On to the Next Crisis: Glimpsing a Post-SVB World

The collapse of Silicon Valley Bank has rocked the banking sector and left financial markets wary. What can we expect moving forward?

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In a matter of days, the cumulative effect of US Federal Reserve (Fed) policy tightening has hit the US banking sector hard, beginning with the collapse of Silicon Valley Bank (SVB) on March 10.

Panicked depositors in several banks have since rushed to the exits, setting off a liquidity crisis and leaving some banks' capital positions in precarious shape. The Fed and the US Treasury have taken swift steps to help stabilize the banking system by providing liquidity and assuring impacted depositors that they will be made whole. This past weekend, they unveiled several new facilities designed to ease the liquidity crunch and to prevent further bank runs.

However, growing investor concerns are sweeping financial markets. While safe-haven assets have benefited, Fed rate-hike expectations have been all but extinguished, government bond yields are lower and credit spreads[1] wider, and the US dollar (USD) has strengthened. Meanwhile, global equities are down, and small-cap stocks are the biggest laggards so far.

The situation is evolving rapidly, as are the potential economic and market implications. Here are some key points from Wellington's latest discussions, highlighted by a common theme that there's now a greater probability of a US recession in the near term. Many of us also think investors should consider pivoting to a risk-management mode that favors higher-quality assets.

- **A liquidity crunch is what got us here:** The fragile liquidity conditions that started as a bank run on SVB have spread to other regional US banks, especially those most dependent on customer deposits. The dynamic basically involves a mismatch between a bank's assets and its liabilities: Depositors demand their money back (short-term liabilities), forcing the bank to sell securities from its investment portfolio (long-term assets) at large losses (due to the 300 basis-point[2] (bps) spike in interest rates over the past two years).
- **Liquidity issues can turn into capital issues:** Large unrealized losses in some banks' securities portfolios could be a more widespread problem. These losses have fed into the banks' concerns around having sufficient capital to continue operating normally. Therefore, I expect robust capital-raising efforts to be undertaken as a next step toward fortifying the US banking industry. Considering the size of banks' portfolios and the likely losses caused by rising rates, I estimate that a manageable $50-$100 billion of capital will be needed.
- **Many banks' net-interest margins and profitability may be pinched:** Banks' cost of doing business will rise in the period ahead, due to increasingly tighter financial conditions and as a direct result of the banks having to raise their customers' deposit rates. Therefore, I suspect that many banks' net-interest margins will inevitably narrow,

Key Points

- Following the collapse of Silicon Valley Bank, panicked depositors in several banks rushed to the exits, setting off a liquidity crisis and leaving some banks' capital positions in precarious shape.
- Further issues resulting from the crisis could include unrealized capital losses, bank-profitability risks, tighter lending conditions, and a greater probability of a near-term US recession.
- The US banking system is generally strong, especially the large, well-capitalized banks, and US regulation is designed to deal with commercial bank failures. I believe the Fed and Treasury will respond decisively to avoid a worst-case outcome.

as will their profitability in all likelihood. This could be a particularly troublesome issue for the continued viability of smaller, more vulnerable banks that generally have only regional access to customer deposits.

- **There may be spillover to broader credit conditions:** Since the banking system is at the heart of credit transmission, the challenges facing many banks are likely to have spillover effects, including creating even tighter lending conditions (which had already tightened meaningfully with the Fed's rate-hiking campaign). A tighter lending environment, in turn, could impact the volume of lending that actually takes place. This is a cyclical risk that could impair the US economy and further increases the odds of a recession.
- **The Fed is likely to respond as needed:** Tighter credit conditions tend to be disinflationary, leaving the Fed room to ease up on the size and pace of its rate hikes. I'm reasonably confident that the Fed will prioritize stimulating growth over fighting inflation if the current banking crisis risks destabilizing the financial system. Markets are currently pricing in one 25-bps rate hike, followed by nearly 75 bps of policy easing by year end. However, markets may be disappointed if liquidity-generating measures can contain the damage from recent events.
- **What about the rest of the world?** There are clearly different dynamics at play from one global region to another. For example, China's economy seems fairly well-insulated from current US woes, with its economy (and other Asian economies) benefiting from its recent reopening. Europe and Japan may also improve relative to the US, especially if the USD loses some of its luster and the Fed becomes less hawkish. These outcomes will depend, importantly, on whether US liquidity worsens further and restrains global growth.

Final Thoughts

The speed and magnitude of the Fed's about-face from easy to tight monetary policy was bound to expose firms caught on the wrong side of rising rates. That's precisely what's happening here, and with the broader financial system now caught up in the turmoil, systemic risks should not be taken lightly. However, the US banking system is generally strong, especially the large, well-capitalized banks, and US regulation is designed to deal with commercial bank failures. I believe the Fed and Treasury will respond decisively to avoid a worst-case outcome.

My Base Case and Investment Implications

In the near term, I think risk-off dynamics could dominate and less-risky assets could outperform. Financials and other sectors tied to the economic cycle could struggle the most. I also expect large-cap stocks to outperform smaller-cap stocks and growth-style equities to outperform value in the short term. China and other Asian markets tied to China's recovery are apt to outperform the US and Europe, in my view.

Longer term, I see investment opportunities. Notably, I think quality assets may still be rewarded over time—for example, large money-center banks that have ample capital and have been subject to stricter regulation than smaller banks. In addition, some high-quality US fixed-income assets may offer relatively attractive yields and total-return potential if the economy softens. In terms of risks, if the Fed's additional liquidity succeeds in averting a full-blown financial crisis but fans the flames of inflation, the Fed may need further rate hikes down the line. This is another reason I suggest favoring quality.

Bottom line: Until this all subsides, proceed cautiously, and be prepared to consider the "higher for longer" investment playbook for inflation and rates in your long game.

Talk to your financial professional about how you can help position your portfolio for potential market volatility.

[1] Spreads are the difference in yields between two fixed-income securities with the same maturity, but originating from different investment sectors.

[2] A basis point is a unit that is equal to 1/100th of 1% and is used to denote the change in a financial instrument. The basis point is commonly used for calculating changes in interest rates, equity indices and the yield of a fixed-income security.

Important Risks: Investing involves risk, including the possible loss of principal. • Fixed income security risks include credit, liquidity, call, duration, and interest-rate risk. As interest rates rise, bond prices generally fall. • Small-cap securities can have greater risks and volatility than large-cap securities. • Foreign investments may be more volatile and less liquid than US investments and are subject to the risk of currency fluctuations and adverse political, economic and regulatory developments. These risks may be greater, and include additional risks, for investments in emerging markets. • Investments focused in specific sectors may be subject to increased volatility and risk of loss if adverse developments occur. • Different investment styles may go in and out of favor, which may cause an investment to underperform the broader stock market.

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