Madison INVESTMENTS

WEEK IN REVIEW | REINHART FIXED INCOME BY MADISON INVESTMENTS

March 10, 2023

SILICON VALLEY BANK

Silicon Valley Bank (SIVB), a bank specializing in lending and banking for technology and healthcare startups, failed and went into FDIC receivership. SIVB was facing a run on deposits when many of its clients' venture capital backers urged them to withdraw their funds from the bank following an attempted share sale and disclosure of large losses on sales of Treasuries. Bank stocks dropped on contagion fears and interest rates fell on speculation that the Fed may have to back off of monetary tightening due to financial system fragility.

Our Take: SIVB does not appear to present a systemic financial risk given the relatively small size of its balance sheet and lack of large trading, derivatives, and funding market positions. In all likelihood the FDIC will arrange for a healthier bank to take over SIVB's assets and deposits on favorable terms and all depositors will be made whole. SIVB's troubles stem mostly from its concentration of deposits from cash burning startups that have seen venture capital funding dry up and operational mistakes in managing liquidity and asset-liability matching. Banks as a whole are unlikely to face the same extent of deposit outflows, but SIVB's failure highlights the need for bank investors to pay attention to liquidity and asset-liability management during a prolonged period of yield curve inversion.

EMPLOYMENT

Nonfarm payrolls rose by 311,000 jobs in February, while the unemployment rate ticked up from 3.4% to 3.6%. Average hourly earnings were up 0.2% for the month and have risen 4.6% year-over-year. Labor force participation rose from 62.4% to 62.5%.

Our Take: All in all, this was a relatively strong employment report. Payroll growth exceeded expectations, while the unemployment rate rose due to people joining the labor force. The largest jobs gains were in the leisure and hospitality industries, suggesting that there is inflation pressure coming from service sector employment. This is the Fed's exact concern and is another data point supporting a 50 basis point move at their next meeting. Inflation numbers are reported next week and are the last major set of indicators that could move the rate hike needle before the Fed rate decision on March 22.

POWELL TESTIMONY

This week, Federal Reserve Chairman Jerome Powell provided his semi-annual testimony on Fed policy to Congress. He indicated that given the continued strength of recent economic data, the Fed will likely need to raise rates above the 5%-5.5% range that was previously expected. He even stated his willingness to go back to 50 basis point rate increases if the incoming data supports it. Noting that Fed actions depend on the data, the Chairman stated that "If the totality of the data were to indicate that faster tightening is warranted, we would be prepared to increase the pace of rate hikes." Powell added that the process of getting inflation down to 2% "has a long way to go and is likely to be bumpy."

Our Take: Chairman Powell had a more openly hawkish tone in his testimony to Congress than in recent comments following the last FOMC meeting, but his message is the same. The Fed remains committed to reigning in inflation and there is more work that needs to be done. On that front, the Fed will raise rates as high as necessary and keep rates at restrictive levels for as long as necessary to achieve its goal.

MUNICIPALS

West Virginia Governor Jim Justice signed House Bill 2526 into law, which will allow for the largest tax cut in state history. Income tax rates will be cut by 21.25% and the tax cut is expected to return approximately $750 million to West Virginians. In addition, the bill will allow a 100% tax credit on vehicles and a 50% rebate to small businesses for equipment and inventory.

Our Take: Estimates indicate that the tax cut will amount to two-thirds of West Virginia's current budget surplus. Skeptics worry that such a large tax cut could lead to negative effects in the future. The West Virginia Center on Budget and Policy issued a statement with concerns that a change in economic conditions, including a drop in energy prices, could lead to future tax increases or spending cuts.

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