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A Crisis of Free Money

Fixed Income Macro View

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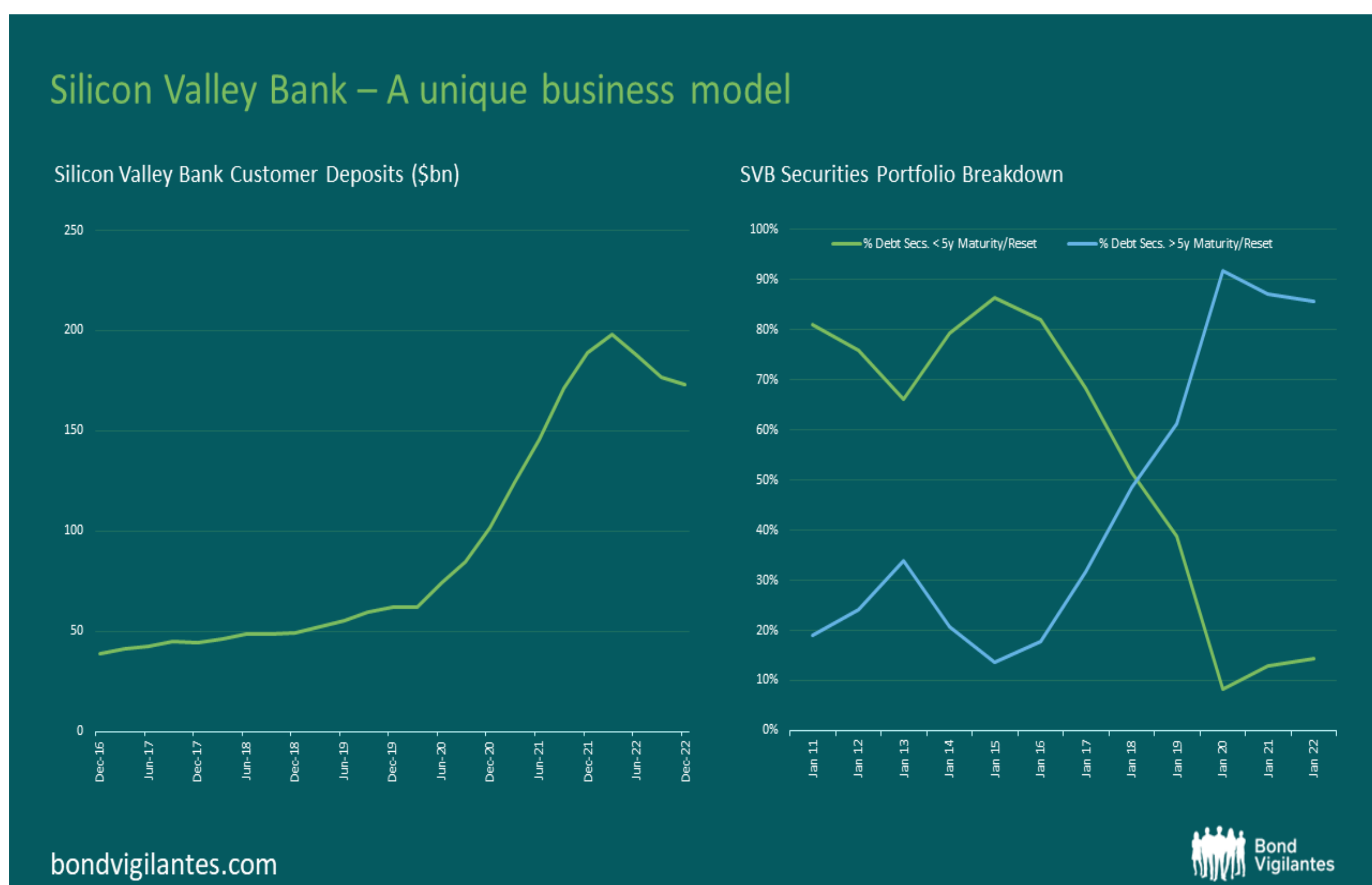
Free Money Fallout

While the collapse of Silicon Valley Bank (SVB) has all of the hallmarks of a classic banking crisis, the fact of the matter is it had more to do with an excess of free money. From the perspective of both the bank's management and its clients, cheap money and avarice combined to result in the second largest bank failure in US history.

Absence of Risk Management

The most pressing issue for the banks' risk management team was how to manage the spectacular growth in deposits that flowed from the firm's core client base (PE/VC firms) on the back of the extraordinary COVID-era stimulus. The flows were simply too strong to be deployed in the form of loans and needed to be invested in other qualifying assets e.g. Treasuries. While banks' risk officers recommended short-dated securities (yielding zero at the time), management decided to improve margins by buying riskier longer dated Treasury securities. The sharp increase in Treasury yields that ensued (mostly throughout 2022) on an unhedged portfolio was enough to cause a significant mark-to-market loss.



Source: M&G Bond Vigilantes

Deteriorating Environment for Clients

Under peak zero rate and QE policies, combined with the explosion of Covid related stimulus, capital came flooding into PE/VC companies and their underlying startups. As SVB was their most supportive bank in this space they unhesitatingly deposited large amounts of uninsured cash. This was until 2022 when rising rates started to bite and capital flows slowed. As a result, clients began drawing down on their deposit holdings. The bank lost 13% of total deposits ($25bln) in 2022 and a further $8bln in January and February of 2023.

Coup de Grace

To facilitate the deposit outflows, SVB had to sell their aforementioned qualifying assets (long dated securities) realising a loss of over $1bln dollars in the process. This exposed a serious problem, namely the losses on a mark to market bases would wipe out the bank's equity. Once an asset raise was announced, the clients got spooked and tried to withdraw assets (deposits), with over $40billion exiting last Friday. That marked the end.

What is the Wider Impact on the Banking Sector?

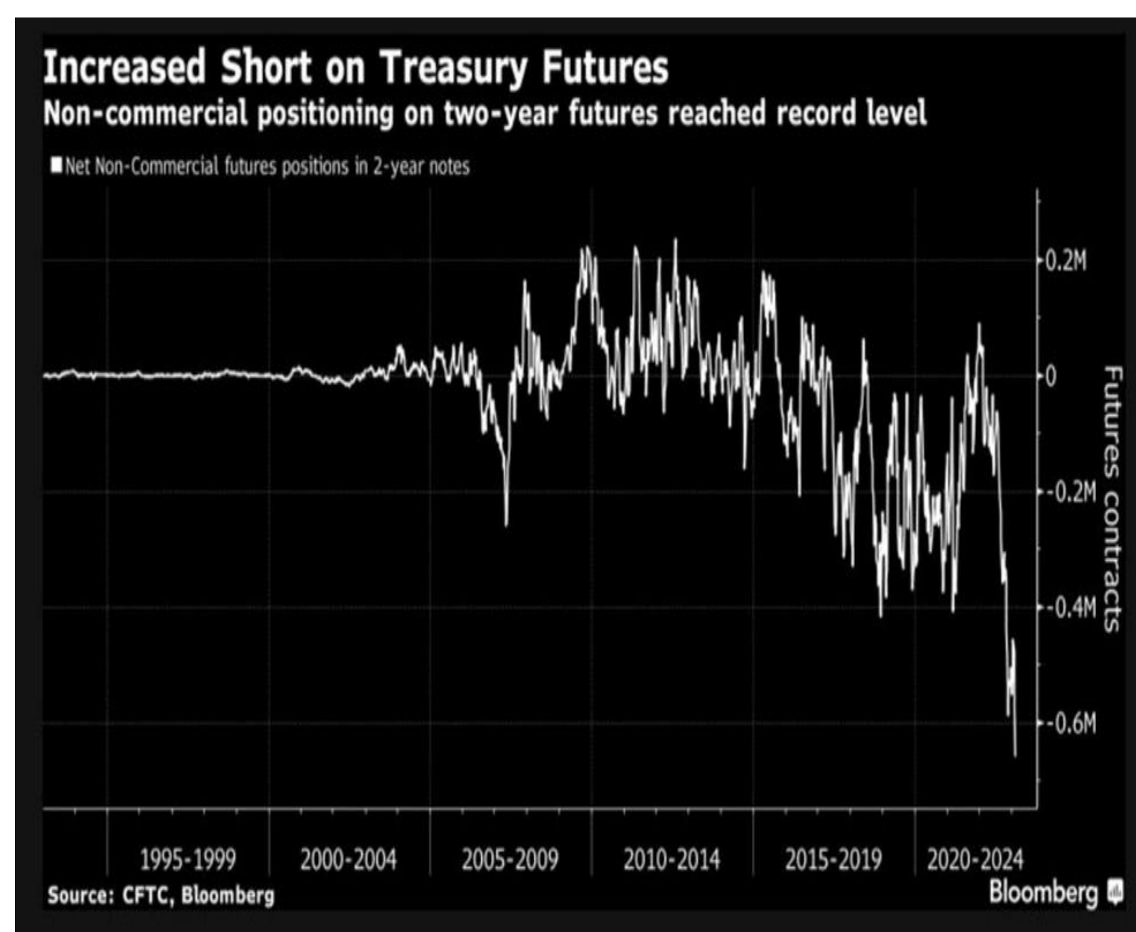
While we have seen other speciality regional banks like First Republic come under renewed pressure over the last 24 hours, larger national banks with a large diversified client base may end up benefiting from the growth in their deposit base, as smaller less regulated banks come under more stress. Large European banks for example would not have the same problem with respect to having such a concentrated deposit base - both in terms of the number of depositors and the lack of industry diversification. More broadly, management of the overall asset liability mix is typically far better aligned in the larger entities while access to Central Bank liquidity operations (e.g. Reverse Repo) should negate the need to suffer outsized losses on asset disposals. From a Net Interest Margin perspective, there will likely be increased pressure on banks (both market related and in some cases political) to pass on a higher proportion of interest rate rises to depositors which can potentially start eating into what was a very profitable area for them. This however is more likely to be source of equity related volatility as opposed to impacting the credit side of the equation.

Will the Crisis End the Rate Hikes?

Directly this crisis should not change the minds of Central Banks in their fight against inflation. Indirectly however, this episode will tighten financial conditions for critical elements of the economy, over and above what higher rates have already achieved. For sure the Central Banks will continue to watch the data closely (even though it is somewhat backward looking). The Fed has been explicit for some time in signalling their intent to go to 5.25% on Fed Funds and we don't think they will pull back from this target just yet. However, this event has demonstrated that after years of cheap money, a sudden "turning off of the taps" will have consequences particularly in those areas which flourished most from the extraordinary levels of stimulus (e.g. VC/PE).

Why was the Price Action in the Bond Market so Violent?

Market volatility has been increasing for a number of years now. The largely forgotten moves in Nov/Dec 2018 for example represented the fastest 20% drop in equities from the high on record. Today we continue to make new records and Monday's bond moves were no different. Their were two reasons for this (1) Markets were aggressively short US Treasuries and the early moves caused a significant unwind into a bid only market (2) Muscle memory from 2008. Many of us have memories of how big crises can grow out of a number of smaller events. From a longer term perspective this is a clear indication that rate hikes are having an impact.



Source: Bloomberg

Where do we go from Here?

The authorities acted decisively in stepping in to protect the depositors - but not the bond or equity holders. While some have called this a bailout, it is not 2008 and no bank investors (excluding depositors) were given anything. This has certainly ended any 'Goldilocks' narrative for now. While lower rates have been a boon for risk assets, yesterday they were not. If could well be that markets are moving towards the fear gauge and away from greed. That shift in itself can have its own ramification for market price action going forward.

Portfolio Positioning

The Rubrics Funds have had no exposure to any regional US banks. As has been the case for a number of years, bank exposure across our Funds has been concentrated in the large European Money Centre institutions. While there has been an increase in volatility since last Thursday, this has thus far been felt far more on the rates side than in credit. From a portfolio management perspective much of the focus of the past 12 months has been on positioning our portfolios for a more difficult economic environment. As Treasury yields rose throughout 2022, this involved reallocating cash from maturing bond proceeds into short dated government securities to varying degrees across our portfolios. As a result we have greatly increased the liquidity profile of the funds as well as overall credit quality, while yields continue to offer attractive return potential.

	Global Credit UCITS Fund (GCF)	Global Fixed Income UCITS Fund (GFI)	Emerging Markets Fixed Income UCITS Fund (EMF)
Liquid Govt plus Cash%	37%	70%	25%
Credit %	63%	27%	0%
FX%	0%	3%	75%
Avg Duration	2.2	3.2	1.2
Avg Yield	6.0	4.5	6.2
Avg Credit Rating	A	AA	AA

Source: Rubrics AM as at 13/03/2023

IMPORTANT INFORMATION

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