Perspectives

Flash Comment

14 March 2023

Implication of US bank closures

The backdrop

- The downfall of Silicon Valley Bank and Signature Bank that were taken over by the Federal Deposit Insurance Corporation is primarily the result of idiosyncratic factors such as poor risk management and a concentrated deposit base.
- However, the macroeconomic and regulatory backdrop plays a decisive role: (1) the rapid increase in interest rates has led to high losses in banks' bond portfolio valuations; (2) the significantly inverted yield curve is undermining US banks' profitability; pressure to increase deposit interest rates is immense to address flights into alternatives such as high-yielding T-Bills; (3) the loosening of regulations in the past years, i.e. exemptions for smaller banks from stress testing.

Implications for the economy and monetary policy

- The swift reaction of the US authorities – unlimited guarantees of deposits and better conditions for banks to tap liquidity at the Federal Reserve – has likely avoided a major crisis.
- Still, the macroeconomic backdrop, notably the inverted yield curve, is keeping uncertainty elevated. This will only change if the Fed signals the start of a rate cutting cycle, which is unlikely given the elevated level of inflation at 6.0% by February 2023.
- However, the episode corroborates our base case view that the US economy is steering towards a recession in H2/2023: (1) lending conditions will tighten further, also as a result of more regulatory scrutiny; (2) the recent events might undermine the confidence of US corporates and consumers.
- In combination with softer inflation, a turnaround of US monetary policy is still likely at some point and could come earlier than we had anticipated.

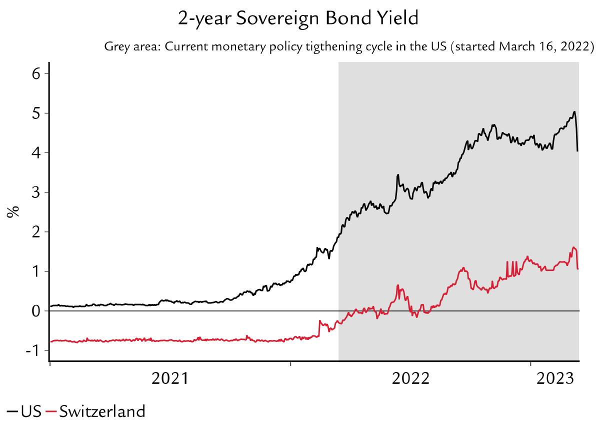
Impact on financial markets

- US government bond yields declined across the curve, but most spectacularly for short maturities. 2-year yields plunged from 5% to 4%. European bond yields declined somewhat less sharply.
- Credit spreads have widened significantly. The US equity market has wiped out its year-to-date performance. European equity markets are still positive.
- The US dollar came under pressure and safe haven flows have resulted in renewed CHF strength.

How we are reacting

- Our strategies have generally had a defensive bias as we thought that the financial markets were too optimistic in the final quarter of 2022 and at the beginning of 2023. As a result, we were able to soften the impact of the recent market corrections.
- Markets tend to overreact to such events, creating opportunities which brave investors can exploit. Still, in our view the current valuations across asset classes do not reflect the economic risks ahead despite the recent corrections.
- We therefore stick to our defensive stance, keeping an underweight in credit and equity market risk, while keeping a neutral stance on interest rates

Significant re-pricing of monetary policy expectations



Sources: Macrobond, Swiss Life Asset Managers

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