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FIRST ANALYSIS
Institute Alert

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Stay defensive as bank sector comes under pressure

Key takeaways

- Two bank failures late last week likely will raise questions about some small- and mid-sized banks to start the new week.
- What is notable about the two failed banks is their overexposure to assets whose values come under pressure as interest rates rise and their concentrated business models. However, we view systemic risk to the overall banking industry as low, because most banks are well capitalized and have more diversified balance sheets.

What it may mean for investors

- We maintain our neutral rating on the Financials equity sector and reiterate the specifics of our defensive portfolio allocation posture, in place since February 2022.

At the end of the week, two banks failed. Unlike most banks, these two had concentrated business models with a focus on assets with expected payoffs long in the future — i.e., long-duration[1] assets.

Deposit flows into banks were strong over the 2019-2021 period, and some banks came to specialize in investing the money in assets such as long-dated U.S. Treasuries and mortgage-backed securities — all long-duration assets whose values have declined on paper since interest rates have risen. Higher interest rates have another effect. As depositors come in looking to transfer their funds to higher-paying money market rates, some banks must sell their long-duration assets to raise cash for depositor withdrawals. These sales recognize losses that previously had only been on paper. Some banks will be obliged to write-down capital, but we do not believe this problem affects the banking system as a whole.

1. Duration is a measure of a bond's interest rate sensitivity.

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For the overall economy, it is important to note that household and corporate balance sheets are in much better condition today than they were in 2007 – 2008. Federal Reserve (Fed) data shows that corporate debt as a share of net worth in the fourth quarter of 2022 was 41.6% and falling, compared with 46.9% in fourth quarter of 2008. For households, the ratio of loans to net worth has fallen to 13.2% from 24.3% over the same period.[2]

Maintaining a neutral rating on the Financials sector of the S&P 500 Index

The Financials sector is diversified, with roughly one-third weighting in banks, 21% in insurance, and the rest in diversified financials. The large banks represented in the sector are well-capitalized and have passed rigorous stress tests administered by the Fed. Most have been setting aside reserves to cover potential losses that may occur in a recession. As financial conditions have tightened, loan growth has remained steady. However, even with higher rates, net interest margins have fallen below pre-pandemic levels.[3] Capital market activity has weakened considerably in areas such as initial public offerings, debt issuance, and mergers and acquisitions.

The Financials sector is highly cyclical, and we downgraded the sector to neutral in 2022, anticipating an economic slowdown. Performance of Financials has slightly lagged the S&P 500 Index over the past five months. Historically, the sector has been a market performer as the economic cycle ages, the Fed tightens monetary policy, and short-term interest rates come to exceed long-term rates.

A quick check on private equity and venture capital

Many of the deposits of the failed bank appear to be venture capital firms, and some may suffer deposit losses. We continue to maintain our current guidance as neutral for Private Equity – Venture Capital strategies. On the positive side, our longer-term view of the asset class looks through the economic uncertainties of this year. Current vintage funds typically invest committed capital over the next three to five years, a time frame that we expect to include a sustained recovery in economic growth and lower interest rates. For the immediate present, however, the venture capital industry should continue to experience slowing deal activity, declining valuations, and a restrictive exit environment for venture holdings, as start-up businesses adjust to current market conditions and the current elevated interest rate regime. We view these longer-term positives and shorter-term negatives in a balance, for a neutral stance.

Conclusion

Up to this point, we are maintaining the defensive posture we have held since February 2022 across equities and fixed income. We have been saying for the past year that rising interest rates, falling money supply growth, declining bank reserves, and tighter liquidity conditions across the Financials sector are all working to quell inflation, but at the cost of a slower pace of economic activity. As we wrote on March 2, the equity markets are likely to trade in a range.[4] In fact, the S&P 500 Index has traded in a wide band since April 2022 and, similarly, the 10-year U.S. Treasury note yield has traded in a range since September 2022. We reiterate our view and our main investment preferences from March 2. Some specific implications of our view include the following:

1. In fixed income, we favor a "barbell strategy," that is, overweighting positioning in short- and long-term maturities. A barbell should take advantage of high short-term rates and attractive long-term yields that we have not seen in multiple decades.
2. Fixed-income sector positioning should be more defensive, and we favor moving up in credit quality.

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2. Source: Federal Reserve *Flow of Funds* tables for nonfinancial corporate balance sheets and for household balance sheets, March 10, 2023.
3. According to the FDIC's "Statistics at a Glance", March 10, 2023, bank net interest margins increased in 2022, as rates rose, but remain below their 2019 levels.
4. Please see Wells Fargo Investment Institute, "Revising our outlook to reflect higher rates for longer", March 2, 2023.

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3. We do think the environment is improving for international fixed income, and international equity opportunities could arise as 2023 progresses.
4. Several highly cyclical areas of the market found their footing early in the year, but we believe that declining earnings have not been fully priced in the majority of cyclically oriented sectors. Thus, we still favor quality sectors (Information Technology, Health Care, and Energy) when their risk-reward balance becomes more attractive, at or near the lower end of their trading ranges.
5. Commodity prices are below their 2022 highs, but we expect gains from current levels, as the economic recovery gains momentum. And, especially for long-term investors, the supplies of raw materials are likely to lag strong demand growth, while countries around the world replace and improve infrastructure. Upward pressure on commodity prices should continue beyond 2023, and we favor building exposure into a multi-year position in portfolios that may still be underexposed.

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Forecasts are based on certain assumptions and on views of market and economic conditions which are subject to change.
Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. **Stock markets**, especially foreign markets, are volatile. Stock values may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. **Foreign investing** has additional risks including those associated with currency fluctuation, political and economic instability, and different accounting standards. These risks are heightened in emerging markets. **Small- and mid-cap stocks** are generally more volatile, subject to greater risks and are less liquid than large company stocks. **Bonds** are subject to market, interest rate, price, credit/default, liquidity, inflation and other risks. Prices tend to be inversely affected by changes in interest rates. **High yield (junk) bonds** have lower credit ratings and are subject to greater risk of default and greater principal risk. The **commodities** markets are considered speculative, carry substantial risks, and have experienced periods of extreme volatility. Investing in a volatile and uncertain commodities market may cause a portfolio to rapidly increase or decrease in value which may result in greater share price volatility.

Sector investing can be more volatile than investments that are broadly diversified over numerous sectors of the economy and will increase a portfolio's vulnerability to any single economic, political, or regulatory development affecting the sector. This can result in greater price volatility. Investing in the **Financial** services companies will subject an investment to adverse economic or regulatory occurrences affecting the sector.

Alternative investments, such as hedge funds, private equity/private debt and private real estate funds, are speculative and involve a high degree of risk that is suitable only for those investors who have the financial sophistication and expertise to evaluate the merits and risks of an investment in a fund and for which the fund does not represent a complete investment program. They entail significant risks that can include losses due to leveraging or other speculative investment practices, lack of liquidity, volatility of returns, restrictions on transferring interests in a fund, potential lack of diversification, absence and/or delay of information regarding valuations and pricing, complex tax structures and delays in tax reporting, less regulation and higher fees than mutual funds. Hedge fund, private equity, private debt and private real estate fund investing involves other material risks including capital loss and the loss of the entire amount invested. A fund's offering documents should be carefully reviewed prior to investing.

In addition to the risks associated with investment in debt securities, a fund's investments in mortgage-backed and asset-backed securities will be subject to prepayment, extension and call risks. Changes in prepayments may significantly affect yield, average life and expected maturity. Extension risk is the risk that rising interest rates will slow the rate at which mortgages are prepaid. Call risk is the risk that If called prior to maturity, similar yielding investments may not be available for the Fund to purchase. These risks may be heightened for longer maturity and duration securities. Commercial Mortgage Backed Securities (CMBS) are a type of mortgage-backed security backed by commercial mortgages rather than residential real estate. CMBS tend to be more complex and volatile than residential mortgage-backed securities due to the unique nature of the underlying property assets.

Hedge fund strategies, such as Equity Hedge, Event Driven, Macro and Relative Value, may expose investors to the risks associated with the use of short selling, leverage, derivatives and arbitrage methodologies. Short sales involve leverage and theoretically unlimited loss potential since the market price of securities sold short may continuously increase. The use of leverage in a portfolio varies by strategy. Leverage can significantly increase return potential but create greater risk of loss. Derivatives generally have implied leverage which can magnify volatility and may entail other risks such as market, interest rate, credit, counterparty and management risks. Arbitrage strategies expose a fund to the risk that the anticipated arbitrage opportunities will not develop as anticipated, resulting in potentially reduced returns or losses to the fund.

Definitions

S&P 500 Index is a market capitalization-weighted index composed of 500 widely held common stocks that is generally considered representative of the US stock market. An index is unmanaged and not available for direct investment.

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