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MACROCOSM

It's Over For SVB – And the Fed

Monday, March 13, 2023
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Not sure about the bailouts. But enough glass has broken to end this tightening cycle.

Banking is a matter of confidence, and bank crises are a matter of lack of confidence. Confidence is a matter of both individual judgment and mob psychology. So who the hell knows where the Silicon Valley Bank crisis, in the wake of the weekend's attempted rescues, will lead? Here are some thoughts.

THE BAILOUTS Yesterday the Treasury, the Fed and the FDIC jointly announced that all deposits at SVB and Signature Bank (which was closed by New York authorities yesterday) would be insured, under the "systemic risk exception."

- For a Democratic administration, insurance against losses borne by

Generative AI token: "Jerome Powell's voice shattered the glass, style of 1950s sitcom"

Source: DreamStudio running Stable Diffusion 1.5

Update to strategic view

US MACRO, FEDERAL RESERVE: Treasury, the Fed and the FDIC will make all depositors of Silicon Valley Bank and Signature Bank whole. The Fed has initiated a new Bank Term Funding Program, a super discount window that lends cash for one year against the full value of depreciated Treasuries, MBS and agencies. This solves the balance sheet problem that killed SVB, but not the income statement problem that has collapsed net interest margins. And to be effective, banks need to be willing to use BTFP without fear that doing so will be a stigmatizing signal to wary depositors. The systemic risk is a flight to bank quality in which all smaller or regional banks are abandoned by depositors. Relationships with such banks are sticky, but anything is possible in a panic. At minimum, this will lead to a speed bump in credit activity. Our "house of brick" characterization of the economy indicates this would not trigger a hard landing. This probably ends the Fed's tightening cycle, the scorched-earth pace of which is responsible for this crisis in the first place.

[Strategy dashboard]

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depositors in California and New York – the most left-leaning states – in technology, social media and crypto – the most free-spending and left-leaning industries – was inevitable. Sorry to talk politics. But let's be real: that's the way it is.

- That's why smart politically-connected players like Howard Marks of Oaktree were trying to buy up deposits from scared depositors for cents on the dollar over the weekend before the announcement.
- The statement says, "Shareholders and certain unsecured debtholders will not be protected." We're not sure what "certain" means. The one thing it doesn't mean is "all."

Additionally, the Fed announced a new Bank Term Funding Program (BTFP) that would lend banks cash for one year against assets valued at par, irrespective of their mark-to-market value. The term-sheet is simple, with no punitive or politicized provisions.

- *The program amounts to a super-duper discount window*, or a version of what the European Central Bank did under similar duress in 2011 when it introduced Long Term Refinancing Operations.
- In order to get cash to pay depositors – without having to sell depreciated Treasurys, MBS or agency securities, locking in mark-to-market losses – a bank simply lends the assets to the Fed. The Fed lends the bank cash, at the par value of the securities, at the 1-year market rate plus 10 bp. *On the face of it, this solves the balance sheet problem*.
- *It does nothing for the income statement problem*.
- There is a real risk beyond this, though. Banks may worry that they will be stigmatized if they access this facility – showing weakness that would trigger a run on deposits.[1] This problem was solved, at great cost, in 2008 in the Troubled Asset Relief Program by requiring all banks to use it whether they needed it or not. But right now it's not solved, and this may prove to be a fatal weakness.

FLIGHT TO BANK QUALITY In a number of client conversations over the weekend, the same question kept coming up. In light of events, *why would any depositor not move all his money to the top five banks, or for that matter, just buy Treasury bills*?

- It's a good question. Presumably there must be something valuable that the 4,229 banks who aren't the top five do, or they wouldn't exist. It's likely something about personal relationships, local access or domain expertise. Losing this would be the cost of a flight to safety. And that safety is far from perfect, as the 2008-2009 experience demonstrated – when even the very largest banks needed bailouts.
- So it's not like the whole world will just throw a switch and every dollar will end up tomorrow at JP Morgan. But that will surely happen to some extent, depending very much on arbitrary and emotional personal decisions – and therein remains the greatest question about how this will all turn out.

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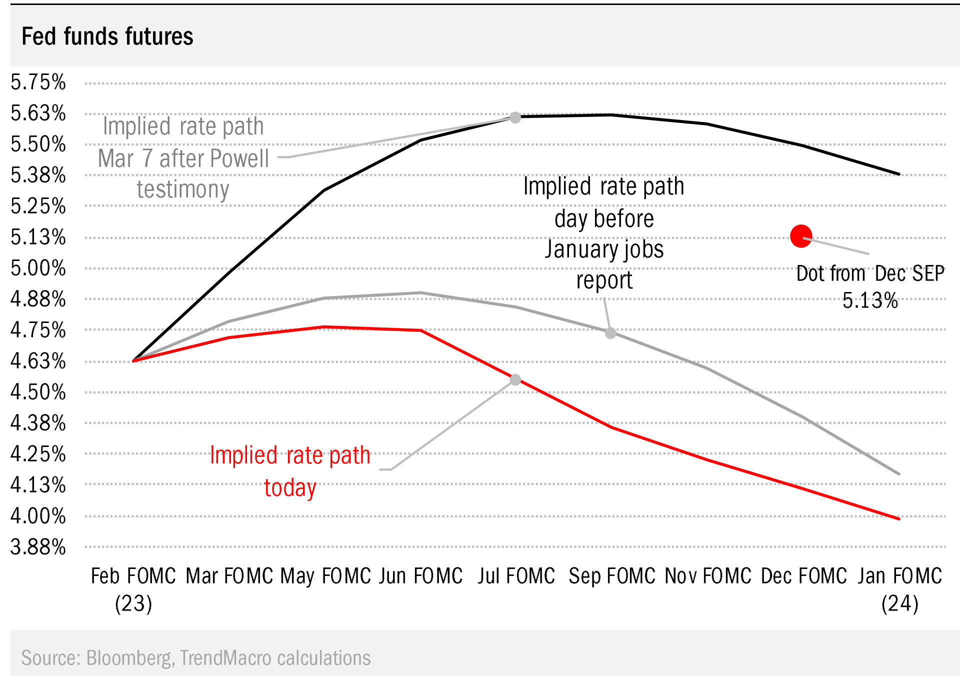
[About us]

RECESSION RISK AND FED POLICY We said Friday that this would be a test of our belief that the US economy is a "house of brick" that would be resilient to shocks – unlike the house of cards of 2008, the last time a banking crisis emerged (see "On the February Jobs Report" March 10, 2023). Again, the imponderables overwhelm any analysis, but *our going-in position is that this will be a blow, but not a death-blow*.

- Assuming no catastrophic system-wide bank run, surely both borrowers and lenders (and both banks and their customers are both borrowers and lenders) will at least pause here, and that will lead to a speed-bump for the economy. Our "house of brick" outlook (see "Good News is Bad News is Equilibrium" February 16, 2023) leads us to expect that such a speed-bump would not be sufficient to produce what everyone would agree would be a "hard landing" recession.
- *In part that's because there's a decent chance that this crisis will end up making us right that the February Fed rate hike was the last* (see "On the February FOMC" February 1, 2023). As of this writing, the fed funds futures have gone from implying a 75% probability of a *50* bp hike at next week's FOMC to only a 75% chance there will be *any hike at all* (please see the chart below). At just below 4%, the implied rate for the January 2024 FOMC entails two rate cuts from here, and is even lower than before the blockbuster January jobs report (see "On the January Jobs Report, and US Services PMI" February 3, 2023).

Fed funds futures



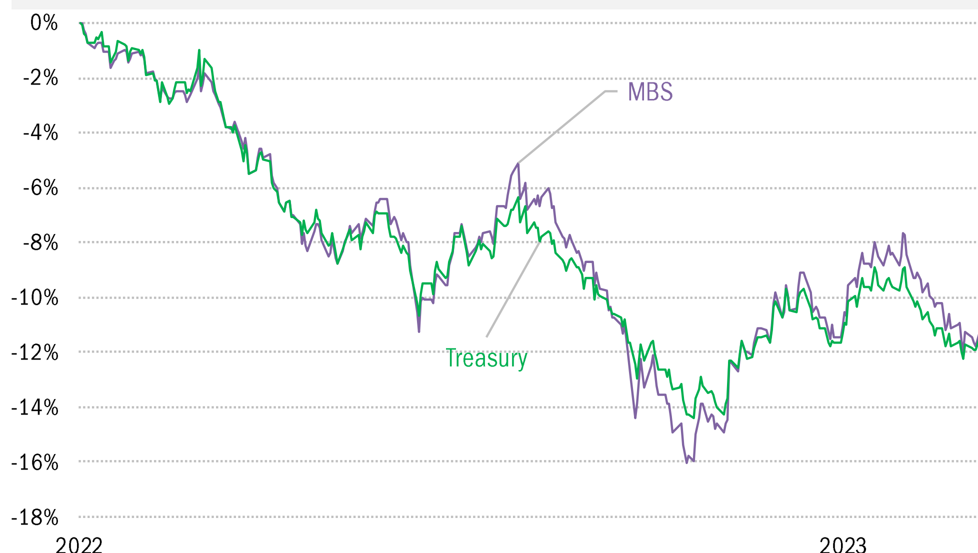
Source: Bloomberg, TrendMacro calculations

- *How can even someone as tone-deaf as Chair Jerome Powell not see that the SVB crisis arose the very day last week that he told Congress that the Fed was considering re-accelerating the pace of rate hikes* (see "On Powell's Shocking Testimony" March 7, 2023)?
- SVB invested its deposits unwisely perhaps, but what caused its losses was the hit to the bank's balance sheet and income

statement arising from record rapidity of the Fed's scorched-earth rate-hiking campaign over the last nine months.

- *First, the balance sheet hit*. The sudden rise in rates depreciated the bank's long-duration government securities, so on a mark-to-market basis the bank's assets were insufficient to cover its deposits. Even assuming portfolios of Treasurys and MBS diversified across the maturity spectrum (SVB's reportedly skewed long), cumulative losses in these "riskless" securities from January 2022 stand at 10% and 11% respectively (please see the chart below).

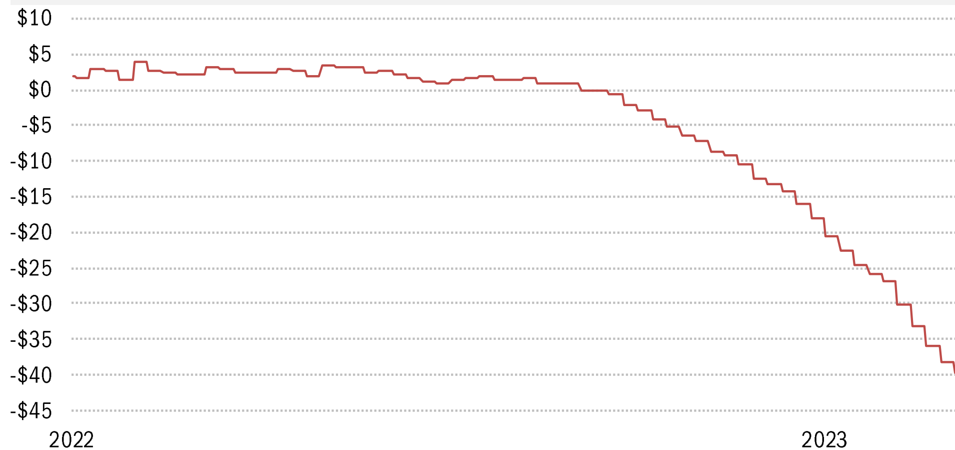
Bloomberg Aggregate Index, cumulative loss from Jan 1, 2022



Source: Bloomberg, TrendMacro calculations

- *Second, the income statement hit*. SVB locked in its Treasury and MBS portfolios when yields were low – but so were the rates it had to pay its depositors. The fixed rates of the assets haven't changed, of course, but the bank must effectively index its rate paid to depositors to the rapidly rising fed funds rate, collapsing net interest margins.
- *Trillions of dollars of Treasurys and MBS are on the Fed's balance sheet as the result of quantitative easing*. So the Fed has absorbed some of the balance sheet and income statement hits that might otherwise have impacted the banking system overall. The Fed's asset portfolio now yields $9 billion per month less than it must pay out as interest on overnight excess reserves (please see the chart on the following page). But the Fed can do what SVB cannot – it just accrues that growing shortfall as a "negative remittance" to the Treasury.
- Yes, you can say that this is just another yield cycle and SVB should have known better. Fair enough. But Powell should have understood that in a crisis like that of the 2020 pandemic lockdowns, *easing policy must be both massive and rapid – but when the crisis is over, normalization must be small and gradual*. Bondholders must have time to earn their way out of the problem.

Cumulative remittances due from Federal Reserve System to Treasury



Source: FRB, TrendMacro calculations

- *<u>So this is when the Fed has to give that gift of time and stop raising rates</u>*. Hopefully they will not be so prideful, nor so in denial of their own culpability, that they will have to bull through no matter what with one more hike just for show. And what about their holy crusade against inflation? Well… they can just brush up on their TrendMacro research and explain that inflation peaked months ago (even by the secret unpublished price index that Powell says he uses now – again, see "On Powell's Shocking Testimony"). Or they can explain that the labor market is beginning to cool, citing the February uptick in the unemployment rate and the slowest-but-one gain in average hourly earnings in almost two years (again, see "On the February Jobs Report").
- *<u>We can't rule out that the Fed would also suspend normalization of its balance sheet by resuming reinvestment of maturity securities.</u>*

DIFFERENCES TO 2008 While the root of the problem is the depreciation of assets on a mark-to-market basis, the issue is not that the assets are low-quality or toxic. *<u>This is not a credit problem caused by the kind of preposterous and over-engineered lending that prevailed from 2003 to 2008.</u>* It is an interest rate problem afflicting high-quality assets, caused by the Fed raising rates too far too fast. Very different animal.

- Well, there is one similarity. The Chief Administrative Officer of SVB Securities was the Chief Financial Officer of Lehman Brothers' global investment bank.
- Oh. And former Representative Barney Frank (D-MA04), he of the Dodd Frank Act that was supposed to prevent all this, sits on the board of Signature.

Bottom line

Treasury, the Fed and the FDIC will make all depositors of Silicon Valley Bank and Signature Bank whole. The Fed has initiated a new Bank Term

Funding Program, a super discount window that lends cash for one year against the full value of depreciated Treasuries, MBS and agencies. This solves the balance sheet problem that killed SVB, but not the income statement problem that has collapsed net interest margins. And to be effective, banks need to be willing to use BTFP without fear that doing so will be a stigmatizing signal to wary depositors. The systemic risk is a flight to bank quality in which all smaller or regional banks are abandoned by depositors. Relationships with such banks are sticky, but anything is possible in a panic. At minimum, this will lead to a speed bump in credit activity. Our "house of brick" characterization of the economy indicates this would not trigger a hard landing. This probably ends the Fed's tightening cycle, the scorched-earth pace of which is responsible for this crisis in the first place.

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1 After this report was initially published, the Fed announced that the names of banks participating in BTLF will not be announced until March 2025, one year after the program ends. Anonymized aggregate facility participation will be published weekly. Nevertheless banks may feel compelled by reasons of potential subsequent liability if they do not themselves disclosed their participation.