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Investment Institute *Asset Class Views*

Banking sector controversy spooks markets

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Key points

- Rising interest rates and increasing number of deposit withdrawals sees SVB fail
- The broader impact of SVB's situation has several dependencies including monetary policy
- The current environment is not comparable to 2008; that was down to credit risk and bank balance sheet weakness
- AXA IM has a more positive view on European banks

Markets have taken a hit in the wake of the failure of Silicon Valley Bank (SVB) with some commentators even drawing comparisons to the events of 2008.

But we do not believe this is an accurate assessment. Fundamentally, SVB had been struggling with the impact of rising interest rates on its bond portfolio as well as an increasing number of technology firms withdrawing deposits following a drop in venture capital investments.

On 8 March, SVB announced it had been forced to sell a large tranche of the bond portfolio at a significant loss of about $1.8bn and needed to raise $2.25bn in capital through selling shares.

This triggered a run on the bank and by 10 March, regulators had intervened to place it in receivership under the US Federal Deposit Insurance Corporation, which usually means liquidating the assets to repay depositors and creditors.

Market impact dependencies

The broader impact of SVB's failure on bond and equity markets depends on three things. First, whether this issue is a localised or systemic one. Second, what the implications are for the way the broader banking system operates and how that may affect economic growth - and third, whether it will impact Federal Reserve (Fed) monetary policy.

The SVB issue was essentially a problem of a mismatch between the duration of assets and liabilities. The bank saw tremendous deposit growth in recent years because of broader liquidity trends (quantitative easing and fiscal stimulus during the pandemic) and specific investment flows into the technology sector, to which SVB had a significant exposure.

The growth in deposits exceeded what was necessary to fund loan growth, so the excess was invested in Treasuries (US government bonds) and mortgage-backed securities. When the technology sector saw weaker demand, companies needed to pull their deposits out of SVB – meaning the bank had to sell these assets. However, as interest rates had gone up, the value of these securities went down.

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As many of the securities held on the balance sheet were in a buy-to-maturity portfolio, they could not be sold without crystallising an investment loss. Other securities were sold at a loss and SVB's losses soon exceeded its capital, forcing insolvency.

Growing deposits

The rise in deposits has been a common feature of the banking system in the US in recent years. However, banks have dealt with this in different ways with most managing their asset and liabilities in a more conservative way (i.e., matching the duration by investing in shorter-dated securities or hedging the interest rate risk of their asset portfolio). As such it is not anticipated that many other banks will confront the same problems as SVB. However, this is a risk given the large number of regional banks in the US and the growth in deposits that resulted from years of quantitative easing. Further banking problems cannot be ruled out, although recent policy initiatives from the Federal authorities should help contain the risks.

A more systemic issue is that of potential deposit flight from banks. As interest rates have gone up so much, depositors are able to get higher yields in Treasury Bills (T-Bills) and money market funds relative to rates paid on deposit accounts. As such, there could be an incentive to take deposits out of banks and invest in T-Bills.

This could stress some regional and smaller banks, making it difficult for them to grow their loan portfolios and thus having an impact on local economies. At the same time, there is pressure on banks to raise the interest rates paid on deposits to prevent deposit flight.

This will reduce net interest margins and bank profitability. Finally, there has already been evidence of deposits being switched from smaller to larger so-called systemically important banks which are subject to more exacting regulatory oversight.

As such, banks may underperform because of pressure on margins, reduced scope for lending and weaker investor confidence in the sector. However, we do not see a systemic risk of a run on the entire banking system when deposits would be withdrawn and held in physical cash, as has typified bank runs in the past. The banking system as a whole is well capitalised, there is flexibility to provide broader deposit insurance and the Fed has many tools to use to provide liquidity to markets.

The broader equity market faces increased risks of economic slowdown and tighter credit conditions. Further downgrades to corporate profit expectations are likely with the banking sector in focus and energy sector earnings unlikely to match those of 2022 given the recent declines in global energy prices. Aggregate earnings per share levels remain above long-term trend levels so the risk remains for further downward adjustments which could result in lower levels for US and other equity markets.

The response of the Federal authorities to make good on deposits and create a loan (repurchase) facility for banks to pledge their securities at par in return for liquidity has probably been enough to underpin confidence in the broader banking sector. However, at the margin these developments are negative for the growth outlook.

Policy response

After almost 500 basis points (bps) of monetary tightening, there is growing evidence of the US economy responding. As a result, stresses in the financial system are not surprising, particularly given the decline in valuation of bond portfolios. If these are used to back up liabilities, then the risk of a liquidity or solvency event increases.

As such, credit spreads in the corporate bond market could widen, reflecting the increased risk and the potential for disruptions to the supply of credit to the corporate sector going forward.

Companies that rely on both debt and bank financing face higher funding costs and reduced availability of bank credit going forward. The more leveraged a company is, the more difficult it may see the financing environment. As such, any widening of credit spreads may impact high yield borrowers more than investment grade.

The Fed moved quickly to deal with SVB and other related situations. It wants to focus on its primary objective of getting inflation down. US inflation remains well above target at 6% in February - and 5.5% for core inflation. As such its preference is to raise interest rates a little more. We expect that the mindset of the European Central Bank is also firmly focused on the inflation fight.

But the market is pricing a 60% chance of a 25bps hike at the Fed's 22 March meeting. This is a much lower level of certainty than the market displayed prior to the SVB event, reflecting the fact that the Fed needs to put more weight on financial stability at this meeting than just on the inflation outlook. On balance we think a hike is still likely and that the peak in interest rates is still likely to be above 5%.

More positive on Europe

European markets have also endured volatility in recent days, with the focus on the banking sector. This was part triggered by what was happening in the US but also by specific concerns about Credit Suisse. Overnight on 16 March, the Swiss National Bank pledged support to the bank.

This has supported confidence that the risk of a near-term disorderly resolution of the bank has been reduced. The future for that particular institution remains unclear. However, we remain positive on European financial institutions in general.

Deposit risk seems less than in the US while bank balance sheets have been more conservatively managed. From both a credit and equity point of view, we have a positive view on European banks and see little risk of contagion from the Credit Suisse situation.

The economic influence

The banking events of the last week are, on balance, negative influences on sentiment towards the economy, towards credit and equities and towards the banking sector. They have highlighted how tightening monetary policy can expose financial weaknesses, with this showing up through the channel of interest rate risk rather than credit risk.

But in 2008, it was all about credit risk and weaknesses on bank balance sheets related to credit impairments.

Today it is about interest rate risk and the cost of servicing debt and the challenges to managing assets and liabilities. Interest rates can be cut more quickly than credit issues can be resolved so we do not see the current situation being anything like 2008.

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