

May 5, 2023

CIO Strategy Bulletin

David Bailin
Chief Investment
Officer and Global
Head of Investments,
Citi Global Wealth

Steven Wieting
Chief Investment
Strategist and
Chief Economist

Joe Fiorica
Head, Global Equity
Investment Strategy

Banking on Quality

SUMMARY

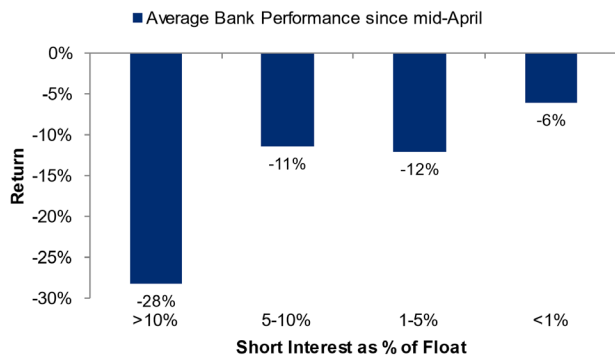
- While concerns around unrealized losses on loan portfolios and balance sheet securities are partially to blame, we see the latest decline in banking shares as a panic that was initiated by meaningful deposit outflows. Markets have been in a short-selling spiral, where weaker, individual banks are targeted, their stocks decline, and headlines trumpet broader concerns about deposits. And as institutions fail, “systemic confidence” is eroded.
- A Gallup survey released May 4 found that nearly half of participants were either “very worried” or “moderately worried” about the safety of their bank deposits.¹
- The increase in capital and stronger risk management standards following the Global Financial Crisis sought to make the US and world banking system much safer. From a macro level, the data are unambiguous and positive as equity capital surged relative to lending. The nature of the post-Covid recovery – led by stimulus, not private borrowing – also makes a systemic banking/credit crisis far less likely.
- The US economy’s underlying resilience shouldn’t be forgotten in moments of fear. The coming slump in the US economy won’t be historically severe. The recession we anticipate should be mild even if some small banks don’t survive. This was the pattern of the 1990/1991 downturn in the aftermath of the savings and loan crisis. While earnings declined by less than many feared in Q1, we see market expectations for a rapid recovery in profits by H2 2023 as overly optimistic.
- Our positioning in portfolios seeks to weather market uncertainty while potentially generating reliable income as we wait for a better moment to add risk. We most recently moved to increase global diversification, building positions in non-US assets trading at significant discounts to the US while reducing our overweight to the US dollar.

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The Latest Bank Equity Selloff

Regional US bank stocks fell 5% on May 4, 2023, led by those banks most targeted by short sellers in recent weeks (**Figure 1**). These shares are now down 39% year-to-date, while large banks considered “too big to fail” have outperformed, “only” 17% lower this year (data to 5/4/23).

Figure 1: The most shorted bank stocks have performed worst over the past 2 weeks



Source: Haver Analytics as of May 4, 2023. Past performance is no guarantee of future results. Real results may vary.

While concerns around unrealized losses on loan portfolios and balance sheet securities are partially to blame, we see the latest decline as a panic that was initiated by meaningful deposit outflows. Markets have been in a short-selling spiral, where weaker, individual banks are targeted, their stocks decline, and headlines trumpet broader concerns about deposits. Targets include banks with relatively homogenous and geographically concentrated deposit bases, and in some cases with lending concentrations in commercial real estate. And as institutions fail, “systemic confidence” is eroded.

Rapid declines in regional bank shares have begun to impact consumer confidence and their perception of deposit safety. A Gallup survey released May 4 found that nearly half of participants were either “very worried” or “moderately worried” about the safety of their bank deposits.¹

Meanwhile, short sellers in the equity market appear emboldened by the full wipeout of shareholder value across three major US banks this year. Yet, those banks had much higher and more concentrated levels of uninsured retail deposits than typical large banks. More recent stock price declines are in banks with “normal” levels of insured deposits. This indicates that the level of contagion is rising.

This week’s declines began soon after JPMorgan’s purchase of (much of) First Republic (FRC) this past weekend. Markets got about 48 hours of respite before concerns around regional banks re-emerged. Fed Chair Powell commented at Wednesday’s FOMC meeting that the FRC purchase was an “important step” toward ending the ongoing banking turmoil. Signaling that the peak of the crisis had passed – and conditions in banking had generally improved since March – catalyzed short sellers to test this view.

Following Silicon Valley Bank’s failure in March, steps the Fed and Treasury took to support banks with underwater bond positions were indeed strong and systemically important (see our [CIO Bulletin discussion of the Bank Term Funding Program](#)). Yet, there is nothing about the government’s response to the second-largest bank failure in US history that prohibits another one. On Wednesday evening, shares of several smaller regional banks dropped sharply, in part precipitated by PacWest’s announcement that it is considering “strategic options,” including a potential sale.

This is all happening as the country faces a debt-ceiling showdown in June. Political posturing and a likely cliffhanger ending will exacerbate market concerns. New US fiscal restraints are possible as a result of debt ceiling negotiations in the coming month. These could impact the economy negatively at a time when it’s already decelerating.

¹ [Gallup poll](#), May 4, 2023.

Stemming this panic in the near term will likely require several steps. The first is clarity on the government's intention to support banks facing deposit and temporary balance sheet challenges. This can be accomplished by clear communication but also by a change in policy, such as raising the level of deposit insurance for the next few years, though this would require an act of Congress. A more forceful deposit backstop from Treasury and the FDIC is also necessary. Ultimately, a Fed pivot toward easing will have the largest positive impact as it will help support the value of long duration assets on bank balance sheets. The persistent strength of US employment data thus far stands in the way of this.

The impact of the Fed rate hike

On Wednesday, the Fed made the historic choice to [raise rates again](#) in the face of an inverted US yield curve and a shrinking supply of money and credit (apart from a new emergency Fed lending facility). The Fed has raised US policy rates 500 basis points in just 14 months – even as the US banking system is coming under greater stress as noted above. This timing and the words used to describe the Fed's actions have stoked public fears in a self-reinforcing way.

Beginning last year, the US central bank moved from increasing its balance sheet to shrinking it within the space of three months. The Fed abruptly set its sights on attacking inflation after seeing its credibility threatened because of an extended easing cycle that lasted through an economic boom in 2021.

The Fed's economic and balance sheet stimulus during and after the pandemic was too strong and it is possible that the strength of its inflation fighting medicine will be as well. Put simply, recent macroeconomic policy has been reactive and sub-optimal. Just as higher rates attracted capital to move from deposits to money market funds and T-bills, so too have higher rates caused the held-to-maturity values of bank assets to fall precipitously.

Markets, the banks and the economy face several incremental risks. Banking turmoil is causing a decline in available credit in the economy. Bank lending is likely to tighten further with negative and imminent repercussions for the real economy. Second, reserves for commercial real estate loans are likely to rise as more heavily exposed banks prepare for restructurings. Third, market attention will soon focus on credit deterioration that will occur in the future. Fourth, greater regulation of small banks is in the mix, even if imminent action from Congress is improbable. And finally, further consolidation in the US banking sector is likely, with smaller regionals across the country teaming up to diversify their localized pools of deposits and loans.

Where to be wary

Small and midsized banks grew their lending books far more in commercial real estate than large banks (**Figure 2**). The loan loss reserves of smaller banks do not appear adequate, in the aggregate, for the future commercial real estate (CRE) credit cycle to come (**Figure 3**). As widely reported, office vacancy rates have risen despite the post-Covid economic recovery. However, the ramifications of record-high deliveries of multi-family apartments in the coming year has not received the same attention as a source of credit risk (**Figure 4**).

What's an investor to do?

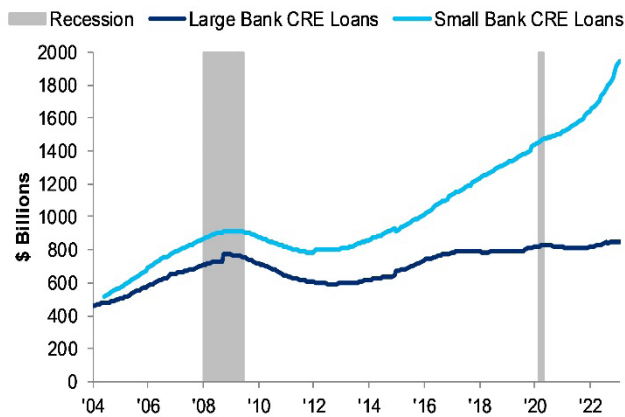
As we have said repeatedly, the increase in capital and strong risk management standards following the Global Financial Crisis have sought to make the US and world banking system safer. From a macro level, the data are unambiguous and positive as equity capital surged relative to lending (**Figure 5**). The nature of the post-Covid recovery – led by stimulus, not private borrowing – also makes a systemic banking/credit crisis far less likely (**Figure 6**). Even with the jump in small bank CRE lending, broad private credit growth has been negative in real terms overall. Government borrowing for Covid stimulus surged in 2020 and 2021, but has collapsed since then.

Further, the US economy's underlying resilience shouldn't be forgotten in moments of fear. A decline in inflation is underway helping real consumer incomes rebound (**Figure 7**). While we expect employment gains to fade, we believe producers are beginning to make progress on reversing excess inventories across key industries while this consumer demand persists.

The coming slump in the US economy won't be historically severe. The recession we anticipate should be mild even if some small banks don't survive. This was the pattern of the 1990/1991 downturn in the aftermath of the Savings and Loan Crisis (see our [March 26 CIO Bulletin](#)).

With that said, it may not take long for a significant pullback in bank lending to spread to non-financial sectors. While earnings declined by less than many feared in Q1, we see market expectations for a rapid recovery in profits by H2 2023 as overly optimistic. Our positioning in portfolios seeks to weather market uncertainty while potentially generating reliable income as we wait for a better moment to add risk. We most recently moved to increase global diversification, building positions in non-US assets trading at significant discounts to the US while reducing our overweight to the US dollar (see [Quadrant](#) for full discussion).

Figure 2: Commercial real estate loans: Large vs small banks



Source: Haver Analytics as of May 3, 2023. Note: grey areas are recessions.

Figure 3: Allowance for loan losses: Large vs small banks

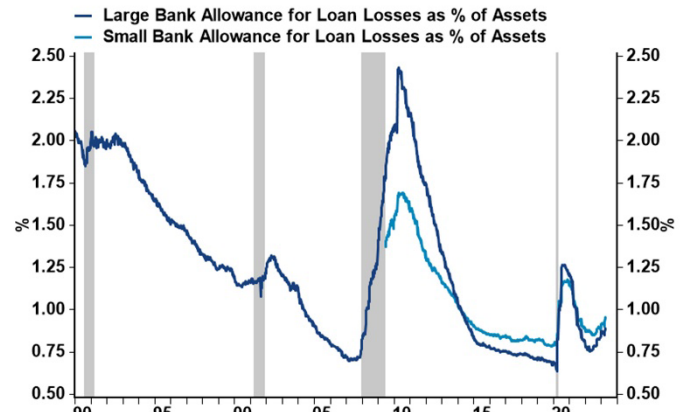


Figure 4: Apartment housing units under construction



Source: Haver Analytics as of May 3, 2023. Note: grey areas are recessions.

Figure 5: US bank tier-1 capital as % of assets

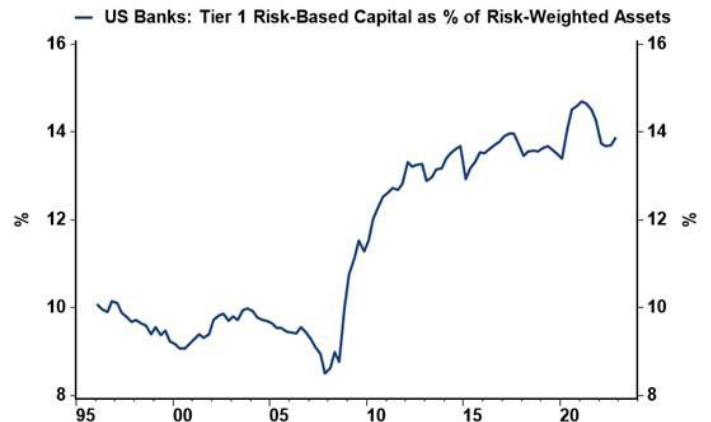
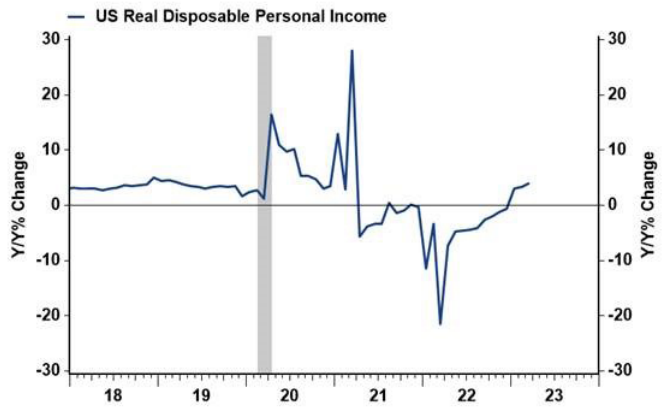


Figure 6: Real private non-financial debt Y/Y%



Figure 7: US real disposable income Y/Y%




Source: Haver Analytics as of May 3, 2023. Note: grey areas are recessions.

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High quality (very strong)	Aa	AA	AA
Upper medium grade (Strong)	A	A	A
Medium grade	Baa	BBB	BBB
Not Investment Grade			
Lower medium grade (somewhat speculative)	Ba	BB	BB
Low grade (speculative)	B	B	B
Poor quality (may default)	Caa	CCC	CCC
Most speculative	Ca	CC	CC
No interest being paid or bankruptcy petition filed	C	D	C
In default	C	D	D

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