# MARKET UPDATE

Albemarle STREET PARTNERS

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## SVB Crisis: They don't wear swimming costumes in California

An over-used saying in markets is that when the tide goes out you find out who is not wearing their swimming costume.

Over the past year, we have seen the fastest cycle of interest rate rises for 40 years. This process puts the whole financial system under pressure; making it more expensive for companies and individuals to finance their borrowing and sending the price of the assets held by banks, in particular government bonds, falling fast. This is the financial equivalent of the tide going out.

In recent months we have been at pains to tell investors that whilst the real economy looks surprisingly resilient in the face of these interest rate rises, history teaches us that something will happen, a gremlin will emerge somewhere in the financial system as a result of the pressure imposed by tighter financial conditions.

Sure enough last week such a gremlin emerged in the form of the Silicon Valley Bank (SVB). This California-based institution is not a household name in the United Kingdom but has been a major lender to some of the most innovative start-ups in the technology market, as well as a home for the cash generated by the private equity investors who back them.

The particular problem for SVB was that because it was small-enough to escape the stress-testing imposed on banks by the US Government it was able to hold large amounts of US Treasury bonds without hedging (or paying to reduce) the risk that they could fall in value. Sure enough as rates have risen, these bonds have fallen sharply in value. The switched-on private equity investors depositing money at the bank were unsurprisingly pretty quick to spot this and rushed to the exit.

As long as these bonds simply live on a bank balance sheet without being called upon for sale, the bank is able to price them at their issue price, for example $1. However, as soon as they need to sell them to fund the withdrawals, they must mark them to the price being paid in the market, which is now far less. The bank tried to alleviate this problem by raising new funds. However, this just sped up the bank run it was suffering.

So should we panic that this problem will now infect the whole global financial system and cause a crisis such as we saw in 2008-2009. We think the answer to this is that this is highly unlikely for a number of reasons.

Firstly, SVB is unusual. The larger US banks are required to abide by far tighter rules on these risks. In Europe, much smaller institutions are also required to stick to tighter rules. The focus therefore of stress in the US financial system will be on small regional banks. Depositors can be expected to move their capital to larger institutions and this could well cause further problems for the US government to solve, albeit of a size that the losses caused by it can probably be passed back to the large banks.

Our analysis shows that for major banks, if they were forced to write down the value of all of these government bonds – rather than simply hold them until they mature at their issue price– they would see their capital ratios (a measure of their safety) fall sharply but only to around the levels capital ratios were after they were 'fixed' in the global financial crisis. In other words, big banks look strong enough to cope.

Secondly, governments are able to respond far quicker than they were in the Global Financial Crisis to tackle the problem. Within hours of the SVB problem emerging, the US Treasury Secretary Janet Yellen stepped in to pledge that all depositors in SVB would be made right by the government. The Federal Reserve also rapidly announced that banks could post their government bonds with them for up to a year at their face value (rather than their market down market price) in exchange for hard cash. This effectively removes the problem that SVB suffered from. In comparison to the hand-wringing and talk of moral panic that occupied the first few months of the Global Financial Crisis, this is a remarkably rapid response.

There are still transmission mechanisms for this shock in the global financial system. The share prices of weaker banks around the world are being hit hard. In Europe we can expect Credit Suisse to be the most in focus and the cost of insuring against its default has risen from 4% to 5.5% in recent days – a highly elevated level. A failure of a major European bank is highly unlikely. However, the European Central Bank will need to act to prevent fear spreading. This will require it to row back from the withdrawal of support it was planning. Ultimately this means that whilst these problems are containable, they require good and rapid policy decisions. The risk of a policy error has therefore grown.

So, what can an investment manager do to help in a situation such as this?

Firstly, we do not panic. We know that the central banks will still prioritise driving down inflation with more rate rises but will probably now do so with more caution. Policymakers will see that their actions are just starting to break things and will apply a justifiable caution to going further. This is particularly true as roughly half of the impact of the interest rate rises that have already happened have probably not yet been felt by the economy. It nudges them towards wait and see.

We must also understand though that it is highly unlikely that the economy will stay strong even though interest rates will stay high for a more prolonged period of time. That is a fairy tale scenario. In reality, it is much more likely that economic growth will fall faster than the optimists hope but inflation will also fall faster than the pessimists fear.

In this scenario, portfolios can be protected by owning longer-duration assets. These are ironically the very holdings that hurt investors when inflation was rising quickly. However, in investment it is always vital to remember that the overriding economic environment will determine which asset classes can protect portfolios in the future.

We continue to believe that as inflation falls, we will see a significant recovery in the value of bonds. It may take a little longer before equities can stage a recovery, but we will ensure our portfolios are ready when they do.

We believe the emerging financial risks in the global economy can be comfortable contained by strong policy decisions from governments and central banks. In this context, and as inflation falls, the problems can to a large extent self-heal. However, we are watching carefully for any policy mis-steps that could undermine this optimism.