

Recession Watch: SVB triggers risk-off mood

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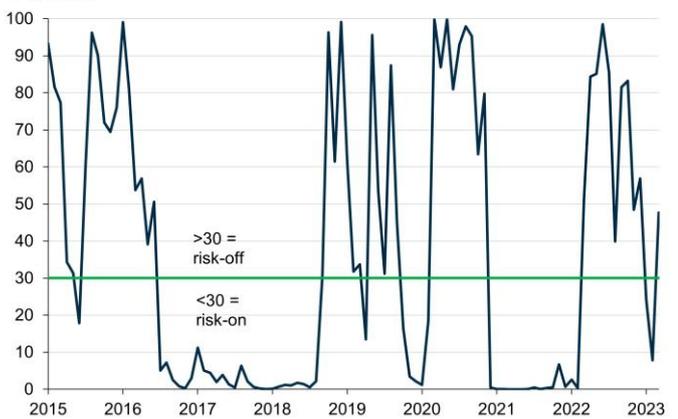
Headlines

- Investors are back in risk-off mood following bank collapses — although sentiment seemed to improve on Tuesday, markets were volatile again on Wednesday morning
- The causes of the Silicon Valley Bank and Signature Bank collapses were a combination of idiosyncratic factors and common drivers (higher rates)
- We do not expect a systemic banking crisis for now, but will keep the situation under close review
- The situation at Credit Suisse, a systemically important financial institution, warrants close attention

With inflation still not defeated and the path of interest rates uncertain, we noted in our *Global Outlook, Spring 2023* (released last Wednesday) that it seemed like an odd time for investors to be risk-on. That was of course before the failure of two mid-sized US banks: Silicon Valley Bank (SVB) and Signature Bank. Now, the latest reading from the Fathom Risk-Off Gauge (FROG) shows that investors' positions have flipped to a more cautious mindset. This was reflected in asset returns on Monday — equities sold off, especially bank stocks, while US Treasuries rallied, with the two-year yield seeing its largest daily decline since the 1980s. This pattern reversed on Tuesday, although it is probably too early to conclude that sentiment has entirely recovered. Indeed, European bank stocks sold off again on Wednesday morning following comments by Ammar Al Khudairy, chair of the Saudi National Bank, suggesting that the SNB would not provide additional support to Credit Suisse (SNB is its largest shareholder).

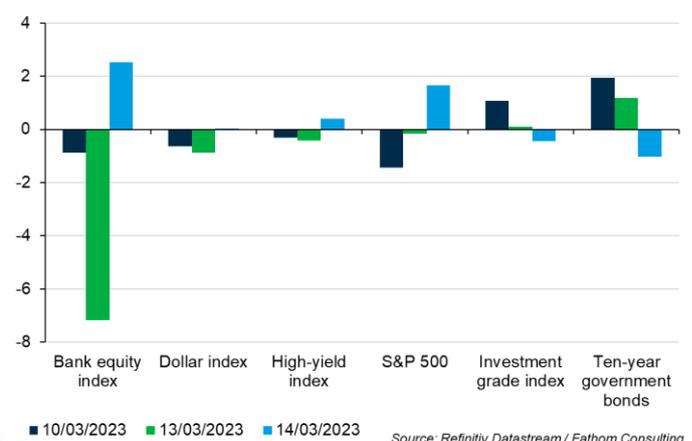
Fathom Risk-Off Gauge (FROG)

Per cent



US asset movements

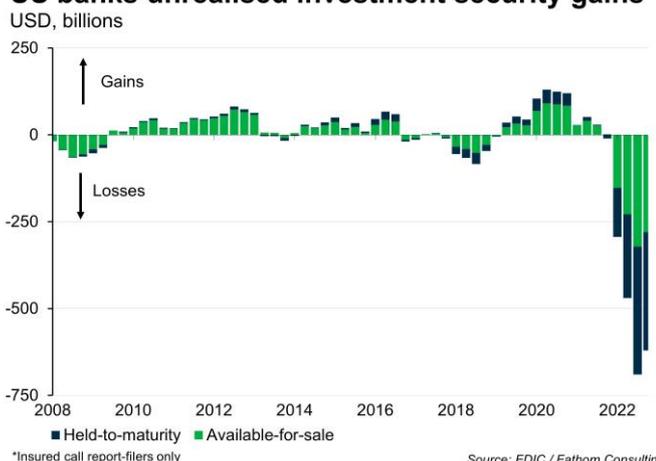
Daily percentage changes



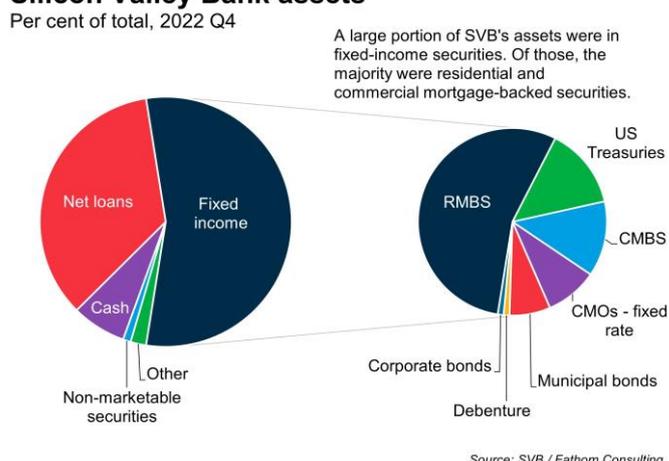


Higher interest rates have had a profound impact on the value of many investment securities. The chart below shows the losses that the US banking system would incur if it were to sell these assets. For now these losses remain largely unrealised, as the banks have not had to sell. However, the fall in value of fixed-income securities played a crucial role in SVB's collapse. The majority of the institution's assets were in fixed-income securities (mainly being held to maturity) or in loans, often to the tech sector (which are also sensitive to higher rates). The Fed's new Bank Term Funding Program, which was designed to offer liquidity support to banks, crucially treats fixed-income assets at par value as opposed to their mark-to-market value, in an attempt to limit banks' vulnerability to these unrealised losses.

US banks unrealised investment security gains*

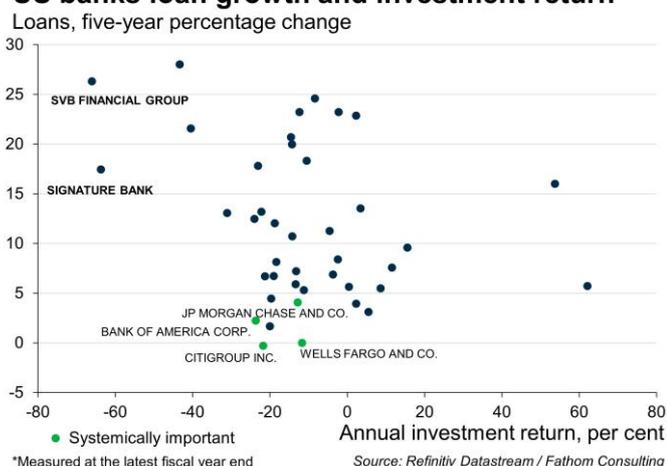


Silicon Valley Bank assets

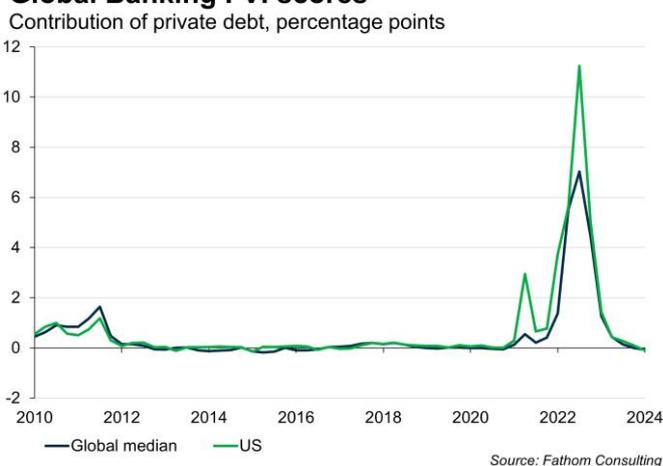


Both SVB and Signature Bank failed to properly diversify, meaning that they were extremely vulnerable to rising interest rates — this is possibly what explains their dire investment returns. In hindsight, it should have been obvious that these two institutions might be at risk. It is also worth noting as a point of interest that, aside from the systemically important institutions, there does seem to be some correlation between those banks who have seen the largest increases in their loan books over the past year and those who have suffered the greatest losses in the past twelve months. This second effect through the credit quality channel has not yet come into play, and perhaps offers a secondary source of banking risk going forward. Interestingly, it was this surge in credit that caused our Financial Vulnerability Indicator (FVI) to flag an elevated likelihood of banking risk through the tail end of last year. It may have got the timing wrong, but recent events suggest that it was right to flag concern.

US banks loan growth and investment return*



Global Banking FVI scores

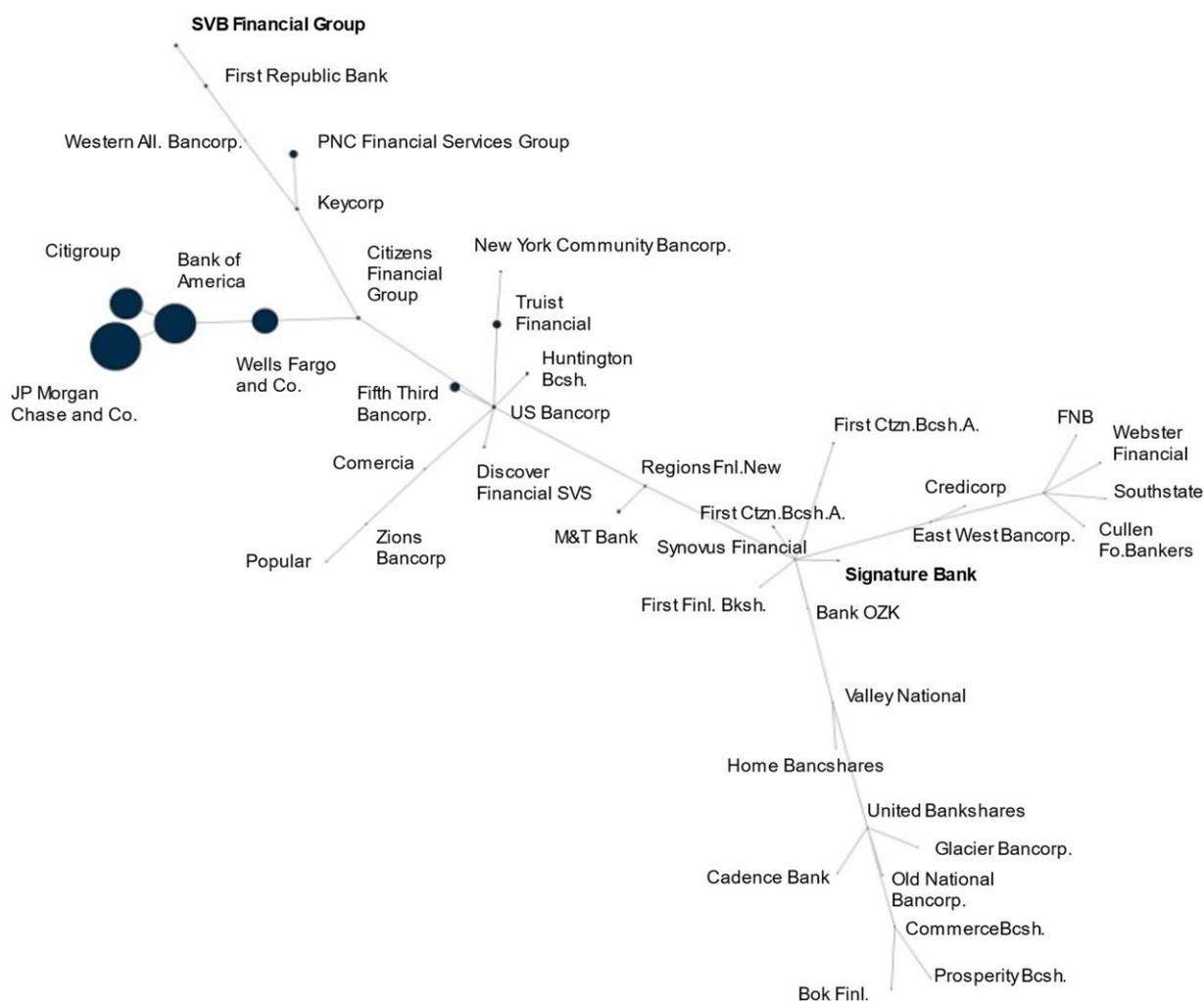




Inevitably, the focus has now turned to which will be the next bank to fall. The minimum spanning tree (MST) below is based on correlations in equity prices within the Datastream US Banks index. It shows the path of least resistance through which shocks can be transmitted in the US banking system — this will often be the likeliest route for contagion to spread. As can be seen, SVB lies close to the top-left corner of the tree, while Signature is closer to the centre. First Republic Bank and Western All Bancorp., the two institutions nearest to SVB, suffered the largest falls in prices on Monday and the largest rebounds on Tuesday. The effects were more muted elsewhere, however, and the systemically important institutions (the larger bubbles, to the left) generally saw smaller falls in their equity prices. This begs the question: how likely is a banking crisis? We do not expect a banking crisis for now but, given the pace of developments, we will keep this under close review. It is important to note is that investors can, and do, get things wrong.

Equity price correlations in the Datastream US Banks index

Calculated since 1 January 2022, size of bubble = size of bank's assets



Source: Refinitiv Datastream / Fathom Consulting

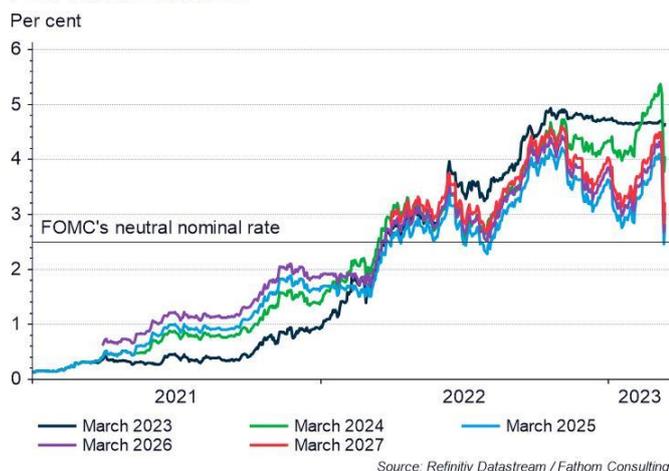
The fed funds futures market has reacted dramatically to the events of the last few days. As we pointed out in our *Global Outlook, Spring 2023*, investors were previously pricing in tight Fed policy (i.e., a nominal fed funds rate above neutral) for the



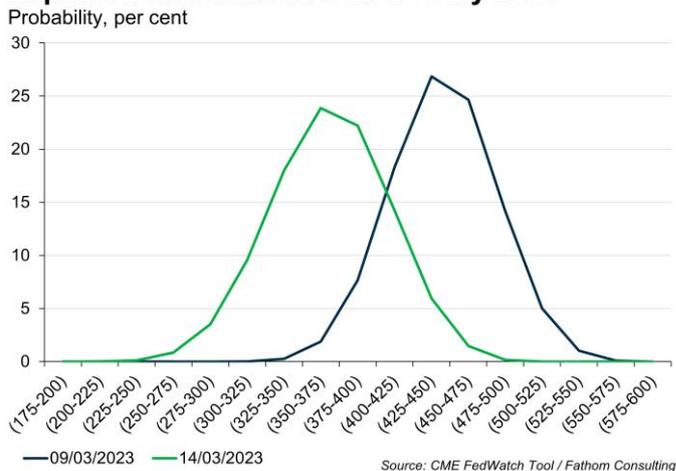


next five years, an outcome we consider unlikely. Futures prices suggest those longer-dated rate expectations have now come down, but perhaps for the wrong reason. Looking at the second chart below, expectations for the fed funds rate two years from now have undoubtedly shifted lower but remain normally distributed. In reality, systemic banking crises are binary events — you either have one or you do not. If the US does experience one, it seems highly likely that rates will go to zero and stay there for a long time. If it does not, then the outlook for rates will be determined by the outlook for inflation — core CPI surprised to the upside this week, incidentally.

Fed funds futures

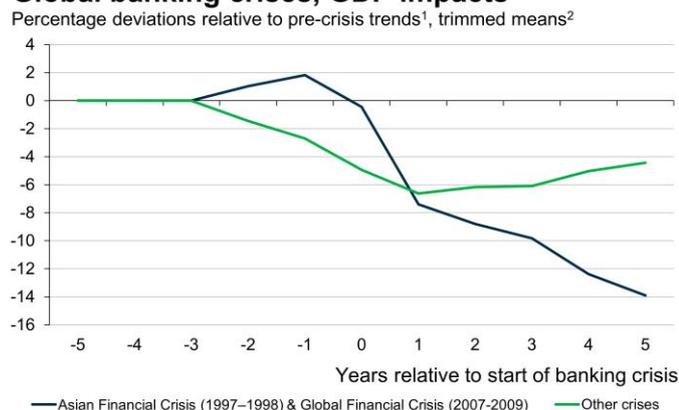


Expected fed funds rate on 31 July 2024



Why do we say this? The chart below is taken from [a previous FVI Update](#) and shows the typical impact of a banking crisis. As can be seen, the economic damage is severe. Banking shocks are a lot more damaging than other types of economic crises, with more recent events resulting in permanent hits to output relative pre-crisis trends — our estimates suggest this rises to as much as 15% within five years.

Global banking crises, GDP impacts



¹Pre-crisis trends are calculated as the average growth rate between t-5 and t-3.
²Trimmed means are calculated by discarding extreme values at each end of the distribution. In all, 25% of observations are discarded.



Events are currently moving at a rapid pace. The fall in Credit Suisse's equity price is particularly concerning, given its role as one of the world's systemically important banks. We will monitor this closely and alert clients if our views on the likelihood of a global banking crisis change.

Further reading

[Contagion risks from SVB failure](#)

[Global Outlook, Spring 2023: markets risk repeating past mistakes](#)

[Recession Watch: flipflopping](#)

[Recession Watch: spotting European risks](#)

[Recession Watch: no landing for now](#)



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