Market Watch

Hot inflation, cold banking

Summary

- Fed faces a tug-of-war between still-elevated inflation and worries over impact to banking sector from higher rates. Inflation worries could still dominate.
- Recent policy measures to support smaller banks as well as the stronger balance sheets of larger banks can limit the likelihood of a contagion.
- Given the elevated inflation pressures, as seen in yesterday's CPI report, we assign a high probability of a 25bp rate hike by the Fed in its upcoming meeting.
- The rise in credit spreads has offset some of the decline in government bond yields, which means the window to add high quality bonds and income assets remains open.

Regional banks have stabilised somewhat after sharp losses

Dow Jones US Large Cap and Regional Bank Total return indices

Source: Bloomberg, Standard Chartered

Assessing the fallout

Our focus in an event-filled week remains on two areas. The first is the market reaction a few days after the failure of two regional banks in the US and policy efforts to limit any contagion across the broader financial sector. The second is the release of February US inflation data, which remained elevated at both a headline and core level.

US banking sector damage likely to fade

The current crisis in the regional US banking sector has triggered the failure of Silicon Valley Bank. Several reports have noted that a key driver of this failure was a mismatch between short-term deposits and the deployment of reserves in longer-term securities. The latter lost value as bond prices fell amid rising yields, resulting in the bank being forced to sell reserves at a loss to meet depositor withdrawals and then try to raise capital to cover these losses.

This, in turn, raised concerns about whether other banks, and more recently a major equity brokerage, faced similar risks. However, we believe SVB's failure was driven by more idiosyncratic reasons as the relatively concentrated depositor profile together with a lack of sufficient hedges against higher yields is likely not replicated elsewhere.

Policy efforts over the weekend also pointedly targeted the main sources of concern. First, US authorities stated that

Market concerns have fallen more broadly as seen by decline in equity market volatility over the past few days

VIX index

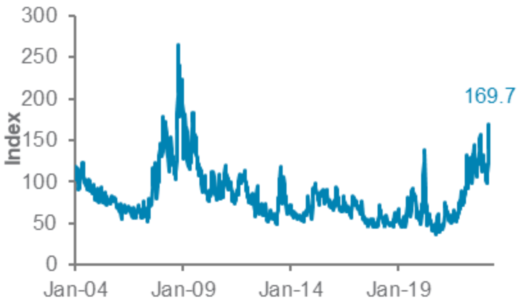
Source: Bloomberg, Standard Chartered

depositors would be protected, the goal being to limit a run on similar regional banks. Second, authorities noted banks would be able to raise liquidity using bonds priced at par (ie. face value rather than a lower mark-to-market price) as collateral, directly addressing worries about the value of bank capital. Third, equity and some bondholders would take losses rather than taxpayers, a measure aimed to limit moral hazard of a 'bailout'.

In our view, these measures should limit the fallout from the bank failures. While there are some uncertainties about the size of funds available for liquidity needs, these measures have arguably targeted the main concerns.

Interest rate uncertainty at highest since Global Financial Crisis

MOVE index



Source: Bloomberg, Standard Chartered

Separating the US regional banking sector

One important distinction, in our view, is separating the impact on the US regional banking sector vs. the US large banking sector. Many of the problems identified are arguably concentrated on the regional banking sector. Larger US banks also benefit from additional regulatory scrutiny, such as maintenance of Liquidity Coverage Ratios (LCR) which small US banks are not. Several reports that examined the potential impact of a full recognition of lower bond prices on capitalisation ratios also noted the impact was manageable across larger, more regulated banks. This is a key reason why we believe a contagion or a broader financial crisis is unlikely at this stage.

A second important distinction is between US and European banks. It has been argued that European banks could face similar risks given European bond yields have risen as well. However, most European jurisdictions impose more stringent regulatory requirements (including liquidity coverage ratios) more widely. Therefore, while it is possible investors use the opportunity for some profit-taking given the sector's recent outperformance, we similarly do not expect contagion to spread to European financials at this time, beyond any idiosyncratic situations. Shifting the focus to bond markets, the yield premiums of Additional-Tier-1 debt (the riskiest bank debt) have increased broadly in line with the increase seen in High-Yield corporate bond space. This indicates that apart from the bonds of the impacted regional banks, there are limited signs of a contagion at present.

Recent events may lead to further tightening of lending standards in US

Percentage of banks tightening lending standards of loans to Large and middle-market borrowers

Source: Bloomberg, Standard Chartered

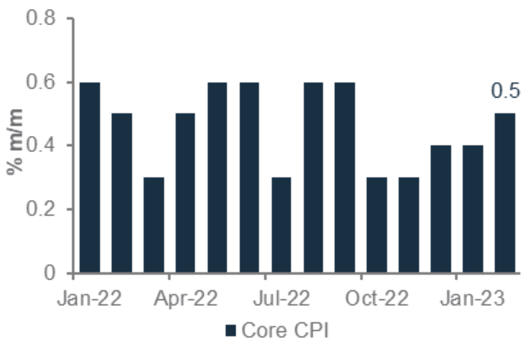
Macro-economic implications

While we see limited risk of a contagion in the US financial system, we do believe that the recent events could negatively impact US growth. Even before the closure of SVB and Signature Bank, Senior Loan officer survey indicated that lending standards had become considerably stricter over the past few months. Tighter lending standard have historically resulted in lower loan growth with a 6–12-month lag.

In the aftermath of the recent events, it is likely that US regional banks, who are an important part of the financial system, could further tighten their lending standards. This could result is lower

Persistent inflation still warrants tight monetary policy

m/m increase in US core CPI



Source: Bloomberg, Standard Chartered

loan growth and could act as a drag on US GDP growth over the next 6-12 months.

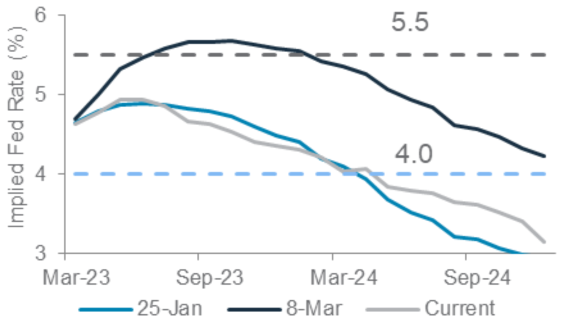
Inflation could cause Fed to refocus

It has been argued in recent days that the stress on regional banks, partly a result of higher bond yields, is likely to cause the Fed to slow or pause its rate hiking cycle. Indeed, market expectations have gone almost full circle since January in pricing significant rate cuts before year-end.

We do not entirely agree. The February US inflation report illustrated that inflation pressures remain elevated, with month-on-month core inflation rising at a faster pace than January, higher than market expectations. The nature of the Fed facility that allows banks to use bonds as collateral at par also creates room for the Fed to focus on raising rates without directly impacting bank capital. This suggests the Fed is likely to maintain its focus on fighting inflation, consistent with Fed Chair Powell's tone at his Congressional testimony, as long as banking sector worries do not prevent it from doing so. We continue to believe a 25bp rate hike is likely.

Repricing of Fed rate hike expectations brings us back to the late-January levels

Fed Fund Futures implied rate hike expectations



Source: Bloomberg, Standard Chartered

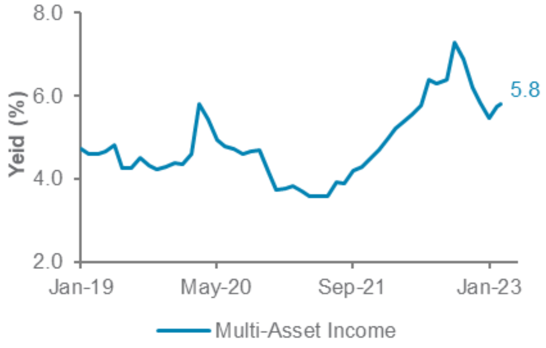
Asset class implications – Stay SAFE

We view recent events, and a scenario where banking sector worries fade to a reasonable extent, as being highly consistent with our SAFE investment strategy:

1. The rapid fall in US government bond yields following banking sector worries illustrated the value of high-quality bonds both as an income source and a short-term volatility hedge, something we emphasised in our 2023 Outlook, Playing it SAFE. Bond yields are likely to rebound to some extent, but both fundamentals and short-term positioning favour adding exposure on rebounds.
2. This applies equally to a broader multi-asset income strategy, with the moderately lower US government bond yields offset by rising yields on riskier bonds.
3. Gold also illustrated its value in environments of short-lived volatility. Having said that, on a very short horizon, we would consider taking some profit given this hedging characteristic has been stronger over shorter rather than longer periods of volatility.
4. European financial sector equities could face some profit-taking in the short term given recent jitters. However, given stronger fundamentals in this region, we would consider adding exposure to this preferred sector on pullbacks.

The increase in credit spreads partially offset the decline in yields. Income window remains open

High quality bonds and Multi-Asset income strategies continue to offer attractive yields



Source: Bloomberg, Standard Chartered

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