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Weekly perspective on current market sentiment **March 15, 2023**

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Last week's S&P 500 Index: -4.6%

Banks and market volatility

Key takeaways

- When bank depositors all want their money at the same time, bad things can happen. Banks can potentially go out of business.
- From a portfolio perspective, we remain defensive as has been the case since the March/April 2022 time frame.

Clearly, a lot can happen in just a couple of trading days. We have heard many comments in recent years from analysts, economists, government officials, and a herd of others about how well-capitalized U.S. banks are now versus at the onset of the Great Financial Crisis of 2008 – 2009. But what happened last week, and is continuing to affect markets at the time of this writing, was a culmination of a number of different events that ended up being something that older financial market participants have seen a number of times: an old-fashioned run on a bank.

As we all know and are reminded of each holiday season in Frank Capra's classic movie "It's a Wonderful Life," banks do not hold on to all of the deposits their customers have in their checking and savings accounts. They take those deposits and turn them into various types of assets, including securities and loans — everything from home mortgages to commercial and industrial loans. And, as that holiday favorite from 1946 so clearly illustrates, when depositors all want their money at the same time, bad things can happen. Banks can potentially go out of business. Fast-forward 77 years to 2023, and that is precisely what we saw happen late last week. The banks in question were forced to sell fixed-income securities at a loss to meet immediate depositor demands for their funds. These fixed-income investments were made when interest rates were much lower (and, therefore, bond prices were much higher).

Of course, Federal Deposit Insurance Corporation (FDIC) insurance protects depositor accounts up to a certain limit. But, based on what the Federal Reserve and U.S. Treasury announced on Sunday, there apparently is not a limit on the size of the depositor account that is fully protected. Or at least that is the case in these specific situations, where a West Coast bank and an East Coast bank both were shut down by authorities this past Friday and depositors were guaranteed access to 100% of their funds on Monday morning (March 13).

So, what do we believe are the investor implications? It appears that investors holding stocks or bonds issued by these two specific banks could possibly lose their entire investment, and other small and regional banks may likely have similar problems as those that failed last week. As far as the broader financial markets, volatility has clearly increased meaningfully across fixed income and equities. We anticipate that this increased volatility is likely to last anywhere from a few days to potentially months. But we do not expect systemic risks. In our view, banks, especially large entities, should be better capitalized and have more diverse deposit sources and types of assets than prior to the Great Financial Crisis.

From a portfolio perspective, we remain defensive as has been the case since the March/April 2022 time frame. We continue to carry a neutral rating for the Financials sector, of which approximately one-third of total capitalization is made up of banks and another 21% is insurance companies. Our equity focus has been quality sectors that are less cyclically sensitive. In terms of fixed income, we continue to favor the short and long portions of the yield curve and, as with equities, we emphasize quality.

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