MyStratWeekly
Market views and strategy

Ostrum ASSET MANAGEMENT

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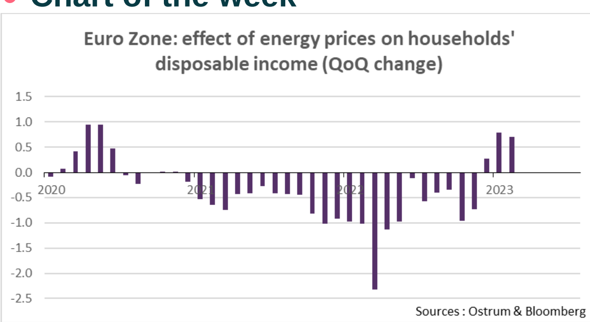
Topic of the week: SVB, quick take

- **In the last two years there has been no bank failure in the US. In the last weeks there have been two bankruptcies;**
- **The reaction of the authorities, both regulator and central bank, has been very ambitious and should help avoiding a contamination effect throughout the sector;**
- **The market remains extremely doubtful.**

Market review: The Fed caught between inflation and bank risks

- **Powell changes his message on inflation;**
- **Fed: 50 bp hike possible at March FOMC…**
- **…despite a bank run on SVB in the US;**
- **Wild swings in bond yields, upward pressure on spreads.**

Chart of the week



After their dramatic rise last year, energy prices are falling. Even though we hear a lot about persistent inflation and rising prices, that is no longer the case for energy.

We thus arrive at this paradox, that the energy budget of European households allows them to increase their purchasing power. The fall in energy prices over the last three months represents the equivalent of a wage increase of 0.7%.

Unfortunately, the other components of inflation continue to rise and continue to weigh on consumption.

Figure of the week

6

Source : Ostrum AM

France ranks 6th out of 29 OECD countries in the Influence of Women in the Workplace Index.

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Topic of the week

SVB, quick take

In the last two years there has been no bank failure in the United States. In the last week there have been two bankruptcies. The reaction of the authorities, both regulator and central bank, was very ambitious and should help to avoid a contamination effect for the whole sector. Markets, unfortunately, are not convinced (at least as we write).

SVB's default

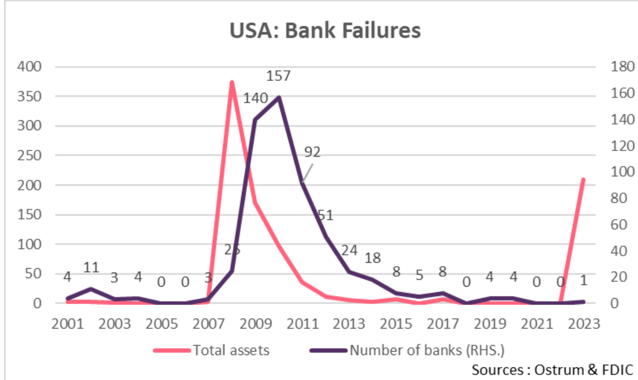
This weekend, the FDIC, the American regulator, announced the bankruptcy of Silicon Valley Bank (SVB).

SVB is a $211 billion asset bank with $182 billion in deposits. The customer base consists mainly of small innovative companies, start-ups (tech, pharma, IA...) themselves partly owned by venture capital funds, who advised them to reduce their exposure to SVB.

The leakage of deposits was extremely rapid, we are talking about more than 40 billion in a few days. This forced SVB to liquidate a portfolio of long-term securities, mainly Treasuries or MBS, thus securities with a long duration. With the rise in rates these sales were made at a loss, which contributed to abound in the panic of depositors. In total, SVB has incurred losses of around 1.8 billion.

So the problem is, to some extent, specific. Deposits have risen tremendously, prompting the bank to invest its liquidity in long-term securities. Another specific element was that interest rate risk was not hedged, a total aberration in terms of risk management.

However, it should also be noted that Signature Bank in the United States has also gone bankrupt. That's two bank defaults in less than a week when there had been none in the previous two years.



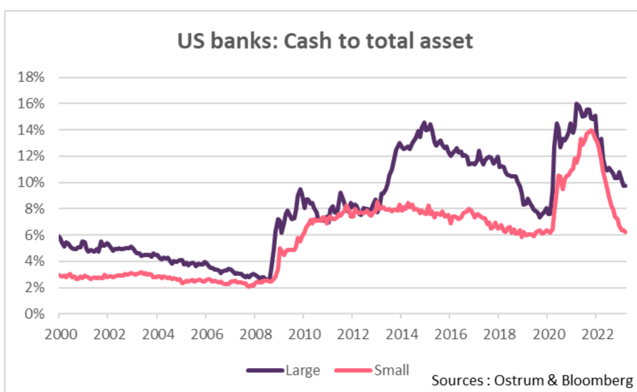
The reaction of the authorities

The American regulator reacted very quickly and announced a package of measures before the markets reopened on Monday morning. We analyzed these measures with Cynthia Voorhees, our US-based specialist in banking. Basically, it's twofold:

1. Deposits are fully secured

Deposits are normally guaranteed up to $250,000, beyond that the depositary has, de facto, provided to the bank of an "unsecured lending" with a zero coupon. The regulator cancelled this limit for both SVB and Signature. If the limit has not been explicitly lifted on the other banks, this decision if it does not completely cancel any bank-run reason, greatly reduces the incentives.

As a consequence, bank financing is partly protected. This is necessary because, as the chart below shows, small banks, with the monetary tightening of the Fed, have had a rapid decline in their liquidity position.



By contrast, shareholders and creditors are not protected. If the bank-run is avoided, the risk on the liabilities of the banks remains very present for their equity financing and their debt issues on the market.

If a bank-run is therefore less likely, on the other hand the cost of financing banks could be affected, and in fine their profitability over time. The rather optimistic view of markets (until recently) on future eps growth could be questioned.

How does it work?

To construct the graph below, we start from a classic DCF:

$$P = \frac{DpS}{k - g}$$

Where the share price (P) is calculated as the dividend per share next year (DpS) divided by the difference between the cost of capital (k) and expected earnings growth (g).

By writing, on the one hand, that the DpS is the product of the earnings per share (EpS) and the payout ratio. And by writing on the other hand that the RoE is the ratio between the EpS and the book value of the assets, we obtain:

$$P = \frac{(book\ value)(ROE)(payout\ ratio)}{k - g}$$

And so, the price to book is:

$$PtB = \frac{(ROE)(payout\ ratio)}{k - g}$$

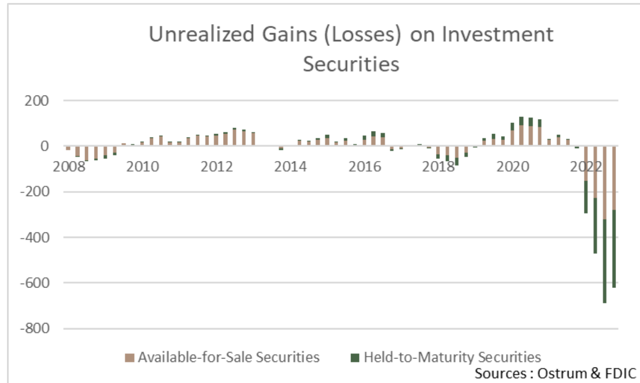
Ultimately this gives the implicit earnings growth rate expected by the market:

$$g = k - \frac{(ROE)(payout\ ratio)}{PtB}$$

2. Bank Funding Term Program

The aim is to prevent banks from having to sell their portfolios of Treasuries or other high-duration instruments at a loss. For this a new program has been set up, the Bank Funding Term Program. As such, banks can receive Fed liquidity for up to a year, via a repo transaction, in exchange for the Treasuries they have. The fundamental point is that these Treasuries will be valued at par. All losses on the portfolio are thus erased, at least for this operation.

The problem of asset losses is therefore largely solved since these losses have no influence on the ability to finance themselves. The FDIC estimates these losses at more than 600 billion. So taking that number out of the equation, at least in terms of funding, is a great step forward for securing banks' funding.



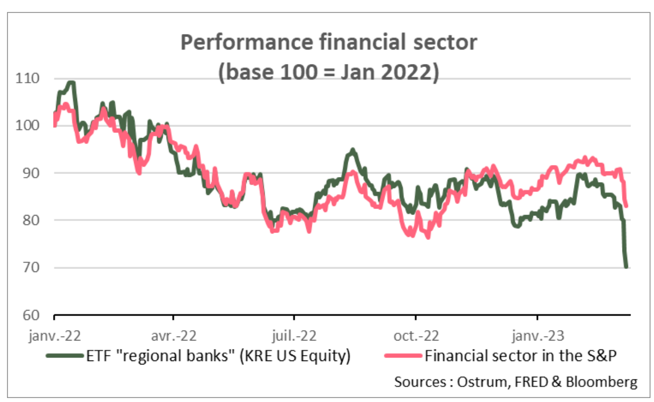
Finally, it should also be noted that the conditions are generous: funds are provided at OIS 12-months plus a small spread of only 10 bp. For a bank lacking liquidity this is a very good proposal.

The market is not convinced

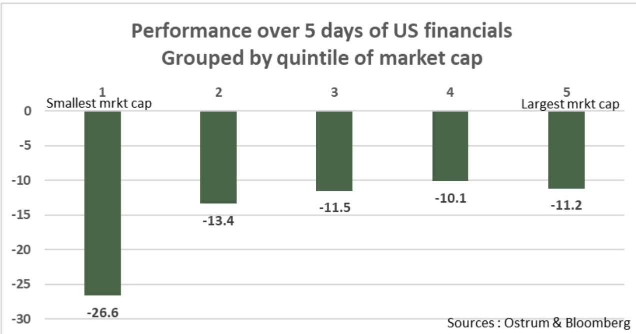
At the time of writing the market reaction remains for the very skeptical.

NB: we write these lines Monday 13 March at 19:00. The figures below are presented at this time.

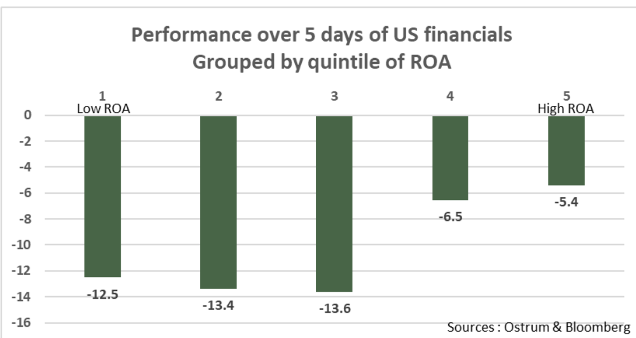
On the one hand the small banks are very clearly under pressure. The chart below compares the performance of regional banks to that of the overall S&P financial sector. The recent underperformance is impressive.



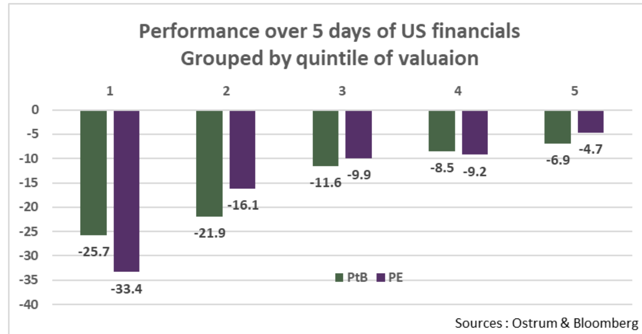
With a shorter focal length, looking at the last week, we get, obviously a very similar signal, with a very strong underperformance of the smallest caps.



If we look at the typology of this decline, the other striking fact is that quality has held up better. Not surprisingly. This can be seen in two ways. First, by looking at company margin levels.



Another way of looking at the same argument is that the most underpriced banks, the unloved ones, have been penalized the most.



Conclusion

When we left the office on Friday night, we thought the risk of a systemic crisis was significant. We believe, with Cynthia Voorhees, that the measures taken by the FDIC and the Fed significantly reduce the likelihood of such a systemic crisis. There are the after-effects, the profitability of the banks, or at least the ability of the banks to allocate credit that will inevitably be affected. This is, after all, the credit crunch the Fed wanted to slow inflation…

The market though remains extremely doubtful.

Stéphane Déo

Market review

Fed caught between inflation and bank risks

Powell paves the way for a possible 50 bp rate increase in March before the bank run on SVB triggers a flight to quality on US T-notes.

The nervousness of the financial markets went up a notch last week. Hopes for rapid disinflation appear invalidated by revisions to the PCE deflator forcing Jerome Powell to toughen his stance in his semi-annual testimony before Congress. The possibility of a 50 bp rate hike in March is making headlines again. Meanwhile, the setbacks of Silicon Valley Bank, plagued by a massive flight of corporate deposits, sparked a bout of risk aversion. Given SVB's corporate customer base (start-ups), this news echoes the announcements of layoffs in the technology sector and, more generally, the drying up of start-up funding via SPACs evident for several months now. Fears of contagion across the banking system trigger a knee-jerk bid for safe-haven bonds (T-note, Bund)… which fully priced out additional monetary tightening expectations due to Jerome Powell's change of heart. The versatility of the financial markets needs not being demonstrated. The Bund reacted even more than the T-note, as swap spreads widened in the euro area bond markets. Higher risk aversion caused a widening of spreads on high yield, and, to a lesser degree, on investment grade sovereign or corporate debt. Equities plunged in the wake of US banks' woes. In Asia, the rebound in stock indices linked to the China reopening trade is running out of steam. The dollar is coming down, in keeping with the downward adjustment on US rates. The equity market seems to be counting on better consideration of financial risks by central banks. Nothing is less certain as long as inflation remains well above target. The BoJ is procrastinating as expected, leaving its next governor the scoop on an inevitable monetary tightening announcement. For now, the BoC still commits to monetary status quo… knowing that the decline in the Canadian dollar and the likely tighter Fed policy will put it in a difficult situation in the months ahead.

During his address to Congress, Jerome Powell took the opposite view of his February press conference stressing the need for more monetary action in the face of persistent inflation. At the next FOMC on March 22nd, the Fed's rate forecasts will probably be raised to 5.25-5.50% by December 2023. A prolonged status quo on interest rates cannot be ruled out for all or part of 2024. The market now expects a 150bp cut next year, in line with the December dots. The labor market shows no signs of turning around. Job creations stood at 311k in February with an unemployment rate of 3.6%. It will all depend on the inertia of price pressures unless a sharp recession or financial crisis unfolds. Across the Atlantic, the ECB is also faced with persistent high core inflation which is fueling expectations for higher policy rates. A deposit rate of 4% now seems to be consensus. Robert Holzmann even envisages a series of 4 rate increases of 50 bps. The ECB's monetary policy will nevertheless remain a subtle mix between contraction of the balance sheet with the upcoming maturities of the TLTROs (€550 billion in June) and repayments of the APP (€60 billion between March and June) and increases in key policy rates. The multiplicity of financial risks nevertheless requires a degree of flexibility in the conduct of monetary tightening. The BoJ was not ready to change its policy, but the new governor Kazuo Ueda will soon have to act as he will chair his first board meeting on April 28th.

Fixed income markets are tossed between the macro-economic environment and the resurgence of financial risks. Inflation risks sent the 2-year yields through the 5% ceiling before a brutal market turnaround towards 4.65% in the panic following the SVB news. With the release of the February US CPI on Tuesday and the meetings of several Central Banks (ECB, then Fed and BoE the following week) on the agenda, the market's attention should refocus on the Fed's dual mandate. Market positioning is difficult to read given the lack of available data, but investor surveys describe a large majority of "neutral" stances suggesting the possibility of new positioning. Investor caution partly explains the weak demand for 10-year notes at last week's auction, which sold out at a yield limit of 3.98%, and the continued flows into money market funds ($192 billion in 2023). The inversion of the yield curve has legs. The 2-10 year spread is trading under -110bp. The overreaction of the Bund down 25 bps probably reflects a broad-based short positioning given the latest statements from ECB members. Sovereign spreads, which proved insensitive to recent tensions on German yields, widened amid renewed risk aversion. Before that, the announcement of a new DSL had sparked some selling flows of core sovereign debt. The 10-year OAT is approaching 50 bps. The Italian BTP is modestly wider but still trades near the bottom of its recent range. The start of the ECB's QT did not jolt markets.

Credit is facing both a slight outflow from euro IG ETFs and a slightly more active primary market last week. High yield was waiting for an reason to take profits after a solid start to the year. Financials react strongly to the negative news on SVB. The equity market fell in the wake of US banks. Asset reallocations in favor of Europe continue at the expense of US equities, especially US large caps.

Axel Botte
Global strategist

Main market indicators

G4 Government Bonds	13-Mar-23	1wk (bp)	1m (bp)	2022 (bp)
EUR Bunds 2y	2.69%	-63	-9	-7
EUR Bunds 10y	2.26%	-49	-11	-31
EUR Bunds 2s10s	-44.4bp	+13	-3	-24
USD Treasuries 2y	4.09%	-79	-42	-33
USD Treasuries 10y	3.52%	-44	-18	-36
USD Treasuries 2s10s	-58.4bp	+35	+24	-3
GBP Gilt 10y	3.37%	-50	-3	-30
JPY JGB 10y	0.35%	-16	-2	+4
€ Sovereign Spreads (10y)	**13-Mar-23**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
France	54.2bp	+6	+8	0
Italy	192.41bp	+10	+10	-21
Spain	110.34bp	+16	+15	+2
Inflation Break-evens (10y)	**13-Mar-23**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
EUR 10y Inflation Swap	2.5%	-24	+12	-5
USD 10y Inflation Swap	2.47%	-23	-6	-5
GBP 10y Inflation Swap	3.82%	-10	+4	-9
EUR Credit Indices	**13-Mar-23**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
EUR Corporate Credit OAS	152bp	+4	+10	-15
EUR Agencies OAS	70bp	+3	+0	-9
EUR Securitized - Covered OAS	80bp	+7	+4	-3
EUR Pan-European High Yield OAS	451bp	+22	+23	-61
EUR/USD CDS Indices 5y	**13-Mar-23**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
iTraxx IG	93bp	+18	+15	+2
iTraxx Crossover	468bp	+80	+63	-6
CDX IG	89bp	+19	+17	+7
CDX High Yield	525bp	+97	+86	+41
Emerging Markets	**13-Mar-23**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
JPM EMBI Global Div. Spread	474bp	+22	+29	+21
Currencies	**13-Mar-23**	**1wk (%)**	**1m (%)**	**2022 (%)**
EUR/USD	$1.074	0.524	0.131	0.3
GBP/USD	$1.219	1.372	0.420	0.9
USD/JPY	JPY 133	1.981	-0.653	-1.6
Commodity Futures	**13-Mar-23**	**-1wk ($)**	**-1m ($)**	**2022 (%)**
Crude Brent	$80.9	-$5.3	-$5.3	-5.12
Gold	$1 911.5	$64.6	$58.0	4.80
Equity Market Indices	**13-Mar-23**	**-1wk (%)**	**-1m (%)**	**2022 (%)**
S&P 500	3 883	-4.09	-6.15	1.1
EuroStoxx 50	4 097	-5.04	-3.41	8.0
CAC 40	7 012	-4.91	-2.73	8.3
Nikkei 225	27 833	-1.43	0.83	6.7
Shanghai Composite	3 269	-1.61	-0.75	5.8
VIX - Implied Volatility Index	25.83	38.80	26.99	19.2

Source: Bloomberg, Ostrum AM

Additional notes

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