FVCM

U.S. MARKET REPORT

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S&P 500

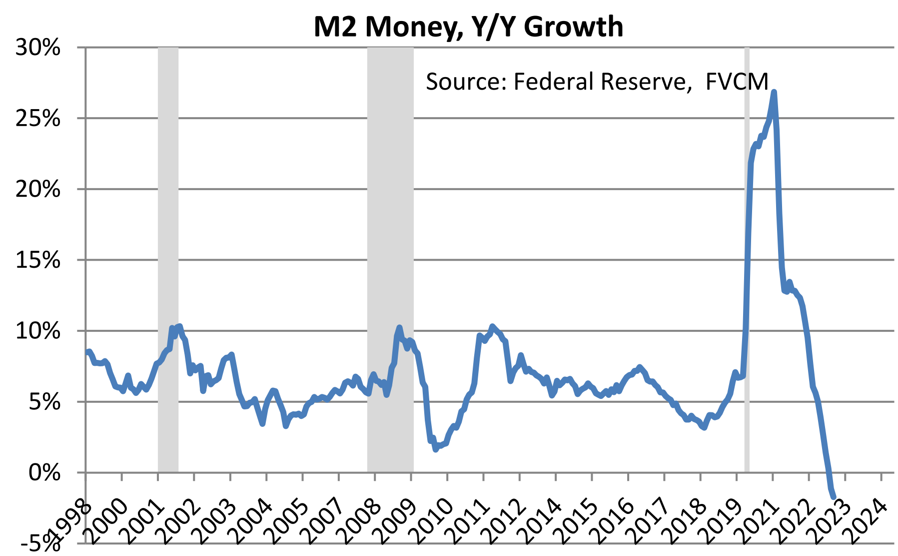
Higher Interest Rates and Financial Stress

Silicon Valley Bank (SVB), the 16th largest bank in the U.S., failed for reasons rather unique to itself, but the Fed's rapid increase in interest rates over the past year is a proximate cause. SVB didn't get in trouble because it was making foolish loans to risky companies. SVB got in trouble because its deposit base grew very fast in recent years, and it recycled those deposits into some of the "safest" securities in the world—United States Treasury securities (USTs). At the holding company level, SVB's assets rose from \$57 billion at the end of 2018 to \$212 billion by the end of 2022. This huge increase in assets occurred as the Fed's policies of low interest rates and easy monetary policy added fuel to the most speculative types of investments, including tech startup companies, from which SVB took deposits. Easy monetary policy also fueled the cryptocurrency craze as well, and there have also been two recent bank failures tied to the crypto bust (Signature Bank in New York and Silvergate Bank in California).

In the case of SVB, the implosion reflects the fact that the *market value* of bonds, even USTs, fall as interest rates go up. SVB did suffer because of incompetent risk management, but also due to the fact that it was hit by rising interest rates from two directions: 1. Tighter monetary policy meant that many of its depositors needed to draw down their deposits as money became more scarce; 2. SVB was forced to sell USTs to cover those deposit withdraws as the market value of the USTs fell because of rising interest rates. With all the deposit withdraws, SVB didn't have the luxury of holding those USTs to maturity. They were forced to sell bonds at a loss to cover the withdraws. The bank also responded by trying to raise capital by selling stock. The bank's CEO helped destroy that possibility by saying that everyone had to "stay calm" during a conference call regarding the stock offering. For sure, no one I know would buy stock in a bank when the CEO was warning folks to stay calm. SVB clearly had severe management issues.

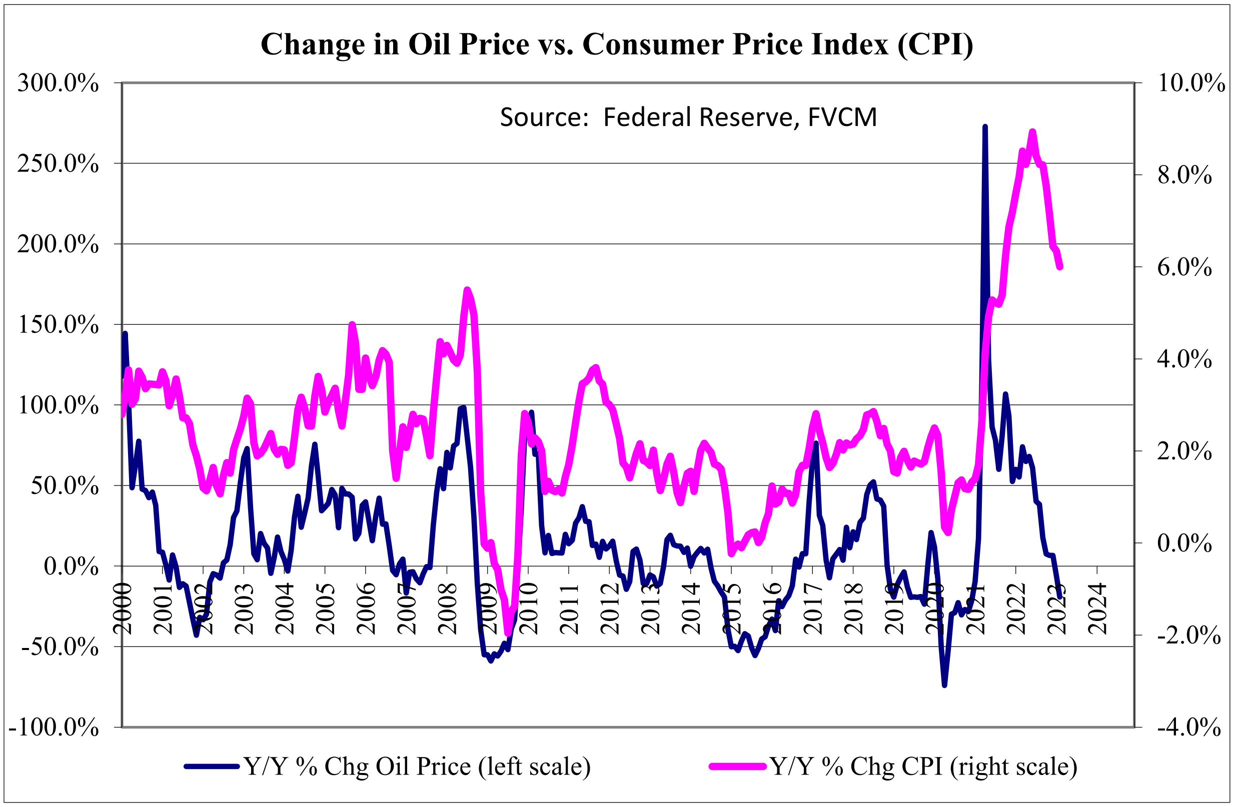
Are there more financial shocks to come? It seems likely. As with SVB, the underlying factor is a cycle of accommodative monetary policy, which spurred what the Austrian economists like Ludwig von Mises and Friedrich Hayek would call malinvestment, followed by the hangover as monetary policy is tightened. As we mentioned, SVB didn't fail by making foolish loans, but too much capital flowed into speculative tech investments in recent years and the rapid withdraw of deposits by those companies is what blew up SVBs balance sheet. There are likely other banks and businesses under stress now with interest rates rising and money becoming scarce. The U.S. M2 money supply, which is cash and certain bank deposits, is now actually contracting on a year-over-year basis (see Chart 1 below). But it is the speculative players in the market that are in serious trouble, not the solid businesses with solid balance sheets.

Chart 1



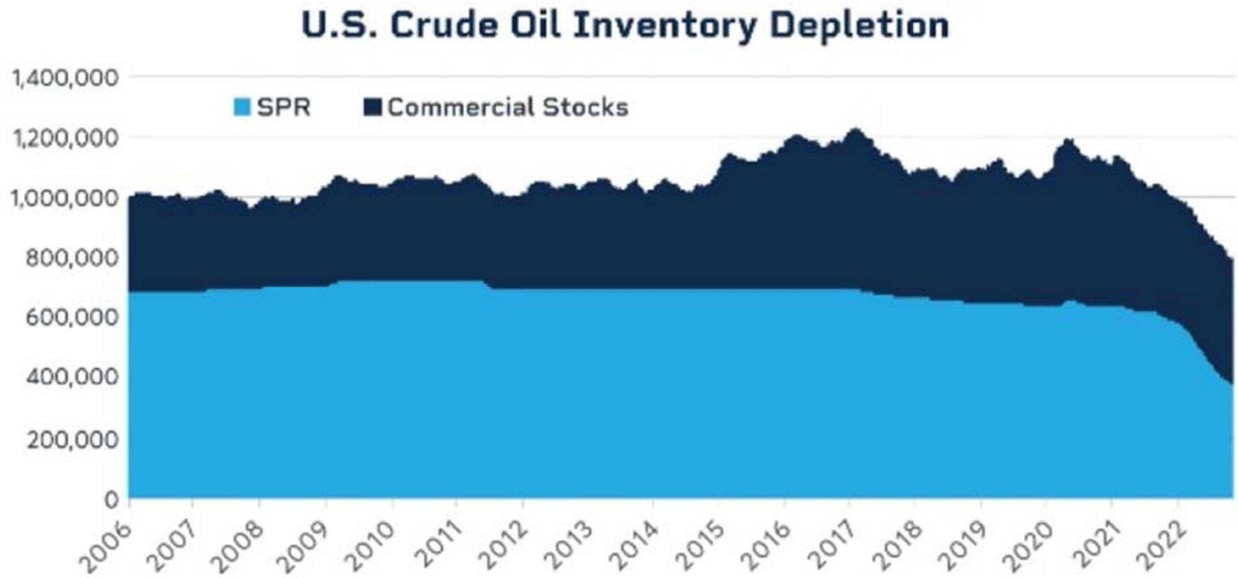
There has been a historic correlation between changes in oil prices and inflation (Chart 2 below), although it's not clear that the cause-and-effect relationship is simply one way. Ultimately, inflation, which is the same as saying a currency's purchasing power/value has declined, is the determinative factor and it causes commodities and other real goods to rise in price. But over short periods, changes in commodity prices, especially energy, can cause changes in measured inflation. Crude oil prices have already fallen sharply over the past year (discussed more below). Considering the decline we've seen in oil prices, combined with the contraction in the money supply, it would seem that there are good reasons to believe that inflation will continue to decline in the months ahead. Whether inflation plays out like this is key to stock and bond returns through the end of the year.

Chart 2



The good news is that the decline in energy prices *that has already occurred* is a sign that inflation will likely continue to fall, but we don't expect the trend in energy prices to continue much longer. One of the factors that has impacted oil prices over the past year is the current U.S. administration's decision to release massive amounts of oil from the strategic petroleum reserve (SPR). The purpose was to drive energy prices down before the November 2022 election. With that goal accomplished, the Biden administration has signaled its intention to begin refilling the SPR. Stock levels are down 218 million barrels (38%) and inventories are now at their lowest level since 1984 (see Chart 3 below). Keep in mind, for perspective, the U.S. produces about 12 million barrels of oil per day, so 218 million barrels is a big swing number. The administration has announced that the Department of Energy (DOE) will begin refilling the SPR when oil prices are between $67 - $72 per barrel. West Texas Intermediate crude oil is now trading at $72 per barrel, and one may interpret the DOE's mandate as having put a floor under the current price of oil. In fact, it will be interesting to see how much oil the DOE can actually buy before oil prices start rising out of the indicated range. Our guess is that it will be difficult or impossible to refill the SPR at the prices that the administration has targeted. Bottom line, it looks likely that energy prices are not going lower, and the next move is more likely upward, especially if the Fed reaches an end to its tight monetary policies.

Chart 3



Source: Institutional Investor, Energy Information Administration

It is markets like this where investors can get whipsawed by sharp ups and downs. Monetary policy is like an art because there are so many unknown factors. When the Fed says monetary policy is "data dependent," they're basically saying that they don't know what's going to happen next and they will change policy as new information develops. In early February, interest rates started moving higher after January employment increased 517,000, way above the 187,000 expected. Also, retail sales increased 3% in January, well above expectations of 1.9%. Both of these figures implied that the economy was a long way from a recession and that the Fed could and would continue to move interest rates higher. Stocks reacted badly and the S&P 500 fell 5% from early February to the 1st of March. But now, the implosion of SVB raises the possibility that stresses are greater than yet recognized. Interest rates have suddenly fallen because it seems that we are near to the end of the current upward rate cycle.

Ultimately, the near-term direction of interest rates and stock prices will be determined by inflation, and we're moving in the right direction. This morning the February report for inflation came out and the month-to-month Consumer Price Index (CPI) was up 0.4%, as expected, down from 0.5% in January. The year-over-year increase in the CPI was 6.0%, down from 6.4% in January and well below the 9.1% from June 2022. The Fed's ability to stop the continued tightening of monetary policy is dependent on inflation, not failures in parts of the banking system. The failure of SVB and other poorly managed banks will be taken as data points that may suggest slower growth and lower inflation ahead, but it is unlikely that these events themselves will directly impact Fed policy. We still think the Fed will increase interest rates 0.25% at the meeting which will be held on March 21st and 22nd but we are probably nearing the end of the tightening cycle. The timing of these moves is open to a great deal of uncertainty. Hence, investors will do best by not reacting to every sharp jump or decline in stock prices in the short run. A gradual accumulation of good businesses during this volatile period will likely result in attractive returns in the years ahead as conditions normalize.

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