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US bank turmoil: FAQ and investment implications

UBS House View - CIO Alert

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What's happened so far?

Silicon Valley Bank, a midsize bank with a heavy presence in Silicon Valley, announced that it would need to sell a large portfolio of US Treasuries at a significant loss seemingly to cover deposit outflows. Pressure on the technology sector was driving reduced deposit balances among the bank's clients, while higher US bond yields had contributed to mark-to-market losses on its asset portfolios.

Efforts over the weekend to find a buyer for SVB were unsuccessful, and late on Sunday the US Treasury, Federal Deposit Insurance Corporation, and Federal Reserve announced they would guarantee all deposits at the bank and ensure access to all funds this week. They also announced they would take control of similarly troubled New York-based lender Signature Bank and guarantee all of those deposits.

In an attempt to prevent wider contagion, the Fed announced a new Bank Term Funding Program (BTFP), offering banks the possibility to take loans of up to one year against Treasuries and other collateral. Importantly, the collateral will be accepted at face value (instead of at market prices), allowing banks to meet deposit withdrawals without being forced to immediately sell securities portfolios at a loss.

Could this happen to other US banks?

Certain aspects of the Silicon Valley Bank situation were unique. It had the highest ratio of securities to total assets of any US bank; a far higher-than-average proportion of its depositors were corporate clients in the technology sector; and its uninsured deposit mix was one of the highest in the industry. That made it especially vulnerable both to deposit outflows and to mark-to-market losses when it attempted to meet those outflows.

However, to some extent, the fundamental challenge faced by Silicon Valley Bank is also faced by other banks. Most banks invest customer deposits into mortgages, government securities, and loans held on the balance sheet. Over the past year, the fair market values of mortgages and government securities have fallen as a result of higher interest rates.

This isn't necessarily problematic: Bank portfolios are made up of high-quality securities, which, if held to maturity, are highly likely to be paid back in full. However, if banks are forced to sell assets prior to maturity, there is a risk of loss, as we saw with Silicon Valley Bank. As has long been known, banks are also fundamentally vulnerable to depositor panic, as we saw with Signature Bank over the weekend.

The Fed's Bank Term Funding Program will provide banks with the funding needed to meet deposit outflows without needing to sell securities immediately. By only providing funding for one year, banks are still faced with a potential duration mismatch between their securities and their liabilities, and the Fed's program is no substitute for maintaining a robust depositor base. But the facility does give the banks more time to generate additional capital to help fund any demands from depositors, and it's also possible that the facility could be extended, if needed, to ensure banks have sufficient liquidity.

From here, in order to minimize the risk of deposit outflows, many smaller banks may be forced to further increase deposit rates. As demonstrated by equity market performance on Monday, this is not good for any bank's profitability, though those banks with higher capital ratios, smaller pools of securities relative to total assets, strong brands, and diversified funding sources should be better able to weather the current market dynamics.

All that said, it's important to note that from a solvency perspective, potential mark-to-market losses are far smaller than the US bank capital base. Even if we assume that the USD 620bn of unrealized losses that the FDIC estimates are held in the banking system were in fact realized, the impact on the capital ratios of the US banking system would be manageable. Silicon Valley Bank was virtually the only US bank that had close to negative equity if mark-to-market losses on securities were included. Furthermore, the Fed's liquidity facility largely eliminates the need to recognize the losses on the securities portfolio, and the decline in bond yields over the last several days will reduce the size of the unrealized losses.

What about other regions?

Like in the US, European banks also own securities portfolios with unrealized losses as a result of the increase in bond yields. However, exposure to mark-to-market losses appears to be lower. Securities designated as "available for sale" are also regularly marked to market against regulatory capital requirements in Europe. And Goldman Sachs estimates the unrealized losses on hold-to-maturity securities at EUR 1 billion on average, equating to around 30bps off the average European estimated common equity Tier 1 capital ratio this year.

Even this only becomes an issue if they are forced to sell before maturity. And here the good news is that European banks generally have more diversified deposit franchises than some of the more technology-concentrated US banks.

What are the economic implications?

Banks are a key conduit for transmitting central bank interest rate policy into the broader economy. In recent months, despite significant *tightening* in the US federal funds rate, financial conditions had been *easing* because risk asset prices have rallied, while Treasury yields were off their highs from last fall. This partly explains why the US economy has been able to perform well despite higher Fed interest rates.

The events of the past few days could reverse this dynamic. Greater counterparty risk increased stress in overnight bank lending markets, while banks may tighten lending standards and be more reluctant to originate new loans in order to preserve their liquidity and profitability, as they are forced to raise rates to mitigate the risk of withdrawals. This would tighten financial conditions, which should lower economic growth in the coming quarters, as, at the margin, consumers opt to save rather than to spend, and businesses choose to forgo investment opportunities due to the higher cost of funding.

Even a change in Fed policy may not be sufficient to avoid this potential risk. The more than 100bps drop in the 2-year US Treasury yield in less than a week shows that investors are expecting much looser Fed policy than had been anticipated. Interest rate futures are now pricing a peak in the policy rate at 4.77% (down from 5.69% last Wednesday) and for the Fed to start cutting rates as early as August, with around 125bps of rate cuts priced in the subsequent 12 months. But in terms of the economic impact, it’s important to remember that looser Fed policy won’t necessarily mean looser financial conditions for the broader economy.

If the Fed pauses, what will it mean for inflation?

It will be hard for the Fed to hike rates shortly after taking extraordinary measures to support the financial system, particularly given that the problems have been triggered in large part by higher rates. And delaying rate hikes for a few weeks would not have a material impact on the inflation outlook. So the Fed could decide to pause at next week’s meeting in order to buy more time to contain financial stability risks, while using the “dot plot” to signal that it remains committed to tackling inflation.

In the longer term, much will come down to the economic impact of tighter bank funding conditions. If the US economy is pushed into recession, the Fed might need to cut rates soon, but inflation is also likely to be less of an issue if consumer demand is weakening. If growth remains relatively robust, the Fed would likely need to continue increasing interest rates to tackle inflation, while monitoring and tackling financial stability issues as they arise.

What are the investment implications?

Equities: Diversify beyond the US
We are cautious on the outlook for US equities over the remainder of 2023. Although lower bond yields and potentially looser Fed policy may come as a partial relief for equity markets, high valuations, falling earnings estimates, an increasing chance of recession, and the risk of further unforeseen consequences of Fed tightening all diminish the attractiveness of investing in the market.

By contrast, we see opportunity in equity markets exposed to China’s reopening, including emerging market equities, Chinese equities, and German equities. China's economic performance is likely to prove more robust than other regions this year. On a price-to-book (P/B) basis, the MSCI Emerging Markets index is trading at a 43% discount to developed markets

(12-month forward P/B at 1.5x versus 2.4x for MSCI World), a level historically consistent with a relative positive return over the medium term.

At a sector level, we have a least preferred view on US financials due to many of the aforementioned issues, as well as weak capital market activity, and now likely more regulatory scrutiny. We recommend investors who have above-benchmark weights in global financials (15% of the MSCI All Country World Index) to revisit their exposure. Within the sector, we prefer select universal banks, which have sold off in recent days, but which also remain well capitalized and hold sufficient liquidity to serve clients without needing to realize losses on securities portfolios. Elsewhere, we favor global energy, consumer staples, and industrials.

Cash: Manage liquidity as rate expectations evolve
For many investors, higher central bank interest rates have increased the appeal of holding cash in anticipation of further rate hikes. But the events of recent days show how quickly future interest rate expectations can change.

In a portfolio context, we generally recommend that investors hold no more than 3–5 years' worth of expected net portfolio withdrawals in a Liquidity* strategy, and we believe investors' best strategy for managing liquidity is to lock in interest rates in higher-quality cash and fixed income instruments that align with the time horizon of expected portfolio withdrawals.

Such an approach can help ensure investors have sufficient funds to meet portfolio withdrawals, while not over allocating to cash at a time when interest rates could peak and start to fall.

Bonds: Seek high-quality income opportunities
We generally prefer the higher-quality end of the fixed income market, with a preference for high grade and investment grade bonds, though we also see opportunity in emerging market bonds.

Our exposure to credit is selective and has a defensive tilt. The defensive fixed income themes that we favor have gained strongly in response to the sharp fall in rates, and have outperformed risky bonds, where wider credit spreads have reduced the beneficial rates effect.

Investors do, however, need to be selective and active in their approach. Sharp rate hikes by central banks have increased the chances of sudden cracks appearing in the economy, with the risk of individual, weaker companies getting into trouble. Furthermore, changes in the relative prices of bonds of different maturities as markets price the future path of Fed policy speak in favor of a more active approach.

Bank credit
We continue to believe that the Big 6 US banks, which are considered to be globally systemically important banks, or GSIBs, will maintain strong credit profiles through this crisis of confidence affecting select US regional banks. The US GSIBs have been diversifying their businesses, including growth in fee-based areas, and have strong deposit franchises that are of smaller average size and have a lower proportion of uninsured deposits. The GSIBs are subject to stringent regulatory liquidity requirements, including a liquidity coverage ratio that requires the bank to hold liquid assets sufficient to meet cash withdrawals over a 30-day stress scenario. We also note that for the US GSIBs, mark-to-market losses in their securities portfolio are included in their

regulatory capital, meaning their robust levels of common equity Tier 1 (CET1) take the security market losses into account.

Systemically important European banks have displayed solid fundamentals throughout last year. They enjoy solid capital levels, strong asset quality, abundant liquidity, and improved profitability, boosted by higher net interest income, on the back of rising interest rates. Nevertheless, the potential negative impact from central banks' tighter monetary policy is likely to put banks' fundamentals under pressure. Asset quality deterioration has not yet materialized, though we expect the trend of improving loan performance to reverse from 2023 onwards, as corporate and household defaults start to rise. However, we do not expect any significant fallout, and the deterioration will most likely be manageable in most countries thanks to tighter lending standards.

Private credit

Venture capital debt deal activity has been on an upward trend over the past 10 years. In 2022, there was a significant pickup in demand as startup companies, reluctant or unable to raise capital without slashing valuations, used borrowing facilities. But, relative to overall private debt fundraising activity, VC debt represents less than 5% of fund count and about 1% of total dollar value raised.

More broadly, we continue to see private debt as a source of funding for companies as banks pull back and regroup with tighter controls. While tightened lending may create headwinds for traditional banking lenders, private credit funds are poised to capitalize on the opportunity. Flush with cash after raising record funds over the past few years, private lenders are in a solid position to deploy capital. Private debt, typically in the form of direct lending to middle-market companies with a private equity sponsor, bear floating interest rates—meaning that any interest rate hikes are passed onto the borrowers. Private credit does not respond as quickly to widening spreads as the public market does.

We continue to see private debt as attractive for investors as a diversifier from traditional fixed income. However, if existing investors are concerned about liquidity, we could see increasing redemptions in open-ended private credit funds, which would trigger gates and limit withdrawal capacity. Given the illiquid nature of private assets, investors should be aware of liquidity risks and challenges that come with private credit.

Currencies

The US dollar has weakened in response to lower Fed rate expectations following the recent events. In the near term, the dollar's status as a safe haven could help keep it relatively highly valued. But for the longer term, we continue to believe that the US dollar will weaken against most G10 peers and think that investors can use periods of dollar strength to reduce allocations to the currency.

Investors worried about the risk of a financial crisis can consider diversifying into traditional safe havens like the Swiss franc and gold. For those with more risk appetite, the prospect that the Fed will be tightening policy less aggressively than the European Central Bank should favor the euro. And for investors who believe that China's domestically driven consumption recovery can continue despite the events in the US banking system, we recommend the Australian dollar, where we have a most preferred view.

*Liquidity. Longevity. Legacy. disclaimer: Timeframes may vary. Strategies are subject to individual client goals, objectives and suitability. This approach is not a promise or guarantee that wealth, or any financial results, can or will be achieved.

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Non-traditional asset classes are alternative investments that include hedge funds, private equity, real estate, and managed futures (collectively, alternative investments). Interests of alternative investment funds are sold only to qualified investors, and only by means of offering documents that include information about the risks, performance and expenses of alternative investment funds, and which clients are urged to read carefully before subscribing and retain. An investment in an alternative investment fund is speculative and involves significant risks. Specifically, these investments (1) are not mutual funds and are not subject to the same regulatory requirements as mutual funds; (2) may have performance that is volatile, and investors may lose all or a substantial amount of their investment; (3) may engage in leverage and other speculative investment practices that may increase the risk of investment loss; (4) are long-term, illiquid investments, there is generally no secondary market for the interests of a fund, and none is expected to develop; (5) interests of alternative investment funds typically will be illiquid and subject to restrictions on transfer; (6) may not be required to provide periodic pricing or valuation information to investors; (7) generally involve complex tax strategies and there may be delays in distributing tax information to investors; (8) are subject to high fees, including management fees and other fees and expenses, all of which will reduce profits.

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