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Bank stock sell-off: Investment implications

Weekly - Regional View US

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A crisis of confidence has arisen in the banking industry negatively impacting the sector and sparking broader market concerns. Over the last week, the S&P 500 Financials sector is down 8% while the S&P 500 is off 4%. Market concerns have been brewing for some time around the potential impact of rapidly rising (and higher for longer) Fed Funds rates on bank liquidity and funding costs. Meanwhile, credit and capital concerns in a potentially recessionary environment remain in the background. Bank stock investors seem to be taking a sell first and ask questions later approach to the group, which will likely continue to weigh on bank shares for a while. Nevertheless, while we remain cautious on US financials with a least preferred view, we believe some of the recent sell-off in banks has been overdone—especially in select universal banks, which remain well capitalized and sufficiently liquid to continue to serve clients.

What happened?
After the market close on Wednesday, a mid-sized bank with a heavy presence in Silicon Valley, SVB Financial (SIVB), disclosed plans to raise USD 1.25bn in common equity and USD 500mn of mandatory convertible preferred. They also announced the sale of nearly all of their "available for sale" securities at a USD 1.8bn loss. The news was a surprise and resulted from significant deposit outflows and negative 1Q guidance for loans, deposits, net interest income, investment banking fees, and 2023 EPS. As a result, the stock traded down ~60% on Thursday. On Friday following the withdrawal of the planned equity raise, in a relatively dramatic move, the FDIC announced it was taking over the bank.

In our view, the SIVB situation is somewhat unique. With a heavy focus on clients in Silicon Valley, the bank has a large concentration to venture capital sponsored start-ups which expanded significantly during the pandemic and were flush with cash which was held on deposit at SIVB. These start-up companies are now burning through their cash at a rapid rate, driving a decline in SIVB deposit balances—apparently forcing the bank to sell investment securities at a loss and attempt to raise capital.

While there are significant unrealized losses in "available for sale" and "held to maturity" securities portfolios across the banking industry due to higher interest rates, the pressure to sell these securities and realize the losses appears to be unique to SIVB—at least for now. Bear in mind that these securities are very high quality Treasuries or mortgage-backed securities, whose value has fallen due to the rise in interest rates. Usually this is not an issue, because it's unusual for a bank to experience significant deposit outflows.

Systemic risks unlikely
However, the SIVB news has raised concerns that other banks may have to take the same measures—sell securities at a loss and raise capital. That doesn't appear likely to us. SIVB's heavy reliance on deposits from venture-capital backed businesses is very unique and created this vulnerability. Most large and regional banks have much more diversified deposit bases.

Still, we acknowledge that maintaining depositor and investor confidence is crucial for a financial institution. And we cannot completely rule out the possibility that other banks could face similar concerns, despite what appear to be very sound balance sheets across the industry. For example, outsized stock price moves could influence depositor behavior, whereby poor share price performance fuels heightened depositor anxiety and outflows. At this point, we think this is a low risk but are monitoring the situation very closely.

Also bear in mind that higher Fed Funds rates are forcing all banks to raise deposit rates. This will likely pressure earnings growth in the months ahead. In addition, we are concerned that the Fed's efforts to slow inflation could lead to an increase in the unemployment rate at some point. This would likely lead to higher credit costs for the banks. Plus, the regulatory environment for banks has become a bit more stringent, resulting in less ability to return capital to shareholders.

For these reasons we have a least preferred view on the US financials sector. While some of the selling in certain banks seems overdone, it's hard to know when the "crisis of confidence" will improve. For those investors that do want to take advantage of the sell-off, we recommend focusing on some of the largest US banks.

The flight to quality bid in US interest rates just added to the continued volatility we have witnessed this year. Two-year yields moved over 40bp in one day as the market once again re-adjusted its expectations for the path of the fed fund rate. We continue to view the trend in US Treasury yields as lower into the second half of the year and increased our interest rate exposure near the 3.95% level. Although we are monitoring the funding markets and the potential negative sentiment as it relates to an environment that is already facing tightening lending standards, we do view this recent event as a material headwind to market liquidity.

Late cycle environment
The situation in bank stocks does not alter our view on the overall equity market. The S&P 500 is now in the middle of the somewhat large range that has persisted since last summer. We think stocks will likely remain in this range until investors have greater clarity on whether the Fed's efforts to rein in inflation will result in a recession or a soft landing. Investors may not have clarity on this question for several more months. If a soft landing is achieved, the S&P 500 could rise to our upside target of 4,400. But in a hard landing, the index could fall to 3,300. As of this writing, this equates to about equal upside and downside potential (+/-15%) in these two scenarios. Our year-end price target is 3,800, and we maintain our least preferred view on the US versus other equity regions.

Within global equities we see better opportunities in the UK, Australia, and emerging markets, which are all most preferred. Within US equity sectors we have most preferred views on consumer staples, energy, and real estate. Please note that the S&P 500 real estate sector has heavy exposure to secular growth companies such as wireless towers, data centers and industrial. There is almost no exposure to the beleaguered office market.