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Conversations with Commerce Trust podcast
Episode 5: Banking and the Markets
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David Hagee: Hello and welcome to *Conversations with Commerce Trust*, our show about the markets, investment themes and economic insights that matter to you. I'm your host, David Hagee, chief investment officer with Commerce Trust. Today, we're reviewing recent events in the banking sector with Tim Michel, our director of portfolio management, and Scott Colbert, our chief economist and director of fixed income here at Commerce Trust. Welcome to the podcast, gentlemen.

Tim Michel: Good morning, David.

Scott Colbert: David, hi.

David: So, if we didn't use all the "extraordinaries" that we had in the bank during the pandemic, I think this qualifies as an extraordinary week inside banking. We've seen two major failures, the second and third largest bank failures in U.S. history, along with a third U.S. bank, Silvergate, that went under over the course of the past ten days. Additionally, there's distress in European banks with Credit Suisse finally maybe having their day as their poor decisions over the past decade have come back to really penalize the bank.

We've also seen the Fed step in more recently creating a new term facility to try and provide a little bit of liquidity for banks. And then most recently, you've seen the Treasury organize a small rescue of a fourth U.S. bank, First Republic, where they generated $30 billion in funds to go over to First Republic to help provide liquidity over there. As we think about this, how is this different, Tim, from historical banking crises?

Tim: Well, this one is different because it's a liquidity issue and an error made by management in how they handled that liquidity. And basically, what I'm referring to is during the pandemic, as a lot of deposits came into Silicon Valley Bank, they didn't have the loans to deploy all that deposit base that came in. And so, what management did was invest in U.S. treasuries and mortgage-backed securities, which is not unusual. But the error made in hindsight over the past year, the Fed started increasing interest rates approximately one year ago, and during that time period, as Silicon Valley Bank was making these investments in treasuries and mortgage-backed securities, the value went down because interest rates were going up. And so that's part of the issue that arose.

And then secondly, their deposit base, Silicon Valley Bank catered significantly to the venture capital part of the economy. And actually, if you take a look at their deposits a little

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over 90% of the deposits that Silicon Valley Bank had fell into that above $250,000 FDIC (Federal Deposit Insurance Corporation) limit, which compounded the issue that the bank has faced here in the last couple of weeks.

David: So, Scott, that's a look at Silicon Valley. But could you maybe talk about the banking sector in general and what we've seen and what are the causes of these issues?

Scott: When a bank has a deposit, the depositor comes in and asks for their money. The bank needs to keep a cash cushion for that. These banks that got taken under quickly basically had no cash cushion and had their money entirely tied up. They had further troubles in that they had assets they could sell, but assets at a loss. And of course, if you have enough losses, you're going to have trouble.

There's a huge difference between the credit crisis that we went through back in (2007-09) that was largely driven by bad mortgages and bad credit compared to just an asset liability mismatch. That's largely, you know, pushing and hurting the banks that have the least amount of liquidity. This is a narrow set of banks, banks that have unique niche sets of depositors that aren't very diversified. And we will get through this.

But when you take a step back from all of it, what does it really mean? It's that when the Fed (Federal Reserve) pushes up interest rates, something bad is going to happen. You're not sure where the cracks first start to show up, but they're obviously showing up in a few places in the financial system. The Federal Reserve will likely ring fence these banks and we'll be able to move on and calm the financial system down. But it doesn't mean that this isn't the start of the slowdown that the Federal Reserve wanted to engineer to basically bring inflation under control.

So, while it's not a subprime crisis or a credit crisis, it's one of liquidity because the money market funds are basically taking a lot of the money out of the banking system because they're paying higher rates. And this kind of thing happened back in the 1980s when interest rates were jumping. So, I don't think it's terribly inconsistent to think that when interest rates have moved up 450 basis points within basically one year exactly. They started raising interest rates one year and one day ago. This is the highest, quickest move the Federal Reserve has done since 1980. And they're getting a similar response out of probably what I would say the least, liquid banks in the banking system.

David: So, as we move from the banking sector in specific to the broader economy, we've had this discussion around hard landing and soft landing for quite some time. What are we anticipating are the effects of this banking crisis on the economy and specifically on inflation, Scott?

Scott: Well, the specific thing that this banking crisis does is it tightens financial conditions. And we always expected financial conditions to tighten as the Federal Reserve raised

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interest rates. But the markets have been very resilient in the face of these higher interest rates. Stock prices have been rallying since last September. Credit spreads or the average cost to borrow relative to risk free rates was below average.

But today that's begun to swing the other direction, the stock prices giving up most of their gains for the year and interest rate spreads widening. And so, it's likely to be the start of the slowdown.

Now we've been talking, as you mentioned, hard landing, soft landing, no landing. About a half a year ago, the yield curve inverted. That typically is a sign that's been a perfect predictor of an eventual recession. The key is when. On average it's about 18 months away, and the yield curve inverted in July. That would have told us by late this year we should be having a slowdown.

And then the leading economic indicators, which are ten separate indicators, including the yield curve, including credit spreads, including stock prices, were also falling broadly enough to possibly suggest that we ought to have a recession within about a year. That happened about last November. So, the historical markers would suggest there should be something very, very close to, if not a soft landing, a hard landing, basically by the end of the year.

That's been our position. The markets haven't really bought into the fact of recession is likely. I think this financial crisis, though, that we're going through the mini one that we're going to go through right now, just point us towards higher probability of a hard landing than a soft landing.

David: And so, as that translates into the narrative that we've had over the past year, that the Fed is out there fighting inflation. Where do we think inflation is headed? Are they going to be able to engineer this without too many more rate hikes?

Scott: I think that, you know, if they're looking for this soft landing, they're going to have to stop hiking rates very, very quickly and pause, perhaps gradually. They haven't had inflation cooperate quite as much as they want. The CPI (consumer price index) has come down from a high of a little over 9% to 6%. That's nowhere near their 2% inflation target. And this thing that they like to refer to all the time called the Personal Consumption Expenditure (PCE) Index that has dropped – core PCE, excluding energy out of it – from a high of 5.4% to 4.7%. So, in their mind, they've made 70 basis points.

I think it's a little ironic that Chairman Powell just last week in front of Congress, testified we still have a long way to go. When, in fact, this financial crisis may shorten the time period between the higher inflation rates and the lower inflation rates by cooling off the economy a bit quicker. The leading edge of inflation – when we look in terms of energy prices, home

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prices that are falling, rents that are beginning to ease – indicate that we ought to see a sharp slowdown in inflation towards the end of the year.

David: So, Tim, given that we have a recession looming out there, where do we go from here?

Tim: With Scott's expectation that we enter a recession late this year or early next year, there will be an opportunity to redeploy cash. Having said that, and to answer your question, we don't think the timing is appropriate yet. At some point we will have an opportunity to deploy the cash into more equity risk type investments. But for the time being, we're not there yet.

Scott: On the buy side, it's pretty much the same thing, David. It's not the time to be buying high yield, emerging market debt, floating rate bank loans or those kinds of riskier assets. But that opportunity is going to present themselves as this economy cools and we're likely take our investment grade bonds and push them out into some higher yielding, slightly more risky securities as the year progresses. But just like Tim said, we're holding back that firepower now because we think this is the start of the slowdown. It's not the end of the slowdown or a pause that refreshes, that allows the economy to reaccelerate.

David: So certainly, I think we have more regulation on the horizon for banks. But more specifically inside the economy in the short term, what should we be looking for, Scott?

Scott: I think what you're going to see is a further deterioration of the leading economic indicators. You're going to see a slowdown in spending as consumers basically react to this. You're going to see banks tighten their lending standards. Why? Because they don't have as much money to lend and they're worried about the money that is flowing out of their bank. And so, they're going to be much more cautious about extending credit.

One way to raise liquidity in a bank is to not make any more loans. And so, you'll see lending standards tighten and you'll see economic activity in general begin to slow. We are off to a positive start for the year. There clearly will be positive growth in the first quarter, likely slowdown in the second quarter, but sets us up basically for the slowdown that results an ultimate a recession as the year progresses.

The leading economic indicators are largely what you need to track. There are ten of them. We publicize them all the time and unfortunately, they're not getting any better. They continue to deteriorate. Ultimately, the Fed will pause. Ultimately, they will lower rates. Ultimately, we work through this. But that cycle has yet to unfold.

David: We will continue to remain defensive in our overall portfolio positioning and keep an eye on the banking sector in specific but are anticipating an economic contraction at some point here in 2023.

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Thanks for the interesting discussion today. For more information about this topic, you can download our piece at www.commercetrustcompany.com. Thanks for joining us on Conversations with Commerce Trust. I'm David Hagee, we'll talk again soon.

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