



Bank Runs and Interest Rates

Matching assets with liabilities is one of the prudent rules of banking. The failure to do that led to such financial crises as the Savings & Loan collapse of the 1980s and it surfaced again when a little-known, yet financially prominent California bank collapsed last month, sharply shifting economic fortunes and central bank policy.

The Economy

Rising interest rates amidst high inflation was the backdrop of much of last year's investment story. The Fed raised interest rates seven times in 2022 and twice in the first quarter of 2023. Those rate hikes increased short-term yields by 4.75 percentage points, a giant move upward. Long-term rates followed suit, though they didn't rise quite as much, and the resulting decline in the values of long-term bonds was breathtaking: down 21% – nearly double the decline of the S&P 500 – since the beginning of last year.

During the years of near-zero interest rates, many investors bought long Treasury bonds in search of modestly higher interest rates. Though safe in terms of credit risk, long Treasury bonds were subject to these dramatic losses as interest rates rose. Suddenly, Silicon Valley Bank (SVB), a buyer of long-term Treasuries, found itself caught in the vice of sharply falling asset values and the need to raise funds to meet rapid deposit withdrawals by its predominantly tech startup clients.

The ensuing runs on SVB and then Signature Bank in early March, and their sudden collapses, soon followed by the near-collapse of global banking giant Credit Suisse, created the imminent risk of financial contagion that could have quickly taken down the American and even global banking systems. Prompt action by the FDIC to insure all deposits at the American banks, and the rescue of Credit Suisse by Union Bank of Switzerland, stemmed the tide. It also quickly replaced the environment of sharply rising interest rates with a sharp, market-led decline in rates, and a very moderated response by the Fed to avoid sparking further banking crises.

With that, investment perspectives shifted. Despite an initial sharp selloff in equities, stocks generally staged a rebound following the onset of the SVB crisis, spurred upward by the decline in interest rates. Though the KBW Bank Index declined nearly 25% from March 8 through quarter-end, the S&P 500 gained almost 2%, marking a significant shift in investor sentiment. (SVB lost 100% of its market value.)

Suddenly, the Fed's year-long war against inflation was replaced with a delicate balancing act, with rising prices on one side and financial contagion on the other. Despite the rate hikes, inflation remains a concern. Recent measures showed prices up 6% year-over-year. Strong job production and a tight labor market (unemployment is a mere 3.6%!) will keep the Fed vigilant in its inflation fight. More rate hikes are not off the table.

Meanwhile, the US economy appears to have maintained surprisingly modest growth during the first quarter, pacing a 2.5% growth rate, despite growing expectations of an interest-rate-induced slowdown or recession later this year. The possibility of more restrictive bank lending in the aftermath of the SVB failure could impose further hardships on the economy going forward.



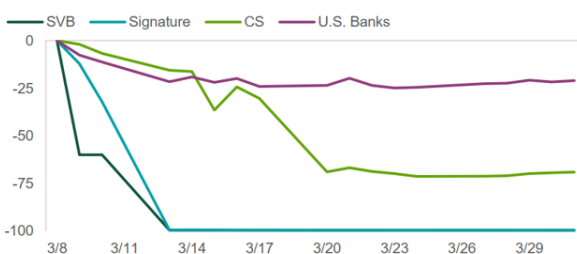
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Mark has over 30 years of experience in the financial services industry. As Senior Wealth Advisor, he participates in setting investment policy standards and strategies within the group. Mark manages portfolios for high-net-worth, trust, and institutional clients, guiding them through the process of identifying personal objectives for wealth management, and developing appropriate investment portfolios and strategies to help meet those goals.

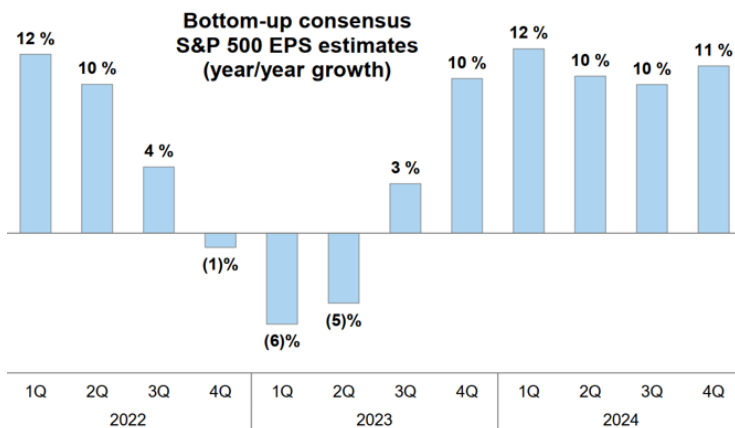
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% RETURN ON BANKS – March 8-31, 2023



Source: Northern Trust Asset Management, Bloomberg, SVB (Silicon Valley Bank); Signature (Signature Bank); CS (Credit Suisse); U.S. Bank = KBW Bank Index.

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Source: FactSet, Goldman Sachs Investment Research; as of 2/16/23

Despite the quick action by federal policymakers, analysts are not certain that this most recent banking crisis is yet behind us. Likewise, the forecast for near-term corporate earnings continues to be weak, but with brighter prospects in the second half of this year. It is always important to remember that markets are forward-looking.

The Markets

Despite the severity of last year's equity selloff, particularly among growth stocks, equity markets may have turned a corner as long ago as September. With the S&P 500 posting a 7.5% gain in the fourth quarter, it had momentum coming into the new year. Optimists might conclude that the Fed's aggressive rate hike program was largely in the rearview mirror. If so, that would provide opportunity for equities to continue their recovery. Moderation in inflation reports last year supported that case and equities climbed through early February (up over 9% for the S&P 500) as longer-term interest rates began to drift lower – responding to, and creating, concerns about a potential recession via a more inverted yield curve.

However, inflation was not abating as quickly as investors or the Fed would have liked, and by February, stubbornly high inflation measures reignited fears of yet more aggressive rate hikes by the Fed. The collapse of Silicon Valley Bank in early March brought another big shift in interest rates as described above. From peak to trough, the yield on five-year Treasuries dropped 100 basis points during March (despite a smaller 25 basis point rate increase by the Fed late in the month). Although many regional bank stocks dropped sharply, the large money center banks (generally considered too big to fail) fared better. Outside the banking sector, the drop in interest rates sparked a renewed rally in stocks. By quarter end, the S&P 500 closed 7.5% higher.

Beneath the broad numbers, however, there remained large disparities. Growth stocks, the bane of equity markets last year, became the darling of investors in January. Having trailed value companies by more than 20 percentage points last year, the Russell 1000 Growth Index far outpaced its value counterpart by

more than 13 percentage points in the first quarter. Moreover, the Russell 1000 Value Index posted a meager 1% gain for the period. That pattern was duplicated across the various equity sectors: solid gains for growth with generally flat returns for value. Among the broad benchmarks, international modestly outperformed US large cap stocks, with the MSCI EAFE Index posting an 8.7% gain. US small companies were up 2.7%. Real estate rose 1.6%.

On a year-over-year basis, the broad stock averages were generally still down by double digits. International stocks are a notable exception, with an almost flat return for the past year, providing renewed validation that globally diversified portfolios can help reduce portfolio volatility. International stocks continue to reflect relative value compared to most US markets. Having finished their worst year on record in 2022, bonds were up nearly 3% or more during the highly volatile quarter.

Index Returns as of 3/31/23	Q1 2023	YOY
S&P 500	7.48%	-7.75%
Russell 1000 Growth	14.36%	-10.91%
Russell 1000 Value	0.99%	-5.96%
Russell 2000 Value	2.73%	-11.63%
Dow Jones US Real Estate	1.57%	-18.70%
MSCI EAFE (net)	8.65%	-0.79%
MSCI Emerging Markets (net)	3.97%	-10.39%
Bloomberg US Aggregate Bond	2.96%	-4.78%
Bloomberg Municipal Bond	2.78%	0.26%
Bloomberg High Yield Bond	3.57%	-3.35%

Data from Northern Trust Asset Management

Tempered Expectations Ahead

Looking ahead, many of the same concerns that vexed investors last year remain concerns this year. Inflation remains a hot spot with the Fed. Saying that "inflation remains elevated," the Fed's rate-setting Federal Open Market Committee (FOMC) re-affirmed its commitment to a long-term inflation target of 2%, adding that it "remains highly attentive to inflation risks." Noting the economy's modest growth and "robust" job creation, the FOMC also called the banking system "sound and resilient," but warned of the likelihood of "tighter credit conditions" that could slow or choke off economic growth. All of these are factors that have been echoed by private economists and equity market analysts as well, highlighting the uncertainties on all sides. Nevertheless, the Fed's historically aggressive rate hikes are almost certainly near completion, perhaps allowing more stable conditions upon which to make decisions. That would be a positive and welcome development.

As always, we encourage you to seek out the guidance of your Canandaigua National Trust Company team to navigate the short-term bumps on the path to your long-term goals.