19/19 INVESTMENT COUNSEL
Complexity to Clarity

Weekly Market Insights

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A Damaged Market Psyche!

Financial Markets

Roiled by the failure of Silicon Valley Bank, markets were certainly volatile last week. Despite quick action by regulators, fear of a broad-based banking collapse mounted as the week progressed. For the week, the Dow closed down 0.15%, the S&P 500 closed up 1.43%, and the NASDAQ closed up 4.41%. Large cap stocks outperformed their smaller brethren. Notably, a flight to quality and a reassessment of future Fed policy caused yields to drop precipitously during the week. For example, the two-year Treasury yield fell from 4.59% to 3.82% by the end the week.

The Economy

A lot of interesting things are occurring in the world economy, but the issues surrounding the global banking sector are dominating the discussion. Three big questions must be answered: 1) Why wasn't it caught earlier? 2) What must happen now? 3) How do we prevent something like this from reoccurring? These questions will be debated for a long time and will be found in many future Ph.D. theses. Most economists would agree that the banking system is too big and too important to fail. From a general standpoint we know what happened—poor banking practice and a crisis of confidence by depositors. There will be two great debates about the next two questions. Solutions to address the problem at hand and to prevent a reoccurrence are really very interesting, and we don't believe many economists or banking analysts will be neutral. Focusing on the present, a major question must be answered. What is the greater danger? Potentially systemic risks in the banking sector or inflation? Those who think inflation is the greater risk believe the Fed should not alter their current stance and should continue to raise interest rates.

The general consensus is that the problem is localized to certain institutions and will work its way out with some continued pain and disruption. Many very distinguished economists have argued this way. In fact, this is the case argued by the ECB. The other line of thinking is that the banking system is too big and important to become unstable and that the Fed should not raise interest rates any further this cycle. A pause would give the banks and the Fed time to reassess the impact of the disruption, but the Fed would likely have to reiterate that they are not done fighting inflation in the longer-term.

The other question is what to do to prevent future failures? At first blush, the current issues are the result of poor banking practices, weak auditing, and the lack of regulatory zeal. The interesting debate going forward will revolve around future bank regulation. This topic has been debated by the greatest names in economics. Perhaps the most famous was in the first half or the 20th century between John Maynard Keynes and Friedrich Hayek. We will have more on this another time.

Conclusion

We don't expect investor concerns to be overwhelmingly relieved by the Fed's interest rate decision this Wednesday. The market will most likely show an immediate reaction one way or the other, but we believe investors will ultimately wait for the next shoe to fall. It is certainly a difficult decision for the Fed. One interesting thought experiment is to look at the worst case scenarios—continued inflation or a destabilization of the banking system. It seems likely that an economy would be unable to function without a solid banking system, but the Fed should be able to reinvigorate the battle against inflation.

The political battle between regulation and no regulation is age-old. In the United States, it is heating up again. This topic deserves more time, and we will address it further in future papers.

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