# Despite Rising Rates, Banks Are Down While Stocks and Bonds Are Up

Investment performance in 2023 continues to both surprise us and upend the conventional wisdom.

**Morningstar Inc.**
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"The inevitable never happens," said John Maynard Keynes. "It is the unexpected always." Just as Russia's invasion of Ukraine made few lists of top risks going into 2022, prognosticators missed bank failures as a likely scenario for 2023. This year we've seen runs on financial institutions linked to venture capital and cryptocurrency, as well as the demise of a 167-year-old Swiss bank. That was just in March. While the Federal Reserve and other central banks have continued to hike interest rates to combat inflation, the Morningstar Global Markets Index, a broad gauge of equities, and the Morningstar Global Core Bond Index, have both logged solid gains so far in 2023. [1]

Remember that in 2022, rising rates were blamed for steep losses in both stocks and bonds. Obituaries were written for the 60/40 portfolio, as the two major asset classes exhibited a positive correlation. Within equities, the shares of some of the most profitable, best-positioned companies sank furthest, widely pinned on higher rates taking a heavier toll on growth stocks. Meanwhile, slow-growing dividend-paying stocks held up well, defying the old saw that rising rates make dividends less attractive.

Now, rising rates are being held responsible for bank failures. Aren't higher interest rates supposed to be good for banks? Meanwhile, no one is complaining about a breakdown in asset-class diversification this year because equities and fixed income are simultaneously rising. Investment performance in 2023, like 2022 before it, has both surprised us and upended conventional wisdom.

### Key Takeaways

- Banks may benefit from rising interest rates, but tighter borrowing costs also bring negatives for the financial-services sector. Magnitude matters, and the broader context is key.
- Bonds performed well despite interest-rate hikes in the first quarter of 2023, providing a port in the storm. While asset-class diversification didn't help much in 2022, the fact is that investment correlations are always bouncing around.
- Bank failures have opened up potential opportunities in the financial-services sector, while bonds have a lot going for them.
- Investors should question the conventional wisdom about the forces that move markets, how assets interact, and which investments best suit the macro environment.

1 For a full discussion of index methodology, see https://indexes.morningstar.com/our-indexes/details/morningstar-global-markets-FSUSA0AOJI?tab=overview and https://indexes.morningstar.com/our-indexes/details/morningstar-global-core-bond-FS0000E72H?tab=overview

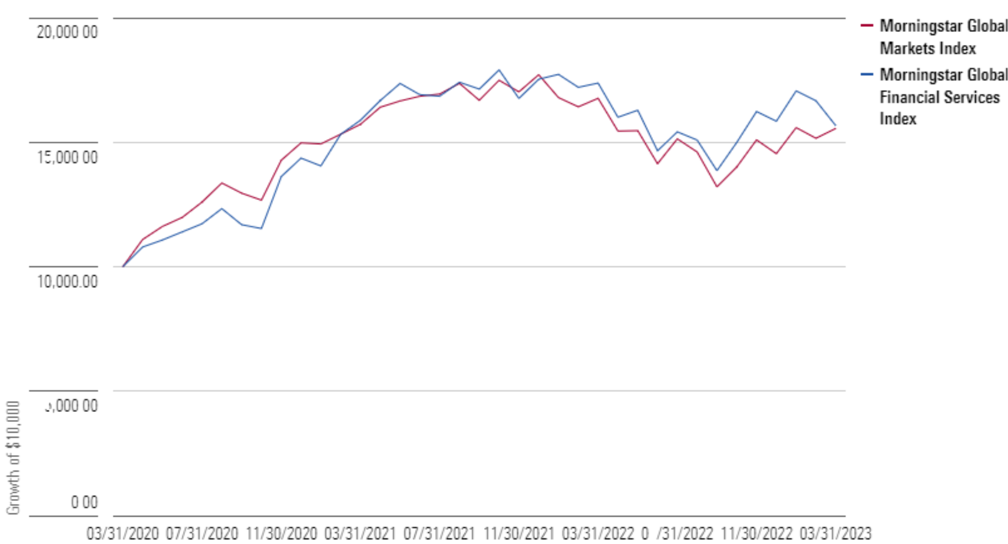
### Aren't Rising Rates Good for Banks?

Investors are often told that banks benefit from higher interest rates. Rising rates increase the spread between what lenders pay on deposits and what they earn on loans. As depositors and borrowers will attest, lending rates not only exceed deposit rates, but they rise more quickly.

Banks are not the only financial institutions that profit when rates rise. "Higher rates are a positive driver of earnings across much of the financials sector, from banks that charge more for loans to insurers that earn more on their investable float," wrote Michael Wong, Morningstar's director of equity research for financial services, in early 2022.[2]

Indeed, the Federal Reserve's seven interest-rate hikes in 2022 were welcomed by banks after years of rock-bottom borrowing costs—first in response to the 2007–09 financial crisis and then the pandemic. Financial-services stocks had trailed sectors like technology and communication services for years, especially when the pandemic accelerated digitization. Tightening monetary policy in 2022 to combat stubbornly high inflation brought a turnaround. The broad global financial-services sector lost considerably less than growth equities. Then in March 2023, a string of bank failures sent the sector down sharply.

**Exhibit 1** The Financial-Services Sector Followed a 2022 Comeback With a March 2023 Swan Dive



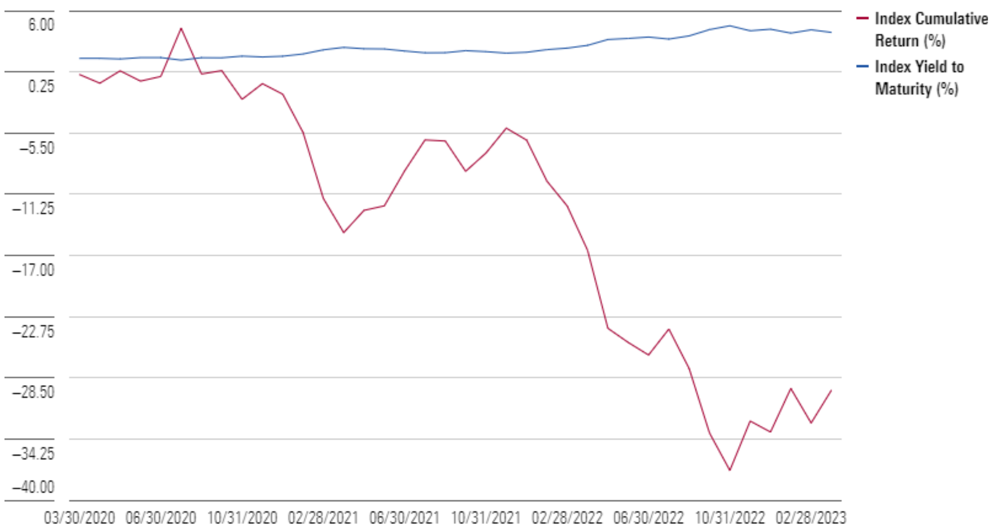

Source: Morningstar Direct. Gross Return, USD index variant displayed.

The first of the dominoes to fall was Silicon Valley Bank, which contributed to a 28% decline for the Morningstar US Regional Banks Index in March 2023 alone. The postmortem is ongoing, but the run on SVB was largely triggered by losses on its book of long-term U.S. Treasuries and agency mortgage-backed securities. The federal-funds rate's increase from the 0.25%–0.50% range at the start of 2022 to

2 Wong, M. "Higher Interest Rates Could Lift Financials Stocks." Morningstar Quarter-End Insights. April 6, 2022. https://www.morningstar.com/articles/1087452/higher-interest-rates-could-lift-financials-stocks

the 4.25%–4.50% range at year's end—the fastest pace of rate hikes in four decades—devastated long-duration bonds. As yields rose, prices of existing bonds tanked. The Morningstar US 10+ Year Composite Treasury and Government-Related Bond Index shed nearly 30% of its value in 2022, as its aggregate yield to maturity jumped from 1.5% in 2020 to 4.3% at the end of 2022.

**Exhibit 2** Morningstar US 10+ Year Treasury and Government-Related Bond Index—Rising Yields and Falling Prices




Source: Morningstar Direct and Morningstar Indexes. Total return, USD index variant displayed.

So, it turns out that the relationship between interest rates and the health of banks and other financial institutions is far more complicated than indicated by the old rule of thumb. Duration risk on bank balance sheets is a critical variable, which is hardly news to regulators. A 2005 report by the FDIC blamed the savings and loan crisis of the 1980s on the steep interest-rate hikes of 1978–82, while also noting that less dramatic rate spikes in 1994 and 2000 did not lead to failures in the financial system.[3]

It's not all about interest rates for banks, either. The 2007–09 crisis, which included the biggest bank failures since the Great Depression, was triggered by subprime mortgage lending and financial products linked to it. Nor can Credit Suisse's demise be pinned on rates, but rather on a loss of confidence in a scandal-prone financial institution.

When it comes to interest rates and banks, magnitude clearly matters. So, too, does the economic backdrop. Morningstar's year-end 2022 sector review was titled "In Financial-Services Sector, Benefits of Higher Interest Rates Must Be Weighed Against Likely Slowing Economy." It noted the recessionary pressures caused by central banks' fight against inflation. The banks will feel the effects of declining corporate capital expenditures, a real estate slowdown, falling private equity activity, and more.

3 Ligon, K. 2005. "A Changing Rate Environment Challenges Bank Interest Rate Risk Management." FDIC. https://www.fdic.gov/regulations/examinations/supervisory/insights/sisum05/sisummer05-article1.pdf

The end of the "free money" era won't be victim free. As we consign to history's dustbin the acronyms ZIRP (zero interest rate policy) and TINA (for "there is no alternative" to equities), bonds, cryptocurrencies, meme stocks, growth equities, and U.K. pension funds have all suffered heavy blows. March 2023 brought bank failures. It's anyone's guess what lies ahead. According to *The Economist*, "The search for portfolios like Silicon Valley Bank's leads investors to Japan." Time will tell.

**Don't Bonds Fall When Rates Rise?**

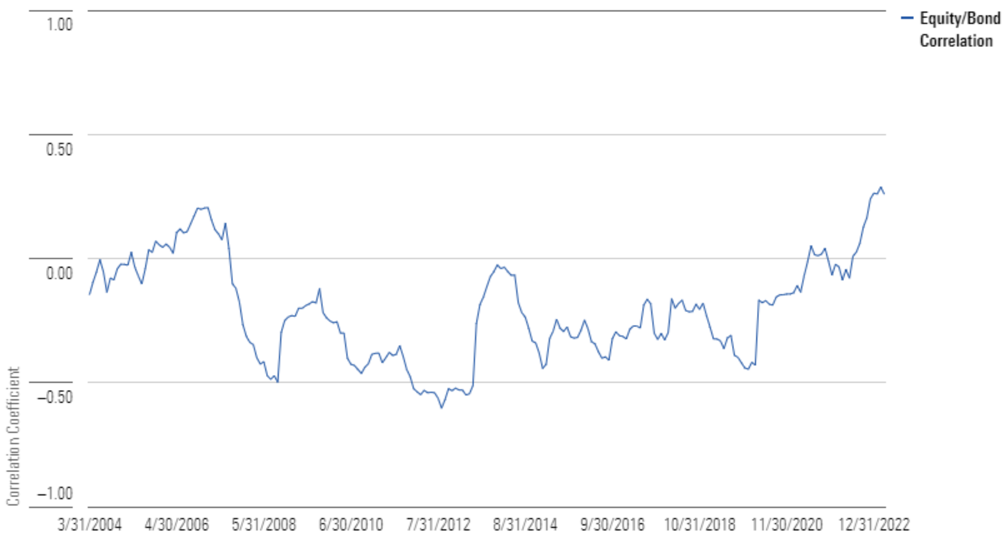
"The Worst Bond Market Ever" declared Morningstar's John Rekenthaler in 2022. Steep interest-rate hikes were kryptonite for all manner of fixed-income securities. The Morningstar US Core Bond Index shed 13% of its value in 2022, and the Global Treasury Bond Index lost nearly 19% in U.S.-dollar terms.

Adding insult to injury in 2022 was that the bond market selloff coincided with an equity rout. In several previous equity bear markets, high-quality bonds provided safe haven. In the worst stretches for equities over the past 20 years—at the onset of the coronavirus pandemic in the first quarter of 2020, the global financial crisis of 2007–09, and the dot-com bubble bursting of 2000 followed by recession and 9/11—the Morningstar Global Core Bond Index actually gained ground.

The Morningstar US Moderate Target Allocation Index, which represents the traditional mix of 60% stocks and 40% bonds, declined more than 15% in 2022, not much better than a pure equities portfolio. Morningstar's range of multi-asset indexes for investors in Australia, Canada, the eurozone, Japan, New Zealand, and the United Kingdom were also down. The "death of the 60/40 portfolio" was proclaimed.

The fact is that asset-class correlations are constantly in flux. No one complains when stocks and bonds climb in lockstep. But when they simultaneously fall, it's a "breakdown of diversification." Over the past 20 years, correlations between stocks and bonds have varied significantly, as seen below. In some 12-month rolling periods over the past 20 years, stocks and bonds have moved in opposite directions (negative correlation coefficients), and at times their correlation has been positive.

**Exhibit 3** Stocks and Bonds Don't Always Move in Opposite Directions

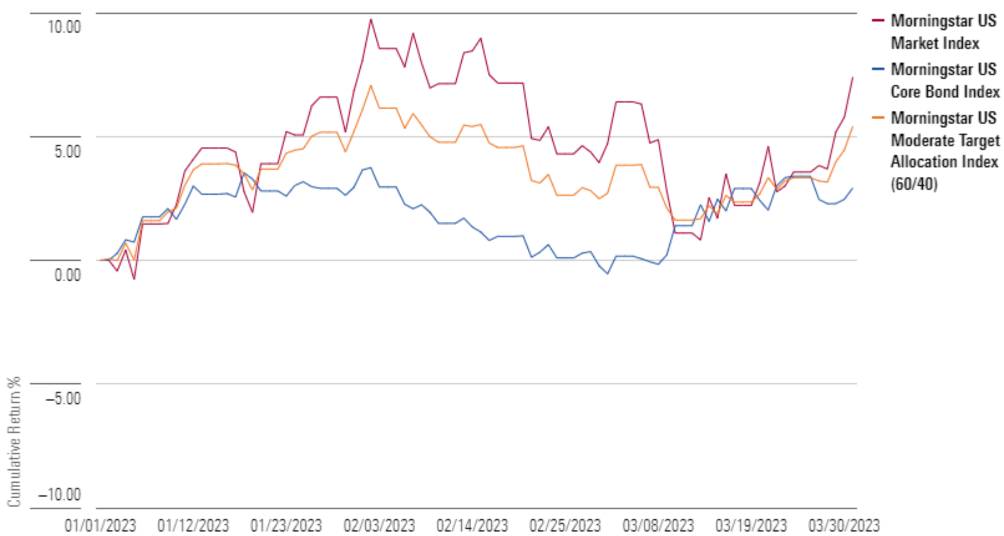



Source: Morningstar Direct. Morningstar US Market Index TR USD Correlation Calculated Against Morningstar US Core Bond Index. TR USD returns displayed. April 1, 2003 to March 31, 2023. Rolling Window: 1 Year. 1 Month Shift.

Fast forward to 2023. With yields having reset dramatically in 2022—the Morningstar Global Core Bond Index's yield to maturity rose from 1.05% at the start of 2022 to 3.3% at year's end—bonds were certainly more appealing to income investors. Optimism that monetary tightening would turn to loosening by year end lifted both equities and bonds in January. February was a down month, with the Fed hiking interest rates and signaling "ongoing increases."

Then came the SVB crisis in early March. Panicked investors flooded into high-quality bonds, driving down yields. On March 13, the yield on the two-year U.S. Treasury bond fell roughly 0.60 percentage points, the largest one-day drop since the 1987 "Black Monday" stock market crash. Even with another Fed interest-rate hike in late March, the Morningstar US Core Bond Index gained 2.6% for the month. Once again, bonds were a port in a storm. Whether they rise in in the next crisis is anyone's guess.

**Exhibit 4** Stocks, Bonds, and a Balanced Portfolio Shook Off Interest-Rate Hikes and Bank Failures in Q1 2023




Source: Morningstar Direct.

### How Much Is Priced in?

Markets are forward-looking. Continued inflation, further financial instability, and a potential recession are all clear negatives, but they're not necessarily reasons to avoid markets. Prices could already reflect bad news. Upside surprises happen.

In a financial sector outlook for the second quarter of 2023, Morningstar's Wong noted that liquidity, solvency, and profitability risks raised by bank failures had driven down prices to such an extent, that more than half the North American financial-services stocks under analyst coverage were trading at discounts to estimated intrinsic business values. Citigroup was cited as one such undervalued company. It shares traded below tangible book value as of early April.

What about fixed income? "The Return of the Bond Market" screamed the title of a Morningstar Investment Management commentary in late March. "Given where yields sit today, it's not unreasonable to believe the worst could be behind us," write the authors, explaining that interest-rate hikes hurt most at the beginning and pointing to the contribution to total return from reinvested bond coupons at their highest levels since 2007. If the fight against inflation results in recession, bonds could benefit. Interest-rate cuts could even follow.

The impact of potential cuts isn't easy to predict, though. We have learned since the start of 2022 that a range of variables is always interacting to drive investment performance. Investors should question the conventional wisdom about the forces that move markets, how assets interact, and which strategies best suit the macro environment.

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