

**What Mattered this Week? Banks, Banks, Banks**

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On one hand, the answer to “what mattered this week?” is an easy one: the banks. On the other hand, the more difficult questions are, why does it matter and what does it all mean? So, let’s take a look at what happened and exactly why it matters.

**Week in Review**

To summarize, three banks were shut down over the last weekend, and several more are under pressure. I will spare you the details, as millions of words have already been written about that. But what matters is this: First, with one major sector bank (Silicon Valley) collapsing, the government stepped in hard to stop a wider problem, taking over that bank and guaranteeing all the deposits. Second, with other banks with similar solvency risks under threat, the government stepped in as well. It offered a new program that lends against bank assets at par, giving them time to resolve those problems and prevent closure.

The FDIC also upped its review and surveillance process to get ahead of the problem with the rest of the industry. Finally, several large banks combined to aid a bank under threat—First Republic—by putting in tens of billions in deposits as a vote of confidence. Looking abroad, we saw a similar problem with Credit Suisse bank, with similar results as the Swiss National Bank put in tens of billions to support it.

**What’s Going On?**

Looking at the situation from a distance, there are two things going on here. First, some banks got in trouble as they borrowed short term with their deposits and lent long term in government bonds. When depositors found out about it, they pulled their money in a classic bank run (watch *It’s a Wonderful Life* if you haven’t already). Obviously, this is worrying—but it is also reassuring, and we will get to that. Second, and unlike the 2008 financial crisis, the government both here and abroad decided to step in before a systemic blowup, rather than trying to clean up afterward—and that is also reassuring.

**What Does It Mean Going Forward?**

**The crisis is not over.** With the government taking a much harder look at the books of banks and likely to show much less patience with problems, we can expect to see more banks either publicly flogged or even shut down. I expect a band-aid ripping-off phase over the next month or two. Because this past week has been a classic bank run, with clear-cut reasons that can be identified and dealt with, that means the problems going forward should be easier to both identify and solve proactively.

**Tough road ahead for regional banking sector.** That solution will not just come from the government either. As we have seen with the drops in the stock prices of regional banks and the relocation of their deposits to larger banks, businesses are now very actively reviewing their own risk exposure to their banks. Why be at a bank that may be small enough to fail when you can be at a bank that is too large to fail? Why take that risk? The regional banking sector is in for a very tough couple of quarters as banks fight to retain their customers, but the government has laid the foundation for them to strengthen their balance sheets and survive. With that cushion, the private sector can now start to solve the problem.

Worth noting here is the difference between the regional banks (large enough to have significant uninsured deposits) and smaller, local banks (with a primarily retail depositor base, the vast majority of whom have less than $250,000 in deposits and are therefore fully insured). Smaller banks will face much less pressure, as we are seeing in the markets.

**Banks will be pulling back.** But not no pressure, as all banks are facing the same problem: the erosion of the value of their assets with higher interest rates. The decision by the government to allow them to borrow against those assets at par instead of market value, for a time, will allow them to fill that hole. But that means they have to cut costs and reduce their liabilities. Across the board, banks will be pulling back, and that will lead to slower growth and tighter financial conditions. If there is one thing that will bring forward the recession we have heard so much about, this is it.

**Turning Point for the Better?**

From a Fed perspective, this is a good thing—what it has been trying to accomplish, in fact. Lower interest rates in the market are a direct result of a more likely and deeper recession this year, which would make the Fed stop raising rates sooner and maybe even cut. Those lower interest rates have also started to solve the banks’ asset valuation problems. So, despite all the headlines and turmoil, arguably this week could end up being a turning point for the better.

But not just yet. First, we will have continued turmoil while the banking system sorts itself out and recapitalizes, while we see whether and how bad that recession will be. Markets right now are struggling between the worst-case scenarios and the less bad but still pretty bad scenarios. With so much uncertainty, that will take some time to sort out.

**Moving Toward a Solution**

The good news is that, between the government’s strong action and the consequent results as interest rates have dropped, we are moving faster than anyone expected toward a solution. That cuts off much of the downside risk—a [rerun of the Great Financial Crisis](https://blog.commonwealth.com/independent-market-observer/are-bank-failures-signaling-a-rerun-of-the-great-financial-crisis) continues to look less and less likely—and should accelerate the rebound eventually.

Expect more volatility, but it’s not the end of the world.

Keep calm and carry on.

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