

Asset Management

Crisis of confidence

Investment event | 17 March 2023

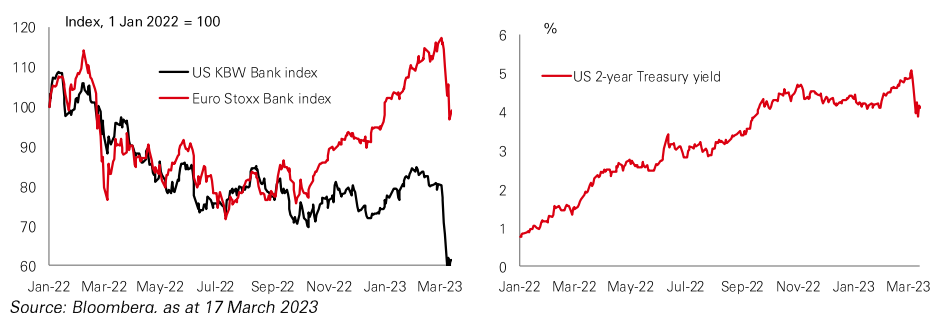


Nervous investors

Following the collapse of Silicon Valley Bank (SVB) last weekend, investor confidence has remained fragile all week. Concerns about the solvency of US regional banks, unrealised losses on 'hold-to-maturity' bond books at other global banks, and fears for Credit Suisse, have intensified investor worries about the stability of the US and European banking systems.

Consequently, while the SVB story looked like a highly-idiosyncratic event earlier in the week, the contagion in equity markets (see figure 1) marks a new test of the banking system, policy makers' resolve, and investors' risk appetite. Bond yields have fallen sharply (figure 2), due to flight-to-safety flows and as analysts re-assess the near-term direction for interest rates.

Figures 1 and 2: Bank stock performance, and US 2-year Treasury yields



Policy to the rescue

The high-speed bank run on SVB was met with equally rapid policy action to support bank liquidity.

The US Federal Reserve (Fed) has introduced the Bank Term Funding Program (BTFP), facilitating a ready-made 'discount window' for banks with USD25bn of loans available, and accepting eligible collateral at par value. Indeed, data this week shows heavy usage of the discount window, increasing by USD148.3bn in the five days ending Wednesday 15 March, while lenders also borrowed USD11.9bn from the BTFP.

Meanwhile, in Europe, the Swiss National Bank (SNB) has provided a liquidity backstop for Credit Suisse. These measures, criticised by many economists as bailouts, have been very important in providing some stability and limiting potential spill overs to other banks and financial firms.

A manageable situation

This week's events are a stark reminder of the financial stability implications of rapid monetary policy tightening following many years of low interest rates. The situation remains uncertain and is very fluid. And with Credit Suisse, a global systemically important bank (GSIB), now embroiled in the developing market narrative, events have clearly escalated.

Nevertheless, we would make the following observations:

- History suggests that this episode will be limited. So far, the areas of concern appear idiosyncratic, rather than correlated. And policy action has been rapid and decisive.
- Recent moves in bank stocks have been violent, but we should remember that European banks rallied strongly in January and February. Even after this week's sell-off, the sector still shows positive year-to-date returns.
- Measures of financial market stress remain mild. Unlike in 2008, banks have not lost the confidence to lend to each other. Corporate credit spreads sit in their recent trading range. FX market signals show limited evidence of US dollar shortages. And broad stock market volatility has risen, but not spiked. Only bond market volatility is unusually elevated.
- The fundamental health of banks is better than in 2008. This follows years of more stringent regulation and rising capital ratios. Data suggests that, for the vast majority of banks, unrealised losses sitting on bank balance sheets is a small proportion of bank capital.

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This week's events are a stark reminder of the financial stability implications of rapid monetary policy tightening following many years of low interest rates

The situation is moving very fast and remains uncertain

The fundamental health of the global banking system is significantly better than in 2008

Authorities have also shown their agility in responding to events at high-speed

We do not think we are at the beginning of a renewed financial crisis

We continue to expect a choppy environment in investment markets over the next 6-12 months. Our house view is for a defensive asset allocation

SVB was a significant outlier in this respect. For the GSIBs, securities held on balance sheets are regularly marked-to-market and stress-tested against regulatory capital requirements.

- Policymakers also have a toolkit to establish more measures to support confidence. For example, there is scope for deposit insurance guidelines to be revised, and regulations to be tightened, in particular for smaller US banks (which may include stress tests as well as higher capital and liquidity requirements). This would likely reduce the risk of bank runs.
- The other option is for collective action within the sector to support smaller, more vulnerable players. This is already underway in the case of First Republic with large US banks depositing USD30bn to bolster its finances. Such a strategy is reminiscent of 1998 when Wall Street banded together to support failing hedge fund Long-Term Capital Management (LTCM).

Special focus on Credit Suisse

As mentioned above, Credit Suisse is a GSIB, and is now at the centre of investor concerns around the European banking sector.

In the near term, the SNB’s liquidity injection into Credit Suisse seems to be sufficient to address potential outflows of deposits, eases the immediate pressures on the bank and buys time. But in the longer-term, investors will expect the bank to stabilise its business model. It is even possible that stabilisation can only be achieved with a new owner, as has been reported by the global media.

What happens next? Our base case assumption is that there is **no asset quality problem at Credit Suisse** in light of last year’s deleveraging process. That would mean that **available resources are sufficient to protect most creditors**.

But things could become more complex for credit investors depending on restructuring charges and changes to the business model (e.g. some non-core businesses may not be sold but put into a wind-down entity). In this case there is significant uncertainty about the potential scenarios and recovery rates. In all scenarios, we believe the hierarchy of credit seniority will be respected.

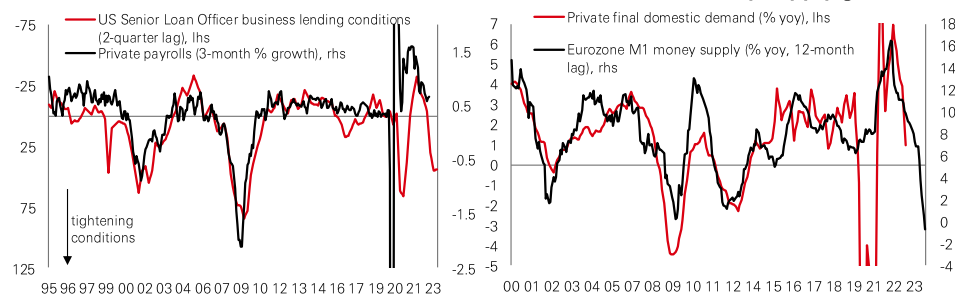
Importantly, what the SNB action shows us is that it is still in the interest of the regulator to find an orderly solution. The SNB has essentially delivered its own version of former European Central Bank (ECB) President Mario Draghi’s “whatever it takes” intervention. But clearly, as active credit investors, we cannot exclude the scenario in which more junior creditors are impacted.

Investment implications

The fundamental health of the global banking system is significantly better than in 2008, and concerns over solvency have been overdone. Authorities have also shown their agility in responding to events, with liquidity provision a key tool in helping manage bank functioning. **Recent market developments, therefore, are not the beginning of a renewed financial crisis, but rather reflect the rapidity at which monetary policy has been tightened over the past year.**

Nevertheless, challenges remain. Investor confidence remains fragile and there is the risk that pockets of the banking sector remain vulnerable to deposit flight and tighter funding conditions. Further bouts of volatility cannot be ruled out.

Figures 3 and 4: US bank lending conditions and jobs, Eurozone money supply growth



Source: Macrobond, as at 17 March 2023

What’s more, headwinds to bank profitability from potentially higher funding costs, a push to boost liquidity provision, and increased provisions against bad loans point to tighter lending standards and a reduction in new loan issuance. This adds to macroeconomic headwinds stemming from higher interest rates. Even before this week’s event, US banks were tightening lending conditions (figure 3).

The equivalent data in Europe shows the same pattern of tighter money and credit supply, which does not augur well for future GDP trends (figure 4).

There had also been some speculation in financial markets that fragile investor sentiment may induce central banks to ease the pace of monetary policy tightening at upcoming meetings (*the pivot*). This is reflected in the significant repricing of interest rate expectations for 2023 (figure 5).

Indeed, market pricing just prior to the ECB meeting on 16 March was consistent with a 25bp rate hike, rather than the 50bp expected last week.

Nevertheless, the ECB pushed ahead with 50bp citing ongoing concerns over inflation, although did not pre-commit to any further tightening. This suggests central bankers retain a strong commitment to getting inflation back to target, despite concerns over financial stability. The ECB, like many other central banks believe those concerns should be addressed with other policy tools.

This implies the possibility that the repricing of near-term interest rate expectations has gone too far, especially if investor sentiment recovers over the coming days. Investors might even experience a *double-pivot*, in which policy makers wait for things to calm down, before resuming hikes amid persistent inflation.

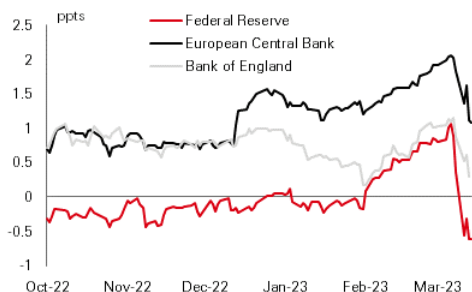
All eyes will now be on the Fed's next policy decision on 22 March. Consensus is coalescing around a 25bp rate hike, rather than the 50bp that the market assumed as recently as last week. A 25bp hike is in line with our own view. And we expect Fed policy to peak in a 5-5.5% range.

Our scenario assumes that **limited tightening continues in the near term, driven by central bankers' inflation concerns. Ultimately, we believe central bankers will then have to ease policy by more than markets currently expect in late 2023 and 2024, as recessions bite.**

For investment markets, we continue to expect a choppy environment over the coming months (figure 6). There is significant uncertainty about the 6-12-month outlook; the combination of noisy economic news and data-dependent policy makers seems to guarantee further market volatility.

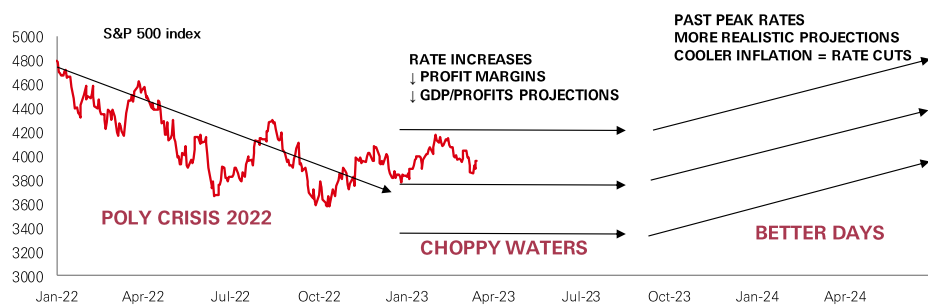
Inflation will come down significantly during 2023, but there are question marks over how fast this process plays-out. And amid the fastest interest rate hiking cycle since the 1980s, the risk of recession is very high. Crucially, we don't expect a severe recession. Strong private sector balance sheets, and no return to the fiscal austerity of the 2010s, point to a more average-looking recession scenario ahead.

Figure 5: Pricing of policy rate changes in 2023



Source: Bloomberg, as at 17 March 2023

Figure 6: Investment playbook



Source: Bloomberg, HSBC AM as at 17 March 2023

Our house view remains for a **defensive asset allocation** at this juncture. We think short-duration fixed income is the natural asset class to own. And we also favour a high-quality bias in credits, taking advantage of an **active, selective approach, with in-depth credit research.**

We remain cautiously positioned on developed equity markets, which face the twin risks of a required re-pricing for a higher interest rate world and a profits recession. However, **emerging markets remain appealing** due to a combination of lower valuations, cautious investor positioning, China's rapid and successful re-opening, and the prospect of Fed cuts. In particular, Asia finds itself in a 'parallel world', far removed from the recession and persistent inflation mix in the West.

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