantly ease conditions. • Short- and long-term rates remain lower. • Markets recover and benefit from this liquidity. • Business and consumer sentiment rebounds. • Recession timeline is extended to first half of 2024. 	<ul style="list-style-type: none"> • Banks tighten lending standards, squeezing economic outcomes and pushing the economy towards recession in the next one to two quarters. 	<ul style="list-style-type: none"> • Bank failures bring more attention to the excesses brought during the pandemic. • The Fed is unable to soothe broader sentiment. • Businesses, consumers, and investors pull back hard. • Recession begins sooner rather than later.
Implications	<ul style="list-style-type: none"> • More liquidity in the short term increases the risk of a “double peak” in inflation. • While a near-term upside scenario may appease the markets for now, we see this as a more challenging scenario for the economy and markets over a 12-month time horizon. 	<ul style="list-style-type: none"> • Our base case perspective is now seeming like the “goldilocks” scenario. • Slowing growth now brings inflation under control in the next six months. 	<ul style="list-style-type: none"> • A hard landing puts an end to the Fed’s tightening cycle. • However, we doubt the Fed could reverse its policy until inflation comes under control. • It would take a few months for a sharp deceleration in growth to impact inflation, and the Fed is highly concerned about a 1980’s-style “double peak,” which hurts both the economy and markets.
Fed policy in the next three months?	Gradual tightening	One to two more 25 basis point hikes	Done

A closer look at the situation

Why did SVB fail? Half of this story is about the Fed. We need to remember that one year ago, interest rates were still at zero. The current hiking cycle is the most severe (largest percentage increase over the shortest amount of time) in U.S. history. Banks everywhere do their best to match their liabilities (client deposits, which they must deliver when the client demands) with assets (using deposited cash to make loans and invest in securities to earn a return). This job is hard when interest rates are at extremely low levels but becomes even harder when the interest rate environment moves dramatically higher in the span of a few months.

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This is where the second part of the story comes into play—SVB's decisions and exposure. SVB was almost entirely exposed to the tech sector, which meant it had a huge inflow of deposits when technology boomed during the pandemic. SVB chose to lock around \$100 billion in agency mortgage-backed securities (MBS) and Treasuries—low risk, but also locking in a low yield. This was intended to generate some yield for the bank when interest rates were low. However, it exposed the bank to huge risk once interest rates rose quickly and severely. In other words, a bank lending almost entirely to long duration business models invested the deposits from those businesses in long duration assets.

When tech firms entered a tougher environment in the past few months, they needed some of their deposits back—and to meet those needs, SVB announced the week of March 6 that it would liquidate \$20 billion of its investments in government securities. This sparked fear among its concentrated client base, resulting in a bank run where clients withdrawing deposits forced further liquidation of the bank's investments—creating a classic downward spiral.

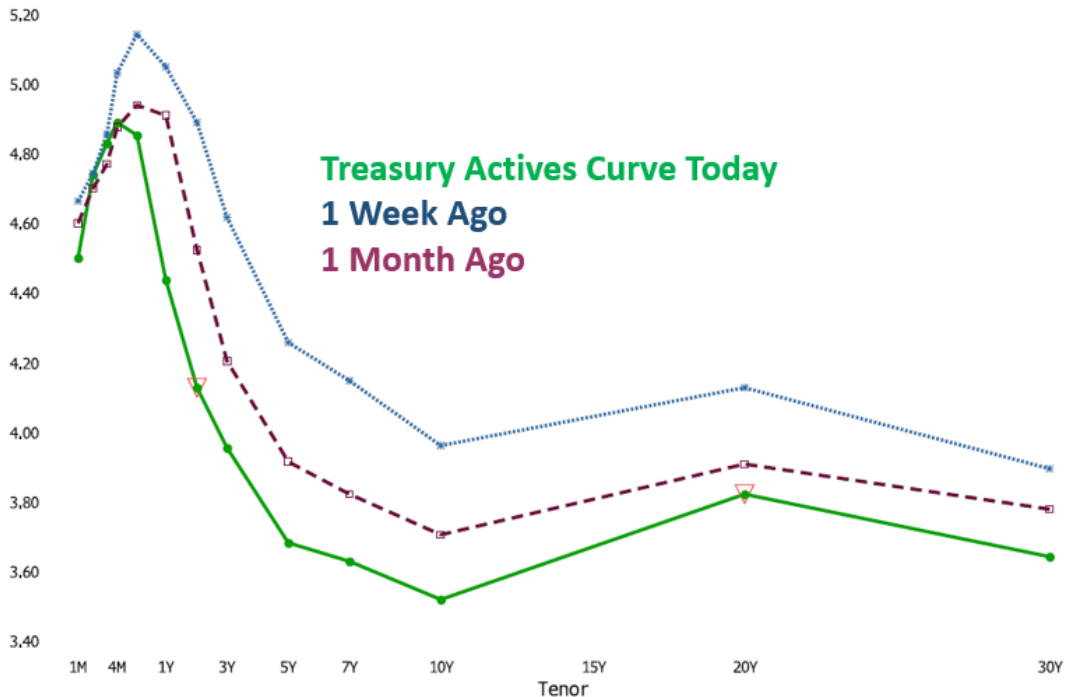
But aren't deposits insured? The FDIC (Federal Deposit Insurance Corporation) guarantees deposits of up to \$250,000 per account. The problem is that 85% to 95% of SVB's deposits (estimates vary by source) were over this limit—meaning they were uninsured.

How did authorities respond? Regulators took over the bank on Friday, March 10, but over the weekend, vague statements about whether the government would bail out depositors created much angst in the market. So, at 6:15pm on Sunday, March 12, the Treasury, Fed, and FDIC together announced they would be bailing out all depositors of both SVB and Signature Bank (which was another now failing bank), covering all their deposits—not just the ones covered by FDIC. This helped forestall the worst-case scenarios for a potentially broader financial sector (and tech sector) issue, but also created a moral hazard. We expect vocal conversations about this in the coming weeks.

If half of this story is caused by the Fed, it begs the question of **whether this failure is systemic and signals a threat to the banking system as a whole (refer to Chart 1)**. It's a fair question, but we are currently not concerned about the health of the large, systemic banks. There is more room for questions relating to smaller, regional banks who might not have the same sector exposure as SVB but have unrealized losses in the securities they hold. The Fed is trying to get ahead of this with a new liquidity facility for all banks.

Chart 1: Treasury Actives Curve

As the 2-year yield plummeted, some market participants noted that such dramatic moves were last seen during the Global Financial Crisis (GFC)—and we do not anticipate a GFC 2.0



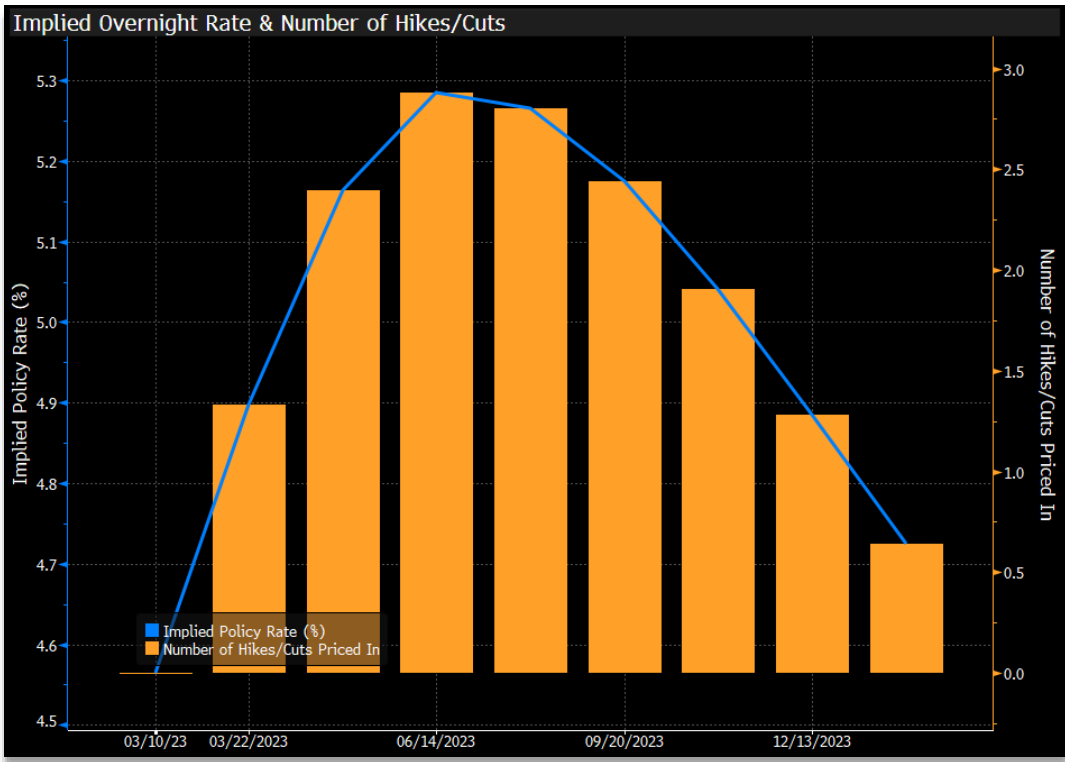
Source: Bloomberg Finance LP, 3/13/23.

If depositors got bailed out, why are Financials still down? Financial firms are still suffering meaningful negative price action today, even after the significant announcement that all SVB and Signature depositors would be made whole. We attribute this to investor confidence: it has been shaken and it will likely take a few weeks of seeing no further banks fail, more assurance from authorities, and calming Fed-speak to assure the market that systemic dominoes will not fall.

How does this affect your view on interest rates and recession? When banks fail, it's hard to feel very confident about the trajectory of the economy—even if these are “bumps in the road” and not signs of banking system collapse. Fed Funds Futures are pricing a dramatic shift in expectations (refer to Charts 2 and 3)—one that has potentially overshot reality a bit, but new expectations for meaningful policy easing in the second half of 2023 point to an increased acceptance of the likelihood of recession.

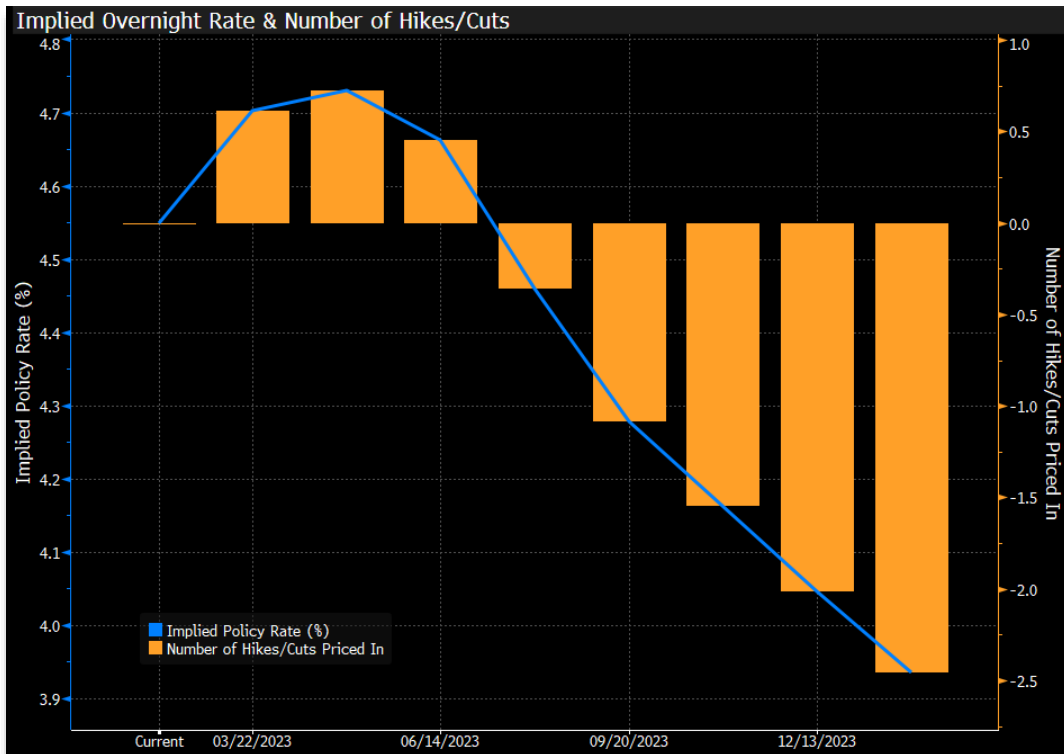
For the near term, this certainly pressures the Fed to slow or stop hiking and provide more liquidity support to banks. Last week, the debate was whether the Fed would deliver 25 basis points or 50 basis points in its March 22 meeting—but as of the writing of this note on March 13, only 74% of market participants expect any hike at all.

Chart 2: Expectations for Fed Funds Rate (as of Friday, March 10)



Sources: Bloomberg Finance LP, World Interest Rate Probability, 3/10/23.

Chart 3: Expectations for Fed Funds Rate Point to ~250bps of Easing in Second Half of 2023



Sources: Bloomberg Finance LP, World Interest Rate Probability, 3/10/23.



Information in this note was informed through a large variety of sources, including Bloomberg, CNBC, Time, the Financial Times podcast FT News Briefing, and others.

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