Ameriprise Financial

Weekly Market Perspectives

March 13, 2023

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A Rapid-Pace Bank Collapse Adds Pressure for Investors and the Fed

Coming into last week, many investors were on pins and needles waiting for what Federal Reserve Chair Jerome Powell might say about rates and the economy in his two-day testimony to Congress. In addition, Friday's February nonfarm payrolls report, which provided a key update on the strength of the labor market heading into this week's inflation reports, was expected to be the week's highlight. But by market close on Friday, each seemed a distant focus for investors. On Friday, regulators seized Silicon Valley Bank (SVB) deposits after a frenzied attempt by the bank to remain solvent, unexpectedly ending the financial institution's 40-year run at serving primarily start-up companies in the technology and life-sciences space as well as venture capital customers. While customers with deposits of $250,000 and under receive protection from the Federal Deposit Insurance Corporation (FDIC), most of SVB's customers had deposits above the FDIC threshold.

In just 48 hours, SVB went from a well-capitalized financial institution to becoming the biggest banking collapse since the 2008 Financial Crisis and the second largest in history behind Washington Mutual. On Friday, regulators shuttered the bank and seized control of its deposits following the announcement earlier in the week that SVB would need to raise $2.3 billion to shore up its balance sheet on incurred losses from its portfolio of mortgage bonds and U.S. Treasuries. Simply, the backup in rates over the last year made the current value of SVB's longer-dated bond holdings less valuable.

According to *Barron's*, SVB's deposits grew from over $70 billion in June 2020 to nearly $200 billion at the end of March 2022. Given banks' need to do something useful with their deposits, SVB chose to invest the bulk of their deposits in government bonds with longer-dated maturities and when rates were very low. Fast forward, and over the last year or so, SVB customers (e.g., in the start-up space) began consistently drawing down cash deposits to fund business operations and the like (as IPO activity dried up), finally creating a liquidity event that SVB could not manage through. Notably, by the second half of '22, the backup in rates no longer benefited SVB's net interest income, with the Fed raising rates aggressively.

What seems obvious in hindsight is that SVB invested in long-dated bonds and ultimately had an asset mismatch when rates backed up quickly, leaving it unprepared to deal with a quick drawdown in its deposit base. While the epicenter of the banking issue is squarely centered on a situation mainly unique to SVB and the types of customers it served, that didn't stop investors from quickly turning their anxiety to other California banks. As a result, and combined with last week's collapse of Silvergate (a cryptocurrency-focused bank), several regional banks came under intense selling pressure by the end of the week.

As one might suspect, banking stocks and Financials as a whole faced severe selling pressure as a result of SVB's failure. The S&P 500 Financials Index lost 8.5% last week, while the KBW Bank Index shed an astounding 16.0%. For the KBW Bank Index, last week's declines were its worst since March 2020, when the Index shed nearly 19.0% in one week at the height of the COVID-19 pandemic. More broadly, the S&P 500 Index lost 4.6%, posting its worst week of performance since September. The NASDAQ Composite fell 4.7% in its worst

week since November. The Russell 2000 Index (which carries over 30% of its market capitalization across small-cap Financials and Healthcare combined) dropped 8.1%. All eleven S&P 500 sectors closed the week lower. Consumer Staples (down 1.9%), Utilities (down 2.9%), and Healthcare (down 4.0%) helped modestly mitigate some of the selling pressure. **Notably, in an environment where short-term interest rates have risen this year, the 2-year U.S. Treasury yield made its biggest two-day downward move since 9/11 and Black Monday in 1987.** The 2-year yield ended the week at 4.59%, after touching 5.80% following Fed Chair Powell's appearance in front of the Senate Banking Committee on Tuesday. The 10-year and 30-year U.S. Treasury yields ended the week at 3.69%, with both term structures backing off recent yield highs. The U.S. Dollar Index was little changed on the week, Gold rose +0.7% to $1,872.60 per ounce, and West Texas Intermediate (WTI) oil fell 3.8% to $76.53 per barrel.

Regulators and the Fed Take Action; The Fed Now Facing Added Pressure for Their Next Rate Decision

On Sunday, regulators and the Federal Reserve employed measures to make all depositors at SVB and Signature Bank (a crypto-focused bank that failed over the weekend) whole. The Fed will also provide a loan facility to all banks if needed to help prevent similar runs on the bank. Importantly, the strength of a financial institution often comes down to the underlying confidence the market, investors, and customers place in said entity. **The lightning-fast collapse of SVB last week should remind investors how precious that confidence is and how critical it is for financial institutions to maintain trust and liquidity — especially during times of stress.** That said, bank stocks have come under selling pressure over recent weeks. Rising interest rates, growing fears of a recession, deposit risks, and potential losses on security holdings eroding bank stability and profitability have weighed on the industry group. However, the underlying strength and stability of the major U.S. banks are not an issue, in our view.

Yet, SVB's unexpected need to raise capital, losses booked on low-risk security holdings, and ultimate failure last week (at a time when others in the industry are warning about deposit pressures) are putting investors on guard. Importantly, capital reserves across the major U.S. banks are on solid footing, and each has multiple levers to pull to maintain liquidity and meet depositor needs. As a result, investors and depositors should feel confident the U.S. financial system can weather higher rates and a potential recession. In our view, years of stringent Federal Reserve stress testing against various adverse economic scenarios and higher required capital cushions compared to pre-financial crisis levels have placed major U.S. banks in a position of strength with the ability to weather multiple headwinds. With that said, most major U.S. banks have recognized over several quarters that the macroeconomic environment (including threats from higher interest rates) could become more challenging. Thus, most banks have set aside earnings to reserve against potential loan losses or unforeseen risks. As a result, while we expect Financials as a group to face increased volatility over the near term and as the rate/economic environment evolves, we believe the system is well capitalized and positioned to weather incoming challenges.

Investors Keeping an Eye on Inflation and Retail Sales; Markets Expected to be More Volatile this Week Given Many Shifting Dynamics

Getting back to the events that most expected would drive markets last week, February nonfarm payrolls jumped +311,000, down from the +504,000 jobs created in January but much stronger than the +215,000 expected. In addition, the unemployment rate ticked higher to +3.6% last month from 3.4% in January, with the labor force participation rate hitting 62.5% and the prime-age employment-to-population ratio moving back to early 2020 levels. Private payrolls and jobs across construction as well as leisure and hospitality, all showed strength in February.

Earlier in the week, Fed Chair Powell told Congress, *"The ultimate level of interest rates is likely to be higher than previously anticipated,"* and in response to stronger-than-expected economic data in January. In our view, it doesn't get much clearer than that and may keep the stress elevated across banks and the market as a whole over the near term. *Bottom line:* Rates are headed higher, and current projections made by the Fed in December are now stale. A new dot plot in the upcoming Summary of Economic Projections later this month will likely show a higher terminal rate than December's forecast. Markets ascribed a nearly 80% chance of the Fed hiking rates by 50 basis points on March 22 and shortly following Powell's testimony to the Senate on Tuesday. But after Friday's jobs report, and SVB developments, markets now see a zero percent

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chance the Fed will move rates higher by 50 basis points this month, with a roughly 34% chance they hold rates steady this month.

Looking ahead to this week, it's all about inflation and retail sales. Reports on price trends and consumer activity will likely cement market odds on whether the Fed moves rates at all this month. And while meeting-to-meeting moves are less important than the final destination for rates, we expect markets to see added volatility ahead and following Tuesday's February Consumer Price Index (CPI) report. On Wednesday, the February Producer Price Index (PPI) and Retail Sales reports could also create added volatility for stocks in the middle of the week. Notably, investors will look to discount inflation trends and their ongoing influence on consumer and producer behaviors while simultaneously trying to anticipate forward Fed policy. As we have seen over the last twelve months, that's no small feat, and more often than not, that exercise has led to inaccurate assumptions. As it stands coming into the week, *FactSe*t estimates show February headline CPI dipping to +0.4% month-over-month from the +0.5% pace seen in January. As a result, the year-over-year rate in headline CPI is also expected to moderate to +6.0% in February from +6.4% in January. In addition, core CPI (excluding food and energy) is forecast to have moderated slightly last month, falling to +5.5% year-over-year from +5.6% in January.

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Sources: FactSet and Bloomberg. FactSet and Bloomberg are independent investment research companies that compile and provide financial data and analytics to firms and investment professionals such as Ameriprise Financial and its analysts. They are not affiliated with Ameriprise Financial, Inc.

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Past performance is not a guarantee of future results.

An index is a statistical composite that is not managed. It is not possible to invest directly in an index.

The **Standard & Poor's 500 Index (S&P 500® Index)**, an unmanaged index of common stocks, is frequently used as a general measure of market performance. The index reflects reinvestment of all distributions and changes in market prices but excludes brokerage commissions or other fees. It is not possible to invest directly in an index.

The NASDAQ composite index measures all NASDAQ domestic and international based common type stocks listed on the Nasdaq Stock Market.

The **Dow Jones Industrial Average (DJIA)** is an index containing stocks of 30 Large-Cap corporations in the United States. The index is owned and maintained by Dow Jones & Company.

Definitions of individual indices and sectors mentioned in this article are available on our website at ameriprise.com/legal/disclosures in the Additional Ameriprise research disclosures section.

A **10-year Treasury note** is a debt obligation issued by the United States government that matures in 10 years. The 10-year yield is typically used as a proxy for mortgage rates, and other measures.

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The **Consumer Price Index** (CPI) measures change in consumer prices as determined by the US Bureau of Labor Statistics.

Producer Price Index (PPI) measures change in the prices paid to U.S. producers of goods and services. It is a measure of inflation at the wholesale level. The index is published monthly by the U.S. Bureau of Labor Statistics (BLS).

The U.S. Dollar Index (DXY) measures the dollar's value against a trade-weighted basket of six major currencies.

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