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Institute Alert

FIRST ANALYSIS

News or events that may affect your investments **May 1, 2023**

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Keeping perspective on worries about banks

Key takeaways

- Bank regulators have taken control of First Republic Bank and sold most of the bank's operations to JPMorgan Chase & Co, making the third failure of a large regional bank since mid-March.
- Rising interest rates have strained many small and regional banks, and an echo of some additional failures in this group is possible. However, the vulnerability to rising interest varies greatly across the banking industry. We do not anticipate a banking crisis.

What it may mean for investors

- We do foresee a second echo effect, this time from bank strains to economic recession. Financial markets do not yet appear to appreciate this effect, and we have lowered exposure to equities across portfolios.

What's behind the ongoing stress in the banking system?

Three of the four largest bank failures in U.S. history have occurred in the past two months. Higher interest rates, especially short-term interest rates, have created headwinds across the banking industry, but the balance sheets of the three failed banks shared a vulnerability to rising rates that exceeds that of most other regional banks. While these headwinds are likely to continue, we do not expect a new and broad-based crisis across regional banks.

The dramatic 2020 decline in interest rates, to 15-year lows, encouraged a flood of bank deposits (see Chart 1). Households banked government checks, and low rates everywhere made the convenience of a checking account attractive. While rates stayed low during the pandemic, banks put the cash to work. Many originated new mortgages.[1] Another popular choice was long-term bonds, which offered a bank perceived safety and yields sufficient to pay depositors and still leave a profit.

Investment and Insurance Products: ➤ NOT FDIC Insured ➤ NO Bank Guarantee ➤ MAY Lose Value

1. 2020 and 2021 were back-to-back years of mortgage originations exceeding $4 trillion. See *Wells Fargo Investment Institute*, "Views on developments in regional banking", March 13, 2023.

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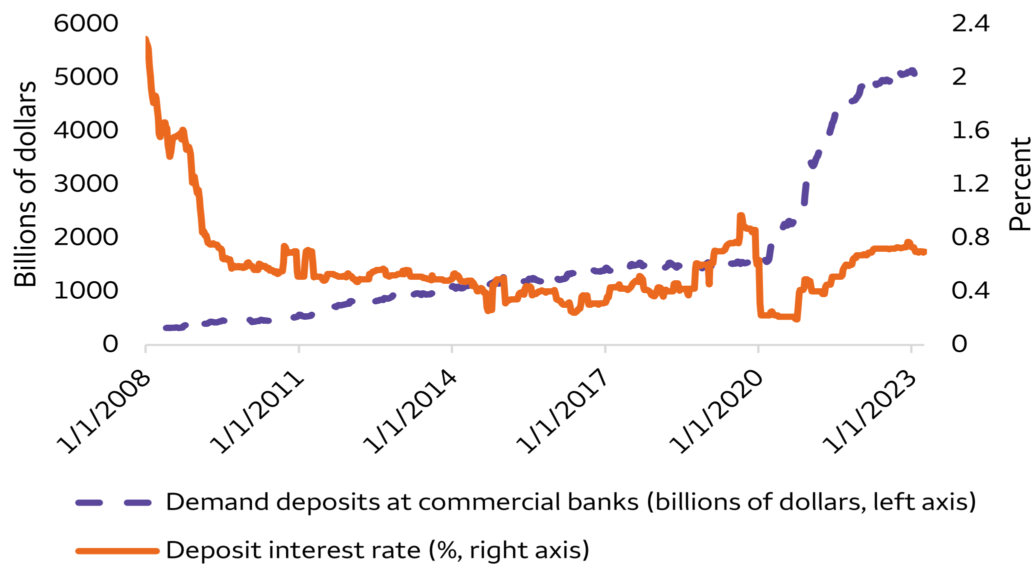
Chart 1. Surge in interest rates triggered higher costs for banks



Sources: Federal Reserve Board, Bloomberg and Wells Fargo Investment Institute, weekly and daily data, Jan. 1, 2008 - Apr. 3, 2023. Deposits are shown as a four-week moving average. The deposit interest rate is the weekly average of daily U.S. deposit rates, averaged across the U.S. by Bankrate.

The dramatic increase in short- and long-term interest rates over the past year showed the vulnerability of this strategy. From the cost of funds side, the high level of deposits that persists today accrues much higher interest costs than in 2020. That is the second lesson of Chart 1. While most banks face this challenge, some special cases among the recently failed banks may be exceptional:

- One of the failed banks during March had most of its deposits from very large private capital managers, whose deposit levels mostly exceeded the FDIC deposit insurance limit. As questions arose about the bank's financial health, it did not take many account closures to create a solvency problem. Many banks with a greater mix of large and small deposits might not experience such a sudden and significant loss of their funding.

- Another of the failed banks tied deposit growth to its lending. As an illustration, suppose a home buyer is looking for a $2 million mortgage. The bank that offers a below-market mortgage rate if the customer makes a large deposit at the bank is relying on low rates to continue. Once rates suddenly rise, however, this bank quickly may find its interest costs rising sharply — just as its below-market-rate mortgages are less attractive to potential mortgage buyers.

This last point illustrates the squeeze on profitability. As long- and short-term interest rates have risen, the asset (the mortgage or bond) likely falls in value, while funding the liability (the deposit) adds significantly to the bank's costs. Based on figures from year-end 2022, the three failed banks all were relatively large (over $50 billion in assets) regional banks, had a deposit base of at least 50% uninsured by the FDIC, and had loans plus held-to-maturity securities above 90% of their deposit base.[2] This lack of deposit diversity (between insured and uninsured deposits) and long-term assets as a large share of deposits made both sides of the balance sheet and profits very sensitive to rising interest rates.

2. See S&P Global Market Intelligence, "SVB, Signature racked up some high rates of uninsured deposits", March 14, 2023; and The Wall Street Journal, "The Era of Easy Deposits Is Over for Main Street Banks", April 19, 2023.

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We may not have seen the last of the failures among the small and regional banks. There may be echoes that bring additional closures in this group, particularly because we expect additional Federal Reserve rate increases this year. The echoes can come at varying and unpredictable intervals, but not all these banks relied on low interest rates to-the same degree. Importantly, the universal banks appear to have more diversity in their funding sources, are well capitalized, and follow stringent liquidity requirements.[3] We do not anticipate a global banking crisis.

Keeping focus on the bigger picture

We foresee another echo effect, this time from the banks to the broader economy and financial markets. Historically, the rise in interest rates slows the economy, and then the two forces become mutually reinforcing, first and most notably among those firms that relied too much on low interest rates.

We believe the historical sequence is setting up again: Rising interest rates increase funding costs, while inflation raises materials and wage expenses. High interest rates and inflation also slow consumer spending and reduce corporate revenue growth. Then comes strain on the banking system, which already is limiting household and business credit, just as falling profits no longer cover a firm's liabilities. Eventually, the economy sees layoffs and bankruptcies.

Credit was already becoming more costly and difficult to get, even before the recent bank failures. The latest Federal Reserve data show that bank interest rates on credit cards and new auto loans have surged since early 2022 and hit 30-year highs in February 2023.[4] Small businesses have felt the pinch since mid-2022. A March 2023 survey of business owners showed the percentage saying that credit is harder to get hit its highest level since November 2012.[5] Financial strains among the banks are very likely to tighten credit further and bring a recession closer.

The economy's supports should help cushion the downturn — we are not expecting a repeat of 2008 — but are unlikely to prevent a recession. Spending on services and the labor market started the year on a strong note. However, services spending typically does not counter the contraction in goods spending, and the labor market is usually the last support to drop before recession. Any seasonal housing momentum is likely fleeting, as high prices, weaker income growth, and elevated mortgage rates increasingly box in this sector.

Our guidance

The bottom line is that bank stress is part and parcel of the interest rate environment. Stress levels likely will differ in degree, according to the diversity that a bank's managers created in the balance sheet these past two years. And the system as a whole operates in a stronger regulatory and capital environment than in 2008.

In our view, the more pressing problem for investors is that mutually reinforcing higher-for-longer interest rates and rapidly tightening credit put the economy on recession's front porch and moving ever closer to the threshold. Meanwhile, financial markets are giving mixed signals that we believe underestimate the downside risk in equities. For this reason, on April 21, we reduced our exposure to equities and reiterated our defensive positioning in portfolios.[6]

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3. For additional details, please see Union Bank of Switzerland, "US bank turmoil: FAQ and investment implications" Mar. 14, 2023; S&P Global, "SVB, Signature racked up some high rates of uninsured deposits", Mar. 14, 2023.
4. See the Federal Reserve's Consumer Credit report (G.19) for April.
5. National Federation of Independent Business, *Small Business Optimism Index,* March 2023, and historical data from Bloomberg.
6. Please see our report, *Wells Fargo Investment Institute,* "Announcing 2024 targets, and updated guidance", Apr. 21, 2023.

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