Summary

Economic data for the week was largely focused on labor markets, with nonfarm payrolls and ADP employment coming in stronger than expected, while job openings declined and the unemployment rate increased. This pointed to a mixed overall message.

Stocks fell back in both the U.S. and foreign markets due to tough central bank talk that pointed to higher interest rates, as well as volatility in financials late in the week due to a large regional bank failure. Bonds benefited from flows away from risk. Commodities declined due to lower perceived demand as recession risks remained high, in addition to warmer weather.

Economic Notes

(0/-) The government **JOLTs** job openings report for January showed a decline of -410k to 10.824 mil., but above expectations calling for 10.546 mil. Openings fell by the largest amount in construction (-240k, a sizable ratio of that industry), accommodation/food services (-204k), and finance/insurance (-100k). Gains of lesser magnitudes were seen in professional/business services, transportation/warehousing, and nondurable goods. By factor, the job openings rate fell by -0.3% to 6.5%, while the hiring rate rose a tenth to 4.1%. On the departure side, the layoff rate rose a tenth to 1.1%, while the quits rate fell a tenth to 2.5%. With this data, the gap between jobs and workers tightened a bit further, but still remains wide as measured by openings vs. total unemployment and size of the labor force. Worker power relative to employer power remains in place.

(+) The **ADP private employment** report for February rose by 242k, well above the 225k expected and two times the size of the January report. Services jobs rose 190k, led by leisure/hospitality (83k) and finance (62k). Goods production rose 52k, the bulk of which was in manufacturing (43k). This report continued to show strong jobs growth, although correlation with the government payroll report later in the week has been sporadic.

(0) **Initial jobless claims** for the Mar. 4 ending week rose by 21k to 211k, above the 195k expected. Continuing claims for the Feb. 25 week rose by a more substantial 69k to 1.718 mil, well above the 1.660 mil. expected. Gains and declines were widely disbursed among larger states, with little clear pattern. It's been hypothesized that residual seasonality, due to the extreme distortions from the pandemic, continue to alter these figures, but that is expected to dissipate in coming weeks.

(+/0) The employment situation report for February came in strong, which caused financial markets to show mixed results, although the financial sector dominated sentiment this time. **Nonfarm payrolls** rose by 311k, beating expectations of 205k, but nearly -200k short of the January number. Several prior months were revised down by -34k in total, offsetting some of the effect. By industry, job gains continued in leisure/hospitality (105k), as well as education/health care (74k), retail (50k), government (46k, mostly in local), professional/business services (45k), and construction (24k). On the other hand, job losses were largest in information (-25k, including tech layoffs as well as niche areas such as music/film) and transportation (-22k). In leisure, the majority of jobs continued to be added in bars/restaurants, and a smaller gain in hotels. Interestingly, leisure employment still remains down -2% from the pre-pandemic level, so there is more room for improvement. In fact, breadth of job growth weakened in this report to 56% of industries, the lowest ratio since before the pandemic.

The **unemployment rate** rose by 0.2% to 3.6%, relative to expectations of no change. The labor force participation rate ticked up a bit, affecting this calculation, translating to a 177k gain in household employment. The U-6 underemployment rate ticked up by 0.2% to 6.6%, as part-time workers rose.

Average hourly earnings rose 0.2%, a tenth below the expected 0.3%, and was driven by production/non-supervisory job wage gains. This was considered a soft reading, although it still caused the year-over-year change to rise 0.2% over the prior month to 4.6%. **Average weekly hours** fell by -0.1 to 34.5, relative to expectations of no change.

Question of the Week

What is the status of Silicon Valley Bank (SVB)?

The week ended with the unusual mid-day Friday FDIC takeover of SVB (usually these happen at closing time), followed by the weekend closure of another large institution, Signature Bank in New York (with over $100 bil. in assets), which had significant exposure to the crypto market. Treasury Secretary Janet Yellen went on the weekend news circuit to reassure the public. It appeared a good deal of work was occurring in the background along with the FDIC to get to the bottom of the damage, negotiate with a possible buyer for the bank, and/or provide a backstop of sorts. However, any type of solution was downplayed until late Sunday, when it was announced the U.S. government would guarantee all depositor funds beyond bank assets, using the 'systematic risk exception' (SRE). In fact, a new Fed facility, the Bank Term Funding Program (BTFP), was created to help banks with liquidity problems by offering short term loans by posting high quality (Treasury or agency MBS) collateral at par value. It was also communicated that taxpayers would not bear the brunt of any losses—which appeared to be an important part of the government's message. There is some precedent to this, such as the Bank of New England failure in 1991, where the FDIC insured deposits above the then-lower $100k limit. Such an outcome provides a soft landing for depositors, and puts a stop on run risk for other regional banks, but stockholders are still likely wiped out.

The speed of SVB's collapse was unsettling to financial markets, to put it mildly, especially to the financial/banking sector, which saw sharp stock price declines. While the SVB failure is the second-largest in history (behind WaMu in 2008), the consensus at this point is that it was a one-off of sorts due to the nature of the bank's clientele, sector concentration, and financing. There are a variety of concerns that raised the stakes of this bank's failure in particular:

- It was a preferred bank of the U.S. technology and biotech sectors, with both private and public companies as clients, as well as venture capital. These have been obvious key drivers of American innovation and catalysts for economic growth. As such, there's little political will to inflict long-term damage there, particularly as the global technological competition with China has been continually ramping up, in one of the only areas of broad bi-partisan support.
- Because of this concentration in tech, and large balances held by certain firms (which could be more of a corporate finance diversification issue to be further probed), payrolls and routine corporate liquidity were at risk.
- The problem was exacerbated by SVB's large loan and securities portfolio as a percentage of deposits. The sensitivity of those assets to rising interest rates, and realized trading losses to shore up capital requirements based on how these were accounted for on the books, were the impetus of last week's sudden insolvency.
- Retail depositors only represented about 10% of the total (per JPMorgan data). While this is the group that typically falls under FDIC insurance limits, it represented a small part of the problem in this case. For the average large U.S. bank, that insured number has fallen in the 40-60% range.
- That means corporate investors represented approximately 90% of the remainder, and are far less likely to fall under the FDIC umbrella. In theory, all uninsured assets were at risk of loss, beyond what can be recovered from the bank's assets, were the Treasury Dept. not made an exception.

The Fed and Treasury acted relatively quickly, at least as quickly as conditions at SVB fell apart. The announcement of a backstop for other banks using collateralized loans or swap-type tools isn't unusual in these situations since the quality of collateral isn't the problem. So, it isn't a 'bailout' as much as it is an 'extension' of sorts. The treasury and agency MBS debt is expected to mature at par—the failing banks just can't wait that long for market prices to recover, while another more liquid bank (or the government) can.

Regulators have been careful to walk a tightrope here. Excessive help can flip the positive sentiment negative due to the classic 'moral hazard' problem. As discussed widely during the 2008 financial crisis, routinely bailing out every problem bank takes away the responsibility for banks to act prudently. In fact, it could give the impression of a 'put option' in place potentially allowing a bank to take on a variety of extra risks since much of the downside is removed (other than wiping out jobs and stockholders). This creates more instability in the system. While 'creative destruction' is painful, it's also necessary to ensure risk is handled in a responsible way. Of course, a line is drawn when it comes to depositors, who are considered the innocent victims of such bank management problems. Trust in the banking system is the most important factor to its proper function, above all else, which is often echoed by the Treasury, Federal Reserve, and FDIC in their comments when reassuring the public and creating these new facilities.

At the same time, the problem appears to not be one of improper or missing regulation. Bank rules have often been put into place in response to the most recent crisis. After 2008, it was about bank capital but also classifying various types of capital into 'tiers'. This was intended to guard against problems with taking excessive credit risk. However, with fixed income securities (a key bank asset), credit is only half the equation—the other half is interest rate risk. Credit wasn't an issue with SVB, as the assets appeared to be treasuries and agency mortgage-backed securities, which are considered top-tier, due to their lack of default risk. Instead, rising rates pushed down the value of long-maturity bonds, turning this more into a duration risk issue.

What happens now? After the Treasury Dept. and FDIC guaranteed all depositor funds, they appear to be seeking to broker a merger of some sort behind the scenes to absorb SVB's assets for a low price (insolvent banks have been sold for as little as $1). It might even involve a foreign bank.

What are the wider ramifications of SVB's failure? There had been some push in social media over recent days (before the government stepped in) to pull funds from regional banks in favor of the 'big 4' banks (by assets, considered to be JPMorgan, Citibank, Bank of America, and Wells Fargo—the 'too big to fail' group). This gets to a breakdown in trust, again a concern for the Treasury Dept. and Fed, potentially creates consolidation risk, and reduces competition, which many policymakers also want to avoid. This is the primary reason why a structured and targeted 'bailout', coupled with a merger/absorption, fortifies trust in the banking system, while not giving the impression the bank is off the hook completely.

Will this have an impact on Federal Reserve policy? While the Fed has held steadfast to beating inflation by raising rates, with more tough talk last week, this episode is a powerful example of the byproducts of sharply rising rates and the banking system problems caused by an inverted yield curve, which ultimately can put a dent in financial stability. The dilemma of balancing those two goals is being closely monitored by financial markets (on a weekly, if not hourly basis these days).

The Fed meets again on Mar. 21-22—over the past week Fed funds probabilities flipped back and forth from first assuming a 0.25% rate hike, to 0.50% mid-week, and now back to 0.25%. However, there are growing calls for no hike, due to this banking system pressure. In fact, the June probabilities are already back to showing a possible rate cut, and several again priced in by December. This reflects the view that the Fed has finally 'broken' something, which has often happened at some point historically during the tightening process.

Market Notes

Period ending 3/10/2023	1 Week %	YTD %
DJIA	-4.35	-3.24
S&P 500	-4.51	0.92
NASDAQ	-4.68	6.63
Russell 2000	-8.03	0.89
MSCI-EAFE	-0.76	5.96
MSCI-EM	-3.29	0.03
Bloomberg U.S. Aggregate	1.17	1.45

U.S. Treasury Yields	3 Mo.	2 Yr.	5 Yr.	10 Yr.	30 Yr.
12/31/2022	4.42	4.41	3.99	3.88	3.97
3/3/2023	4.91	4.86	4.26	3.97	3.90
3/10/2023	5.01	4.60	3.96	3.70	3.70

U.S. stocks suffered a variety of negative days last week, as interest rate expectations repriced higher due to Fed comments, and related concerns over certain bank balance sheets dominated sentiment by the week's end (as discussed in an earlier note). Every sector ended in the negative, led by financials down over -8%. Defensive stocks such as consumer staples and utilities performed marginally better, with declines of 'only' -2% to -3%.

An initial catalyst was Fed Chair Powell delivering semi-annual testimony before the House Financial Services Committee, sharing that interest rates will likely end up 'higher than previously anticipated.' This naturally disappointed both stock and bond markets, as discount rates rose along with the assumed higher terminal value for the Fed funds rate, at least until the SVB issue discussed earlier, which reversed this sentiment.

Foreign stocks fared about as well as U.S. equities, with Japan experiencing outperforming with minimal losses. Concerns over higher interest rates and effects on the global banking system carried to Europe as well. In emerging markets, Chinese stocks fell back in keeping with other regions, with a below-expectations 5% GDP growth forecast, as well with the communist party meeting resulted in more defensive rhetoric towards the U.S., threatening relations.

Bonds gained last week as the risk-off sentiment from equities resulted in strong flows into intermediate- and long-term treasuries, and to some degree into investment-grade corporates. Unsurprisingly, high yield bonds underperformed in keeping with their correlation to equities. Foreign developed market debt also gained for similar reasons, with emerging markets mixed.

Commodities were down across the board last week by a few percent in most groups, aside from a small gain in precious metals. Crude oil was down nearly -4% on the week to under $77/barrel, due to assumed continued Fed rate hikes, which have traditionally weighed on economic activity and petroleum demand. Volatile natural gas prices fell over -15% on the week as early March weather has turned milder, reducing heating needs.

Have a good week.

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Sources: FocusPoint Solutions, American Association for Individual Investors (AAII), Associated Press, Barclays Capital, Bloomberg, Citigroup, CME Group, Deutsche Bank, FactSet, FDIC, Financial Times, First Trust, Goldman Sachs, Invesco, JPMorgan Asset Management, Marketfield Asset Management, Morgan Stanley, MSCI, Morningstar, Northern Trust, PIMCO, Standard & Poor's, Seeking Alpha, StockCharts.com, The Conference Board, Thomson Reuters, T. Rowe Price, Univ. of Michigan, U.S. Bureau of Economic Analysis, U.S. Federal Reserve, Wall Street Journal, The Washington Post. Index performance is shown as total return, which includes dividends. Performance for the MSCI-EAFE and MSCI-EM indexes is quoted in U.S. Dollar investor terms.

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Notes key: (+) positive/encouraging development, (0) neutral/inconclusive/no net effect, (-) negative/discouraging development.