SVB: everything everywhere all at once?

March 2023

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Isolated incident – or a sign of systemic weakness? The US Federal Reserve has responded promptly to the Silicon Valley Bank failure – but it could spell a bumpy road ahead as higher interest rates continue to bite.

Key takeaways

- The US Federal Reserve (Fed) reacted promptly following the collapse of Silicon Valley Bank, a specialist lender to technology companies and start-ups.
- With the creation of a new facility to provide liquidity to banks, the Fed's action should calm nerves in the immediate term, but concerns will persist.
- The banking sector faces headwinds – and higher interest rates could continue to trigger weakness in the economy and volatility for investors.

Last week Silicon Valley Bank (SVB), a bank that specialised in the financing of technology start-ups, came under tremendous difficulties due to massive mark-to-market losses on its portfolios of long-duration bonds, triggering a wave of deposit outflows.

This was followed by high market volatility – especially in the US banking sector – with S&P 500 banks shedding more than 15% over the week.

This event had the potential to destabilise part of the US financial market and trigger further sell-offs – justified or not. This explains why the US Federal Reserve acted promptly this past weekend under the systemic risk exemption, by guaranteeing all the bank's depositors. The Fed also put in place a new facility – the Bank Term Funding Program – to provide an additional source of liquidity against high-quality securities, "eliminating an institution's need to quickly sell those securities in times of stress".

This should reduce substantially the risk of a "domino" banking crisis and a vicious sell-off cycle, as banks should be able to keep their assets on the balance sheet, instead of being forced to sell them on the market and realise losses. This is especially critical in an environment of rising interest rates, as the market value of those assets will remain under pressure if considered mark-to-market.

Canary in the coal mine?

While the latest Fed action should reduce systemic risk and protect against further bank runs, it is unsurprising that the sector is coming under pressure in an environment of quickly rising interest rates and, in particular, an inverted yield curve (where interest rates on long-term bonds drop below short-term lending rates).

Banks' "traditional" business models are based on borrowing at lower rates while lending at higher ones – which is pretty much the opposite of what is currently offered by the market, although they do earn more on their excess reserves.

In this environment, US commercial banks will be especially under pressure, as they have a large exposure to the housing sector. The latter has seen a substantial slowdown in market activity and an uptick in repricing – a trend that should accelerate over the coming quarters.

At the same time, parts of the US economy are starting to suffer in the higher yield regime, triggering more defaults that over time will increasingly affect banks' balance sheets and may necessitate an adjustment of their risk-taking activities. Loan defaults could also accelerate as consumers' indebtedness increases. In conclusion, the SVB incident has highlighted the weakness of the overall banking sector in an environment of an inverted yield curve, although it's worth noting that the current crisis focuses rather on the unwinding of cheap money in the technology and start-up sectors.

Even so, the news that HSBC has stepped in to acquire SVB's UK arm (for a symbolic GBP 1) shows the appetite among other banks to pick up assets cheaply.

Caution ahead

The financial markets should react positively to the Fed's prompt action as it has removed a layer of systemic risk in the banking sector, strongly associated with the Lehman Brothers crisis of 2008.

But one should not be complacent. The new Bank Term Funding Program should allow the Fed to continue to focus on its core target, which is to bring core inflation under control by raising leading rates.

This could trigger further weakness in the economy and a softening of core inflationary pressures, which is the ultimate goal of the Fed, especially considering the latest – strong – labour market data from last week.

This confirms our opinion that we are due for a weaker phase in US equities, especially as valuations remain on the higher side and margins deteriorate.

This outlook supports our recent reduction in US equities in multi-asset portfolios. Given the rising risk of a financial accident – as borne out by the SVB collapse – we were not the only ones to be positioned this way.

After the recent rapid rise in US interest rates, we have reversed our position in US treasuries to a more positive stance – at least tactically. This should be supported by further Fed action to weaken the economy and tighten financial conditions. But investors should note that these actions could fuel another round of moral hazard and misallocation of resources – and caution should be the watch word in the coming period.

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