The collapse of Silicon Valley Bank (SVB) over the weekend, the biggest bank failure in U.S. history after Washington Mutual in 2008, seemingly caught both regulators and markets off guard, and triggered fears of contagion across the global banking sector. In response, on Sunday night (March 12), U.S. policymakers (the Treasury Department, the Federal Reserve, and the Federal Deposit Insurance Corporation) announced emergency measures to shore up the U.S. banking system.

The solvency crisis at SVB

U.S. commercial banks’ profits have been under pressure from deteriorating asset quality, slowing loan growth, and rising deposit rates. As the Federal Reserve hiked rates, SVB’s situation became particularly precarious. Not only was its deposit base predominantly from the struggling technology sector, the nature of many of the clients SVB served (start-up technology and venture capital funds) meant that a high proportion of its clients’ deposits were in excess of the $250,000 threshold guaranteed by the Federal Deposit Insurance Corporation (FDIC).

In that respect, SVB had been behaving no different than any other bank. However, given SVB’s impressive deposit growth during the ultra-low rate environment of the past few years, they had been forced to hold an unusually large proportion of fixed income securities. When the Federal Reserve started pushing rates higher to combat inflation, those securities lost significant value, and as challenged tech companies withdrew their deposits, it forced SVB to mark to market these now underwater fixed income positions. Essentially SVB became obligated to realize losses, and in doing so, triggered a solvency crisis.

Bank unrealized investment gains/losses

FDIC banks’ unrealized gains/losses on investment securities and the 5-year U.S. Treasury yield, 2008–2022

Silicon Valley Bank collapse

Policymaker intervention

While SVB and Signature Bank (a second bank with deep ties to crypto and tech start-ups which was taken over by regulators this weekend) appear to be relatively unique cases given their very concentrated deposit base, both failures threatened a loss of confidence in the financial system. In response, U.S. policymakers stepped in late Sunday to mitigate contagion concerns:

1. The FDIC, Federal Reserve, and Treasury Department announced that all SVB and Signature depositors, including uninsured depositors, will have full access to their money. In doing so, they have signaled that they will guarantee all deposits, which should prop up confidence among depositors across all U.S. banks.

2. The Fed also introduced a new Bank Term Funding Program—a lending facility which will provide additional funding to banks that run into liquidity problems. Essentially, the program offers banks loans of up to one year, taking government-backed bonds as collateral, and valuing those bonds at face value rather than marking them to market.

The big picture

While the specific nature of SVB’s failure has come as a surprise to much of the market, it should not be surprising that the banking system and broader economy are under pressure from the Fed’s rapid withdrawal of liquidity. Every Fed tightening cycle in history has introduced financial strains and, notably, the current Fed hikes cycle has been the most aggressive in 40 years and one of the most aggressive in history. Indeed, with the U.S. Treasury yield curve inverted by over 100 basis points late last week (an incredibly strong recessionary signal), the writing was very much on the wall that problems may be looming.

Until this past weekend, markets had broadly ignored these threats, not reacting to slowing earnings forecasts or growing recession concerns. SVB and Signature Bank’s failures have reminded investors that risk assets simply cannot escape the wrath of monetary tightening. The risk of a banking crisis has finally underscored the tensions between the Fed’s efforts to tame inflation and growing concerns that the policy tightening to date will spark a recession.

A Federal Reserve re-focused

Just under a week ago, a materially more hawkish narrative from Fed Chair Jerome Powell at his Congressional Testimony, had convinced financial markets that the Fed could revert to a 50 basis point hike in March, with many investors beginning to suggest that a 6% Fed funds rate was possible. In light of the SVB crisis, the policy arithmetic for the Federal Reserve may have changed.

While the inflation problem is still very present, the Fed will likely need to put extra focus on the financial stability side of its mandate, taking consideration of the additional pressures a rate hike could put on the financial system. While a rate hike pause could result in a loosening of financial conditions, it would likely be offset by the inevitable tightening in bank lending standards, greater risk aversion, and (now that there is a greater appreciation of the financial stability risks of higher rates) higher rate sensitivity of risk assets. As a result, pausing in March may actually not set the Fed back in its inflation fight.

Once the immediate financial stability concerns have passed, it will be important for the Fed to restart rate hikes. As such, investors should prepare for only a temporary pause in rate hikes, with a peak Fed funds rate of 5.25%-5.5% likely. The risks to this forecast are unusually elevated and further deterioration in the health of the financial system will inevitably reduce the peak rate forecasts.
ASSET ALLOCATION VIEWS

Given the sudden realization of risks, investors ought to ensure their exposures minimize vulnerability to the macro-driven threats. High-quality, defensive assets should be sought out, while diversification will be increasingly important.

Broad U.S. equity markets will likely remain challenged as the twin concerns of risk aversion and economic weakness come to the fore.

- Maintaining exposure to segments which have lower exposure to cyclical sectors and have less stretched valuations will be important, as will focusing on corporates that are able to preserve margins and top line growth via pricing-power.
- Non-U.S. equity markets, particularly ones with greater exposure to the more positive outlook for China’s economy, stand to potentially outperform in this environment.

Within fixed income, U.S. Treasurys and high-quality credit merit portfolio allocation.

- As is already unfolding, bonds are positioned to provide risk mitigation during periods of volatility and risk.
- The negative correlation between stocks and bonds has reasserted itself, and the diversification benefit of fixed income has been restored.
- By contrast, riskier credit segments will likely see fairly significant spread widening over the coming months.

Ultimately, as investors experienced during the COVID crisis, policymaker intervention can be powerful and can completely change the market landscape. Staying invested and waiting for the situation to stabilize, rather than attempting to time an extremely volatile market, remains the best option for reaching portfolio goals.
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Risk considerations
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