Kennedy Capital Management®

Our investment perspective

Confidence, Banking, and Opportunities

March 2023

Consumers and Investors

The sudden failure of two major U.S. banks over the past week has rattled investors and, more importantly, consumers. An institution's viability is ultimately tied to the confidence that customers have in its capabilities. We saw this in the wild swings in cryptocurrencies over the past year, and we then saw it in Silicon Valley Bank (SVB). Ultimately, the Federal Reserve, the Department of the Treasury, and the Federal Deposit Insurance Corporation (FDIC) united to assure SVB depositors that their funds would be covered whether explicitly insured or not.

As most have seen, the FDIC insures deposits up to a limit of $250,000. In the event of a deemed systemic failure risk, there is flexibility to go beyond this. The aforementioned authorities have invoked this ability to cover all deposits at SVB. Note, however, that the statement that came out late Sunday afternoon, March 12th, explicitly stated that shareholders and certain unsecured debtholders will not be protected. This, along with the sudden failure of Signature Bank, unnerved bank investors.

Notwithstanding this statement, we do not expect a repeat of the Great Financial Crisis of 2007-08. Officials have moved decisively here, banks generally had complex, hard-to-value assets then, and we do not believe we are in the midst of credit stress. SVB was one of the few public banks that would have had negative tangible common equity if forced to liquidate its held-to-maturity securities portfolio. Additionally, customers' increased flexibility to move deposits in a technology-enabled fashion fed SVB's rapid decline and sparked fears of similar runs. However, we believe that stronger capital positions, more stringent regulatory requirements, and lessons learned from the past crisis around managing risks should all bode well for the sector. Credit risk is part of the cycle and will invariably return. Reserves are plentiful, though, and management teams remain vigilant of credit deterioration. In our conversations over the past few days, we are finding widespread stability in deposit bases. In fact, some banks are reporting higher balances today than at the start of the year.

Federal Reserve Chairman Powell and his compatriots have been vocal in their hawkishness. Their "higher for longer" mantra has weighed on debt and equity markets and the Fed has been determined to dampen unbridled growth. Many investors have been unwilling to step in front of this rhetoric for fear of the unknown (e.g., How high will short-term rates escalate? How long will the Fed continue to hike?). It is possible that this recent pressure on banks may have just accelerated the Fed's growth dampening goal. Loan growth is bound to slow, and we believe overall capital availability will be constrained. While we now expect a potentially more abrupt near-term slowdown, we think that – perhaps – a halt to the rate hikes could be in sight. We believe this could ultimately be good news for investors.

Changing Valuations

Our job as equity investors is to determine the characteristics and strength of a business, using this to inform our expectations for the cash flows it could potentially generate in the future. As investors, we must determine the proper discount rate to apply to those cash flows. As interest rates rise, all else being equal, we are inclined to apply a higher discount rate (i.e., lower our price expectations). If interest rates begin to fall, that should bode well for the discounting mechanism and, hence, equity values.

Capturing Opportunity

In sum, these are volatile and uncertain times. Widespread emotional trading tends to create stock-specific opportunities for our clients. We expect that there will be unintended consequences from the regulatory enactments of the past week and that growth will slow. However, we believe that we are making progress on our key goal of containing inflation. We also believe that the Federal Reserve has taken an important step in restoring customer confidence. Ultimately, this can end up as a positive factor for equity markets. As the economy slows, gathers itself, and begins to expand anew, we believe there is potential for us to be able to capitalize on the many opportunities arising from this volatility.

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