ICR® 1st Quarter Newsletter – April 2023

The markets continued their jagged rally from the end of 2022, with the S&P 500 gaining 7% in the first quarter of 2023. It was a reversal, though, in terms of which types of stocks led the way. Last year, value stocks easily outpaced growth stocks, whereas so far this year, growth stocks (up 14.1%) have beaten value stocks (up 0.4%) as measured by the Russell 1000 Growth and Value indexes. The technology sector, which lost almost 22% last year, is already up almost 22% this year, while energy - which led the way by a wide margin last year – is the biggest laggard in 2023.

Foreign stocks continued to perform well, partially driven by the relative weakening of the U.S. dollar. The MSCI EAFE index for developed markets rose 7.7%, while the emerging markets index gained 3.6%. In fact, some foreign markets, like the United Kingdom, made new all-time highs in the first quarter. For reference, the S&P 500 was still off its all-time high by about 14% at the end of the quarter.

Bond investors finally got to see rates fall in the first quarter after a miserable 2022. The ten-year Treasury yield fell from 3.80% to 3.47% and the aggregate bond index gained 3%. This seemed to be largely driven by the bond market pricing in an end to the Federal Reserve's rate hiking cycle in the relatively near future as well as an anticipated slowdown (and likely recession) in economic activity in the coming quarters. The Fed has signaled that they are going to be sure they've defeated inflation before they even start to think about lowering rates, but the inflation rate is still at 5%, which is well above their 2% target. Whether they soften their stance on that will be a key story going forward.

The good news is that something other than inflation was in the headlines in the first quarter. The bad news is that it was bank failures, bringing back bad memories of 2008. Neither of the two banks that failed (Silicon Valley Bank and Signature Bank) were quite as large as Washington Mutual was when it went under during the Global Financial Crisis (GFC), but they now check in as the 2nd- and 3rd-largest bank failures in American history.

While that sounds scary and naturally raises concerns about the health of our banking system, the situation is much different today than it was during the GFC. In 2008, an overheated housing market and the irresponsible mortgages that banks wrote for underqualified borrowers created the potential for the entire banking system to go under. What got Silicon Valley Bank (SVB) into trouble appears to be more idiosyncratic, though even one-off issues can spread in the banking system if depositors – rightly or wrongly – fear that their bank may be next.

SVB grew rapidly from 2019 to 2022, becoming the 16th largest bank in the country, largely because their depositors were heavily skewed towards Bay Area start-ups and venture capital firms who were raking in money from investors. That sounds great, but it actually created an interesting problem: very few of their customers needed loans from SVB because they were already flush with cash. And lending to customers is exactly how banks make money, so SVB needed to find another way to generate interest on their deposits. They decided to take what they thought was a conservative approach and buy the safest asset in the world: U.S. Treasuries. On the surface, that sounds like a responsible thing to do, but the problem is that they didn't seem to take into account the duration risk of the bonds. That is, when interest rates rise (which they have), the value of their bonds declines (which it did). If they held those bonds to maturity, that wouldn't matter much in the short-run – assuming the Federal government doesn't do the unthinkable and default on their obligations. But SVB couldn't hold them to maturity because the rise in interest rates coincided with a slowdown in the tech industry, so their depositors actually did begin to need to withdraw money. SVB was forced to sell some of their bonds to meet those withdrawal demands and had to recognize a $1.8 billion loss. When their depositors got wind of that, the withdrawals only accelerated and SVB's failure became inevitable.

The swift fall of SVB led to a similar run at Signature Bank which was known for having some of the highest exposure to cryptocurrencies of any U.S. bank. They had recently decreased their exposure to crypto, but that wasn't enough to placate their depositors. Even though Signature Bank didn't have the same issues with selling Treasuries at a loss to meet withdrawal demands, the similarities in their depositor base to SVB's (people in the technology sector and large balances over the FDIC limit) was enough to cause a run by its customers and two days after SVB failed, Signature Bank followed suit.

What does this all mean for regional banks and the customers of those banks? The Federal Deposit Insurance Corporation (FDIC) ended up making all of the depositors whole – even those who had deposits above the FDIC limit. That doesn't necessarily seem to be the policy going forward, though. Secretary Janet Yellen told the Senate Appropriations subcommittee, "I have not considered…blanket insurance or guarantees of deposits." Later, she clarified that when a bank failure "is deemed to create systemic risk…we are likely to invoke the systemic risk exception, which permits the FDIC to protect all depositors, and that would be a case-by-case determination." So, basically, if your bank fails and you're over the FDIC limit, you'd better hope your bank is large enough to potentially cause a banking crisis. But any bank failure – even a relatively small one – could lead to a systemic problem if fear spreads quickly enough. Of course, the safest thing to do is to stay under the FDIC limit ($250,000 per person, per institution).

The trouble for regional banks may not be over, with First Republic Bank now in the spotlight as depositors continue to withdraw money. For now, though, it doesn't seem as though this is a GFC-style banking crisis and the concerns seem to be contained to a handful of banks. What is happening, though, is that deposits are shifting from the small banks to the large ones – J.P. Morgan Chase, in particular – where customers feel more confident in the bank's solvency, or perhaps, knowing what Yellen said, feel confident that they'll have infinite FDIC insurance at a too-big-to-fail bank.

If you're concerned about this issue or would like to talk about alternatives to keeping excess deposits in your bank account, please reach out to us so we can help you understand your options. As always, we appreciate the opportunity to assist you in achieving your financial goals.

Sincerely,

James A. Heine

James L. Cobb

Market Report (as of 3/31/23)

Index	2023 YTD (%)	3-Year Annualized (%)	5-Year Annualized (%)
S&P 500	7.0	16.7	9.3
Dow Jones Industrial Average	0.4	14.9	6.7
U.S. Aggregate Bond Index	3.0	0.9	1.4
MSCI EAFE (Foreign Index)	7.7	10.3	0.9