STRATEGY FOCUS

Financial market concerns following the collapse of the US bank SVB

The bankruptcy of the American bank Silicon Valley Bank (SVB) has caused significant turbulence on the financial markets since last week. While the bank's difficulties seem to be largely due to its highly specialised nature and poor management of its financial risk, it nevertheless represents a new warning to the risks posed by the sharp interest rate hikes of recent months.

The rapid and significant reaction of the US authorities suggests that the risks of direct contagion will remain limited. However, it is important to monitor segments of the venture capital industry that are sensitive to declining liquidity. Small U.S. banks remain on high alert, but the authorities are taking the risk seriously and should help avoid a more systemic crisis. U.S. large banks as well as European banks have very diversified business models and much more controlled management of their financial risks. Their capital and liquidity levels reassure of their ability to manage rising interest rates.

This SVB failure, however, raises the question of the capacity of the economies and the current financial system to absorb the very rapid rise in interest rates. Central banks will be vigilant in their future monetary policy decisions, in a context where inflation is still slow to fall significantly.

At this stage, we maintain our balanced strategic positioning between equities and bonds. Indeed, our highly diversified positioning protect our exposure, at least partially, from the decline in equity markets through the rise in bond markets. In addition, our regional differentiation remains favourable in the context of current tensions, both our overexposure to Europe in terms of equity markets and to US government bond markets and well-rated corporate debt. However, we remain attentive in order to be responsive to developments in the situation.

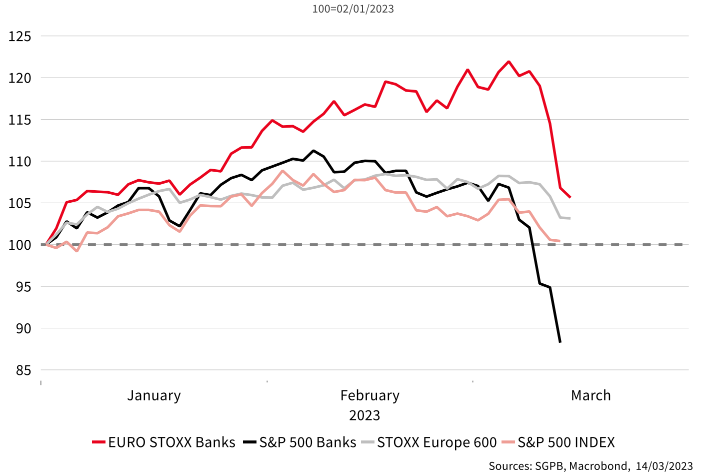
MARKET TURBULENCE

The difficulties of the SVB bank have caused financial market turbulences since last weekend.

Decline in equity markets, especially banking indices.
Since mid-week, the US, UK and Eurozone equity markets have lost around 4%. The declines primarily concern banking indices, with nearly 8% decline in the United States and 5% in Europe. The US tech sector is also down sharply at nearly -6%.

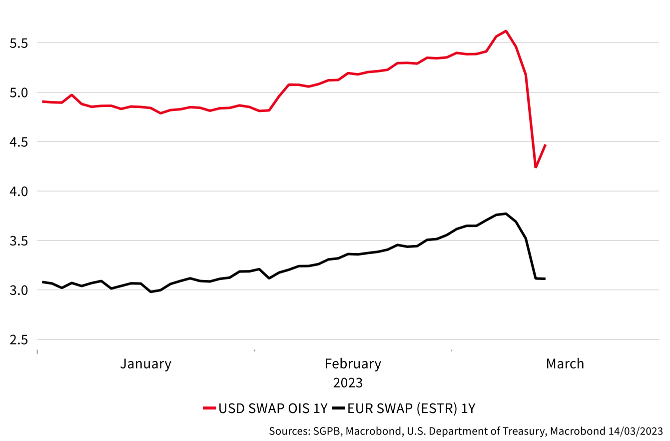
Increased risk aversion
This decline in equity indices was accompanied by a rally in bond markets. Indeed, 10-year yields (US, Eurozone and UK) have fallen by nearly 50 bps since the middle of last week. Shorter maturity rates fell even further, to -80 bps for the US 2-year. The return of a negative correlation between bonds and equity markets, which has disappeared since central banks began their monetary tightening cycle, is a marker of rising risk aversion. At the same time, volatility indices tightened slightly. No specific movement to note in the currency markets.

Equity indices



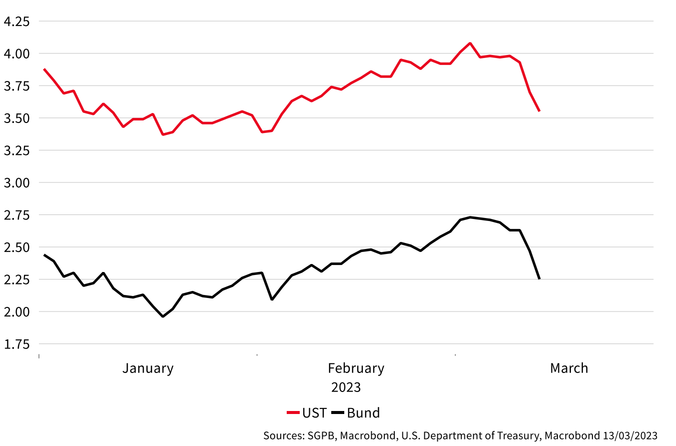
Sources: SGPB, Macrobond, 14/03/2023

Short-term money rate



Sources: SGPB, Macrobond, U.S. Department of Treasury, Macrobond 14/03/2023

Long-term interest rate (10 years)



Sources: SGPB, Macrobond, U.S. Department of Treasury, Macrobond 13/03/2023

BANKRUPTCY OF A HIGHLY SPECIALIZED BANK

The SVB was administratively closed on 11 March by the US financial authorities. It was the sixteenth largest US bank according to an asset size criterion (with 210 billion dollars, 197 billion euros in assets). This failure is a good illustration of the risk of instability that rapid tightening of US policies can cause.

A combination of factors making the bank vulnerable to monetary tightening. SVB was a bank specializing in venture capital. Its very specific customer base is certainly an important explanatory factor of its difficulties. In recent years, SVB has seen massive growth in deposits due to the rise of the venture capital sector in Silicon Valley. The bank has chosen to accompany this growth in deposits with large purchases of bonds that are almost without credit risk (Treasury securities in particular) but with rather long maturities. Apparently, the bank had not covered its risk of maturity mismatch between its liabilities and its assets. The tightening of US monetary policy has weighed heavily on both SVB's assets and liabilities. First of all, the rise in interest rates has led to a decline in the value of its assets (because the rise in rates is mechanically accompanied by a fall in bond prices). Secondly, the Federal Reserve's action reduced access to finance, which particularly weighed on the high-tech sector and therefore weighed on SVB deposits. The difficulties of SVB have accelerated in recent days, prompting massive withdrawals of deposits from customers and causing the closure of the establishment.

A monetary tightening that puts pressure on the very "Growth" segment. The bankruptcy of SVB also comes in a context of difficulties for the startup's environment, and particularly the world of crypto-currencies. Indeed, the banks Silvergate and Signature (the latter being taken over by the FDIC) have gone bankrupt also those days. However, these banks were highly exposed to the crypto-currency sector. Overall, since the beginning of the rate hike cycle, several companies in the crypto-currencies sector have gone bankrupt, the most important name being FTX, in a context of difficulties in financing the latter and a loss of attractiveness of crypto-currencies with high interest rates.

The authorities protect depositors but refuse to bailout shareholders. A small part of the deposits carried by SVB appeared to be covered by deposit insurance, posing a significant risk for corporate clients and therefore for the high-tech sector. The authorities decided over the weekend to finally protect all of the bank's deposits. On the other hand, the authorities favour a solution that avoids a bailout of shareholders by public capital. SVB's bankruptcy will therefore weigh primarily on its shareholders.

FEW RISKS OF CONTAGION BUT FEARS RELATED TO THE MARKED TIGHTENING OF MONETARY POLICIES

The bankruptcy of SVB highlights the difficulties of certain types of players in the high-tech sector. As the protection of SVB's high-tech customers' deposits has finally been decided, SVB's bankruptcy should not specifically weaken the sector. However, this bankruptcy highlights the difficulties of the sector, which appears to be particularly penalized by the reduction in liquidity linked to monetary tightening. The most fragile actors seem to be those most dependent on funding. The cryptocurrency sector also appears particularly vulnerable.

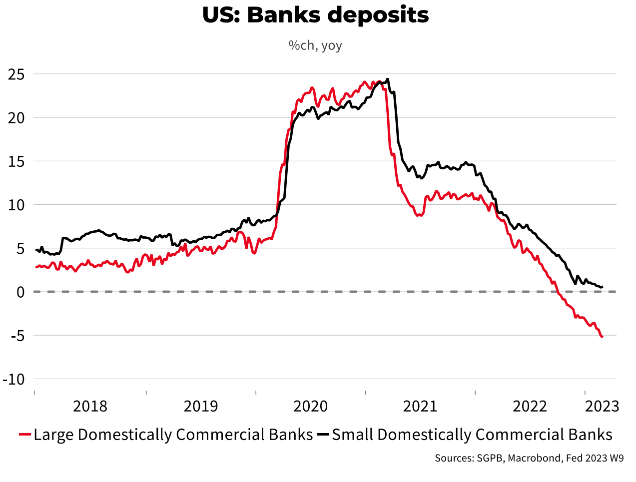
The announcements of the US authorities should limit the risk of contagion to the most vulnerable banks. The direct contagion of SVB's failure to the banking and financial sector is expected to remain limited. The financial market turbulence, including the sharp decline in bank stocks, is more reflective of investors' fears that other banks may have the same type of vulnerability to rapidly rising interest rates. Indeed, the rapid rise in interest rates can destabilize financial players who have mismanaged their mismatches between assets and liabilities on their balance sheets. US banks are particularly concerned because they are facing a double consequence of the Federal Reserve's monetary tightening: (i) the valuation of bonds under their assets has fallen particularly due to the particularly sharp rise in rates and (ii) US bank customers are more active in arbitrating their deposits towards more remunerative media in terms of interest rates due to the existence of easily accessible alternatives (USMMF or direct holding of bonds).

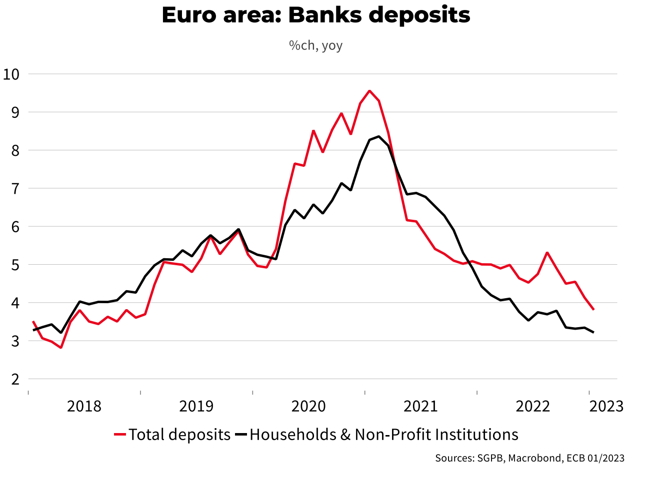
Tensions remain visible on US regional banks, but banking authorities are taking the risk seriously. Small US banks are not subject to the same regulations as large banks, particularly in terms of liquidity ratios (LCR/NFSR). They can carry a significant risk of maturity mismatch between assets and liabilities. This threat can prompt both depositors and investors to want to withdraw, putting immediate pressure on the stability of the institution. The US authorities take this risk seriously and have already taken significant steps to limit its occurrence. They have extended the coverage of all SVB deposits, which gives a signal that depositors of other regional banks could be protected. And they have expanded the capacity of all banks to have liquidity with the Fed and/or the US Treasury (easing constraints on collateral to be provided for refinancing operations with the Fed and creation of a specific Facility line).

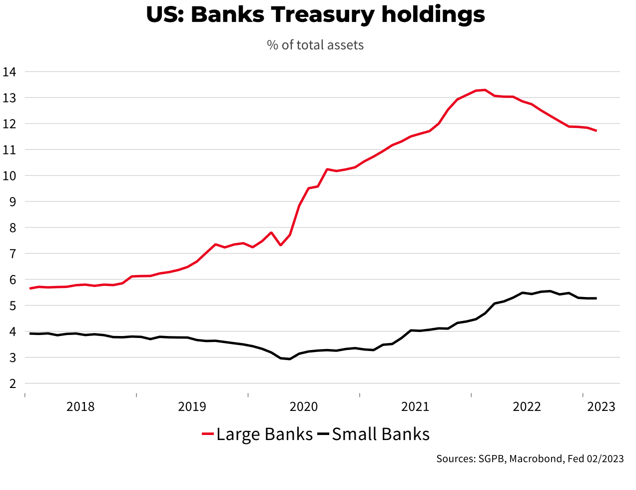
The big American and European banks appear solid. Beyond the U.S. regional banks, it is important to note that U.S. national banks, as well as all European banks, do not present comparable risks at all. Indeed, they are all subject to strict capital and liquidity ratios that allow them to limit these strong maturity mismatches on their balance sheet. Large banks also have a much larger and more diversified depositor base than a bank such as SVB, which is highly specialized in a customer sector. It can also be noted that in Europe, arbitrage by clients towards non-bank vehicles that are more remunerative than bank deposits is less easy because of the lower development of the MMF industry. However, to avoid this type of arbitrage, banks will have more and more incentives to remunerate their deposits, which may ultimately weigh on the profitability of banks.

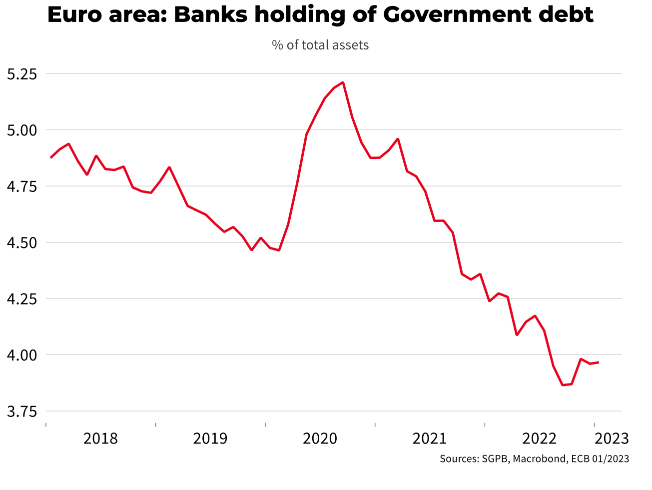
FEW RISKS OF CONTAGION BUT FEARS RELATED TO THE MARKED TIGHTENING OF MONETARY POLICIES

A new indicator of the risks posed by the strong action of central banks. Even if the story is very different, the bankruptcy of SVB is reminiscent of the strong tensions observed on the English financial markets last Autumn. The tensions had also found their genesis in the mismatch between the assets and liabilities of pension funds in a context of sharp rise in interest rates. Indeed, since the end of 2021, central banks have sharply increased their rates (+450 basis points for the Fed, +300 for the ECB and +400 for the Bank of England) and continue to worry about continued high inflation. This rapid and significant rise in interest rates, also visible on longer maturity rates, raises questions about the ability of economies to absorb them, with economic actors whose debt has tended to increase in recent years. Central banks will increasingly factor this risk into their future decisions, starting with meetings starting this week.









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