MARKET COMMENTARY: BANKING CRISIS – HOW BIG OF A DEAL IS IT?

'*You don't find out who's been swimming naked until the tide goes out'*
Source: Warren Buffet, Berkshire Hathaway annual meeting, April 25, 1994

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Most of us had not heard of Silicon Valley Bank up until a few weeks ago, even though it was apparently in the top 20 banks in the U.S. and was included in the U.S. S&P 500 stock index. Many of us had heard of Credit Suisse in Switzerland but we no longer thought of it as a very important bank. That being said, the failure of any bank, even if it is not one of the biggest banks, can have a negative impact on the confidence level we have in our financial system. This is why government institutions have recently stepped in so quickly with various measures in order to help bolster confidence in our financial system.

Is the current banking crisis as severe as what we experienced back in 2008-09 and during the Spring of 2020? Not according to our own bank analyst Gerard Cassidy -*see quote below*. What I recall vividly about the 2008-09 crisis is that its root causes were a combination of a deteriorating speculative real estate market and too many questionable mortgage loans. This in turn led to huge losses at financial firms that did not have enough capital. So bad credit led to losses at financial firms which wiped out a lot of their capital. In my view, this current crisis is mainly due to the vertical increase in interest rates engineered by central banks in order to lower inflation. The central banks have been increasing rates over the past year, and have certainly realized this could lead to negative consequences. Ordinary folks have been renewing mortgages at higher rates. Companies can no longer rely on cheap financing to fuel their growth and hiring sprees. Increasing rates in such a quick and dramatic fashion is the equivalent of cars having their brakes slammed. Some will crash through the window. SVB and Credit Suisse are two such victims.

Even though I do believe that the issues at SVB and Credit Suisse have had the potential of causing a mass financial contagion and loss of confidence in our financial system, I also believe that their problems were not representative of the entire banking system. Without going into the specific details, both banks had been mismanaged for a while. And that is where Warren Buffett's famous quote above is relevant.

So, what will be the consequences of the recent bank failures? I can think of three, one bad, one good and one 'to be determined'.

- Banks will be even more careful with their lending, making it even more difficult for start-up companies to get financing. A net negative.
- The well-capitalized bigger banks with a more stable deposit base and a large of branch network may gain at the expense of smaller community banks in the U.S. Whether this is good or not, I will let others debate. But the U.S. probably has too many banks in the first place, especially compared to Canada on a per capita basis.
- Central banks will need to emphasize financial stability and recognize that further rate increases may be detrimental to our confidence in our financial system. A net positive, in my opinion.

The last point is what makes me take a positive medium-to-long term view of the consequences of the 2023 banking crisis. In fact, the futures market is now projecting that the U.S. Federal Reserve Rate will be lower than its current level in one year from now. In response to this change in rate outlook, we have already seen Big Tech growth stocks that have little-to-no debt do well over the past few weeks. Long-term government bonds have also done well over the past few weeks.

The playbook for 2023 is shaping up to be very different than 2022. Defensive value-oriented stocks did well in 2022, while almost nothing else did. So far in 2023, aggressive stocks, Big Tech stocks, and long-term government bonds have done well. This proves that diversification continues to be a fundamental tenet for successful long-term investing.

Finally, let us recognize that there has been a fair amount of instability in the financial system over the past few weeks. I do not proclaim to know when that instability will subside. Other unpleasant 'surprises' might surface. It will only be in a few years from now that we will know how it all played out.

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<u>Insights/Opinions from Experts</u>

In this section, as I often do, I would now like to <u>offer recent quotes/insights/observations from respected market experts</u> that hopefully provide useful perspective during these very uncertain times.

'*This is not even close to the same magnitude as 2008.'*
Source: Steve Eisman, Neuberger Berman Senior Portfolio Manager, "Big Short" investor, CNBC, March 20

'Sentiment Signals Starting to Look Extreme…. As always, we are keeping a close eye on our sentiment barometers. Some are starting to suggest that fear has gotten too extreme... Although that indicator remains below last year's all-time high, it's still at a level that is typically followed by strong S&P 500 returns on a 12-month forward basis... it's still a range that has typically been followed by strong equity market gains.'
Source: Lori Calvasina, head of U.S. Equity Strategy, RBC Capital Markets, March 20

'The failure of three U.S. banks and a crisis at a European bank are very reminiscent of the events in the early stages of the 2008 financial crisis and subsequent deep recession…just because something sounds familiar, it doesn't mean it is the same. The coming economic weakness will help to bring inflation down, which is the single greatest economic imbalance today, and the eventual adjustment to higher rates will created the necessary condition for the next upswing in economic growth.'
Source: Craig Alexander, served as chief economist at Deloitte Canada, the Conference Board of Canada, and Toronto-Dominion Bank, The Globe and Mail, March 20

'*…deposits outflows will stabilize , and the system will begin I think to stabilize next week and into the end of the first quarter…When we put this current situation on a scale of 1 to 10 versus those other periods, …with 10 being the worst possible scenario ..the current situation might be a 5 maybe a 6 …we don't have the same issues we had in those other time periods* (my note: i.e. the 2008-09 financial crisis and the 2020 COVID recession)'
Source: Gerard Cassidy, head of U.S. bank equity strategy and bank analyst at RBC Capital Markets, CNBC, March 17

‘With the regional banks playing a key role in U.S. credit extension…we have likely seen the peak in both short- and long-term rates during this cycle…When the facts change, my view changes. A financial accident has happened...’
Source: Torsten Slock, chief economist, Apollo Global Asset Management, CNBC, March 15

‘With the back-stopping of bank deposits by the Fed/FDIC…represents the beginning of the end of the bear market.’
Source: Mike Wilson, Chief U.S. Equity Strategist and Chief Investment Officer, Morgan Stanley, CNBC, March 20. My note: Mike has been the king of the bears over the past 16 months or so. Maybe his very recent reflection is a cause for celebration?

‘This is not a credit tide. Credit quality in the U.S. is really good. This is a tide of a mistake...Some of the regional banks bought long-term bonds at very low levels and now have massive market-to-market losses…SVB also failed because it had a very concentrated deposit base which has a very big herd mentality…It is not to say there won’t be pain if Credit Suisse goes down, but it is not a 08.‘
Source: Steve Eisman, Neuberger Berman Senior Portfolio Manager, “Big Short” investor, CNBC , March 15

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Should you have any questions or concerns, please feel free to reach out. And as always, we encourage you to contact us if there has been an important change in your financial situation.

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March 21, 2023

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