NOVUM
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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.

▪ New issuance in the convertibles market has picked up this year given the attractiveness of the asset class in a higher rate environment (as it offers substantial interest rate savings as opposed to a straight bond issuance).

"SVB was taken over by the FDIC, which announced that the insured portion of the deposits will be made available to depositors on Monday."

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.

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

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

Equity Indices	Last Value	Ytd
MSCI World	2,657.41	2.49%
Nasdaq	11,138.89	6.63%
S&P 500	3,861.59	0.92%
DJ Industrial	31,909.64	-3.24%
Nikkei	28,143.97	7.92%
Eurostoxx	4,229.53	11.83%
Swiss SMI	10,765.26	1.01%
FTSE 100	7,748.35	4.81%
Canada	19,774.92	2.56%
Shenzen	3,967.14	2.50%
Hong Kong	19,319.92	-1.98%
MSCI EM	955.28	0.05%

Equity Sectors	Last Value	Ytd
S&P value	145.29	0.15%
S&P Growth	59.42	1.57%
S&P Defensives	1,463.28	-4.32%
ARK Fund	36.02	15.30%
Fangs	5,284.46	18.85%
MSCI Financials	130.81	0.38%
S&P Energy	82.63	-5.53%
Gold Miners	27.20	-5.09%

Commodities	Last Value	Ytd
BBG Commodities	104.55	-7.32%
BBG Base Metals	224.43	-19.55%
BBG Agriculture	66.96	-2.71%
Gold	1,868.26	2.43%
Silver	20.54	-14.26%
BBG Brent Crude TR	1,030.16	-2.99%
BBG WTI Crude Oil TR	183.40	-4.12%

FX	Last Value	Ytd
DXY Index	1,253.53	0.56%
Bbg JP ASIA	100.37	-0.81%
Bbg JP LATAM	40.50	1.90%
EUR/CHF	0.98	0.95%
GBP Index	624.03	0.19%
EM FX Index	1,666.38	0.35%
JPY/USD	135.03	-2.90%
CNY/USD	6.92	-0.27%
Bitcoin	20,104.81	21.56%

Bond Indices	Last Value	Ytd
US Inv Grade	106.82	1.99%
US High Yield	73.44	0.83%
Euro Corps	230.36	1.19%
JPM Europe Govies	9,565.59	3.64%
US Treasuries	2,222.72	1.57%
China Aggregate	256.09	0.32%
EMBI Global	775.44	0.93%
EMBI Local	126.21	2.04%

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 contained for the time being. 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.

"The trade-off between raising rates to combat inflation and the stability of the financial system is becoming increasingly challenging."

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 cheap 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).

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.

"In the coming months, the Fed will increasingly be forced to choose between inflation, growth, and financial system stability."

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.

"Stablecoins are cryptocurrencies designed to maintain a stable value relative to a particular asset, such as the US dollar or gold."

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, 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).

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

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.

"Managers were forced to actively trade their books, repositioning them toward short-dated paper and running tightly hedged portfolios..."

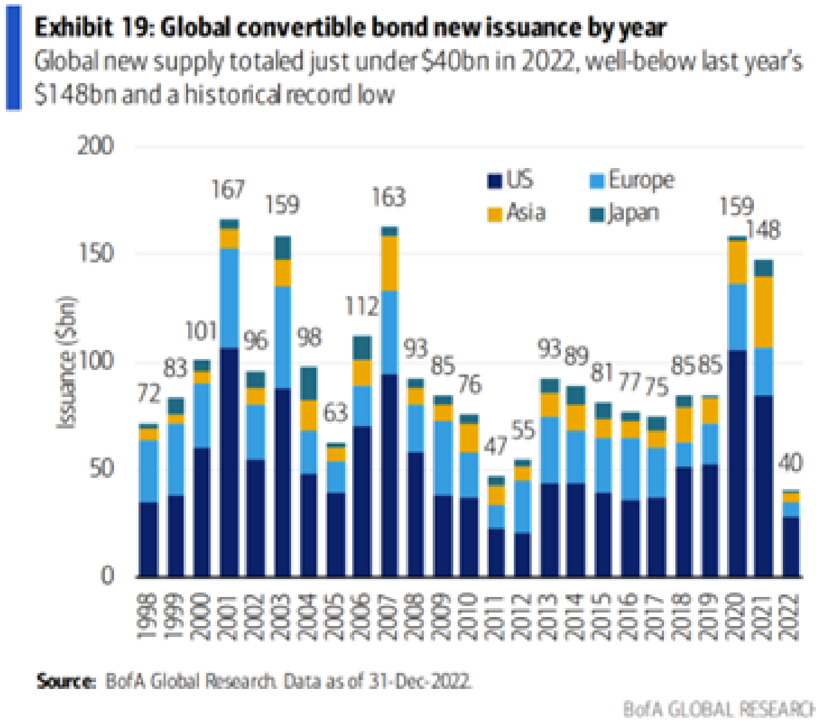
Hedge Funds | Is convertible arbitrage staging a comeback for 2023?

Convertibles are attractive in a higher rate environment.

In 2022, the global inflationary shock of the post-Covid era, which was amplified by the Russian invasion of Ukraine, led to a sharp downturn in both equity and fixed income markets—especially as the only weapon central bankers could use to fight this inflationary boom was raising interest rates. The convertible market was not immune to these movements and suffered its worst year since the GFC (the Refinitiv Global Convertible index ended 2022 down -19.09%). It was hampered by a combination of rising interest rates, spreads widening, negative equity returns and a historically high positive correlation between equities and fixed income, and record low market issuance driven by increased volatility, weaker equity prices and tighter borrowing conditions (Figure 3).

Consequently, convertible bond arbitrage managers saw interest rates and spreads widening impact the credit component of their bonds, while the equity market's negative performance eroded the embedded call options' value. Adding to this, the record low market activity prevented managers from monetizing issuance. Managers were then forced to actively trade their books, repositioning them toward short-dated paper and running tightly hedged portfolios until the overall macro picture becomes clearer.

Figure 3: Convertible Bond Issuance



Source: Bank of America, as at December 31, 2022.

Our view: While 2022 was undoubtedly a difficult one for convertibles, it also created dislocations that skilled managers have the potential to capitalize on. With now most of the Fed rates hikes implemented or factored in by the market, the impact from rate rises that effected bond values last year should be less pronounced on the convertible markets. Convexity also appears to be back, with convertible bonds now offering good downside protection and risk-adjusted upside in a potential equity recovery—especially in the tech or biotech sectors.

"Convexity also appears to be back, with convertible bonds now offering good downside protection and risk-adjusted upside in a potential equity recovery."

At the same time, new issuance has so far picked up this year given the attractiveness of convertibles in a higher rate environment since they offer substantial interest rate savings as opposed to a straight bond issuance (for example, Rivian, the EV manufacturer, came to market last week with a USD1.3 billion green convertible senior bond maturing in 2029). Recent convertibles have also been issued with higher coupons and lower premiums making them more "hedgeable" due to their higher deltas, therefore mitigating some of the potential credit and interest rate risks. A recent change in USGAAP also allows issuers to take the convertible coupon as interest expense, making them an attractive option for corporates. An additional tailwind may come from increased corporate activity either through M&A, given attractive company valuations, or buybacks, given some converts distressed trading levels allow managers to de-risk their portfolio, locking gains and/or swapping into attractively priced new issues.

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The above makes for an attractive opportunity set for convertible arbitrage managers and, as always, this is something we are closely looking at. While our portfolios will certainly benefit from any upside in the strategy given our look-through allocation to multi-strategy managers (for which the convertible allocation is and remains meaningful), we are also mulling a potential allocation on a standalone basis.

Week Ahead | Key events to watch for

- **A number of key releases will come from the US**: the CPI report will be followed by retail sales and sentiment from the University of Michigan. Finally, industrial production and housing market data will be published.

- **In Europe, the ECB will likely raise rates** by 50 bps at its meeting. But it will also be important to hear Lagarde in the press conference.

- **There are some companies still reporting earnings**: Adobe, FedEx and Dollar General in the US, and Porsche, BMW and Inditex in Europe.

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