

Asset Management

US banking worries and impacts

Investment event | 13 March 2023



US bank failures

Financial market volatility has picked up amid the announcement that Silicon Valley Bank (SVB) has failed, which is the biggest bank failure since the Global Financial Crisis (GFC). Another technology focussed bank – Signature – has also been closed by regulators.

“An idiosyncratic event”

Recent events are a reminder that there are financial stability risks associated with aggressive monetary policy tightening. The Federal Open Market Committee (FOMC) has raised interest rates by 450 basis points in just one year (Figure 1) and has reduced its balance sheet by USD626bn since the peak in April 2022.

The current situation also risks a crisis of confidence in the wider banking sector which can exacerbate funding conditions for many lenders.

Nevertheless, there are a number of reasons why we believe this is an idiosyncratic event rather than a harbinger of another 2008 type financial crisis:

- SVB and Signature were highly dependent on customers in the technology and venture capital sector which has experienced a significant slowdown in recent months
- SVB’s assets were invested in long-term securities making the bank’s financial health particularly vulnerable to higher interest rates
- SVB’s clients were primarily businesses with large deposits and thus would typically expect a higher deposit rate, hitting bank profitability

Significant immediate policy response

The policy response to these bank failures has also been impressive and minimises contagion risk to the wider US banking system:

- The Federal Reserve, US Treasury and Federal Deposit Insurance Corporation have announced that **all depositors will have access to their money**, funded by a levy on the wider banking system. This significantly reduces the risk of further bank runs
- The Fed has introduced the **Bank Term Funding Program (BTFP)**, making USD25bn of loans available to ensure “banks have the ability to meet the needs of all their depositors”.

US banking sector in good shape overall

It is also worth noting that the wider US banking system remains in good shape. According to the Federal Reserve, as of Q2 2022, the aggregate common equity tier 1 ratio (CET1)—a regulatory risk-based measure of bank capital adequacy—stood close to the post GFC average.

Meanwhile, large banks continue to maintain levels of high-quality liquid assets that implies redemptions can be met during periods of stress, while reliance on short-term wholesale funding remains low. The Fed also point out that the digital assets ecosystem has limited connections with the broader financial system.

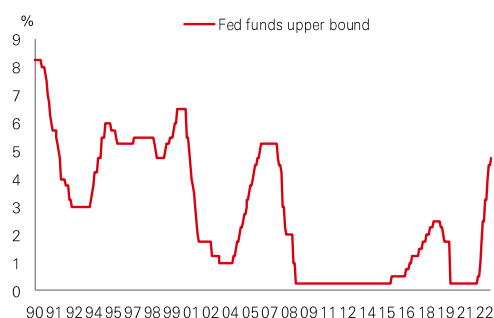
Market implications

Recent developments highlight the risks of rapid policy tightening following a long period of very low rates. As the Fed breaks inflation it also runs the risk of breaking parts of the economy and financial markets, with housing and other more leveraged sectors vulnerable. Unregulated portions of the cryptocurrency market are also exposed to financial stability risks, reflected in recent sector developments such as the collapse of FTX and Silvergate.

But **we believe comparisons to 2008-09 are wide of the mark**. Rather, our central scenario reflects a more traditional monetary policy induced downturn, such as the early 90s recession. This involves tightening of credit conditions, contributing to a profits recession and a GDP drawdown of 1-2%. We would also expect the economy to recover more rapidly rather than experience a prolonged slump as was seen in the period post-GFC. Importantly, policy makers have learned some important lessons and fiscal austerity is unlikely to make a return.

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Figure 1: Fed funds rate



Source: Bloomberg, as at 13 March 2023

The failure of Silicon Valley and Signature Banks is a reminder that there are financial stability risks associated with aggressive monetary policy tightening

But we believe comparisons to 2008-09 are wide of the mark. Rather, our central scenario looks to the early 90s economic downturn as a more relevant historical comparison

We continue to see a choppy market environment in the first half of the year before cooling inflation and less hawkish central banks sets the stage for a period of better market performance

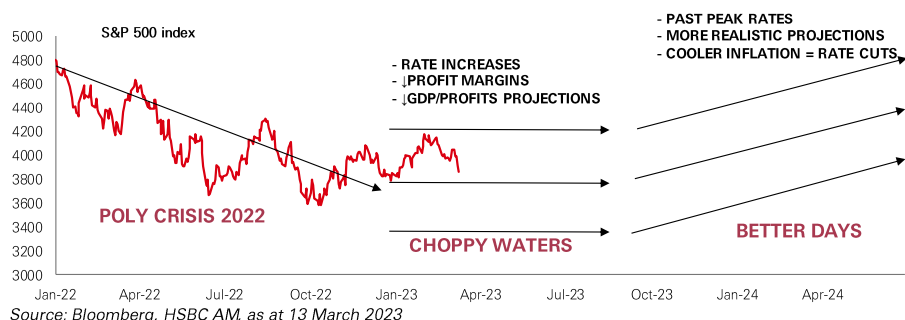
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For markets, we continue to expect a **choppy environment** in the first half of the year as the FOMC continues its battle against high inflation (Figure 2).

Figure 2: HSBC AM investment strategy playbook



In particular, profit margins and corporate earnings are likely to come under further pressure amid diminishing pricing power and stubbornly-high wage bills. We see downside risks to analyst earnings per share (EPS) projections, especially for 2024 (Figure 3).

Positively, however, fragile investor sentiment may induce the Fed to back off from another 50bp jumbo hike at its upcoming policy meeting on 22 March.

Indeed, markets have recently priced-out a significant degree of policy tightening this year on the back of recent events, and as data released last week showed an unexpected pickup in the US unemployment rate (Figure 4).

Barring a further significant deterioration of market conditions, we think there is a reasonable chance that the Fed will push ahead with another 25bp rate hike later this month. This is because US economic data remains very robust and there are signs of sticky underlying inflation. February CPI inflation data released on 14 March will be an important determining factor. **Our central scenario is for Fed funds to peak around 5.5%.**

Later in 2023, we see **'better days ahead'** - markets will be able to move past peak rates and have more realistic GDP and profits projections. Importantly, we also expect cooler inflation amid a mild economic recession to result in outright rate cuts around the turn of the year.

Unchanged House View

Recent events have not led us to change our overall House View. Higher interest rates, inverted yield curves, and our concerns that the macro news flow will be disappointing relative to what investors expect encourage us to view **short duration fixed income as the natural asset class for allocators at this point in the cycle. We take a defensive view.**

Over the last decade, we had ultra-low interest rates and QE-infinity, investors lived by the mantra of 'TINA' - there is no alternative (to stocks). But with policy hikes, TINA is no more. Instead, we have higher interest rates and 'CINDY' (= corporate indexes now deliver yield). High quality, shorter duration FI delivers a good coupon - even if spreads are compact - and is an attractive income option for investors.

Meanwhile emerging markets are in a "parallel world" amid global economic divergence. The headwinds for EMs in 2022 have become tailwinds in 2023, notably China's rapid and successful reopening and a downward trend on the US dollar. We are enthusiastic about the EM asset class which benefits from better macro dynamics, cautious investor positioning, cheap valuations, and the prospect of Fed rate cuts. After a decade of 'US exceptionalism' amid low rates and QE infinity, there is potential for a multi-year phase of outperformance from EMs in this new economic regime.

Figure 3: MSCI USA earnings per share forecast

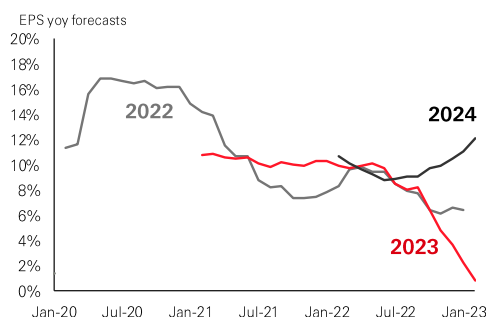
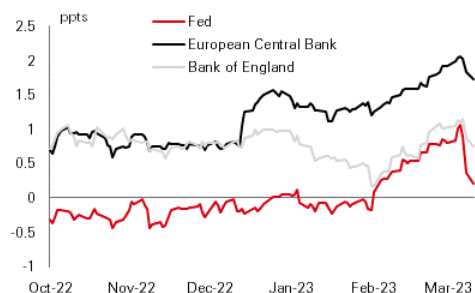


Figure 4: Pricing of additional rate hikes in 2023



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