ClarkCapital MANAGEMENT GROUP

Commentary

**Navigator® Market Update**

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# Fed Steps in to Calm Fears After Bank Failures

There is an old expression that the Federal Reserve hikes rates until something breaks. The Fed has hiked rates 450 bps in a little under a year. Things are breaking now. Three banks have failed, and the Fed stepped in to backstop depositors. Sunday night the regulators developed a plan, the Bank Term Funding Program (BTFP), to calm markets and mitigate further runs on banks and limit potential contagion.

The plan calls for covering all deposits at Silicon Valley and Signature banks, and the Fed has created an emergency liquidity facility for other banks. It also pledged to address future liquidity problems.

- For Silicon Valley Bank, all depositors will have access to their funds on Monday morning. This includes uninsured deposits.
- For Signature Bank, New York regulators seized it on Sunday. The FDIC said all depositors will have access to their funds on Monday including uninsured depositors.
- For other banks, the Federal Reserve announced a new liquidity facility known as the Bank Term Funding Program. Banks can pledge Treasury securities, agency debt and mortgage-backed securities (MBS) for liquidity at par for a one-year term at the one-year overnight index swap rate plus 10 basis points. There is no fee or cap on the program. The Treasury is backing it with $25 billion.
- The Fed also issued a blanket pledge to address any liquidity issues that arise.
- Eligible depositories can now borrow for up to one year pledging Treasuries and agency MBS, which will be valued at par. That plugs a $620 billion hole created by the unrealized losses on securities holdings.
- This should help limit the collateral damage to the economy and allow companies to meet payroll and other obligations.

Ironically, in the aftermath of the 2008 Global Financial Crisis (GFC), the authorities regulated the amount of credit risk banks can take. Credit was not the straw that broke the camel's back this time around. During the GFC, banks were faced with defaults on the loans they issued. That is not what triggered the problems at Silicon Valley Bank. What happened to Silicon Valley Bank is a classic mismatch between assets (loans and reserves) and liabilities (deposits). Banks fund their lending, which is typically longer-term, with deposits, which are typically shorter term. When too many depositors want their money back, this forces financial institutions to liquidate their reserves. In the case of Silicon Valley Bank, it was forced to liquidate Treasuries and other securities at losses to return money to depositors. This has created a capital issue, which has now turned into a credit risk issue.

Last week, Fed Chairman Powell gave testimony before Congress, and his comments were much more hawkish than previous comments, suggesting the Fed was willing to re-accelerate the path of rate hikes. Those comments roiled the market. The rates market has now been aggressively repriced. Just last week the market was pricing in a

50 basis point hike at next week's FOMC meeting and a terminal fed funds rate of 5.50%. Fast forward to today, the market is now pricing in an immediate pause and two rate cuts by year-end. Things are moving fast. What does all of this mean for policy moving forward? In our opinion the Fed can't invoke the systemic risk exception and still hike rates 50 basis points. When faced with the decision to continue fighting inflation or provide for financial system stability, the Fed has chosen the latter.

Thanks to rate hikes and quantitative tightening, the Fed is draining reserves, while banks are bleeding deposits. As the Fed raises rates, the opportunity cost of holding cash in banks rises for depositors. Some have been transferring cash to money market funds to get some yield on their cash holdings. That has caused banks to sell investments and realize a capital loss in order to pay out depositors.

We are evaluating the financial positions in our portfolios based on three criteria:

How secure is the institution's deposits base? What is the institution's asset liability mismatch? What credit risk is that institution exposed to?

We are closely monitoring the situation and the potential implications of policy actions on the financial markets and the economy. We expect the markets to remain volatile for a period of time as this plays out.

As always, we believe it is imperative for investors to stay focused on their long-term goals and not let short-term swings in the market derail them from their longer-term objectives. We have been through previous crises and we will get through this one, too.

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