THE **CAMBRIDGE** WEEKLY

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Bank stress testing - live

Unease about the state of markets had been palpable since more or less the beginning of the year, as noted repeatedly on these pages over the past months. Following the run on Silicon Valley Bank (SVB) last week, financial system fear spread around western markets and the smell of bank stress last experienced during the 2008/2009 Global Financial Crisis (GFC) had some market veterans experiencing a bout of post-traumatic stress disorder (PTSD). However, it seems to us that banks have simply become the unfortunate focal point of market unease and are now experiencing a similar roller-coaster ride, as felt by so many other sectors since the COVID pandemic disrupted every aspect of life.

When interest rates and yields rise so quickly – and after such a prolonged period of ultra-low levels – then something is inevitably likely to break at some point. Whilst that is not what central banks intended, using rate hikes as an emergency brake to slow down the economy inevitably carries the risk of collateral damage.

As it turns out, the stress originated in what had run 'hottest' during the recent boom – the tech sector, healthcare sector and crypto currencies. The failure of SVB, which kicked-off last week's market stress and stock market downdraft, became the first sizeable victim of the yield rise-induced economic downturn, but it is its close affiliation with tech, healthcare and crypto that is notable. After seeing a near tripling of money deposited by start-up companies and their affiliates during the good times (namely the 2020/2021 tech and healthcare boom), those deposits were heavily drawn on recently when those same companies required funds to bridge the financial strains of these distinctively more challenging times.

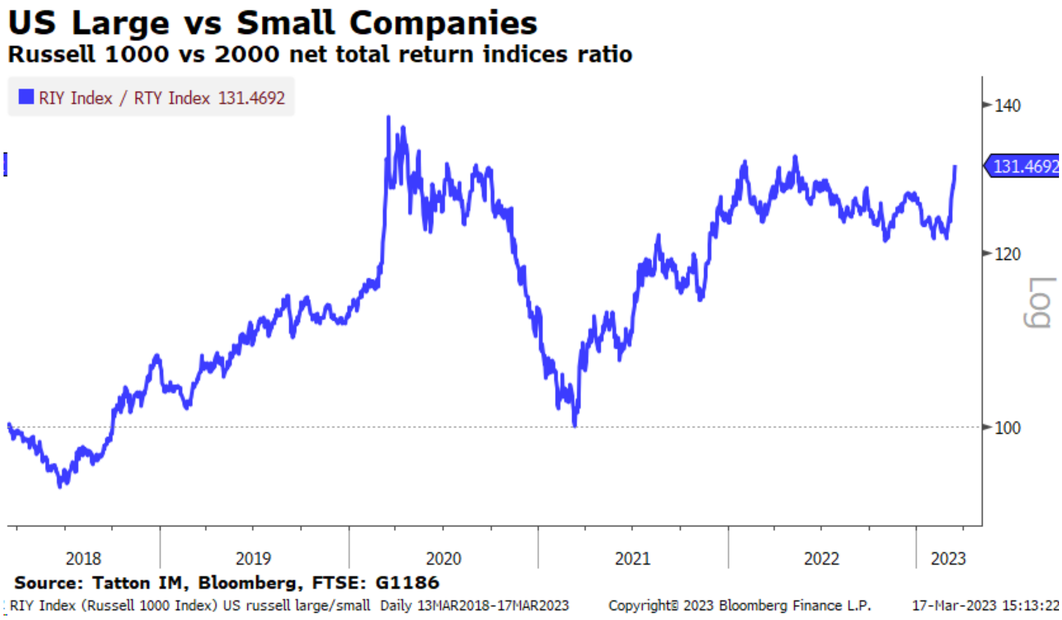
But different to the reckless lending that led to the 2008/2009 crisis, SVB had stashed its client deposits away in what most investors until last year would have known as the lowest-risk investment available, a portfolio of government bonds. Just as private investors found out, when yields suddenly rise very significantly, such holdings with historically low yield coupons can lose substantial value, if marked-to-market rather than held until maturity. When the drawing on their deposits accelerated because of the need to also wind-down its crypto bank specialist Silvergate Capital, SVB's management's decision to raise more liquidity by liquidating their government bond holdings at a loss and raising new equity, was interpreted by their deposit holders as a sign of weakness, rather than determination to repair their mistake of misjudging possible yield rise scenarios. What ensued was a classic bank run as all trust was lost – a scenario that no bank can ultimately withstand.

The nervousness of market participants over recently elevated stock and bond valuations therefore found its focal point, and so the stock index of the aggregate global bank sector had a very bad week, taking away a substantial part of the sector's rally of last year that had been fuelled by the better margin prospects for banks from higher rates.

Taking into account how much better capitalised banks are today when compared to the run up to the GFC, they seemed an unlikely target and victim this time, but it turns out the trust had never been fully rebuilt. Given SVB was an outlier with its losses from its long maturity government bonds wiping out its equity base, it was right that central banks stepped in to stop the self-enforcing avalanche of mistrust. That stock markets continued their highly volatile trading into the latter part of last week goes to show that, once confidence is dented, investors are more open to consider that there is more than a 'steady as she goes' scenario possible this year.

Diving into the wider repercussions and likely medium-term effects of last week's banking crisis, with the effective demise of three US banks, we observe that the NASDAQ composite share index of US tech and growth companies traded within a whisker of the 20-day high at the opening of Friday's US markets. Other markets have not been so buoyant, but it is fair to say that we closed the week with a sense that the height of this crisis lies behind us. Tech indices do not tell the whole story. Companies that fared well last week were those that benefit most from the fall in bond long-term yields, which corrected sharply the previous week. Large caps such as Amazon has done very well; at the end of Thursday's trading, it was up over 6% for March.

The chart below shows the large cap Russell 1000 index's total return as a ratio of the smaller cap Russell 2000. While 2022 saw large caps lose out against smaller rivals by about 10%, that dynamic has reversed almost entirely in just over a week. In the general scheme of things, the move is not unparalleled, but it is still significant. The Russell 2000 has a lot of early-stage highly valued companies of the type that would have banked at SVB.



A similar situation has occurred in Europe, although large cap firms had a worse time in the period before the pandemic.

The lesson from the past few days is that the pain caused by the rises in rates is hitting small and micro-cap firms particularly hard, even if they are strictly speaking growth stocks whose valuations would otherwise benefit. There is other evidence, such as employment rates. According to US employment agency ADP, firms with 1-19 employees have been cutting jobs this year, despite the generally improving employment situation. Firms of this size employ in aggregate almost the same number of people as firms with 250-500 employees. This means that both these groups are larger employers than either larger or other mid-size firms. In Europe and the UK, a similar situation persists.

The rescue of SVB depositors was welcome, of course, from a financial stability point of view, but it does not help at one level. SVB went to the wall because its depositors were having to take their reserves out in order to keep going. That situation is not likely to have improved, it is just they will not reach the end of their reserves right now because of a bank failure.

But we should be heartened that last week proved central banks are reactive to issues of financial instability. The centre of the storm moved to Europe and particularly Switzerland as Credit Suisse came under pressure. We touch on this in the article below. (The European Central Bank (ECB) still raised rates by 0.5% on Thursday as it had promised at its previous meeting, but President Christine Lagarde was notably reticent about offering any further indications of rate moves).

Credit Suisse has underlying issues of years past – under different management - that are completely different in nature to those of the US banks. The Greensill and Archegos debacles of early 2021 showed it had consistently displayed a conspicuous lack of risk control and oversight. But Credit Suisse is still a major counterparty with just about every major bank across the world (although less so than two years ago). Despite its problems differing from those of the US small banks, the problems end up creating the same reaction: depositors and clients look for new bankers which then multiplies the restrictions on the bank they leave with its ongoing business, unless some willing funder is found to replace the depositors. The swift actions of the Swiss National Bank (SNB) were welcome, particularly for the other counterparty banks.

Yet banks did not bounce noticeably, despite the early central bank support. We think this links back to the first point. Small firms are the mainstay of banks' lending books, having lost larger firms that have shifted to raising their own debt in market-based borrowing or to private credit (fund) lenders. Banks, which up until the start of March were celebrating the improvement in the margin between taking deposits and lending (net interest margin) on the back of higher rates and yields, are suddenly faced with the flipside of the same rate rises, namely having to tighten lending to their already stressed borrowers – a recipe for an increase in non-performing loans.

To top it all off, the market is now pricing a strong likelihood that March will see an end to all the rate rises in the Western world, and that rates could be cut everywhere by year-end. Net interest margin will be on its way down again.

As mentioned, the ECB raised its deposit rate to 3.0%, in the first of the round of March central bank meetings. This week, the Federal Reserve (Fed) and the Bank of England (BoE) meet. Despite the turmoil, markets on balance expect a 0.25% move from both. We have revised our views as well and see a 0.25% move in the US where data remains strong enough to justify it, but that the UK will not move. So, for the shorter term it appears that central banks' objective to tighten financial condition to bring down inflation has suddenly been significantly accelerated through market action.

On the inflation side, last week's Spring Budget in the UK surprised some with the forecast of a 2.9% year-on-year inflation rate before 2024. In fact, inflation is already running well below that level on an annualised monthly basis. The NHS pay award could not have been achieved without a general acceptance from the workforce that inflation was no longer out of control, and that will be a strong softening signal to the BoE Monetary Policy Committee's concerns about potential wage-price spirals.

In conclusion to this thoroughly unpleasant week for investors, we would observe that the trend of overshoots that started with the onset of the COVID pandemic continues. It started with too severe restrictions of movement (only clear with the benefit of hindsight), carried on with too much fiscal support for what turned out to be more like a natural disaster economic impact rather than global depression and carried on into a tech and crypto sector boom and 'Roaring Twenties' talk, before inflation and energy prices completely overshot.

However, ever-new overshoots, as unnerving as they are, appear to gradually bring down the prospect of out-of-control inflation and thereby forever rising interest rates. Last week's events may have dented recent improvements in consumer and business sentiment, but they have also brought down the prospect for higher inflation and thereby central banks' tightening action through ever-higher rates. The risk of recession has perhaps not significantly increased as softening sentiment and tighter lending standards seem to be balanced by lower yields and the prospect of an end to rate rises.

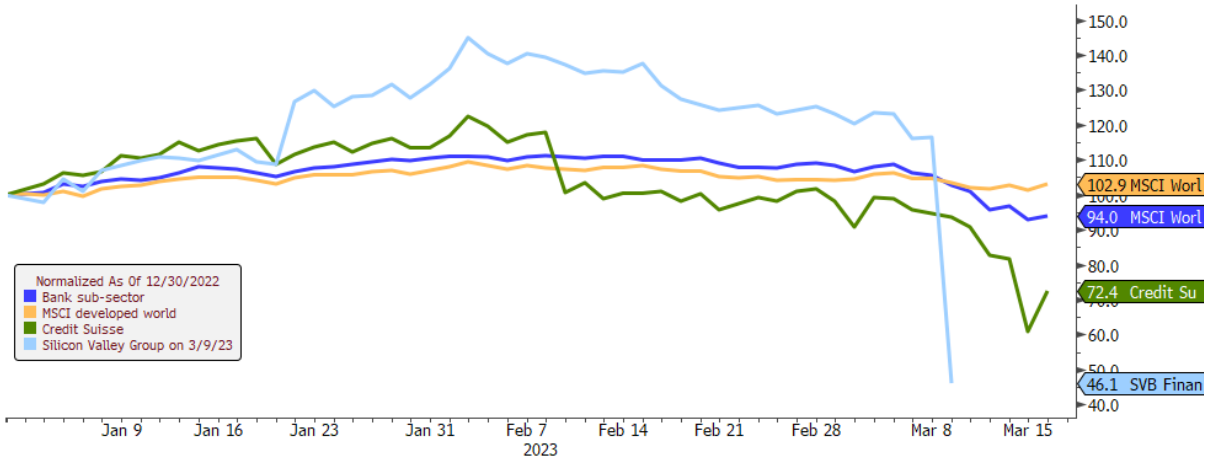
When is a crisis a crisis?

When banks are in the news, it is rarely a good sign. Scars from the 2008/2009 global financial crisis (GFC) are still there for financial commentators and the wider public, so bank failures or excessive risk taking tend to get a high profile. That publicity is justified at the moment, with a second US bank collapse in the space of a week. US authorities rushed to insure deposits, while refusing to call it a bailout. Over the early part of last week, fear spread across the Atlantic. Stocks in Credit Suisse plummeted around 30% during Wednesday trading, after one of its major shareholders ruled out any extra investment. Switzerland's central bank, the Swiss National Bank (SNB) was so concerned by this that it gave its national champion access to a heavy dose of emergency liquidity.

Opinions on what to make of all this are divided. On the one hand, the quickfire failures of high-profile banks have sparked fear in both markets and popular media. The US stock market fell sharply through last week, while UK and European markets have also suffered heavily over the last few days. The finance-heavy FTSE 100 has taken a particular bruising, falling just over 7% in the last two weeks. On the other hand, many commentators and analysts appear unphased, citing stability in the banking system and the rapid response of authorities. Markets are weighing up these factors too: US stocks rose after the (non-)bailout was announced, while even Credit Suisse has now been given breathing room by investors.

World equities and banks

MSCI developed world equities, banks, Credit Suisse and SVB (as of close 16-Mar-23)



Source: Tatton IM, Bloomberg, MSCI: G1287

Is this a banking crisis? And if so, could it get as bad as last time? The short answers, respectively, are: perhaps, and, highly unlikely. To give a fuller answer, we need to look into the similarities and differences between the current environment and previous episodes of stress. What makes a crisis a crisis?

Ernest Hemingway said that bankruptcy happens "gradually, then suddenly". Weaknesses build up over time, and wider economic circumstances add pressure on them. But for any given company, the full extent of its weaknesses is only revealed when things get so bad those weaknesses cannot stay hidden.

The nature of banks means the financial system is more vulnerable than other sectors. Often the first bank failures don't precipitate a crisis, but they do reduce the system's overall willingness to tolerate risk. When the next set of bad news gets out, confidence plummets and financial problems spiral. And when a big player falls, others tied to it come under pressure. We saw this a decade and a half ago with Bear Stearns and later Lehman Brothers. Cracks emerge slowly, but shattering happens all at once.

The business model for banks involves borrowing at low rates and lending or investing to get higher returns. Before the days of mass communication (we're talking before the days of the telegraph system), there were few banks and they controlled access and information. They could take deposits from people who would keep the money with them for years at a low interest rate, and lend that money to highly solvent borrowers who would pay quite high levels of interest. The process had little risk. However, as information flow became better and competition in banking intensified, the net lending margin decreased and banks had to increase the risks in order to make as much money. There were different types of risk which could, when blended, diversify the overall risk but, still, risks were higher.

The deregulation which started in the neo-liberal 1980s brought significant benefits to consumers as the world of finance expanded dramatically. Risks were further amplified as margins went down but were offset by better diversification of assets, liabilities, and counterparties. However, that broadening of the interlinking of financial companies also magnified the potential for the interlinking to drag others down in a crisis. This interlinking was all too evident during the GFC.

The catalysts which make those risks into an actual problem are always troubles in the cost and flow of money. If the cost of capital goes up, banks have to pass on that stress. That is exactly what we saw before last time: interest rates rose, exposing risks embedded in the system. The key point here is not that risks were *taken* – that is always true – but that large risks were *hidden*, meaning no one could properly evaluate them until it was too late.

Over the last year, interest rates have risen at the fastest pace in a generation. Meanwhile, economic growth has slowed dramatically. That means higher capital costs with lower aggregate returns, a difficult environment for banks as a whole. When crypto hub FTX collapsed last year, we said this was a sign of the times – opaque high-risk investments being exposed – and that further casualties down the line were likely. That is exactly what happened with crypto specialist bank Silvergate Capital last week, and then Silicon Valley Bank (SVB) over the weekend.

In the immediate aftermath, many were keen to point out that systemic interlinkages are not what they were before the GFC. These links meant counterparty risks were huge among the big banks, and that these risks were not properly accounted for. Regulation since then has tried to insulate banks and improve their resistance to shocks. In the US, for example, the Federal Reserve (Fed) effectively operates as a central clearer of funds, significantly reducing the reliance on interbank lending.

The fact that troubles have spilt over to Credit Suisse is a sign that contagion is still very possible, though. Even if the US tech banks can fail in a relatively isolated fashion, a bank as big and important as Credit Suisse is a different matter. Moreover, European banks are much more tightly linked than US counterparts. If Credit Suisse were to collapse, shockwaves would be felt far away, and weaknesses at other banks would certainly be exposed.

That being said, there are two key disanalogies to events before the GFC. First of all, the policy response has been swift and decisive. In the US, the Biden administration effectively bailed out depositors of a bank considered too small to be systemically important, as soon as troubles began. Meanwhile, SNB provided billions in liquidity to Credit Suisse on the same day its stock sunk. The long-term merit of these moves is debatable; indeed, European lawmakers are reportedly angry about the US flouting bailout rules they helped create. But they undoubtedly make short-term financial contagion less likely.

Second, crises spiral when unknown risks come to light, but most of the current risks exposed at Credit Suisse were already in the light, and known about for some time. We should not underplay the troubles that could spread from such a big institution, but it is important to note that many other banks will have already reduced their exposure to the investment bank.

We have no doubt that further problems – at different, as yet unknown, banks – will become known in the weeks and months ahead. Such is the nature of a monetary tightening cycle. Those institutions that end up in trouble will be those with opaque or misleading balances of assets and liabilities. In that respect, we also expect financial hardship at some (probably recent entrant) private equity or private debt funds (private meaning not available to the general public and therefore not part of Cambridge's portfolios). It may be that such hardship catches only a very small number, and will be seen as idiosyncratic and containable as the demise of SVB, but it is something of which investors should be wary.

In comparison to such funds, banks tend to have much more transparent risk-reward structures – partly as a result of post-GFC reforms. As developments last week have made clear, these are far from adequate to shield even bigger banks from any harm. But they should help avoid a sudden, widespread and acute crisis.

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20th March 2023

Global Equity Markets			Technical	Technical	Valuations			
Market	Fri 14:31	% 1 Week*	% 1 Week in sterling terms	Short Medium	Div YLD %	LTM PE	NTM PE	10Y PE AVG
UK FTSE 100	7326	-7.1	-7.1	⬊ →	4.3	10.3	10.1	13.4
UK FTSE 250	18467	-6.2	-6.2	⬊ ⇘	3.5	13.3	12.1	0.0
UK FTSE All-Share	4003	-6.9	-6.9	⬊ →	4.1	10.5	10.2	0.0
UK FTSE Small	6077	-4.9	-4.9	⬊ ⇘	3.9	10.3	10.4	0.0
France CAC 40	6910	-5.4	-6.8	⇘ ⬈	2.9	12.2	12.2	0.0
Germany DAX 40	14743	-5.5	-6.8	⇘ ⇗	3.6	11.7	11.3	0.0
US Dow	31879	-3.2	-5.2	⬊ →	2.2	17.1	16.3	0.0
US S&P 500	3927	-1.8	-3.8	⇘ →	1.8	17.7	17.6	0.0
US NASDAQ comp	11675	+0.8	-1.3	→ →	1.0	25.1	25.2	0.0
Japan Nikkei 225	28144	+0.8	+2.0	→ ⇘	2.1	16.5	15.8	0.0
World Bloomberg	1441	-2.5	-4.5	→ →	2.5	13.3	12.6	0.0
China mainland	3967	-4.0	-4.8	⇘ →	2.2	16.1	15.7	0.0
Emerging Bloomberg	1079	-1.9	-3.9	⬊ ⇘	2.4	11.8	11.4	0.0

Top 6 Gainers

Company	%
Endeavour Mining	+7.0
Rentokil Initial	+4.2
Bunzl	+2.4
United Utilities	+1.2
Severn Trent	+1.2
Compass	+0.8

Bottom 6 Decliners

Company	%
Prudential	-21.6
M&G	-20.2
Standard Chartered	-19.1
Barclays	-15.9
Legal & General	-14.3
Ashtead	-14.2

Fixed Income

Govt bond	%Yield	1 W CH
UK Govt 10yr Gilt	+3.24	-0.54
UK Govt 15yr Gilt	+3.56	-0.50
US Govt 10yr Treasury	+3.41	-0.55
France Govt 10yr OAT	+2.68	-0.48
Germany Govt 10yr Bund	+2.11	-0.54
Japan Govt 20yr JGB	+1.21	-0.02

Currencies

Pair	last	%1W
USD : GBP	1.215	+2.0
GBP : EUR	0.875	-1.4
USD : EUR	1.063	+0.6
JPY : USD	132.02	-3.2
CNY : USD	6.887	-1.1
USD : Bitcoin	26,540	+22.2

Commodities

Cmdty	last	%1W
Oil Brent $:bl	72.7	-12.9
Gold $:oz	1954.8	+7.1
Silver $:oz	22.1	+9.8
Copper $:lb	404.2	-0.9
Alumnm $:mt	2283.0	-3.4
S&P soft crops	227.7	-0.9

UK Mortgage Rate Estimates

Rates (LTV c.75%)	17-Mar	15-Feb
UK BoE base rate	4.00	4.00
2yr fixed	5.90	5.17
3yr fixed	5.76	4.92
5yr fixed	5.55	4.69
10yr fixed	5.43	4.87
Standard variable	7.02	6.66

17/03/2023
Prices taken at 2:30pm today and 2:30pm last Friday (where possible)
LTM PE is the index price as a ratio of last 12 months earnings
NTM PE is the index price as a ratio of median analyst forecasts for the next 12 months earnings
Mortgage estimates are derived from sterling swaps markets

* The *% 1 week* relates to the weekly index closing, rather than our Friday p.m. snapshot values

** LTM = last 12 months' (trailing) earnings

***NTM = Next 12 months estimated (forward) earnings

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20th March 2023

Please note: Data used within the Personal Finance Compass is sourced from Bloomberg/FactSet and is only valid for the publication date of this document.

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