Economic Perspectives

Perspectives

Given the financial events that have occurred since last week's newsletter, I wanted to provide information and perspective on the situation since there are clear economic impacts to consider. At this time, nobody has the answers to all of the questions that exist. As always, it will take time before all the facts are discovered, but that has not stopped all the media channels from inundating you with articles and opinions. My goal is to try to provide information and perspective to help those who are not actively involved in the financial world gain a better understanding of the situation. Maybe today's Perspectives section will help cut through some of the noise and drama.

Unless you have been totally disconnected to any media sources, you are aware that three banks were closed by the regulators over the past week.

- Silicon Valley Bank was closed on Friday and Signature Bank was closed on Sunday. Separately, Silvergate Bank closed on March 8th without a lot of fanfare. The real issue was the closure of Silicon Valley Bank on March 10th and then Signature Bank on March 12th. As a result, I am going to focus my comments on the two big failures – Silicon Valley and Signature.
    - Silicon Valley Bank had $209 billion in assets.
    - Signature Bank had $110 billion in assets.
    - Silvergate has $16 billion.

Note: I will use the term "banks" throughout as a broad term to represent banks, credit unions and thrifts.

What happened?

- Rather than go into the weeds of the specific triggers that happened at each bank, at its core, both Silicon Valley Bank and Signature Bank suffered a loss of confidence from their depositors that created a major liquidity crisis due to a rapid withdrawal of deposits.
- From an economic perspective, this was a case of demand (requests to withdraw money) outstripping supply (readily available liquidity). The problem was exacerbated with the capabilities for instant crowd communication. It is one thing to use crowd communication to form a flash mob for a wedding and quite another to use crowd communication to tell everybody to abandon ship. Once people and/or firms started telling people to take their money out of these banks, a catastrophic cascade effect occurred which created the liquidity crisis and led to the closure of the banks.

Is this a repeat of the financial crisis?

It is important to understand that these closures were vastly different than banking closures during the financial crisis.

- The financial crisis was a case of losses occurring due to an asset quality issue. Major banks were suffering large losses due to problems with their assets, primarily defaults on mortgages and commercial loans.
- This time, the closure of these three banks was due to a liquidity issue. As discussed above, a loss of confidence and a rapid withdrawal of deposits caused the issue for both banks. Neither Silicon Valley nor Signature were suffering major loan problems at the time of closure.
- To give perspective on this, here are some facts from a macro level:
    - Banking industry earnings have been at or near record levels over the past two years.
        - 2021 earnings totaled $279 billion.
        - 2022 earnings totaled $267 billion.
    - Capital levels are significant for the industry.
        - Overall, the ratio of capital to assets is greater than 9%.
    - Asset quality is solid.
        - Loan charge-offs are at historic lows: 0.25% of loans annually.
        - Problem assets are very low: 0.40% of assets.
        - Loan loss reserves are strong: 200% of the amount of problem loans.

Is this a systemic problem in the banking system?

There is a major difference between these banks and traditional banks.

- Both banks had concentrated deposit clients.
    - Silicon Valley Bank had a large concentration of deposits centered on the technology industry.
    - Signature Bank had exposure to the cryptocurrency industry.
- This hurt them once these industries started to struggle and their technology or crypto clients had to turn to their cash reserves (deposits) to continue operations. Whether the "cash burn" for these companies would have ultimately developed into an asset quality remains to be seen.

- Both banks had an over-reliance on uninsured deposits. Here is data as of 12/31/22:
    - Uninsured deposits made up 86% of Silicon Valley Bank's deposits.
    - Uninsured deposits made up 90% of Signature Bank's deposits.
- Traditional banks – like Washington Trust Bank and other "Main Street America" banks – have a far lower dependence on uninsured deposits.
    - Traditional banks have well diversified loan portfolios and deposit clients. This spreads the risk if one industry is struggling and businesses in that industry need to withdraw cash.

What did the regulators do?

- As the liquidity issue evolved into a liquidity crisis for the banks, the state regulators stepped in and closed the banks. Silicon Valley Bank was closed Friday morning and Signature Bank was closed Sunday evening.
- The FDIC, Federal Reserve and US Treasury department then worked over the weekend to identify the best course of action to prevent the run on deposits from spreading to other banks on Monday. Ultimately, they did two things:
    - The Treasury directed the FDIC to guarantee all deposits versus only the insured deposits.
    - The Federal Reserve established a new lending facility that allows banks to borrow from the Federal Reserve and use their investment portfolios as collateral to provide liquidity.

Why did the regulators do what they did?

- The FDIC and Treasury Department recognized the potential negative ripple effect that could happen to both the financial system and the economy if they did not guarantee all deposits.
    - Many of the uninsured depositors were small businesses rather than big investors. Stories quickly started to surface throughout the weekend that these businesses relied on their deposits to make payroll and pay other business expenses. If they did not have access to their money, layoffs and business closures could result and have a real-life negative impact on economic growth.
        - This was not isolated in the Silicon Valley or New York. There were businesses in Idaho, Oregon and Washington that would have been at risk if they had lost access to the deposits they had with these banks.

- I believe that the FDIC and Treasury Department realized that even though Silicon Valley and Signature Bank were not "systemically important" financial institutions, not guaranteeing all deposits could potentially create a massive crisis in confidence in the whole banking system. Given the fact that the leaders of the Treasury Department (Janet Yellen) and Federal Reserve (Jerome Powell) lived through the financial crisis, I think they remembered how the decision to let Lehman Brothers fail created a domino effect far more severe than the regulators anticipated. They were determined not to let this happen again.
    - It should also be recognized how quickly the regulators acted this time. For those of us who lived through the 2008-2009 financial crisis, we remember that it took months and failed attempts before the regulators and Congress came up with a viable rescue plan. This time it took three days.

- Remember, covering all uninsured depositors was not done at taxpayer expense. The funds will come from the FDIC insurance pool which is funded by assessments paid by all banks. It is also important to understand that they did not bail-out the investors. Owners of the risk assets of these banks (company stock, preferred stock, and bonds) are not covered.
- The ultimate cost for the FDIC to cover all uninsured deposits remains to be determined. The FDIC will go through the process of liquidating assets of both banks. This includes their loan portfolios as well as their investment portfolios and selling any non-bank entities of the holding company of these banks. This includes wealth management, brokerage and investment banking units. The FDIC insurance fund will only be on the hook for the shortfall between the proceeds received from the asset sales versus the amount of the uninsured deposits.

What would have been the potential economic impact if the regulators had not done what they did?

Here are some of the economic risks that I see. Clearly, this is not an all-inclusive list, and you may be able to think of other risks. The important point is that we all need to understand and think about the potential risks that no action could have caused.

- The biggest economic risk is the unknown unintended consequences. The financial system is a complex web of operations. Assuming that taking action (or not taking action) for two banks would be an isolated situation risked discovering it was not.
    - Hindsight indicates that allowing Lehman Brothers to fail unraveled a lot of interconnections that were not fully understood until they happened and helped ignite the financial crisis.

- The immediate risk to the economy would have been if businesses lost access to their ability to pay expenses and had to lay off employees or were forced to close.
    - We all remember what happened when the COVID lockdowns suddenly deprived businesses of their income source.
    - As discussed above, this would not have been isolated to just the Silicon Valley and New York.
- Another economic risk would be the fear and uncertainty that no action could have created. If people and businesses feared a collapse in the banking system, they could have started hoarding cash rather than focusing on their business and jobs.
    - Even though most consumer deposits are under the FDIC limit, the noise and drama that would undoubtedly have played out in the media could well have caused the consumer to stop spending and hoard cash. How many of you have already had those thoughts?
    - A pullback in consumer spending ripples to businesses as sales drop. That would be compounded if business also started hoarding cash rather than continuing to invest in their business and employees.
- No action could have caused businesses and consumers to lose faith in the banking system.
    - An economy that runs purely on cash spending would be a far slower growing economy than an economy that supports growth through a combination of cash and credit purchases.
    - The other risk is if businesses and consumers turn to "non-bank" institutions for their deposits and loans. The reality is that these businesses are far less regulated than financial institutions. If you are unwilling to do business with a bank/credit union/or thrift because you are concerned about their financial stability, why are you comfortable doing business with an institution that performs similar functions but with far less regulatory supervision?
- Finally, there is always the economic risk during times of fear and uncertainty for scam artists claiming they have an alternative solution that cause financial losses for individuals and businesses who fall for the scam.

What is the potential economic impact if individuals and companies start moving their uninsured deposits out of the banking system?

- There are several potential economic risks to consider.
  - If businesses and individuals decided to move their uninsured deposits to US Treasury securities or money market mutual funds that hold US Treasury securities to achieve safety, banks would have far less money to lend. Deposits are what provide the fuel for banks to lend.
    - This would be another version of making financial conditions more restrictive as less money is available for businesses to borrow to buy equipment, invest in technology or other activities to grow their business.
    - Consumers would also have less money available to borrow.
    - The loss of lending capacity for banks would have a far bigger economic impact than rising interest rates. All else being equal, it will slow economic growth. In the current economic environment, it would slow the economy even further and increase the risk of recession occurring sooner rather than later.
  - You might say "but wouldn't that be good because the Federal Reserve wants economic growth to slow?" My response would be that the Federal Reserve may want economic growth to slow to bring inflation down, but this is not the way it would want to do it. A loss of lending capacity is a long-term issue with long-term economic consequences.
- If deposits are moving to US Treasury securities or Treasury money market mutual funds, that would dramatically increase demand for US Treasury securities. This would drive yields significantly lower and risk re-creating the problems that resulted when the Federal Reserve maintained a low interest rate policy.
  - A misallocation of capital could occur again as businesses and consumers seek higher returns on their cash. This creates the risk of pushing people and companies to take on more risk as they seek higher returns in an effort to outpace inflation.
    - For those who lived through the financial crisis, we all remember what happened when businesses and consumers were drawn to the siren song of Auction Rate Preferred investments. These investments were characterized as being as "good as cash" because you could get your money back in 7 days. Painfully, they found out that they could only get their cash back if someone else was willing to buy it from them. This created a lot of pain for anyone who needed that cash and could no longer access it.

- If businesses and consumers decide to move their money to "too big to fail" banks under the belief that the regulators and governments would always protect these banks, there are three risks to consider.
    - Each financial problem affects different parts of the financial system differently. Remember that the "too big to fail" banks were the banks that suffered the biggest problems during the financial crisis.
    - If billions of dollars flow to the large banks, they may be left with more money than they need to fund loan demand. For the depositor, several unintended consequences could happen.
        - Big banks could dramatically lower the interest rate paid on the deposits.
        - Big banks could decide to not pay any interest on the deposits.
        - Big banks could charge a fee to accept the deposits since businesses/consumers are seeking the insurance coverage and people normally pay for insurance.
        - Big banks could refuse the deposits.
    - A large increase in deposits could also be a concern for the regulators since concentrations could start to build for the big banks.
- If businesses and consumers decide to spread their money out to multiple banks to have all deposits covered by insurance, then this creates a different set of problems.
    - They would either have to staff up to have someone track deposit rates and place the deposits or utilize a firm who would do that for them. They would also need to staff up to facilitate the movement of money and the monitoring of rates.
    - Banks who do not want more deposits could implement one of the same four strategies listed in the four bullet points above for big banks.
- Once again, the concept seems simple to protect all your uninsured deposits. The reality may prove far different with unintended consequences.

What are the implications for Federal Reserve monetary policy?

The financial market jumped to the immediate conclusion that the Federal Reserve will now stop raising interest rates and start cutting rates instead. The reality is that this is a far mor complex issue.

- First, understand that the Federal Reserve has powerful tools to deal with liquidity issues. At its core, this is why the Federal Reserve was created. As a result, the Federal Reserve can use other tools to address liquidity concerns before cutting interest rates.
    - The new lending facility that the Federal Reserve created is a perfect example of this. This new facility now gives banks another tool for liquidity if they experience a faster-than-anticipated reduction in deposits.
    - The Federal Reserve also demonstrated its ability to be the "lender of last resort" during the pandemic crisis when it rolled out a variety of other temporary lending facilities.
- The Federal Reserve's monetary policy committee is meeting next Wednesday. Given the residual fear and uncertainty that still exists, it would not be surprising to see them announce that they are pausing their rising interest rate policy to assess the economic and financial conditions.
    - Pausing does not mean stopping and it clearly does not mean starting to reduce interest rates.
    - For perspective, when the Federal Reserve started raising interest rates in 2015, they paused for a full year before resuming the process of increasing the overnight Fed Funds rate.
- The Federal Reserve's monetary policy arm is different than its regulatory arm.
    - The regulatory arm is dealing with the liquidity question and can access the arsenal of tools available to them. They will probably also issue new regulations in the future to address any flaws that it identifies as it investigates this liquidity event.
    - The monetary policy arm is dealing with the inflation problem and the risks to the economy. The monetary policy committee may continue raising rates – after a pause – if it believes the liquidity event has been addressed and the inflation and labor shortage problem still needs addressing.

Closing thoughts

To me, the liquidity event that occurred with Silicon Valley and Signature Bank highlights the need to focus on the fundamentals of the bank that you work with.

- Deposit insurance is intended as a backstop for depositors, but that does not mean that you should not understand the financial strength of your bank.
- Identifying and working with well run, financially sound banks ensure that you will never need to rely on deposit insurance. Most banks have their financials available either from your relationship manager, an investor relations department or on their website.
    - Part of a successful financial relationship is knowing and understanding your financial partner.
    - Anyone who applies for a loan, or a credit card knows that the bank will conduct due diligence on you or your business to ensure that they understand your financial situation. You can do the same due diligence by talking with your banker, their investor relations department or visiting their website to understand the financial strength of your bank.
- Now that I have said that you probably want me to "walk the talk". Here is information on Washington Trust Bank (no sales pitch, just the facts).
    - Washington Trust Bank just celebrated its 120-year anniversary.
    - Washington Trust Bank has successfully navigated, and kept its doors open, through every recession/depression since it opened.
    - When examined by industry sector (using NAICS codes), Washington Trust Bank's largest concentration to a single industry is just over 5%.
        - Silicon Valley and Signature had high concentrations in single industries (technology and crypto).
    - Washington Trust Bank's company profile and financials can be found on its website at the following link:

      W T B Financial Corporation Company Profile 4th Quarter 2022 (watrust.com)
- Consider the intangibles before making a major decision about your deposits relationship, no matter where you bank.
    - What are the intangibles (service level, customization, access to decision makers, etc.) that go with your deposit relationship?
    - Are there intangibles that you are not aware of? Talking with your relationship manager at your bank will help identify if there are any.

- Part of a banking relationship should always be your ability to talk with your relationship manager during times of uncertainty. Whether that is a corporate, private banking, retail, or wealth management relationship manager, talk with them if you have concerns or uncertainty.
    - Regardless of the liquidity event with Silicon Valley and Signature Bank, now is the time to ensure that you have a relationship with your bank since there is always the risk of economic stress including the ongoing risk of a recession. Having a true relationship with your bank helps ensure that they will be a partner with you through times of stress.
        - This was clearly highlighted during the pandemic crisis. In that situation many businesses found out whether they had a strong their relationship with their bank when the Paycheck Protection Program came out and the application process started.
- Finally, if you are a Washington Trust Bank client, your relationship manager stands ready to work with you.

Economic Data

Business Outlook

- The Philadelphia Federal Reserve reported another negative result for its regional Business Outlook index. The index was not as negative as February but still well into negative territory. The index stood at a negative 23.2 compared to a negative 24.3 in February.

Consumer Sentiment

- The University of Michigan released the preliminary results for its Consumer Sentiment index. The index fell from 67% in February to 53.4% in March. Whether this deterioration in sentiment translates into slower spending remains to be seen.
    - The Current Conditions sub-index fell from 67.0% to 63.4%
    - The Future Expectations sub-index fell from 64.7% to 61.5%

Employment

- The Department of Labor reported a 20,000 decrease in initial jobless claims last week. This reversed all of the increase that occurred the week before. Total initial claims fell from 212,000 to 192,000. Total continuing claims fell from 1,713,000 to 1,684,000.

Housing

- The Mortgage Bankers Association reported a 6.5% increase in mortgage applications last week. This marked the second consecutive week of increasing applications. Given the large drop in interest rates this week, expect another increase for this week.

- The Census Bureau reported a 9.8% increase in housing starts in February. This ended a string of five consecutive months of declines in housing starts. Building permits rose 13.8% in February after being unchanged in January. This has to be encouraging news for people looking to buy a house as more inventory will become available as the houses are built.

Inflation

- The Bureau of Labor Statistics (BLS) reported a 0.4% rise in the Consumer Price Index (CPI) for February. This was an improvement compared to the 0.5% rise in January. On a year-over-year basis, the pace of growth slowed from 6.4% to 6.0%. For the average worker the "core expenses" showed mixed results compared to the official CPI rate. Food prices rose 9.5%, shelter prices rose 8.1%, electricity prices rose 12.9%, natural gas prices rose 14.3%, heating oil rose 9.2% but gasoline prices fell 2.0%. For those who have childcare needs the good news was the childcare cost were unchanged from a year ago.
- The BLS reported a 0.1% decline in wholesale prices in February. This was better than expected. The BLS also provided some positive news in that it revised the January data lower. Rather than seeing a 0.7% increase, the increase is now 0.3%. On a year-over-year basis wholesale prices rose 4.6% after rising 5.7% in January. Prices for wholesale goods fell 0.2% while prices for wholesale services declined by 0.1%. The decline in goods prices were led by a 2.2% decline in wholesale food prices. The decline in service prices was led by a 1.1% decline in transportation and warehousing prices. Let's hope that those declines get passed through to the consumer the same way price increases were.
- The Bureau of Labor Statistics reported a 0.1% decline in import prices in February. This followed a 0.4% decrease in January. Export prices rose 0.2% after rising 0.5% in January.

Manufacturing

- The Federal Reserve reported no growth in industrial production in February. This followed a 0.3% increase in January.
- The Federal Reserve reported slowing in manufacturing production in February. The index rose 0.1% in February after rising 1.3% in January.

Retails Sales

- The Census Bureau reported a 0.4% decline in retail sales in February. This was a large change compared to the 3.2% increase in January. Those economists trying to put a positive spin on the data will point to the fact that retail sales were unchanged if you exclude auto and gas sales. Cherry picking data points does not help people understand what actually happened for the month.

Service Sector

- The New York Federal Reserve reported that its business activity index for the service sector posted another negative result. The index improved from a negative 12.8 level in February to a negative 10.1 level in March.

Small Business Optimism

- The NFIB reported a minor improvement in its Small Business Optimism Index. The index improved from 90.3 in January to 90.9 in February. This was the second consecutive month of improvement.

Wages

- The BLS also reported the 23rd consecutive month of negative wage growth after inflation is accounted for. Real average hourly earnings fell 1.3% on a year-over-year basis in February which was better than the 1.9% decline in January. Real average weekly earnings fell 1.9% which matched the 1.9% decline in January. The average worker remains under financial pressure as expense growth continues to outpace wage growth.

I have always said that I never have to worry about being bored when working in the financial markets and studying the economy. That was certainly true for this week as plenty of interesting and fascinating events occurred!

There is a magical button on most of your electronic devices that you may not be aware of. It has a circle with a line from the center going up. It is called the Power button. Try pressing it to turn off your electronic devices. You may be amazed how much less stressed you feel when you are disconnected from the noise of the media and are simply spending time with your friends, family and loved ones this weekend.

Enjoy your weekend.