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The Howard Group
Market Commentary

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Unintended Consequences
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The more governments intervene in free markets, the more unintended consequences. Ironically, those consequences are often met with more government intervention. This is the nature of the beast and the hallmark of the long term debt cycle that I've been writing about since the summer of 2020.[1]

Last week, Silicon Valley Bank (SVB) and Signature Bank were taken over by the FDIC. This has spilled over into other regionals banks and calls the health of the overall financial system into question.2 While SVB and Signature were sizable banks and the overall market has taken a hit, it's unlikely that this will result in a systemic risk to the overall banking system. While many will blame this on complacent management and poor risk control, in reality these are the types of land mines that tend to pop up when governments are overly entrenched in financial markets and the economy. [3]

So what happened?

Commercial banks consist of assets and liabilities and in order to remain solvent, banks are required to have a certain amount of assets to cover their liabilities. A bank's liabilities are customer deposits such as checking accounts, savings accounts, etc., while their assets consist of mortgages, personal loans, business loans, and securities such as US treasury bonds and various other government securities.[4]

As a result of the six pieces of covid relief legislation totaling 4.7 trillion, customer deposits grew substantially and banks were sitting on huge piles of cash. In order to offset this influx of deposits, banks either needed to provide more loans or increase their security holdings. But given the covid relief funds, the demand for new loans had softened as companies and individual were flush with cash and paying down their existing loans. This forced banks to invest their deposits into treasury bonds and other fixed income instruments at historically low levels. [4]

This was a win for the government as someone needed to purchase these treasuries in order to finance the fiscal spending.5 Keep in mind, there are only three ways to cover a budget short fall: increase taxes, borrow, or print the money.6 Increasing taxes was a nonstarter so in order to cover the shortfall, banks swallowed up large amounts of low yielding US treasuries and the Fed bought whatever was left. Hence why the Fed's balance sheet went from 4 trillion to 9 trillion.[7]

Of course this created a dumpster fire of inflation. The Fed sat on their hands claiming inflation was transitory, then they raised interest rates from zero to 4.75% in one year, the quickest percentage pace in history.8 Bond prices drop when interest rates go up, therefore the banks are sitting on large amounts of unrealized losses. But as long as they hold these until maturity, they will get all their money back with zero risk.[9]

This is much different than 2008, when banks were holding garbage assets, losing value by the second. Treasuries are essentially risk free, therefore, this is not a credit issue but an interest rate issue for banks. But if a bank is losing a lot of customer deposits and is forced to liquidate their treasuries for a loss, their liquidity issue could become a solvency issue as in the case with SVB and Signature. [8]

So what does the government do? More intervention as the FDIC decided to guarantee all customer deposits even above the $250,000 threshold. The Fed also created a new facility called the Bank Term Funding Program for banks to borrow off their treasuries so they don't have to sell.10 While the capitalist in me would say this is a slippery slope, in my view, if they didn't do this, customer deposits may likely move from community and regional banks to the large money centers, only reducing competition and exacerbating the too big to fail issue from 2008. Again this the nature of the beast with government intervention - once you start, it's hard to stop. 3

Don't get me wrong, the banking system should have oversight but ironically if the Federal Reserve Bank were held to the same standards as commercial banks, it would already be bankrupt.15

So what does this mean for markets?

In my November note titled "Free Markets", I said: *while inflation is moderating, there are many other variables at play that may cause the Fed to slow down or pivot very soon. The liquidity issues in the treasury market is chief among them.* Of course, no one thought we would see a large bank, holding risk-free asset guaranteed by the government, go bankrupt. However, the silver lining of all this is the Fed might be forced to pause and cut rates later this year.11

I mentioned in my February note that 10-year treasury yields will likely resume its downward trend from October. Since then, we've seen yields move back down to around 3.4% and the 2-year under 4% which is relieving a lot of pressure for bank balance sheets. More importantly, it is signaling to the Fed that they are mostly likely done.12

While the market will likely remain choppy over the next few weeks as this banking issue gets sorted out, my overall thesis has not changed. The economy is slowing due to the amount of rate hikes already in the system, but most of that was already priced into the market last year. Aside from the banks, the economically sensitive areas of the market are still holding up reasonably well, particularly the home builders and semiconductors stocks.12 Inflation continues to moderate as evidence from the Producer Price index yesterday.14

We had a powerful four-month rally off the October low with breadth and momentum readings that historically only occur at the beginning of bull markets. Since then, the market has given back about half of the rally which is also quite common and can serve as one last panic period before a full advance.13

Time will tell but it's always important to remember that liquidity is what actually drives markets and thanks to yet another unintended consequence.... the system is once again in need of that sweet elixir.

As always please feel free to reach out if you have any questions or comments.

All the best,
Gray

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Sources

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