CETERA® INVESTMENT MANAGEMENT

COMMENTARY

March 13, 2023

Ripples of Fed Tightening Being Felt

- Last week two banks faltered, causing equities to sell off.
- The banks' customer bases were not diversified and more sensitive to interest rates.
- Volatility will remain through this Fed rate hike cycle.

Last week, two California banks collapsed, causing stock markets to retreat. One of the bank closures was the second largest in U.S. history with over $200 billion in assets. The news came as somewhat of a surprise and raised investor worries. Will there be more bank closures, and will these two closures ripple through the economy?

Unique Banks with Liquidity Events, Not Solvency Events

These two banks served a very niche client base that is not representative of most other banks. The larger bank's clients were predominantly start-up companies and venture capital companies. The smaller bank's customers were largely customers in the cryptocurrency business.

The customer bases of these banks were not diversified, and their customers relied heavily on low interest rates. At low interest rates, entrepreneurs can borrow money to start new companies. With the Fed raising interest rates at an unprecedented rate, start-ups (which may not be net cash flow positive) had to use their existing cash balances to pay rents and salaries as new investment capital dried up and borrowing costs rose. Since these banks' customer bases were not diversified, their customers were facing similar challenges simultaneously and needed their money at the same time, causing a run on the banks. This is what caused the banks to close.

This liquidity crunch ultimately doomed the banks that were already hurting because their investments were predominantly in longer dated U.S. Treasury assets. Because bond prices move inversely to yields, these bonds were recently devalued when long-term bond yields rose. It is important to note that these were liquidity events and not solvency events. While the banks' asset values did fall with rising bond yields, the assets were performing, unlike 2008 when the underlying mortgage assets were not performing assets.

Systemic Risk?

It does not appear that these closures will be a systemic risk to the economy. The Federal Government has stepped in and will allow customers of the large bank to have access to their cash. This relieves concerns around liquidity for the customers at the bank as they begin trying to pay payrolls and other bills. We will be watching the government's future actions closely in the coming weeks. U.S. Treasury Security Janet Yellen made it clear that she is not in favor of bank bailouts, but she seemed more sympathetic to customers' liquidity needs.

Summary

This is a painful reminder of the consequences from the Federal Reserve tightening financial conditions. Fed tightening is now showing its mark in banks as well as start-up companies and high growth companies. These recent events may cause the Fed to pause their interest rate hikes sooner than previously expected, and even pivot and lower rates later in the year. They may want to wait and observe the impact they are having on different areas of the economy, since there is a lag between their policy moves and the impact from those moves. Since the Fed began to raise rates only one year ago, much of the policy impact has not been felt yet.

We reiterate that this is not time to become more aggressive in your portfolios beyond your long-term investment objectives. As we navigate mixed market signals and increasing uncertainty, please continue to work with your financial professional to make sure you are properly diversified to help mitigate market volatility. Make sure your portfolio is aligned with your long-term investment objectives.

This report is created by Cetera Investment Management LLC. For more insights and information from the team, follow @CeteraIM on Twitter.

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A diversified portfolio does not assure a profit or protect against loss in a declining market.

Glossary

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The NASDAQ Composite Index includes all domestic and international based common type stocks listed on The NASDAQ Stock Market. The NASDAQ Composite Index includes over 2,500 companies, spanning all 11 sector groups.