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FAQ: The market fallout from the collapse of Silicon Valley Bank (SVB)

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At a glance: Frequently Asked Questions

- Why did SVB collapse and how did policymakers respond?
- Is this a new "Lehman" moment?
- What does the breakup of SVB mean for Europe's banks?
- Are central banks backing away from their monetary tightening plans?
- Will the U.S. economy now plunge into recession?
- What to expect for the stock markets in this environment?
- Will risk spreads widen?
- What effects can be expected from Silicon Valley Bank's bankruptcy on the crypto sector?

Why did SVB collapse and how did policymakers respond?

A very specific niche orientation of SVB coupled with astonishing management mistakes led to the collapse of the mid-sized U.S. bank ($212 billion in total assets; net profit in 2022: $1.5 billion). A massive inflow of deposits in the Corona years from, among others, positive refinancing rounds of venture capital-hungry start-ups tripled the SVB deposit volume. Quite predominantly, the latter was invested in safe, but mostly long-dated U.S. government bonds.

The extreme increases in interest rates in recent quarters left start-up entrepreneurs resorting to withdraw deposits in Q1-23 for lack of alternative sources of liquidity. SVB was only able to pay out the deposits through the loss-making sale of longer-dated bond holdings and through a capital increase. Deposits were much less stable than expected - in contrast, management's investment policy was all the more aggressive. A vicious circle was triggered: a lack of trust resulted in ever new withdrawals of deposits, which in turn undermined confidence in SVB's financial viability.

Over the weekend, crisis meetings were held between U.S. President Biden and banking regulators (including the Fed). We welcome the quick decisions: 1) Contrary to the "non-insured" status of a large part of the deposits of SVB's corporate clients, the policy guarantees the full amount of deposits and provides the necessary liquidity on the part of the companies. Bankruptcies of depositing tech companies are thus being avoided, as are job losses in the sector. 2) For many other banks, especially smaller ones, a generous access to liquidity is provided ("Bank Term Funding Program"/BTFP). Institutions can submit at face value their government bonds without (!) need for write-downs as collateral to obtain a one-year loan. Possible unexpected payout requests from customers can thus be met without burdening the company's own core capital.

Is this a new "Lehman" moment?

No. We do not consider the situation to be a new "Lehman" moment. The SVB is too small for that, but above all it is not sufficiently systemic. In our view, interconnections via the interbank market with domestic and foreign banks are limited, so that systemic contagion is unlikely. In addition, the U.S. banking sector is significantly better capitalized compared with 2008: For example, the average Tier 1 ratio for all U.S. banks with total assets >$10 billion was 13.08% at the end of 2022, up from 8.98% in the fall of 2008. Any major valuation losses can also be buffered - especially in the case of the large, systemically important groups (G-SIBs) - simply by temporarily halting the full distribution policy (dividends and share buybacks).

Nevertheless, we expect increased regulatory headwinds in the coming quarters. In our view, banking supervision should increasingly focus on the large number of small, predominantly regionally active institutions with balance sheet totals < USD 20 billion as well as the shadow banking sector. High unrealized losses in securities portfolios are likely to cause further, but smaller, bankruptcies in 2023. Investors' expectations of a positive results driven by net interest income are likely to be revised down due to higher funding costs. We also expect customers to increasingly shift away from non-interest-bearing deposits.

Overall, a flight to quality is likely to further weaken the smaller and medium-sized banks. According to media reports, a considerable number of SVB clients have already transferred deposit holdings in the direction of the major US banks. For the most part, management teams at the major banks expect a "mild recession" in the U.S. in H2-23. If the tighter policy of interest rate hikes were instead to bring about an unexpectedly severe recession, most groups would have to significantly increase risk provisioning.

What does the breakup of SVB mean for Europe's banks?

In our view, the events around SVB does not pose a direct threat to the European banking system. European institutions are generally broadly diversified, have solid equity and liquidity positions, and are not intertwined with the technology or crypto industries. The situation at Silicon

Valley Bank is not comparable to the business activities of the EU institutions. The British subsidiary of Silicon Valley Bank was sold to the solid major bank HSBC for a symbolic price. According to media reports, it is the largest offshoot of the U.S. regional bank in Europe. In Germany, the regulator has imposed a moratorium on the branch, which only has a partial banking license.

In this respect, we do not see any contagion effects at Europe's banks, although the ECB's rapid turnaround in interest rates has also led to negative valuation effects in fixed-income asset portfolios here. However, these assets do not normally carry too much weight on bank balance sheets in this country, and we see satisfactory overall quality in loans. The business environment is certainly challenging in Europe, but the banks are well positioned.

While we consider the fundamental impact of the U.S. bank collapse on local banks to be very limited, there is an indirect, psychological effect on capital market participants. Risk awareness with regard to financials has returned as a result of this event, whether in equities or bonds. The iTraxx Senior Financials reacted correspondingly negatively, while the reaction was weaker for cash bonds. This mood may well persist for the time being.

Are central banks backing away from their monetary tightening plans?

Concerns about broader contagion effects in the financial sector have triggered a massive correction in key interest rate expectations for both the U.S. and the euro area over the past two trading days. In both cases, the expectation regarding the policy rate summit has shifted down by almost 100 bps from the previous week's highs.

On the one hand, we see this strong reaction as part of a technical correction to the previously explosive speculation about interest rate hikes. The latter had been fueled by ever new "hawkish" signals from monetary watchdogs, most recently from Fed Chairman Powell before the U.S. Congress.

On the other hand, market participants are now speculating that the central bankers' rate hike plans could become obsolete. In this respect, we believe they are falling back on the pattern of past crisis events, when monetary authorities were always ready with an easing of monetary policy and an opening of the liquidity floodgates to relieve bottlenecks and, not least, to reassure financial market players.

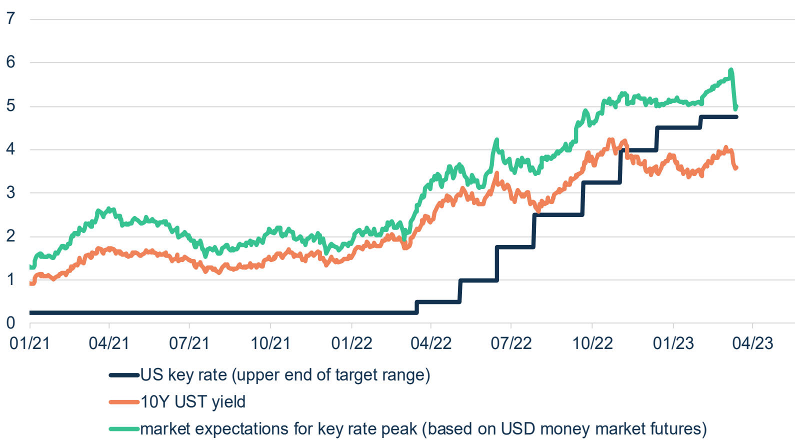
In our view, there is no question that the recent problems in the U.S. banking sector add an additional complication to the already difficult task of central banks to set their monetary policy in times of extremely high macroeconomic uncertainty.

Since the breakup of SVB can be portrayed, at least indirectly, as a consequence of the pronounced and above all very rapid rise in U.S. interest rates, it tends to play into the hands of the monetary policy doves. The latter have recently been only faintly audible in the public debate in both the USA and the euro area. However, their warnings about the dangers of excessive monetary tightening for the economy and financial stability are now gaining weight. At the upcoming Governing Council meeting on March 16 and even more so at the FOMC meeting on March 21/22, the implications of the U.S. bank failures are therefore likely to be an important topic of discussion.

However, we do not currently expect this to translate into a move away from further interest rate hikes. Fed Chairman Powell made it clear just a week ago how important a sufficiently restrictive monetary policy is to curb excessively high inflation. He even opened the door for a 50 bp rate hike. A "major" interest rate hike should now be off the table. Nonetheless, we expect the Fed's monetary policy trade-off to remain in favor of fighting inflation. In our view, this will remain true as long as the U.S. central bankers do not classify the banking turmoil as an expression of an incipient systemic crisis.

In other words: The banking turmoil will be smoothed by means of additional liquidity provision, while monetary policy will be further tightened by means of a 25 bp interest rate hike. For the time being, we are also sticking to our forecast that the US key interest rate (currently: 4.75%) will peak at 5.50%. By contrast, financial market participants have scaled back their "peak expectation" to 5%.

U.S. key interest rate, market expectation for key interest rate summit and yield on 10-year U.S. Treasuries



Sources: Bloomberg, LBBW Research

For the ECB applies: A Lehman-style bank failure followed by a crash on the stock market would certainly be a postponing event for the already firmly announced key rate hike of 50 bps. Nevertheless, so far it looks as if the collapse of Silicon Valley Bank will have only manageable effects on the banking sector in the euro area. Inflation therefore remains the ECB's main focus and a 50 basis point rate hike the most likely outcome of the March 16 Governing Council meeting. The fact that spreads on government bonds issued by EMU member states, especially Italy, have so far reacted only slightly to the turbulence overseas is likely to be helpful in this respect.

Apart from that, the market turbulence is likely to give more weight to those voices in the ECB Governing Council that urged to take a cautious approach rather than committing to a series of rate hikes in advance. The ECB's monetary policy statement at the beginning of the press conference is likely to put into question the 4% "interest rate peak" that the market had considered likely just a short time ago, as the ECB's Monetary Policy Statement again refers more strongly to the data dependency of the next interest rate steps.

Against this background, the wording of the statement is of particular importance this time. We are sticking to our current forecast for the deposit rate (currently 2.50%) of 3.75% until the end of the year. Following a significant downward correction of interest rate expectations, the market currently sees only a rise in key rates to around 3.25% as likely. Meanwhile, the new projections for inflation and GDP growth should more or less confirm the now familiar picture: Inflation will remain well above the ECB's target well into 2025. Tightening monetary policy therefore remains the trump card in the euro area.

Will the U.S. economy now plunge into recession?

The majority of US economic indicators were surprisingly strong at the beginning of this year. There are no signs of weakness on the US labor market in particular. In the wake of this, we recently raised our US growth forecast for the current year from 0.5% to 1.5%.

Nevertheless, the longer-term outlook for the US economy remains gloomy. The index of U.S. leading indicators in January 2023 was around 6% below its value in the same period a year earlier. In the past, such a decline in the index was always followed by a recession. In addition, the spread between the yields of 10-year and 2-year U.S. government bonds has been well into negative territory for several months. This is also a classic recession signal. To make matters worse, U.S. commercial banks have tightened their lending criteria, sometimes in response to the inverted yield curve. It can be surmised that commercial banks will be even more hesitant to extend credit than they have been to date in light of the recent events at SVB. Consumers, in turn, are likely to feel less inclined to make major purchases in view of the declines on the US stock market in recent days.

The Federal Reserve is unlikely to be able to lend a helping hand to the U.S. economy - in contrast to previous phases of capital market turmoil. In view of stubbornly high inflation, we believe the U.S. Federal Reserve has no scope to end its rate hike phase - let alone cut key rates. The Federal Reserve's response to the turmoil has so far been limited to providing a new refinancing facility. In the process, submitted collateral is valued at nominal value. With most long-dated U.S. Treasury bonds trading below par against the backdrop of the interest rate turnaround, this design of the facility should provide additional support for U.S. commercial banks that draw down on the facility.

As a result, the latest development confirms our view that the US economy will slide into recession towards the end of this year. However, we do not consider the effect of the turbulence surrounding SVB to be so serious as to warrant a further downgrade of our already low US growth forecast for next year. We therefore maintain our forecast that the US economy will stagnate on average in 2024.

What to expect for the stock markets in this environment?

For a long time, European equities held their own against disruptive fire from the US. This has now changed with the insolvency of SVB. The U.S. stock market trended weakly, and around the globe the other stock markets followed suit. After the brilliant start to the year, "risk-off" is now the order of the day. Among the biggest losers were naturally banks, which until recently had been at the top of investors' buy lists because they were profiting from the turnaround in interest rates. Where do we go from here?

First, let's look at the equity asset class as a whole: The rally since October last year, which continued at the beginning of 2023, had a number of triggers: The end of the zero-covid policy in China, the non-materialization of the feared gas shortage, and the much better than expected economic development, especially in Germany. In the U.S., too, the economy was very robust. Investors had priced in a goldilocks "best case", according to which a soft landing could be pulled off with a simultaneous decline in inflation.

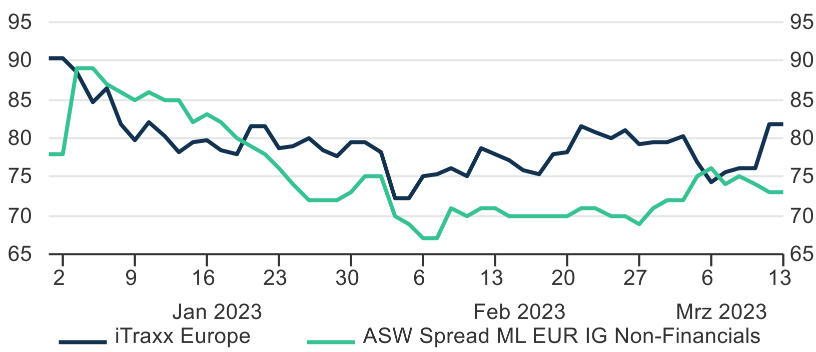
This hitherto hopeful view is now being scrutinized more thoroughly. For example, the U.S. economy could slip into recession with a time lag (2024), and inflation seems more stubborn than hoped. After the recent consolidation, the U.S. market is still valued at a P/E ratio of about 17 based on 12-month forward earnings, which remains above the long-term average. This leaves little room for disappointment. While we do not assume that the SVP resolution is a "Lehman 2.0" moment, the risks still outweigh the benefits in the short term. This applies to both valuation and further earnings development, where the risk of downward revisions has increased. We therefore remain cautious with regard to further developments on the stock markets. The choppy waters are likely to persist in the coming months.

Now to the industry assessment: In our opinion, two aspects have been added after the recent turmoil surrounding SVB’s demise. On the one hand, growth stocks are now likely to be viewed more critically again following the good start to the year. On the other hand, risk premiums for bank shares are likely to rise, i.e. the valuation ratios of banking groups will come under pressure. This sector was the "most crowded trade" in Bank of America's monthly fund manager survey in February. European banks have also been among our favorites in our sector allocation recommendation so far. Since being included in our sector favorites in September 2022, the Stoxx Europe 600 Banks index has gained 23%. Based on aggregate consensus estimates (12-month forward), banking stocks are still favorably valued with a P/E ratio of just under 8. Nevertheless, the opportunity-risk profile has clouded over. We therefore downgrade the sector to "neutral".

Will risk spreads widen?

The credit markets were also unable to escape the strong reaction on the global capital markets. From a low level, spreads widened. The increases were mainly concentrated in the credit derivatives area and less in cash bonds. This pattern is not uncommon. Due to low liquidity in corporate bonds, investors usually shy away from direct sales in the first instance and initially resort to hedging. Accordingly, large-volume portfolio shifts are generally only made in anticipation of a longer-term trend reversal.

iTraxx Europe vs. EUR Investment-Grade Asset Swap Spread (in bp.)



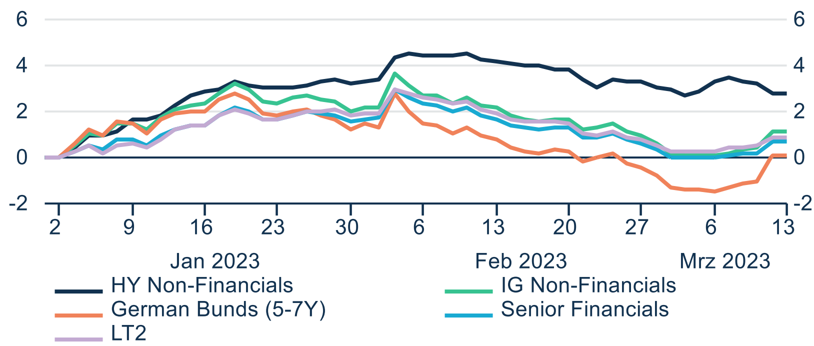
Source: Refinitiv, LBBW Research

The recent spread widening should be seen against the backdrop of the month-long rally that occurred earlier. At the low spread levels reached, a lot of positives had been priced in. The collapse of SVB was the trigger for a renewed risk aversion. In our publication "Bond Weekly", we had repeatedly pointed out that a widening of risk premiums was likely in the short term. Accordingly, our forecasts implied a widening of spreads in the first half of the year.

Negative repercussions could also occur in the short term for new issues. In uncertain market phases, activity on the primary market typically decreases - not only due to a lack of willingness to buy, but often also because issuers want to wait for a calmer market phase. The start to the year on the primary market was very strong. Many companies took advantage of the available window and covered their financing needs. In previous years, too, the majority of companies did their "homework" and geared their financing predominantly to the long term. Apart from individual cases, a temporary weakness on the primary market thus appears to be easily tolerable.

When looking at the total returns of the asset class, we consider that there are currently opposing effects. Although the increase in spreads weighed on performance, the parallel general decline in yields largely compensated for this. In the investment grade segment, the latter driver even prevailed recently, with the result that yields declined. The total return thus increased despite the widening of spreads (see chart below). While this does not protect against possible future losses in the event of a continued escalation on the capital markets, there should not be much selling pressure at present, at least on the valuation side.

Total return of various fixed income classes (in %)



Source: Refinitiv, LBBW Research

Outlook: The recent turbulence could still have an impact in the short term - volatility is likely to remain elevated for the time being. After a long phase of declining spreads, a consolidation phase could now be in the offing. However, we do not see this as a sustained trend reversal to a prolonged phase of sharply rising risk premiums. A systemic crisis is not our baseline scenario. Rather, we expect a return to calmer waters as the year progresses.

Then the positive aspects of a credit investment will come to the fore again. Leading indicators are currently signaling that the impending recession is likely to be much milder than expected just a few months ago. The increase in default rates should therefore be contained. In our opinion, the expected defaults are more than compensated for at the current spread levels. The rise in risk premiums should therefore only be of a temporary nature.

What effects can be expected from SVB's bankruptcy on the crypto sector?

The crypto sector had to deal with plenty of negative shocks last year. Not only did the bankruptcy of the important crypto exchange FTX draw negative cascading effects with further bankruptcies, but it also permanently damaged the image of the sector, especially among institutional investors. Most recently, an important bank for the sector - Silvergate - had to pull out of the race. Silvergate had grown from an obscure, small bank into a major player for the crypto sector. Silvergate, through its banking license, served as one of the important gateways for funds from the traditional financial sector into the crypto sector. Now the crypto sector is taking another hit with the collapse of SVB. Namely, the important provider of the stablecoin USDC, Circle, was prominently hit.

Stablecoins are cryptocurrencies backed by secure assets. Collateralization decreases the volatility of the cryptocurrency. Through this, stablecoins can be used as payment media in the blockchain-based decentralized finance sector. However, stablecoins also serve as a quasi-medium for players in the DeFi sector to "safely park" funds.

The two main stablecoin providers are Circle and Tether. Tether is a notoriously opaque provider and has attracted negative regulatory attention several times in the past. The Circle provider, on the other hand, tried to meet all regulatory requirements clearly and cleanly in the past. Specifically, Circle claimed that its stablecoin was 100% backed by USD-based assets. Bad luck now that it turns out Circle had about $3 billion of about $40 billion in reserves for USDC sitting in accounts at SVB. SVB served Circle as one of six banks managing the 25% cash portion of the Stablecoin USDC reserves.

Accordingly, Circle's stablecoin USDC lost its peg to the USD and turned out to be quite unstable after all. This should give the regulator ammunition once again to strictly regulate stablecoins.

Interestingly, there have been no further dislocations in the crypto market so far. Perhaps no wonder. This is because the sector has already had to contend with an extremely large amount of negative news and events in recent months. Bad news is business as normal.

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