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Banking Crisis Lends Uncertainty to Macro Outlook

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As the Silicon Valley Bank (SVB) and Signature Bank closures dominate news headlines and reverberate through the U.S. financial system, investors and markets continue to navigate the fallout. Beyond the immediate impact, the crisis has broader macroeconomic implications and serves as a potent reminder that the banking system, asset markets, and the broader economy are all intrinsically linked via interest rates.

Contagion Risk

While the coordinated actions of the U.S. Treasury, Federal Reserve (Fed), and FDIC to make depositors whole has stemmed any immediate contagion risk, we will continue to monitor deposit flows over the next several days and weeks to evaluate signs of further stress in other banks. The regulators are clearly concerned about a broader threat to the banking system.

All large deposit holders will be reassessing their counterparty risks, with a strong incentive to switch from regional banks to global systemically important banks (G-SIBs), money market funds, or T-bills, hence we expect further pressure on deposits. Anyone holding deposits in excess of the FDIC guarantee will get a higher yield and more safety by owning Treasuries. As for large corporations that need to hold large deposits to fund payrolls, the contagion risk is that deposits are driven to the money center banks and away from regional and small banks. The Fed's new lending facility, the Bank Term Funding Program (BTFP), means banks do not have to sell their securities at a discount to fund deposit outflows, which will tend to mitigate against illiquidity or forced selling of assets at a loss. While this intervention may help banks avoid insolvency, it still leaves open the bigger question—especially for small banks—as to how big any deposit outflows turn out to be. While all this plays out, it is hard to imagine small regional bank lenders not curtailing new lending plans as they look to defend their equity.

Credit Conditions

Undoubtedly, this incident will result in tighter credit conditions and weaker economic growth. Regional banks will be forced to pay more for deposits at a time when there are growing concerns about potential losses on commercial real estate loans. The recent divergence between the Senior Loan Officers Survey (SLOS) and credit spreads has been noted by many strategists. The SLOS is likely to report even tighter credit conditions following the March 10 failure of SVB and subsequent events. Ultimately, these constraints will lead to higher costs for banks, and we expect reduced availability of credit for borrowers as lenders go into defense to protect shareholder equity. Recession risks have increased because of this likelihood of tighter credit conditions and strained banking profitability.

U.S. Technology Sector

U.S. technology firms benefited from a one-off surge in demand and very easy global liquidity conditions following the COVID shock. As a result, technology equity valuations surged, and the sector saw massive capital inflows. This influx of capital was often spent on technology products, such as hardware, cloud services, cybersecurity, etc., further boosting revenues for technology companies and leading to even higher valuations. Since the start of 2022, this virtuous cycle has reversed. In light of SVB's importance to the technology sector, we would expect more tech layoffs, lower spending on technology products, and more difficult access to new capital, which could potentially become an outright credit crunch for the tech sector.

Monetary Policy

For several months we have been writing about growing monetary tensions and the prospect for something about to break in the system. The history of Fed tightening episodes is that they generally end in a financial crisis, which drives a credit crunch. Current developments may or may not be the start of a similar sequence, but they definitely rhyme with the playbook. The yield curve has been suggesting for some time that the Fed is in overreach mode. At a minimum, the Fed now has a more balanced outlook to consider, which leaves it in a bit of a pickle. Inflation has not been falling fast enough and until last week, rate expectations were rising. However, raising interest rates further in an environment of potentially accelerating credit disintermediation increases the risk of recession. The period between now and the March Fed meeting will be important, but at this point a pause seems highly appropriate. However, we cannot rule out the Fed staying the course with another 25-basis points hike given the central bankers' myopic focus on inflation and the labor market, which are at best coincident if not lagging indicators. Ultimately, the collapse of SVB should result in a lower peak federal funds rate and a greater probability of rate cuts in the second half of 2023 and first half of 2024 for the reasons discussed above.

Asset Prices and Currencies

The events of the past week are clearly negative for risky assets and bullish for fixed income. This situation should ultimately result in lower U.S. yields and a steeper curve than we anticipated prior to the bank failures. If the Fed is forced to cut rates in response to financial contagion even with inflation risks still elevated, that could ultimately lead to a much steeper U.S. Treasury curve. The combination of lower Fed terminal rate expectations, the additional funding available through the new BTFP, and a partial reversal of quantitative tightening (QT) should be U.S. dollar (USD) bearish. G10 creditor currencies, including the Japanese yen (JPY), euro (EUR), and Swiss franc (CHF) should benefit the most, in our view. The impact on emerging market currencies will depend on how much global equity markets fall. On volatility-adjusted terms, we would expect emerging market currencies, which should benefit from reduced Fed hiking expectations, to do better than U.S. equity markets. Emerging market fixed income should fare okay, although these bonds would not be able to keep up with declines in U.S. Treasury yields in the event of a full-blown flight to quality.

Looking Ahead

The Fed's task of reining in inflation has become exponentially more difficult and could face additional challenges as the year progresses. Let us not forget that in a few months, we will also be focusing on U.S. debt ceiling negotiations. The events of the past few days reinforce our preference to be long U.S. fixed income, both outright and relative to European and Japanese bonds. We also believe these developments are ultimately negative for the USD.

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