Macro Update on Market Volatility

March 14, 2023

Macro Updates

The Silicon Valley Bank (SVB) failure could be seen as an accident waiting to happen – something breaking in an unexpectedly tight monetary environment. The same is true of Signature Bank, a smaller commercial bank based in New York. The specifics of SVB shed light on the nature of the general financial risk and, although the policy intervention in the US has probably been decisive enough to stem the systemic risk, the macroeconomic challenge that made it a threat in the first place remains firmly in place. The situation is fluid, and our macro updates may well change with events – especially if investor psychology takes over. We expect this week to be volatile (US CPI data release tomorrow, Fed decision next Wednesday). Look out for further updates as the story evolves.

How did we get here?

To recap: the long period of easy money following the Great Financial Crisis (GFC), followed by the policy response to COVID, when monetary policy was held too loose for too long, generated a flood of money into key sectors, including technology and biotech (venture capital/start-up concentrated). That inflow surged further as COVID signalled a permanent compositional shift in the economy towards tech.

As we see it in the case of SVB, this had enormous, ultimately existential implications for both sides of its balance sheet. On the liabilities side, the deposits of cash-flush tech start-ups grew rapidly, with an increasingly large share exceeding the $250,000 FDIC-insured threshold. On the asset side, its loan portfolio also grew (too) rapidly and, as a result, it chose to invest in (unhedged) government bonds, due to a lack of sufficient opportunities to lend funds elsewhere (i.e., to start-ups flush with VC cash). As tech sector stresses intensified, it was forced to sell these assets as deposits were withdrawn. It was also forced to realise the loss on its bond portfolio when unreported losses began to exceed its capital base.

Realising a large loss ($1.8b) alerted markets to the problem and resulted in a classic bank run – especially amongst those with large uninsured deposits in a relatively small, closely connected tech community. The situation was exacerbated by the fact that SVB, despite being the 16th largest bank in the US, was never subject to the Fed's Liquidity Coverage Ratio (LCR), in which banks are required to hold sufficient liquid assets to fund themselves in a 30-day stress scenario. Put simply, it was not held to the same level of financial stress test requirements of large banks.

SVB was an unusual institution with concentrated deposits held by start-ups and VCs. A combination of poor risk management (no hedging of interest rate risk) and flighty depositors set off Friday's social media-spurred run.

It would be easy to dismiss SVB's business model as the ultimate source of the problem here - and that probably is the main factor. However, risks stemming from banks' large unrealised losses on holdings of fixed income securities are not unique to SVB. The general view is that large banks are relatively well hedged – their bond portfolios are largely swapped out of interest rate risk, and the regulator requires them to hold sufficient 'available for sale' (AFS) bonds to cover a 30-day stress event. What isn't clear is to what extent smaller, regional banks follow the same guidance and that uncertainty could prompt a run. SVB showed that as soon as unhedged Held to Maturity (HTM) securities start to be sold to fund deposit withdrawal, the writing is on the wall. Uncertainty about that issue probably accounts for the volatility we've seen today in key regional banks. And even then, the best interest rate risk management can't prevent a bank failure when there is a deposit run due to lack of confidence.

Policy response:
The policy response has been decisive. [1]

- In the US, the Treasury will make whole all depositors (including those exceeding the $250,000 limit), funding this out of the FDIC.
- The Fed has introduced a new Bank Term Funding Program (BTFP) that will provide 12-month loans, taking collateral valued at par (rather than marked-to-market).
- In the UK, HSBC has agreed to take over the UK subsidiary (for the price of £1), honoring all existing banking services to the tech eco-system.

We think the measures announced on Sunday reduce the incentives to run from smaller, less regulated banks. The measures involve the Fed taking on substantial market risk (via the BTFP), but the systemic threat was felt to be sufficiently large to justify this. Consider the following fact: 1/3 of US deposits are held in small banks and 50% are uninsured. [2]
At a first read, this should be enough to stop contagion from spreading. However, much will depend on psychology and confidence, rather than fundamentals in the coming days. In this respect, the large market moves seen in some of the regional US banks' equities today are not reassuring and could be detrimental to restoring confidence in parts of the financial system.

[1] Federal Reserve Board: https://www.federalreserve.gov/newsevents/pressreleases/monetary20230312a.htm.
[2] Trading View, March 11, 2023. https://www.tradingview.com/news/cointelegraph:345fb1fda094b:0-silicon-valley-bank-failure-could-trigger-run-on-u-s-regional-banks/.

Now what?

The bigger picture story remains. A long period of excessively loose monetary policy threatens institutions whose business models were predicated on this situation persisting. When inflation came along, those institutions were always likely to find their viability under threat, and there may be more of them to come.

In the short run, this will probably prompt the Fed and other central banks to <u>pause</u> on rate hikes, and the tightening of credit conditions could bring forward the downturn necessary to bring inflation back to target. Right now, financial stability likely trumps inflation concerns. However, another possibility is that the pause stabilizes the economy and financial markets. but allows inflation to stay higher for longer. In that case, we could find ourselves in a trickier situation later this year or next, in which monetary stability requires rates to go up, at the risk of uncovering more financial stability issues (these points are illustrated in our new 'Delayed Landing' scenario in Vantage Point Q2). Central bankers have a difficult year ahead, and we will be addressing all these issues in our forthcoming Vantage Point with scenario-based forecasts.

Market implications (US):

Bottom line: Major bond market moves, but broad equity market proving resilient (albeit understandable pockets of weakness), which likely suggests that action from authorities is passing the first market test: maintaining relative calm and avoiding a market freefall.

Equities

- Far more muted volatility in broad equity market so far. **At US close (3/13/23), SPX is down modestly (-0.15%) after trading much lower in pre-market. Market was up +0.5% for much of the day before moving lower near close. <u>This may be a sign that BTFP has contained further immediate risk and broader financial system contagion</u>**. If BTFP is sufficient to ring-fence issues, VC/start-ups will continue to make payroll this week. Business activity will not grind to an abrupt halt.
- That said, acute pain is clear in banking sector indexes, particularly smaller banks captured by the KBW indexes. **<u>Some of these banks still face considerable deposit flight risk despite BTFP backstop, and that's being reflected in their stock prices</u>**. Important to note that SVB depositors were saved but <u>SVB equity holders are likely wiped out</u>. Equity holders in these other smaller banks are rationally concerned.
    - First Republic Bank, Western Alliance – names that were first in line for contagion risk – are down double digits in today's trading.
- S&P 500 Financials are feeling pain, but to a much lesser extent. It's possible some of the weakness there stems for President Biden's comments around increasing bank regulation in the fallout of SVB.

Fixed Income

- Big moves in bond markets, largest drop in UST 2Yr since 1987 (Black Monday), a sign that BTFP has contained further immediate risk.
- The US yield curve shifted much lower, bull steepening aggressively. Curve now sits well below where it was about one month ago (see chart, red solid line is today's curve).
- UST 2yr yield is down ~90 bps over the past week (near ~4% as of 3/13/23).
- UST 10yr yield down ~40 bps to 3.6%. The 2s10s curve is up >60 bps in the past three days (inversion narrowed from ~110 bps to ~40 bps).
- All this seems to pull forward time frame for extending duration risk, long sovereigns on elevated recession risk…YC bull steepening beginning.

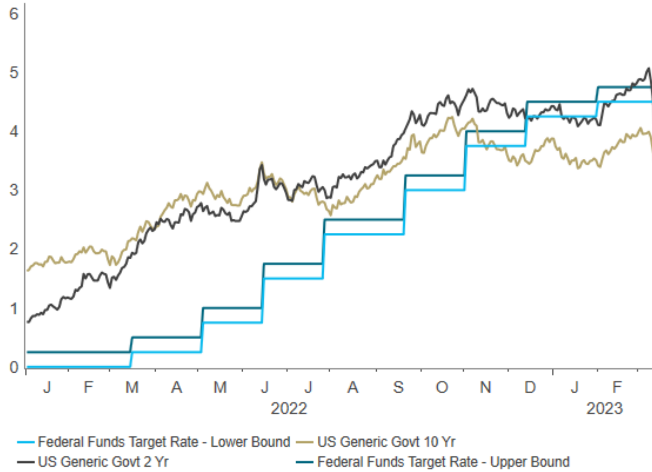
Rates

- Market pricing of Fed Futures has swung wildly for the upcoming March 22nd FOMC decision. Probability of no hike has increased rapidly, jumping over 50% for a brief time. **Near US close, market has stabilized at ~35% probability of no hike and 65% of 25 bps hike.** [3]
- Given elevated stress and rising recession risks, **market is pricing in numerous cuts by year end**. The end of year Fed futures rate plummeted from +5.5% last Thursday to under 4% today (recession risk is up, cut expectations have jumped).
- Is this the financial conditions tightening needed to slow aggregate demand and in turn inflation (few hikes ultimately needed)?
- Or does it set up greater chance of policy mistake? (Delayed landing scenario.)

[3] CME Group: https://www.cmegroup.com/markets/interest-rates/cme-fedwatch-tool.html?redirect=/trading/interest-rates/countdown-to-fomc.html

Key Charts

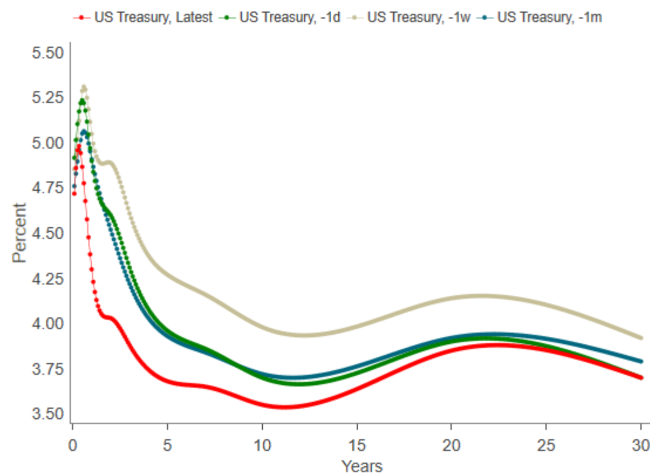
UST Yields and Fed Funds (Upper and Lower Target)



Source: Macrobond, BNY Mellon Investment Management

Data as of Monday, March 13, 2023

US Treasury Yield Curve



Source: Macrobond, BNY Mellon Investment Management
U.S. Department of Treasury
Data as of Monday, March 13, 2023

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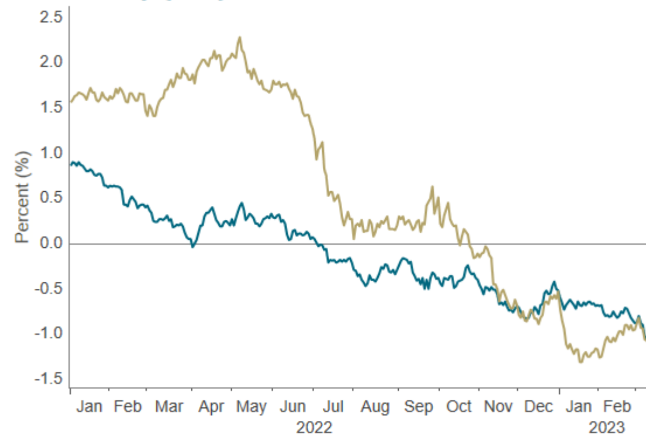
Fed Funds Futures - Rate Expectation for year-end '23

— WIRP Implied Overnight Rate for the US - Futures Model

Source: Macrobond, BNY Mellon Investment Management

Data as of Monday, March 13, 2023

US Treasury (UST) Yield Curves



— UST 10-year / 3-month yield spread — UST 10-year / 2-year yield spread ■ Recessions

Source: Macrobond, BNY Mellon Investment Management
U.S. Department of Treasury, NBER (National Bureau of Economic Research)
Data as of Monday, March 13, 2023

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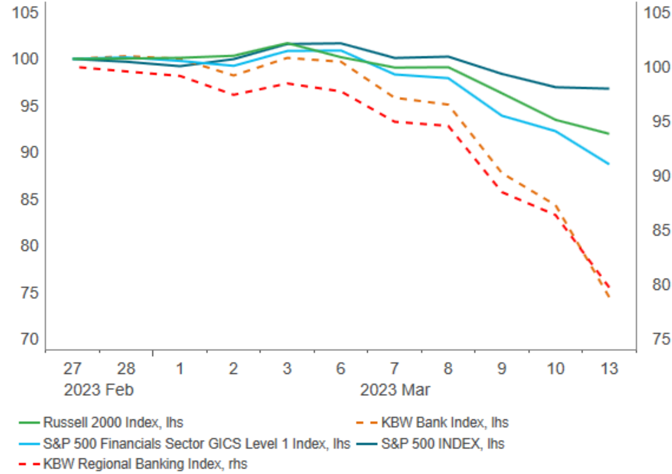
Regional Banks vs. S&P 500 (indexed to 27 Feb 2023)



Source: Macrobond, BNY Mellon Investment Management

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