March 24, 2023

INSIGHTS

INTERPRETING BANK TURMOIL AND MARKET PULLBACKS

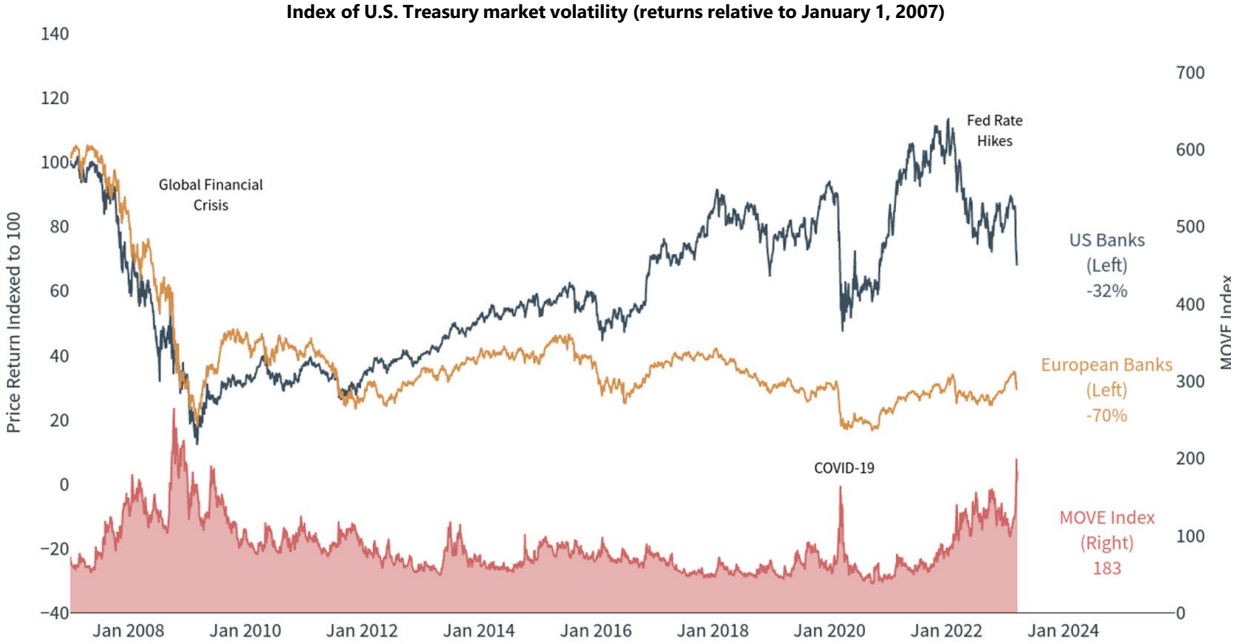
The banking crisis that began in the U.S. has now spread to Europe. Recent concerns over the solvency of Credit Suisse, Switzerland's second largest "global systemically important bank" (G-SIB), were due in no small part to the runs on U.S. banks. What made Credit Suisse vulnerable was that it had been plagued by reputational and financial difficulties over the past decade including problems with its financial reporting, exposure to failed companies, a criminal conviction over money laundering, and more. UBS has agreed to buy Credit Suisse in a $3 billion deal brokered by regulators, hearkening back to JPMorgan's takeover of Bear Stearns in 2008. The situation is still evolving and, in the U.S., regulators continue to monitor banks for signs of contagion.

Banking System Concerns Have Spread to Europe

Banking concerns add to the numerous challenges investors have faced in recent years. Over the past 12 months, investors have navigated through inflation, Fed rate hikes, Russia's invasion of Ukraine, and a bear market. In 2021, many were concerned over the sustainability of the economic recovery and excessive stock market valuations. In 2020, the pandemic and nationwide shutdowns threatened the economic and financial system, in addition to the well-being of everyday individuals. Many of these events occurred seemingly out of left field, catching investors off guard.

U.S. vs. European Bank Performance

S&P 500 Banks Industry Group, MSCI Europe Banks Index, and the ICE BofA Index of U.S. Treasury market volatility (returns relative to January 1, 2007)



Source: Clearnomics, MSCI, Standard & Poor's, ICE, data as of March 20, 2023.

However, while there are unique circumstances behind the failures of Credit Suisse and Silicon Valley Bank, banking crises are not as unexpected as global pandemics and military invasions. In fact, these bank failures echo other collapses across history. Taking a broader perspective, the history of financial markets is full of episodes that have been well documented, including in the classic book Manias, Panics, and Crashes by Charles Kindleberger.

One theory is that the common thread across these episodes is the availability of money, the expansion of credit, and the eventual tightening of financial conditions. Like a sugar rush, the supply of credit and the flow of funds through the global financial system can drive asset bubbles, appreciating currencies, and risk-taking in a particular market or across a whole country. Sooner or later, however, there is a sugar crash as returns peter out, sentiment shifts, and conditions tighten. This not only occurred leading up to the 2008 housing crash and financial crisis, but over countless other episodes including the 1997-1998 Asian currency crisis and the savings and loan crises from 1980 to 1994 when 1,600 U.S. banks failed.

Central Banks Have Tightened Conditions Over the Past Year

This suggests that while failed banks are not innocent bystanders - they often involve poor risk management and excessive risk-taking - they are also subject to macroeconomic trends just like any other corporation. When both the supply and demand for money by

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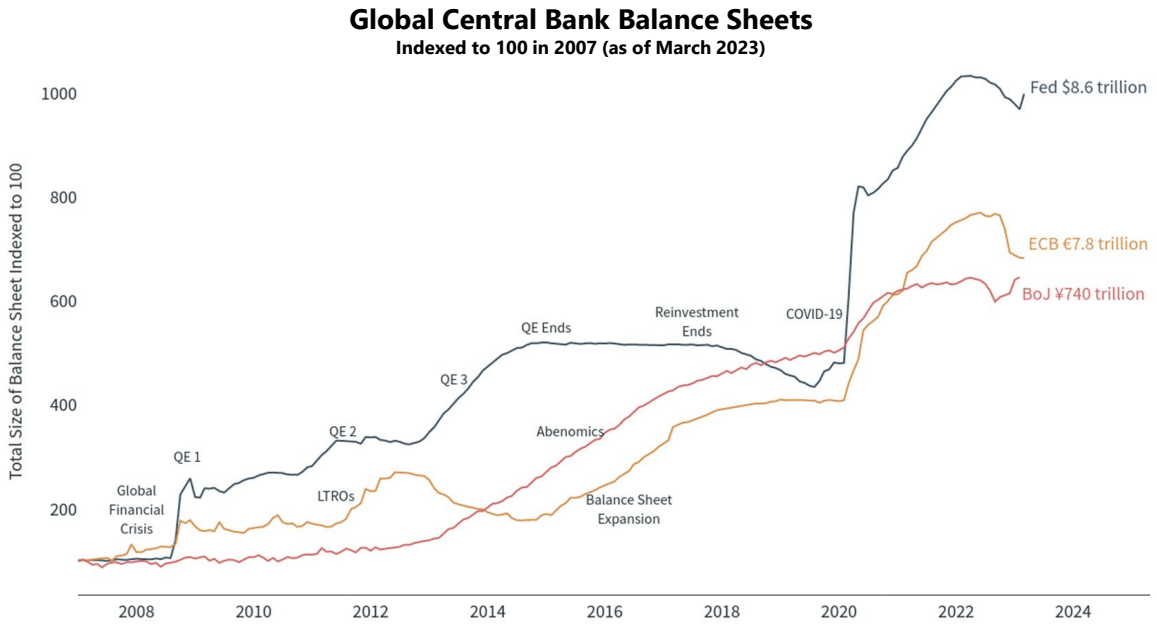
individuals and businesses are expanding, banks have strong incentives to extend more and more credit. As this compounds, it can lead to asset bubbles in real estate, the stock market, and more, which in turn further increase the appetite for credit. While this can continue for longer than expected, eventually it grinds to a halt.

Thus, it is no coincidence that this is occurring just as central banks and other monetary authorities are removing liquidity from the system by shrinking balance sheets and raising interest rates. Coupled with lower asset prices across the broad stock market, the tech sector, and areas like cryptocurrencies, it's natural for financial stresses to build. The following chart shows the reduction in central bank balance sheets across the globe over the past year. This has partially reversed in recent weeks as the Fed has provided hundreds of billions of dollars of additional support.



Source: Clearnomics, Federal Reserve, ECB, Bank of Japan.

This does not mean that we will see a repeat of 2008. Today, banks are much better capitalized and have broader deposit bases. For better or worse, regulators also have playbooks to be used at the first sign of trouble, as we have seen over the past few weeks.

Waiting for Market Pullbacks Often Results in Missed Opportunities

For long-term investors, this reinforces the need to hold diversified portfolios with proper risk management. The S&P 500 continues to trade at the most attractive valuation levels in years and interest rates have been much more stable. Balanced portfolios have already performed better this year, preserving capital and benefiting from stronger bond performance.

The irony is that some investors are always waiting for an opportune time to invest in the market. However, when markets do temporarily fall, these same investors may be hesitant to take advantage due to the nature of each market crisis. What inevitably happens is that investors miss these opportunities when markets eventually recover, forcing them to wait for the next pullback.

History shows that it's better to simply stay invested. Investing does not need to be all-or-nothing - even beginning with a strategy like dollar-cost averaging can help investors take advantage of attractive valuations while spreading risk over time. So, while the past is no guarantee of the future, history is clear on how investors should take advantage of market environments like the present.