Market Strategy
by STRATEGAS A BAIRD COMPANY

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# Addressing the Market Volatility

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Following the failure of Silicon Valley Bank (and the weakness in many related financial institutions), market volatility has ramped up significantly. In this piece, our partners at Strategas will break down the events and give their outlook for both markets and the economy going forward.

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## ON THE SILICON VALLEY BANK COLLAPSE AND ASSOCIATED MARKET VOLATILITY

### Silicon Valley Bank's collapse on March 10

Silicon Valley Bank (SVB)'s deposit base was concentrated in the tech and healthcare startup world. As deposits skyrocketed over the past few years, SVB invested the proceeds in U.S. Treasurys and government-backed mortgage securities. At the start of 2023, it was the 16th largest bank in the U.S.

As the Federal Reserve raised interest rates to combat inflation, the value of U.S. Treasury bonds declined rapidly (though their risk of default was minimal). At the same time, clients of SVB began to withdraw deposits due to growing liquidity and macroeconomic issues in the tech/start-up space (among other issues). This eventually forced SVB to sell some of its bonds at a big loss. When the bank sought to raise over $2 billion in capital, the announcement—combined with the bond sales—spooked shareholders and depositors alike. Per the WSJ, on Thursday, March 9, customers tried to withdraw $42 billion of deposits and SVB ran out of cash. On Friday, SVB's collapse was the second largest bank failure in U.S. history.

Over the weekend, the Federal Reserve, FDIC, and U.S. Treasury issued a joint statement insuring all deposits of SVB. They also created a program for other stressed institutions, offering loans of up to one year to eligible depository institutions pledging qualifying collateral. The aim is to provide additional liquidity against high-quality securities, eliminate a bank's need to quickly sell those securities in times of stress, and broadly reassure an uncertain banking sector. The statement noted that the U.S. taxpayer would not bear the burden for these decisions, that shareholders and certain unsecured debtholders would not be protected, and that senior management has been removed from the institutions in question.

**What do you think will be the longer-term economic effects of SVB's failure and the government's decision to insure deposits?** The longer-term effects of SVB's failure may not be that great, especially to the extent to which the government backstopped deposits. On another level, this brings up serious questions on the government's role in the banking system. It is difficult to provide this type of protection without expecting more control. Unfortunately, the specter of another financial crisis is likely to put a chilling effect on economic activity, bank lending, and the private equity/venture capital world at large.

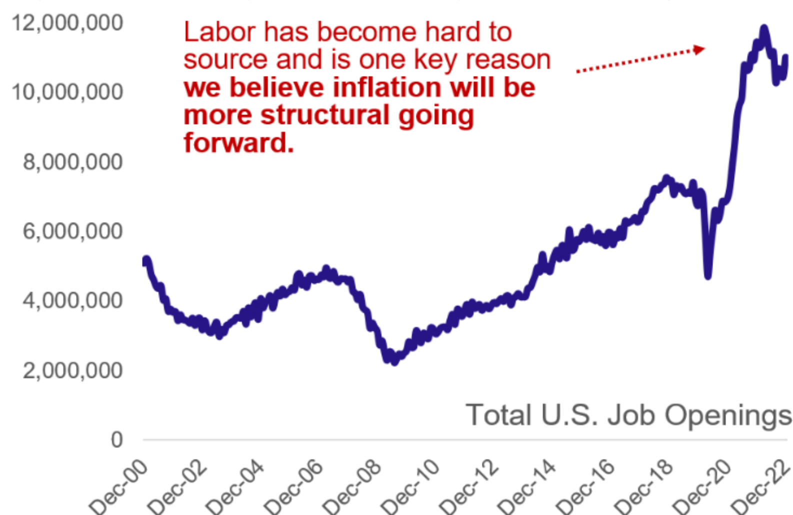
**Do any historical comparisons come to mind, and what are the takeaways?** What's different about this financial crisis in the context of the last 40 years is that the Fed cannot provide support by cutting interest rates. As we wrote recently, the Fed doesn't have the same flexibility today due to high inflation. The politics of bailouts, a rising deficit, and inflation concerns limit any type of fiscal assistance in our calculus. We believe that the end of ~13 years of quantitative easing makes V-shaped (quick) turns in the economy and the markets less likely. Patience may be required.

**How do you expect this to affect the Fed's decision-making in their fight against inflation?** It is difficult not to consider the moves by the Fed and the Administration as an easing of policy. This is a problem if inflation is "sticky" (and we believe that inflation is sticky and becoming more structural—see our chart on the next page). It seems likely that the Fed won't raise the fed funds rate by 50 basis points (bps) this week. This is a big shift—on Friday the market assigned 40% odds of a 50 bp hike this month; today those odds are zero. The question is whether they tighten at all or pause. History suggests a pause. **The new backstopping program will likely make the Fed's job of reaching its 2% inflation target more difficult.** This episode highlights the difficult-to-reverse nature of highly accommodative policy like quantitative easing (i.e., the Fed buying bonds after the Great Financial Crisis). This leaves the Fed in the strange position of being both pyromaniac and firefighter.

*(Questions and Answers continue on the following page)*

**How does an event like this contextualize the broader bear market that began last year?** A recession has been the result of seven of the last nine Fed tightening cycles. It is difficult to avoid a recession when the central bank tightens this much in such a short period of time. To the extent to which monetary policy acts with a lag, and those lags are long and variable, it is not surprising that the economy has remained resilient. Over time, however, a higher cost of capital will inevitably slow the economy. We believed a recession was likely before the events surrounding SVB (~75% chance within the next two years). Recent developments have not changed our view.

With regards to the bear market, this could be the third leg of a recession-related asset bubble deflating (as was the case in 2000-2002). A prolonged zero interest rate policy created a situation that needed to be normalized. This unwinding first saw a selloff in highly speculative assets (e.g., SPACs, crypto), followed by older Tech leadership (FANG & FANG-adjacent stocks), and now we're on to unwinding illiquid assets (commercial real estate & venture capital / private equity).




We believe the current bout of inflation is likely to prove more structural (and therefore more difficult to root out of the system) for several reasons:

- **Globalization** – a key source of disinflation – is waning in effect.
- **Money supply** (M2) is up 40% since February 2020.
- **Upward pressure on wages** from roughly 11 million job openings.
- **Spending** – roughly 60% of the federal budget is indexed to inflation.
- **Rising home prices** (+7% y/y) are generally followed by rising rents.
- **Environmental policies** boost energy prices and the cost of doing business.

**Does this change how you are positioning your portfolios / asset allocation?** Not from where we were. We have been recommending that investors hold higher-than-normal levels of cash and to also orient their equity portfolios to defensive sectors like Health Care and Consumer Staples. We believe investors should continue to focus on shorter-duration, higher quality companies. (See our most up-to-date asset allocation and sector allocation frameworks). As far as investible themes, we continue to believe that "recession protection" and "cash flow aristocrats" are worthy of investor dollars, and the recent volatility does not dissuade us from that view.

**Do you have any other lingering thoughts or insights on the events of the last week? What else are you watching from here?** The only thing we might say is that there is an inherent conflict between providing a backstop for all depositors on the one hand and fighting inflation on the other. While the authorities will be loath to call this a bailout, rank-and-file voters may not be so sure. Further problems in the banking system could become a significant issue in next year's presidential campaign. As noted by our head of Washington Policy, Dan Clifton, "Every fiscal and monetary decision will be criticized by one side or the other or both sides, depending on the issue."

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