CIO View
CIO Flash

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Marketing material

DWS

The (first?) prominent victim of the 2022 hiking cycle

Will Silicon Valley Bank's bankruptcy spill over into broader markets?

IN A NUTSHELL

– Global central banks' fight against inflation via the sharp rate-hike cycle has claimed its first prominent victims.
– By taking decisive action, U.S. authorities will probably have avoided a systemic crisis.
– Nevertheless, vigilance seems warranted in the markets for the time being.

Why SVB went bankrupt

One week ago, it looked as if the U.S. labor market report and perhaps the appearances of U.S. Federal Reserve (Fed) President Jay Powell would be the dominant topics of the week. But things turned out differently. The difficulties of the "Silicon Valley Bank" SVB triggered a wave of "safe-haven" flows, causing government-bond yields to fall and triggering losses in the stock markets.

The big question, of course, is whether the issues at this one particular Californian institute could be an indication of larger, possibly even systemic, problems. As things stand, shortcomings in maturity transformation are likely to have gotten the bank into trouble[1]. Deposits at SVB more than quadrupled from 2017 through the end of 2021, from $44 billion to $189 billion, while the bank's loan book increased only from $23 billion to $66 billion; instead, client money was increasingly invested in long-dated government and mortgage-backed securities (MBS), which of course lost in market value as yields rose in recent quarters. As clients from the California start-up scene wanted (or needed?) to withdraw their deposits, the bonds had to be liquidated, thus realizing the losses. This reportedly cost SVB $1.8 billion, which the bank wanted to compensate by selling shares. But that plan didn't fly, as a) the stock price tanked, and b) depositors pulled out another $42 billion. A bank run, as they used to call it. The good news is that the losses do not seem to stem from the loan portfolio[2]. On Friday, the U.S. Federal Deposit Insurance Corporation (FDIC) took over at the bank, meaning that retail investors are safe up to $250k, however, 93% of the deposits are not covered by this guarantee.

[1] https://www.economist.com/finance-and-economics/2023/03/10/what-does-silicon-valley-banks-collapse-mean-for-the-financial-system
[2] Mark-to-market losses as a consequence of yield increases are of temporary nature, as all bonds eventually will be paid back at face value at maturity. Losses in the loan book, caused by creditors defaulting on their obligations, typically are permanent.

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U.S. regulators stepping in

On Sunday, U.S. regulators announced that on Monday, all depositors of SVB and Signature Bank, another bank with a high percentage of uninsured deposits and significant exposure to crypto assets that had been declared insolvent and taken over by the FDIC, would be able to access their money.[3]

To shore up the U.S. banking system from wider contagion, the Fed announced an emergency lending facility on Sunday. This new facility, the Bank Term Funding Program (BTFP), will make loans available to lenders against collateral such as U.S. Treasuries, agency debt, mortgage-backed securities and other “qualifying assets” for up to one year. As these assets will be valued at par, the loans are supposed to support banks who would otherwise have to sell those securities at market price (and realize losses) to stem deposit withdrawals.

Spillovers so far contained

Let's take a step back: every Fed rate hike cycle has claimed its victims, from the crash of '87[4] to the Tequila crisis[5], Orange County[6] and so on. This time, markets staying calm was making it much harder for the Fed to slow the economy down and thus to get inflation back under control. "We may need more market unrest aka tighter financial conditions to dampen economic momentum in order to defeat inflation, eventually allowing markets to calm down again", a colleague wrote in an internal memo. Almost looks as if his wishes are being honored. Perhaps SVB makes it into the history books as the prominent victim of the 2022 rate-hike cycle.

The effects of a failed bank are not limited to the bank and its immediate stakeholders but can spill-over into the wider sector and economy, in four steps as we believe. Now that the direct (1st order) effect, SVB bankruptcy and FDIC receivership, is done, the 2nd order effect is the behavior of clients that hold uninsured deposits at other banks, with the main focus likely on U.S. regional banks. Analysts, in turn, will probably scrutinize SVB's peer group in particular to see which institutions might have a similar mix of holdings on the asset side of their balance sheets. The 3rd order effect would be any spill over to vulnerable companies with weak balance sheets, such as those issuing high yield, companies in the startup sector or those related to crypto assets. The 4th order effect – and the last – would be mass liquidations in markets and thus widespread contagion, for example when investors would need to hedge corporate-bond portfolios via equity derivatives for lack of other alternatives.

With Signature Bank, we have seen the first victim of the 2nd order effects. We think that the most important factor will be how U.S. authorities are handling the crisis over the coming days. With the measures announced on Sunday, they have taken the first steps to restore confidence and avoid mass withdrawals of deposits.

In any case, comparisons with the great financial crisis of 2008 do not seem appropriate from today's perspective: The group of vulnerable companies that could potentially be affected is likely too small, compared to the enormous size of the U.S. housing market which had caused huge losses in the financial sector in 2008. Banks, on the other hand, are in a much more solid position in terms of funding than they were before the financial crisis.

[3] Source: Financial Times Ltd, “Federal Reserve announces emergency lending facility to shore up US banks” as of 3/12/23
[4] On October 19, 1987, also referred to as “Black Monday”, stock markets globally crashed in response to a general feeling of overvaluation in markets after a combination of news triggered market participants to start selling.
[5] In 1994, the Mexican peso almost collapsed as a currency peg to the dollar, high amounts of debt issued in U.S. dollars and rising interest rates in the U.S. caused foreign reserves to dwindle
[6] In 1994, Orange County, CA, went bankrupt as risky investments and heavy borrowing led to high losses in the face of rising interest rates

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Asset-class implications

We expect to see markets taking a breather after U.S. regulators' decisive action over the weekend. However, a cautious approach in our view is still warranted given that analysts and economists are still assessing the effects rising interest rates have had on banks, corporates and the economy as a whole.

Fixed Income & Currencies:

We have downgraded our view on U.S. structured finance to neutral as we believe the market will be jittery and in cash-preservation mode for some time. SVB is not a large holder of non-agency structured finance, however they are heavy in agency CMBS and MBS.

We stay neutral on U.S. and euro high yield as spreads have widened significantly while fundamentals remain sound and default rates low.

Looking at government bond markets, the decisive question is whether the recent events might mean that the Fed will now shift down a gear, or at least not increase the pace of rate hikes to 50 basis points. After markets as well as many commentators increasingly pushed the U.S. central bank to re-accelerate the rate-hike cycle, expectations for the further path of the Fed's policy rates were scaled back again. One can assume a somewhat more cautious approach by the central bank, provided that no devastating U.S. February inflation report will be released tomorrow. On balance, we would not expect an abrupt turnaround by the U.S. central bank, given the prevailing inflation risks. Over in Europe, the Governing Council of the European Central Bank is meeting this Thursday. Here as well, we should not see a massive change in direction.

Given that we expect the Fed to be slightly more cautious vs. recent expectations we could see the dollar weakening a bit against the euro but don't expect major moves.

Equities:

We stick to our fundamentally positive assessment of the European banking sector. While the UK government is currently working on measures to support UK tech groups affected by the SVB group's separate UK banking unit[7], we expect spillover effects to European banks to be limited as only 8% of SVB deposits are outside of the U.S. There is a chance, however, that markets will test the authorities' determination in the next days.

Looking at the U.S., the still high yield on 3- to 24-month Treasury bills not only raises alternatives to equities but also for bank deposits, as most still yield lower and are unlikely to go quite as high. Thus, competition among banks for saver deposits will intensify in our view. In this fight, we consider smaller banks as disadvantaged. They offer less services and corporate treasurers might now be looking to take their money elsewhere. In addition, U.S. smaller banks are on average more exposed to the more challenged parts of the economy like commercial real estate and, given their regional focus, they also have higher exposure to the office sector.

Alternatives:

Small banks are important players in real-estate financing and development. Should recent events lead to decreased lending activity in this space, it could lead to lower supply and therefore increase real-estate valuations. On the other hand, if startups were to go out of business this could create more supply of commercial real estate.

Decreased bank lending activity might also provide opportunities for private credit.

[7] Source: Financial Times Ltd,"UK prepares cash lifeline for tech companies hit by Silicon Valley Bank collapse" as of 3/12/23

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Glossary

One basis point equals 1/100 of a percentage point.

Collateral refers to an asset that a lender accepts as a security for a loan.

Commercial mortgage-backed securities are mortgage-backed security backed by commercial mortgages rather than residential real estate.

The euro (EUR) is the common currency of states participating in the Economic and Monetary Union and is the second most held reserve currency in the world after the dollar.

The European Central Bank (ECB) is the central bank for the Eurozone.

A hedge is an investment to reduce the risk of adverse price movements in an asset.

High-yield bonds are issued by below-investment-grade-rated issuers and usually offer a relatively high yield.

Inflation is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

A mortgage-backed security (MBS) is a special type of asset-backed security where the holder receives interest and redemption payments from pooled mortgage debtors, secured by the underlying mortgages.

A safe-haven investment is an investment that is expected to retain or even increase its value in times of market turbulence.

The spread is the difference between the quoted rates of return on two different investments, usually of different credit quality.

Treasuries are fixed-interest U.S. government debt securities with different maturities: Treasury bills (1 year maximum), Treasury notes (2 to 10 years), Treasury bonds (20 to 30 years) and Treasury Inflation Protected Securities (TIPS) (5, 10 and 30 years).

The U.S. dollar (USD) is the official currency of the United States and its overseas territories.

The U.S. Federal Reserve, often referred to as "the Fed," is the central bank of the United States.

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