TAM INVESTMENT COMMENTARY

BANK CLOSURES AND THE MARKETS

MARCH 16, 2023

TOM WALD, CFA®
Chief Investment Officer,
Transamerica Asset
Management, Inc.

The sudden and unexpected closures of Silicon Valley Bank (SIVB) and Signature Bank (SBNY) spurred government action and quickly resulted in declining stock prices and falling interest rates as markets looked to sort through previously unrecognized risks in the banking sector and the prospects of wider contagion and broader economic spillover. These concerns have been further accelerated on a global basis following announcements made by Credit Suisse Group AG and its lead investor, Saudi National Bank. With this backdrop, we believe pertinent points for investors to consider include the following.

- **We view the swift actions of the Federal Reserve, U.S. Treasury Department, and Federal Deposit Insurance Corporation (FDIC) as being crucial in averting a potentially wider crisis in the financial system.** Following the collapse of SIVB and SBNY, these three entities jointly announced actions to enable the FDIC to complete its resolutions of SIVB and SBNY in a manner fully protecting all depositors, both insured and uninsured. Under this scenario, no depositors at either bank will lose money, though stock and bond investors will be subject to losses. This outcome provides safety for depositors while not bailing out investors or the banks themselves.

- **The Fed also announced additional funding for eligible depository institutions through creation of the new Bank Term Funding Program (BTFP).** This new program will offer loans of up to one year in length to banks, savings associations, credit unions, and other eligible depository institutions allowing for U.S. Treasurys, agency debt, and mortgage-backed securities to be pledged as collateral.

- **Of vital significance in this new program is that banks will now be able to garner liquidity by receiving up to one-year loans from the government based on the par value (maturity value) of their bond portfolios.** This component of the BTFP could prove critical to avoiding future collapses. Allowing banks to raise capital using the maturity value of their bonds as collateral rather than current market prices (which for most banks have declined materially amid the rising interest rate environment of the past year) should serve to alleviate major balance sheets shortfalls (which played a major role in the SIVB and SBNY collapses).

- **It is also important to emphasize that unlike the global financial crisis of 2008, the SIVB and SBNY failures appear to be mostly the results of asset liability mismanagement as opposed to widespread credit deterioration throughout the banking system.** While the risk of duration mismatch between deposits and longer-term Treasury bond portfolios certainly took its toll in these cases, systemically speaking, we would view the current banking environment as being in more of a liquidity crisis than a credit crisis and thereby effectively addressed through actions such as establishing the BTFP. Therefore, while the overall situation in the banking industry, and for regional banks in particular, remains a fluid one and there is clearly much to play out in the days and weeks ahead, we view recent government actions as helping to avert this liquidity crisis and potentially deterring contagion fears and depositor angst.
- **Global banking concerns have been further exacerbated by nervousness in Europe following news from Credit Suisse (CS) of "material weakness in financial reporting" and a statement from their lead investor, Saudi National Bank, that no further investment in CS will be forthcoming from them.** This elicited a strong negative market reaction in both CS stock and the European bank sector as investors sought clarity as to whether these developments simply reflect a continued decline in operating performance of CS or more serious credit and liquidity issues. This is an evolving situation and one likely to have continuing market impact as clarity on this question emerges. Until then, we see this situation as adding to global economic uncertainty and market volatility.
- **The SIVB and SBNY collapses combined with the growing global banking concerns being fueled by CS will likely now impact Fed policy in the months ahead.** These recent events, in our judgment, could now be shifting the Fed's primary emphasis from fighting inflation to avoiding systemic damage in the financial system. While the Fed will certainly maintain its inflation-fighting profile, there now appears to be a meaningful probability the Fed could take a pause on raising rates at the upcoming March meeting. This could be for no other reason than to survey the ongoing effects of the past year's rate increases and let financial conditions absorb the recent bank closures, and the government's response to them. We are, however, still reticent to accept newer market expectations of the Fed cutting rates in the second half of the year. We believe the Fed is likely to remain resolved in its battle against inflation even after perhaps concluding the current tightening cycle in the months ahead.

- **Recent inflation data, in our view, also increases the probability of the Fed potentially taking a pass on raising rates at the upcoming March meeting and perhaps concluding the current tightening cycle by midyear.** Under this scenario, we could see the tightening cycle finishing in the summer months perhaps after one or two more quarter-point rate hikes and with a lower bound on the federal funds rate in the range of 4.75%–5.00%. Such an outcome could be further supported by the recent February Consumer Price Index report displaying headline year-over-year inflation of 6%, its lowest level since September 2021, and a core (ex food and energy) reading of 5.5%, its lowest since December 2021. While this pace of declining inflation is far from rapid and will be subject to monthly aberrations, we feel there is enough in the general trend to warrant the Fed concluding rate hikes by about midyear to assess conditions and let higher rates fully filter through the economy.

- **Nonetheless, the two bank closures and the tighter credit and financial conditions that are still likely to ensue, combined with growing banking uncertainties in Europe, in our view, support the recession risk we view as increasing into the second half of the year.** We continue to believe there is a high probability of recession beginning by year-end and, at this point, we still lean toward a moderate downturn similar in nature to those beginning in 1990 and 2001 rather than a prolonged and severe recession akin to those beginning in 1981 or 2007. While recent employment and consumer spending data, released prior to the SIVB and SBNY closures, has been strong, leading economic indicators, such as the Conference Board Leading Economic Index and the currently inverted slope of the Treasury bond yield curve, in our judgment, continue to point toward a high probability of recession beginning in the year ahead.

- **Even though longer-term rates have recently come down following the SIVB and SBNY collapses, we still caution bond investors to heed the risk of the currently inverted yield curve and the potential future upward path of longer-term rates.** As of market close on March 15, the 3-month to 10-year Treasury yield curve stood at an inversion of 1.23% (4.70% vs. 3.47%), representing close to its widest margin in more than 40 years and, on a percentage of yield, close to its widest ever. History has shown yield curves typically invert prior to recessions and return to upward slopes as those downturns play out, which has proved to be the case in all eight recessions since 1969. Therefore, should the Fed continue to raise rates, or even simply hold tight at current levels, into an approaching recession, it is most likely the yield curve eventually reconciles to an upward slope via rising long-term rates. For this reason, we believe fixed income investors will be better positioned in short- and intermediate-term maturities.

- **We believe strong opportunities still exist in short- and intermediate-term corporate bonds.** High-yield bonds are now offering close to their highest levels of income since 2020 (ICE BofA US High Yield Index Effective Yield 8.7% March 14) and investment-grade bonds close to their highest yields since 2009 (ICE BofA Single-A US Corporate Index Effective Yield 5.3% March 14). Even given the recent bank closures initiating government actions, we still view overall credit risk in the corporate markets as more benign than prior to previous recessions. This is due, in large part, not only to the BTFP put into place by the Fed but also opportunistic refinancings during the pandemic and aggregate maturity schedules in the corporate markets more heavily weighted toward the latter parts of the decade.

- **Finally, while we see the equity markets remaining volatile in the months ahead, we are maintaining our year-end S&P 500® price target of 4,400.** This is based, in large part, on the markets looking past a moderate recession, recovering in the aftermath of peak inflation, and the conclusion of the Fed's tightening cycle as well as an improving corporate earnings outlook in CY 2024.

THOMAS R. WALD, CFA®

CHIEF INVESTMENT OFFICER TRANSAMERICA ASSET MANAGEMENT, INC.

Tom oversees investment and mutual fund development and the sub-adviser selection process. He heads Transamerica Asset Managment's investment thought leadership with advisors, clients, and media. Tom has more than 30 years of investment experience and has managed large mutual funds and sub-advised separate account portfolios. Tom holds a bachelor's degree in political science from Tulane University and an MBA in finance from the Wharton School at the University of Pennsylvania.

Visit: transamerica.com/market-outlook

Investments are subject to market risk, including the loss of principal. Asset classes or investment strategies described may not be appropriate for all investors.

Past performance does not guarantee future results. Indexes are unmanaged and an investor cannot invest directly in an index.

Equities are subject to market risk meaning that stock prices in general may decline over short or extended periods of time.

Fixed income investing is subject to credit rate risk, interest rate risk, and inflation risk. Credit risk is the risk that the issuer of a bond won't meet their payments. Inflation risk is the risk that inflation could outpace a bond's interest income. Interest rate risk is the risk that fluctuations in interest rates will affect the price of a bond. Investing in floating rate loans may be subject to greater volatility and increased risks.

Growth stocks typically are particularly sensitive to market movements and may involve larger price swings because their market prices tend to reflect future expectations. Growth stocks as a group may be out of favor and underperform the overall equity market for a long period of time, for example, while the market favors "value" stocks.

Investments in global/international markets involve risks not associated with U.S. markets, such as currency fluctuations, adverse social and political developments, and the relatively small size and lesser liquidity of some markets. These risks may be greater in emerging markets.

Value investing carries the risk that the market will not recognize a security's intrinsic value for a long time or that an undervalued stock is actually appropriately priced.

The information included in this document should not be construed as investment advice or a recommendation for the purchase or sale of any security. This material contains general information only on investment matters; it should not be considered as a comprehensive statement on any matter and should not be relied upon as such. The information does not take into account any investor's investment objectives, particular needs, or financial situation. The value of any investment may fluctuate. This information has been developed by Transamerica Asset Management, Inc. and may incorporate third-party data, text, images, and other content to be deemed reliable.

Comments and general market-related projections are based on information available at the time of writing and believed to be accurate; are for informational purposes only, are not intended as individual or specific advice, may not represent the opinions of the entire firm, and may not be relied upon for future investing. Investors are advised to consult with their investment professional about their specific financial needs and goals before making any investment decisions.

The 10-Year U.S. Treasury bond is a U.S. Treasury debt obligation that has a maturity of 10 years.

S&P 500® Index: An unmanaged index of 500 common stocks primarily traded on the New York Stock Exchange, weighted by market capitalization.

Transamerica Asset Management, Inc., (TAM) is an SEC-registered investment adviser that provides asset management, fund administration and shareholder services for institutional and retail clients. The funds advised and sponsored by TAM include Transamerica Funds and Transamerica Series Trust. Transamerica Funds and Transamerica Series Trust are distributed by Transamerica Capital, Inc. (TCI), member FINRA. TAM is an indirect wholly owned subsidiary of Aegon N.V., an international life insurance, pension, and asset management company.

1801 California Street, Suite 5200, Denver, CO 80202, USA

2791602R1
© 2023 Transamerica Corporation. All Rights Reserved.