

Weekly Market Flash

The trade-off between inflation and stability

March 12, 2023

This week began with macro themes between economic data and Federal Reserve (Fed) Chair Jerome Powell's (hawkish) Senate testimony—but as the days passed, the financial events related to the collapse of Silicon Valley Bank (SVB) took over. It resulted in an intense week for financial markets, which saw significant losses erase almost all the gains across the world's major stock indices (with the exception of Europe) since the start of the year. The MSCI World index lost 3.8% during the week, which means that it is up only 2.49% year-to-date. Among the indexes, the DJ Industrial and Honk Kong are already in negative territory (-3% and -2%, respectively), much to the relief of the China economic reopening.

Highlights

- SVB was subject to a bank run this week, which forced it to liquidate USD21 billion in bonds in which it had invested its liquidity—realizing a loss of USD1.8 billion. Over the course of 48 hours, SVB tried to increase its capital with a sale of its own shares and a loan totaling USD1.8 billion, but the operation failed.
- Circle, one of the largest stablecoin operators, has announced that USD3.3 billion of the USD40 billion reserves are trapped in SVB. As a result, Circle's USDC crypto token lost its peg to the dollar, dealing a further blow to the crypto market, which is still recovering from last year's confidence crisis.
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Markets & Macro | The trade-off between inflation and stability

SVB: Idiosyncratic event, but highlights generalized issues.

SVB, a medium to small bank (USD220 billion in assets) was subject to a bank run (digital, first time in history) i.e. a race to withdraw deposits—which forced it to liquidate USD21 billion in bonds in which it had invested its liquidity, realizing a loss of USD1.8 billion. Over the course of 48 hours, SVB tried to increase its capital with a sale of its own shares and a loan totaling USD1.8 billion, but the operation failed. The bank was then taken over by the Federal Deposit Insurance Corporation (FDIC), which has already announced that the insured portion of the deposits (up to USD250,000) will be made available to depositors on Monday.

Figure 1: Year-to-Date Performance of Major Indices

“As we delved deeper into the subject, we realized that the bank's balance sheet management was decidedly superficial...”

Source: Bloomberg, as at March 10, 2023. Performance figures in indices' local currencies.

Our view: We make two different sets of considerations following the event. As far as systemic risk is concerned, this seems particularly low to us. The size of the bank is not large, although it was among the top 20 in the US by assets. The flight of deposits is certainly linked to the specifics of SVB's business, namely the fact that its clients were Silicon Valley start-ups. The cash that these companies typically burn was previously financed with capital increases at ever higher valuations and multiples. But the regime change has made it much more difficult for them to raise capital, hence the need to draw on their financial reserves, withdrawing deposits.

Further, as we delved deeper into the subject, we realized that the bank's balance sheet management was decidedly superficial: liquidity was invested in long-dated securities at very low yields (below 2%), with huge losses following the selloff in fixed income last year. And this created the classic mismatch between assets and liabilities that deflagrated when the bank had to deal with requests to withdraw deposits. Finally, when word got out that the bank was getting into trouble, start-ups behaved no differently from any fearful saver—they rushed to move their deposits to safer banks.

On a general level, the event leads us to make some more general considerations:

1. The trade-off between raising rates to combat inflation and the stability of the financial system is becoming increasingly challenging. In September 2022, we had seen the strains on the UK market that had put the entire solvency of the pension system at risk, which had prompted the Bank of England to have to interrupt and reverse the QT program. The collapse of SVB risks further exacerbating the sustainability conditions of the entire global tech start-up sector (and beyond). And one should not underestimate its size and consequences for the real economy, not only in the US.
2. The credit crunch in this sector also threatens to impact the labor market, given that, particularly in the wake of Covid, the concept of self-employment through the creation of start-ups financed by capital increases has grown exponentially.
3. SVB's difficulty in attracting deposits highlights a more generalized problem that is beginning to impact the entire banking system, even in Europe (as we are seeing with Credit Suisse)—the competition the banks' deposits suffer from other monetary instruments. Moreover, although not at the level of Silicon Valley start-ups, traditional companies and consumers also have greater financial needs as a result of rising rates and the drop in purchasing power caused by inflation (so gradually withdrawing deposits).

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Fatally, this comes at a time when the strength of the market and the economy used to be explained by the unexpected resilience of savers who were better rewarded by rising rates. The truth now seems to be that competition on deposits could damage the interest margins of banks, which until now had benefited from the classic delay in adjusting the remuneration of deposits with the rise in lending rates at the central bank of reference rate. That said, unless the CPI to be published this week comes out particularly above expectations, the risk of the Fed raising rates by 50 basis point (bps) at its next meeting has fallen (something that seemed almost certain following Powell’s testimony, which however passed into the background). But the scenario seems to have definitely changed, along with investor sentiment.

Going back to our usual chart of the S&P 500 index, our defensive positioning, with a fair value target around 3’500 for the index, seems much less distant after this week. In the coming months, the Fed will increasingly be forced to choose between inflation, growth, and financial system stability. The impact of the previous months’ hikes will begin to be felt, and with the economy likely to enter recession, corporate profits will also begin to contract sharply. In short, these will be difficult months, with tension and volatility, so we confirm our positioning and our intention to protect capital as much as possible until the market has returned adequate value for the risk involved in any equity investment.

Figure 2: S&P 500 Index



Source: Bloomberg, as at March 10, 2023.

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Cryptocurrencies | How will SVB impact the crypto market?

Stablecoins require a stable banking system.

Circle, one of the largest stablecoin operators, has announced that USD3.3 billion of the USD40 billion reserves are trapped in Silicon Valley Bank (SVB), which collapsed in what has become the second-largest bank failure in US history. As a result, Circle’s USDC crypto token lost its peg to the dollar, dealing a further blow to the crypto market, which is still recovering from last year’s confidence crisis.

Stablecoins are cryptocurrencies designed to maintain a stable value relative to a particular asset, such as the US dollar or gold. They can be useful in a number of ways, such as a means of payment, a store of value, or a way to transfer funds across borders. Stablecoins have also been used as a trading pair on cryptocurrency exchanges, allowing traders to move in and out of cryptocurrencies without going through traditional banking systems.

“However, stablecoins can also increase the systemic risk of the cryptocurrency market, including Bitcoin derivatives.”

However, there are potential risks associated with stablecoins, particularly if they are not properly designed or managed. One risk is that the stablecoin issuer may not have sufficient reserves to back the stablecoin's value, leading to a loss of confidence in the stablecoin and potentially triggering a run on the issuer. This can have a contagious effect on other stablecoins and cryptocurrencies, as investors may start to question the viability of the entire cryptocurrency market. Stablecoins can have consequences for Bitcoin derivatives, particularly if stablecoins are used as a trading pair on cryptocurrency exchanges. Many cryptocurrency exchanges offer trading pairs between Bitcoin and stablecoins (which, as mentioned, allow traders to move in and out of Bitcoin without going through traditional banking systems).

One consequence of stablecoins for Bitcoin derivatives is that stablecoins can increase the liquidity of Bitcoin futures and options. Because stablecoins are designed to maintain a stable value relative to a particular asset, such as the US dollar, they can be used as a hedge against price volatility in Bitcoin. This can make it easier for traders to enter and exit Bitcoin derivatives positions, as they can use stablecoins to lock in a particular value for their Bitcoin positions. However, stablecoins can also increase the systemic risk of the cryptocurrency market, including Bitcoin derivatives. If a stablecoin issuer experiences a loss of confidence or fails to maintain sufficient reserves to back its stablecoin's value, this can trigger a broader sell-off in the cryptocurrency market, including Bitcoin and Bitcoin derivatives. This can lead to increased volatility and liquidity problems for Bitcoin derivatives, as investors may be reluctant to trade in a volatile market.

Our view: In light of the SVB collapse, we believe that the stability of the banking system remains a crucial aspect for the success of stablecoins. This indicates that the connection between digital and tangible assets is still intact. Despite its aim to offer a decentralized and secure mode of fund transfer, cryptocurrency was initially presented as an alternative to the conventional banking system.

It remains to be seen what impact the SVB collapse will have on the broader cryptocurrency market, but it serves as a reminder of the risks associated with cryptocurrencies and the importance of properly managing those risks. Stablecoins can be a useful tool in the cryptocurrency market, but they also come with potential risks that must be carefully managed to ensure their success.

“Companies have been issuing bonds at a near-record pace in Europe this year and there’s no sign of that slowing anytime soon, even as they lose the ECB as a buyer.”

Fixed Income | Not the time to take excessive risk

IG part of the market remains attractive.

In credit, yields have been climbing for the past month, but US issuance keeps rising, across both high grade and high yield. US Treasury yields across the curve above the 4% level may be prompting some firms to bring issuance forward to avoid potentially even more expensive financing in the coming months. February closed out with over USD150 billion in sales, the highest total for that month ever. Last week, the US junk bond market also effectively reopened and priced about USD5.8 billion.

denominated junk bond in 10 months (2026 maturity at 99.999 to yield 6.875%, 1.10% over Gilts).

Our view: Our view on credit remains unchanged. The January rally faded after questions emerged about persistent inflation and tightness in labor markets. In the investment grade market, there are attractive returns, without having to take a lot of credit risk and stretching to the high yield part of the market. The fear of rising rates will put pressure on lower quality borrowers and if rates stay higher for longer, most levered borrowers will come under pressure. Since it is possible to get an interesting return in the short-end of the investment grade curve (5% in USD and 3.5% in EUR), why take risk in high yield when margins for high yields borrowers could come under pressure?

Week Ahead | Key events to watch for

- **The most important data of the week comes on Friday with the US employment report.** But Fed Chairman Powell's testimony before the House and Senate committees could also move markets, and significantly.
- **Other key data releases will be UK GDP** and economic activity indicators in Germany.
- **In China, the 14th National People's Congress begins,** while on the economic front we will see the release of inflation data. Finally, in Japan, the Bank of Japan will comment on monetary policy.

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