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CRISIS IN US FINANCIALS BREAKING POINT FOR MARKETS?

The collapse of the Silicon Valley Bank and Signature Bank, New York last week have rocked the global markets, with fears of a contagion spreading. Here is complete lowdown on what exactly happened, and what to expect now

WHAT HAPPENED?

Silicon Valley Bank, a major lender to US-based startups, collapsed on March 10 after its efforts to shore up its balance sheet spooked investors.

SVB's deposits had swelled from $55 billion in January 2020 to $186 billion by the end of 2022 as its core customers-tech startups-parked the massive funds they were raising with the lender.

SVB invested the majority of these funds in long-term, fixed-rate Treasuries and mortgage-backed securities.

When the Federal Reserve started to hike rates, the value of SVB's bonds portfolio plunged.

The rate hikes also dried up funding for startups, which started to withdraw their funds from SVB.

To cover this liquidity gap, SVB was forced to sell bonds worth $21 billion at a loss of $1.81 billion. That triggered a panic among venture capital firms, who rushed to withdraw their funds and caused a bank run.

ASSETS **$209 BILLION**

DEPOSITS **$180 BILLION**

THE TREASURY DEPARTMENT WILL UTILIZE $25 BILLION FROM ITS EXCHANGE STABILIZATION FUND TO AID WITH FUNDING THIS PROTECTION. A SENIOR US FEDERAL RESERVE OFFICIAL STATED THAT THIS FUND MAY NOT BE NEEDED BUT WILL EXIST AS A SAFEGUARD.

WHO'S NEXT?

US regional banks have been under pressure with several of them like Ally Financial, Citizens Financial group, First Republic seeing significant share price erosion.

First Republic Bank

Lost 50.33 percent since Friday last week, when SVB collapsed. 11 US big banks, including JPMorgan Chase, Bank of America, and Wells Fargo, have reportedly injected $30 billion in cash and credit lines to rescue this San Francisco lender on Thursday, March 16. The bank has since recovered 10 percent, in hopes it can manage its liquidity.

Credit Suisse

This bank was already facing major challenges, including substantial financial losses related to the collapse of hedge fund Archegos Capital Management and the exposure of the Greensill Capital scandal earlier. Credit Suisse has already taken a hit of over $5 billion in losses due to these events. Fears after the SVB collapse increased the risk perception in Credit Suisse and its one year Credit Default Swap (CDS) spread, a measure of credit risk, surged to nearly 1,000 basis points. Finally, the Swiss National Bank handed out a loan of up to 50 billion Swiss francs ($54 billion) which has averted a crisis for now, as both its capital position and liquidity stands strengthened.

More pain, yet to unravel?

SVB, Credit Suisse were specific cases of bad management, unlikely to lead to a contagion in the banking system. But leverage in private equity and credit funds will be the next place to watch as they begin to see the stress of sharp escalation in interest rates.

On review by credit rating agency Moody's

First Republic
Western Alliance Bancorp.
Intrust Financial Corp.
UMB Financial Corp.
Zions Bancorp.
Comerica Inc.

ANYTHING LIKE 2008 CRISIS IN THE MAKING?

No. That was a case of bad credit, which was hidden in the banking system.

What happened in 2008?

- Fed reduced the federal funds rate 11 times between May 2000 and December 2001, from 6.5 percent to 1.75 percent. This enabled banks to extend consumer credit at low rates to "subprime" or high-risk customers.
- Share of subprime mortgages among all home loans increased from about 2.5 percent to nearly 15 percent per year from the late nineties to 2007.
- Adding to the growth of subprime lending was the widespread practice of securitisation, whereby banks bundled these subprime mortgages and sold them as mortgage-backed securities (MBSs) to other banks and investors, including hedge funds and pension funds.
- As home prices continued to rise through the early 2000s, MBSs became widely popular, but when consumers started to default, these toxic assets took down one institution after another.

NO OF BANK FAILURES IN 2008 **25**

TOTAL ASSETS INVOLVED **$374 BILLION**

But the bank failure rate continued to be high.

NO OF BANK FAILURES 2008-2014 **507**

TOTAL ASSETS INVOLVED **$698 BILLION**

FED ABSORBED THE STRESS IN THE BANKING SYSTEM BY BUYING OUT TOXIC ASSETS.

Fed balance-sheet

2008 **$800 BILLION**

2014 **$4 TRILLION**

2020 **$7 TRILLION**

APRIL 2022 **$9 TRILLION**

MARCH 2023 **$8.34 TRILLION**

How is this time different

- The crisis we are seeing now is because the Fed has raised rates. The Fed has raised rates by 450 basis points to 4.58 percent since April 2022 in a bid to contain raging inflation. But both business and markets have been thriving on low interest rates, and quantitative easing (Fed infusion liquidity in the banking system) since 2008.
- The US saw Fed funds rate in excess of 4 percent, more than 15 years ago before the Global Financial Crisis of 2008. From 2015 to 2019, rates were hiked from near-zero to less than 2.5 per cent before they were slashed again.

US Fed Funds Rate



So, what's the problem?

The immediate problem is one of losses stemming from fall in bond prices. When interest rates rise, bond prices fall so that the yield (rate of return) on the old bonds with lower interest (coupon) rate equal the prevailing new interest rates. The fall in bond prices has to be"marked-to-market", because when you go out to sell such bonds, it will result in a loss as those bonds trade at lower prices.

US BANKING SYSTEM SHOULD BE ABLE TO MANAGE THIS

UNREALISED LOSSES IN US BANK BOOKS **$620 BILLION**

US BANK BALANCE-SHEET SIZE **$24 TRILLION**

The Fed set up a new emergency facility to let banks pledge a range of high-quality assets for cash over a term of one year. It has also relaxed terms for lending through the Fed's discount window.

These measures should provide substantial liquidity to banks facing deposit outflows and to improve confidence among depositors.

But the larger question is...

15 years of low interests have resulted in mushrooming of businesses that have a significantly lower return on capital, which will suffer if rates were to stay longer resulting in poor return on capital, credit losses, and systematic asset price depletion.

Ray Dalio, Billionaire Investor and Founder, Bridgewater Associates

"Low interest rates have encouraged investors to take on more risk, leading to an increase in leverage and a rise in the number of zombie firms that are only able to survive thanks to cheap credit."

Larry Fink, Chairman and CEO, Blackrock

"Years of lower rates had the effect of driving some asset owners to increase their commitments to illiquid investments-trading lower liquidity for higher returns. There's a risk now of a liquidity mismatch for these asset owners, especially those with leveraged portfolios."

WHAT WILL FED DO NOW?

Has to manage both inflation and financial fragility.

Catch 22

@ Any cracks in the financial system will damage the economy, so rate hikes and quantitative tightening has to go slow.

@ But stopping rate hikes and keeping the money tap open will not help cool the economy, and contain inflation

Federal Reserve Chairman **Jerome Powell** said in his testimony to the Congress before the SVB crisis came to the fore that

"The latest economic data have come in stronger than expected, which suggests that the ultimate level of interest rates is likely to be higher than previously anticipated."

Analysts and economist differ on the prognosis for the future, after the SVB collapse:

- **Goldman Sachs:** No longer expects the Fed to hike rates in March. There's considerable uncertainty about the path beyond then.
- **Citigroup:** 25 basis point rate hike in the upcoming March 21/22 meeting. Stopping rate hikes not a good idea, because that will be a threat to the Fed's credibility.
- Citi's view is also the Street's expectation, largely. Rate hikes beyond March are uncertain. Some feel that keeping an emergency lending window open to ensure liquidity for banks in need will allow the Fed to make modest rate hikes without breaking anything. But this will imply prolonged pain for main street.

WHAT DOES THIS MEAN FOR THE US ECONOMY?

Containing inflation and managing fragility, growth, will be a tricky task. The US recession now looks inescapable. High inflation with a recession in the Western world will mean economic turmoil globally.

US GDP Forecast

	2023	2024
Bank of America Merrill Lynch	1.00	-0.10
Standard Chartered	-0.20	1.80
UBS	0.80	0.40

Source Bloomberg, Numbers are in %

WHAT TO WATCH OUT FOR IN MARKETS?

Christopher Woods, Greed and Fear

"2022 was the year when US equities suffered multiple contractions from monetary tightening. This year will be the year when earnings downgrades hit the stock market if the US recession forecast proves to be accurate. This is now the key issue in world financial markets. Then 2024 will be the year when markets will have to deal with emerging credit problems in the private space"

WHAT ABOUT INDIAN MARKETS?

Indian banks seem safe, a run on banks is not a worry

- Rates have not gone up as sharply as in the US.
- Two third of the bonds are held-to-maturity, meaning they are not meant to be sold in the market before their tenure ends so they don't have to mark-to-market these bonds.
- Leverage for India banks is low compared to US banks, capital adequacy ratios are healthy, deposits are granular.

Indian equity markets are vulnerable to negative global sentiment. Risk-aversion causes foreign capital outflows, which continues to be a key risk. But the domestic growth story remains reasonably strong.

Nifty earnings growth

India's benchmark stock index made a small gain of 3.25 percent for 2022 outperforming all major G20 peers. Nifty EPS will end FY23 with a 14 percent rise; next year it is expected to rise 16%.

Nifty EPS

FY22	829.50
FY23e	943.59
FY24e	1101.74
FY25e	1042.10

What will be the drivers

In 2022, the Indian stock market was driven by banks, especially PSU banks, thanks to rising interest margins and asset quality. IT stocks were the worst hit because of fears of US recession, and relatively high valuations. This year, banks are likely to see moderation in stock price performance but steady growth in earnings; IT earnings growth are likely to moderate around 10%; global commodities are likely to moderate; businesses driven by local demand will be the main drivers.

Devina Mehra, Chairperson, First Global

"The US financial problems will have no direct impact on Indian markets. In fact, it might work in the favour of capital markets overall as this crisis might cause the Fed to go easy with the rate hikes. Fed will not stop raising rates altogether, but the terminal rate (where the hikes will stop) might not go up to the extent earlier believed.

After a historically bad 2022, equity markets look better for 2023. Probability of a big crash in Indian markets is limited. Outperformance against global markets in the medium term is likely to continue.

Capital goods and industrial machinery continue their outperformance, although a large part of the move is now done. Also liking some banks, IT services, auto components selectively."

Samir Arora, Founder, Helios Capital

"Indian market is overreacting for sure. This contagion doesn't have much to do with India. It does not have the scale of past events, where the contagion spread to financial assets worldwide. But when there is stress in a sector somewhere, it will have an impact elsewhere in the world also in some way. India will benefit for standing out in the financial sector, because we are fairly well-regulated, the capital is good, deposits are granular...generally, all the good things associated with the banking sector, India has it.

Our belief is to be more (exposed to) India-centric businesses than more global, US-facing businesses."

Adrian Mowat, Emerging Market Strategist

"Within the major markets, my preference would be Korea, Taiwan and China over India. I think China is a deep value trade with a catalyst in terms of the opening up; PE versus history, forecast earnings growth look attractive. In Korea and Taiwan, you've got some deep value tech. India has no specific fundamental issue. It's just (less attractive) on a relative basis."