3/13/2023

# Special Coverage:
# US emergency backstop to contain SVB contagion risk

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HSBC

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## Key takeaways

- SVB (Silicon Valley Bank) rattled the US financial sector and global markets last week. The US Federal Reserve, Treasury Department and Federal Deposit Insurance Corporation (FDIC) jointly announced emergency measures on Sunday night to backstop banks and assure depositors in the latest move to contain contagion from the collapse of SVB. We view SVB's failure as an idiosyncratic rather than a systemic event.
- In the short term, we expect continued volatility in US equities and credit and hence we stress our focus on quality. We think the backstop provided by the Fed for banks should be helpful to restore public confidence in the banking system. While tech VC may face more headwinds than before, we maintain a neutral view on IT and focus on established cash-generative industry leaders. As for financials, some banks may raise deposit rates, which could weigh on profitability but net interest margins are very healthy, causing us to keep a neutral view on the sector.

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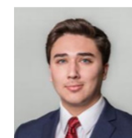

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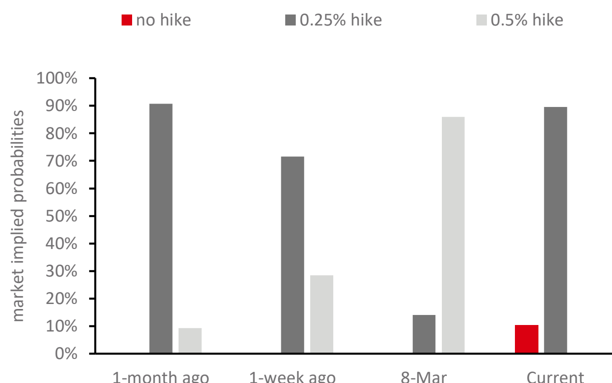
- For fixed income investors, the increased level of uncertainty may direct the Fed to a 0.25% hike (as per our view) rather than 0.5% in March. The volatility and increased unemployment have moved the markets' view of the peak rate from 5.69% to 5.1%, close to our 5.25%-5.5% forecast. We continue to overweight global investment grade and stay invested in senior and Basel III Tier 2 financials bonds. The US dollar should continue to consolidate.

## What happened?

- The US financial sector rattled markets last week. The collapse of the highly US technology and Venture Capital (VC) focused lender was due to the withdrawal of deposits by its clients, which forced SVB to sell Treasuries and other assets at a loss.
- The US Federal Reserve, Treasury Department and Federal Deposit Insurance Corporation (FDIC) jointly announced emergency measures on Sunday night to backstop banks and assure depositors in the latest move to contain contagion from the fallout of SVB. In a joint statement issued by Fed Chair Jerome Powell, Treasury Secretary Janet Yellen and FDIC Chair Martin Gruenberg, the central bank will create a new Bank Term Funding Programme (BTFP) aimed at safeguarding institutions impacted by the collapse of SVB last Friday. The new Fed facility will offer loans of up to one year to banks, saving associations, credit unions and other institutions which can pledge Treasury notes, agency debt and MBS as collaterals.
- FDIC said all insured and uninsured depositors at both SVB and Signature Bank in New York, both were shut down by regulators into receivership, will have full access to their deposits. The Treasury Department will provide up to USD25bn from its Exchange Stabilisation Fund as a backstop for the funding programme. The Fed will ease conditions at its discount window, which will use the same conditions as the BTFP. On Sunday night, US regulators shut down Signature Bank, the second largest lender in the crypto industry after Silvergate, citing systemic risk. Silvergate has announced its impending liquidation last week. The latest slew of fallouts of technology-related banks, from Silvergate, SVB to Signature Bank, have created further uncertainty and volatility in global financial markets.

- A few months ago, the digital markets sent shock waves through the global financial system as one of the largest exchanges in the world filed for bankruptcy. This most recent shock is in the banking sector. The second largest bank collapse in US history unfolded quickly last week. Some of the strains on the bank were due to its lending practices, which were more skewed to venture funding than traditional banking.
- In addition, the institution maintained a very heavy concentration (79% of loans) in the technology business in its loan portfolios, which has struggled with the rapid rise in interest rates in the US. As a result, the issues which created this failure appear largely idiosyncratic due to the nature of the bank's business model and funding profile and do not point to systemic risk for the US banking industry as a whole.

**While Powell's testimony raised the risk of a 0.5% hike, the market thinks a 0.25% hike is now much more likely, following SVB and labour market data**




Source: CME Group, HSBC Global Private Banking, as at 13 March 2023.

- While most of SVB's loans were technology and VC-related, most US regional and big banks have a much better diversified loan portfolio, across commercial, real estate, credit card and mortgage businesses. Moreover, most US banks have very healthy liquidity coverage ratios, and their capital ratios are well above minimum requirements. In the latest stress test report from the Fed, all of the 34 banks tested maintained their Tier I capital ratios, despite the harsh scenarios created. It is worth noting that delinquencies on loan portfolios are very low currently, in sharp contrast to 2008.
- The February US employment report was stronger than consensus forecast of 215,000 jobs, adding 311,000 jobs from the prior month. However, including downward revisions to the prior two months, the level of employment only rose by 277,000 jobs in February. This was about half the pace of job creation we saw in January. Average hourly earnings rose a solid 0.2%, or 4.6% from last February, which suggests that personal income and consumer spending should remain healthy in February.
- Overall, there were several signs of weakness in the US labour markets in February. Significantly, the unemployment rate rose to 3.6% last month, which was above the 3.4% consensus forecast. This occurred because in February 419,000 people joined the labour force, but 58% of them were unemployed as they searched but could not find a job immediately. There were also signs of economic weakness as hours worked and overtime hours declined in most industries. The immediate market reaction was to lower the Fed peak rate from 5.69% to 5.1%. Treasuries benefited, and their move was further exacerbated by the risk-off tone triggered by SVB.

## Investment implications

- After Fed Chair Powell's comments last week, the odds of a 0.5% rate hike at the 21-22 March FOMC meeting rose dramatically. However, the rise in February unemployment rate, combined with the issue of financial liquidity and the risk of a funding crisis in the US banking system may be enough to force the Fed to consider the lagged effects of raising policy rates so aggressively. These factors could prevent the FOMC from re-accelerating the pace of monetary policy tightening in March. We believe the Fed will raise the federal funds rate by 0.25% at the March FOMC meeting, followed by further 0.25% rate hikes in both May and June. This would take the Fed funds rate to an upper bound of 5.5%.
- For equity investors, in the short term, we continue to expect further consolidation for US equities. In addition, continued earnings downgrades and further lack of clarity on the timing of the Fed pause, should continue to drive market volatility higher. However, US equity investors should remain optimistic for the prospects of returns in US equity markets in the long term. This is especially true given the potential for better earnings growth beginning in the second half of this year and into 2024. We continue to focus on quality as slowing

economic growth, higher interest rates, and potentially tighter margins may soon separate strong balance sheets from the rest.  This applies to the aggregate market, but especially to technology and financials given the news. Once the Fed pause comes into sharper focus, we can then begin to look ahead and recalibrate upwards US equity valuations given the better prospects for economic growth and earnings as we head towards 2024.

- For fixed income investors, given the increasing levels of uncertainty surrounding the rapid rate hikes and their effects on balance sheets and the overall economy, the Fed may move more cautiously.  This could mean the peak in rates may be near, so locking in higher long rates might makes sense which is why we recently extended duration recently to 5-7 years.  As a result of the weakness in economic activity that could occur this year we continue to focus on investment grade credit markets.  This is valid in both developed and emerging markets. It is clear that the SVB-related shock is an additional argument to stick to quality.
- The US dollar should continue to consolidate. The fall in rate expectations weighed on USD last week, but on the other hand, USD benefits from a safe haven bid. We expect further USD downside to occur when the economic downturn is further advanced and global risk appetite bounces.

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