

Investment Strategy Update #134

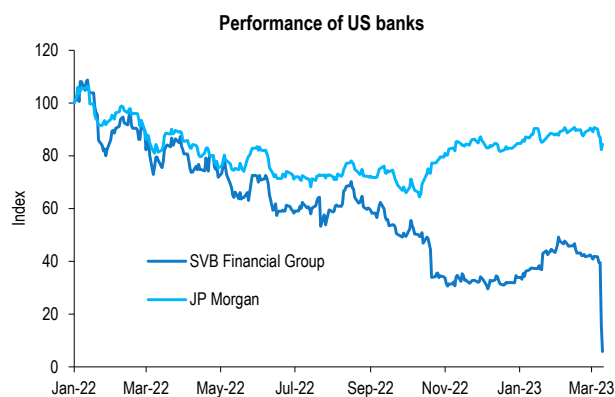
Interest rate and not systemic default risk remains the primary concern for investors post SVB's collapse

- The rapid response by US regulators to step in post the failure of Silicon Valley Bank (SVB) demonstrates that the Fed has the tools available to limit possible systemic issues within the broader financial system as liquidity conditions continue to tighten. US regulators have stepped in to ensure SVB depositors have access to their funds to restore confidence, and additionally, the announcement of a Fed emergency lending facility should help quieten depositor skittishness and limit the risk of further bank runs.
- We think the impact of rising rates and the withdrawal of liquidity for the broader economy rather than systemic liquidity challenges within the financial sector are more important concerns for investors. If the Fed and other key central banks (including the RBA) continue to drain liquidity and raise the cost of borrowing, then markets will be prone to further bouts of weakness as cyclical growth risks rise.
- The collapse of SVB highlights a number of ongoing issues for financial markets and players. First, deposit competition will remain fierce as investors chase higher returns in TDs and money market funds and this will accentuate asset-liability mismatches. And second, the tighter liquidity conditions get, the more acute capital shortfalls will become for illiquid areas such as venture capital (VC) and the lower quality end of private markets. This comes on top of rising operational headwinds for businesses in general (and tech in particular).
- The fall in global equities and financial stocks in particular could finally be the catalyst for a more meaningful correction across equity markets, which to date have sailed through rising rates and growth risks. We can't see the bear market ending before markets are confident that policy makers are ready to pause/end the rate hike cycle and they are not quite there. Until then, bouts of sentiment driven selling are likely to continue and should provide more attractive entry points into risk assets.

SVB was a very specific case

Bear markets are painful and exhausting. They tend to go on until the stale bulls capitulate, they can surprise at any time and skittishness means markets will often (over) react. Heading into 2023, our view was that the bear market remained intact but that further weakness would be the result of rising cyclical (growth driven) risks. The sudden collapse of California based Silicon Valley Bank (the 16th largest US bank by assets) and the ripple effects across global financial markets was a poignant reminder that this bear market is not yet over.

Divide between weak & strong is huge



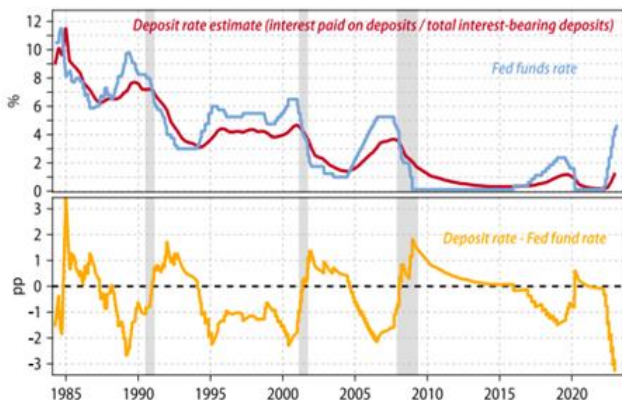
Source: Factset, MWM Research, March 2022

There will be a mountain of work over the coming days that discuss how this was missed by regulators. But US regulators have quickly stepped in to restore confidence with the recent announcement that SVB depositors will have access to funds on Monday and additionally, the creation of a Fed-backed emergency lending facility that will enable other deposit taking institutions to access funding if required.

Investors should worry about rising rates not systemic defaults

As at 4Q22 there was US\$620bn of unrealised losses within financial sector security portfolios. The announcement of the Fed backed emergency funding facility limits the risk that other banks will suffer the same fate as SVB.

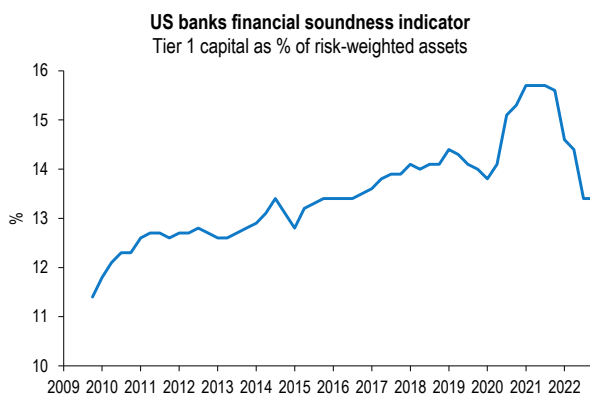
Globally, banks are facing stiff competition for deposits



Source: GAVEKAL, March 2022

But broadly speaking and given industry-wide excess capital sits at over US\$2tn, we think the risk is around how ongoing tight liquidity and rising rates impacts the broader economy rather than a broader shortfall problem relating to asset-liability mismatch.

US banks remain well capitalised despite a deterioration

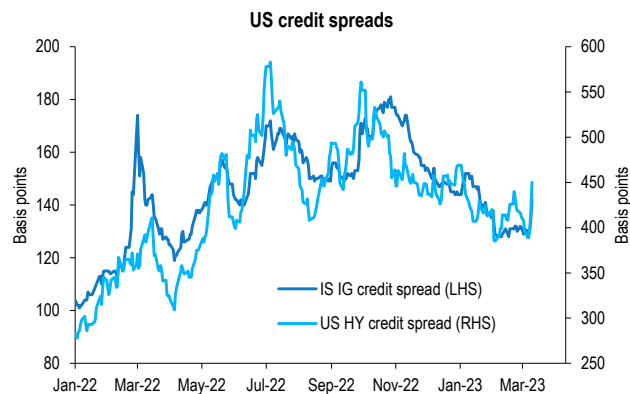


Source: Factset, MWM Research, March 2022

There was significant selling across US financials and global equity markets as well as a significant rally in bonds and while fears are well placed, the scale of the sell-down is as much a reflection of the broad uncertainty that has driven the bear market as it is the catalyst for last week's sell-off. We think the risk for markets is the uncertainty that further rate hikes, ongoing tight liquidity and a pending economic downturn will create for business and consumers. Until the Fed and other central banks become

comfortable that they have tightened liquidity conditions enough, then the underlying cause of SVB's collapse will not have been addressed. It is therefore rates and tight liquidity and not systemic financial sector risks that should be the key concern.

Credit spreads have widened but remain tight



Source: Factset, MWM Research, March 2022

Margin pressures & tightening liquidity remain risks for public & private markets

We think there are two lasting takeaways for investors from SVB's collapse and surrounding drivers:

- Banks are facing increased pressure to raise deposit rates in order to attract inflows. In the US, the gap between the deposit rate and the Fed Funds rate is the widest it's been since data has been collected (1984). This is pressuring bank deposits as households seek better short term returns from TD's and better yielding money market funds. This pressure will continue (and incidentally was a key reason for Macquarie's Australian Bank sector downgrade, see [2023 Australian Banks Outlook - Material headwinds looming](#)).
- Tight liquidity conditions due to rising rates and quantitative tightening will be ongoing as central banks continue to fight inflation. Neither the corporate or household sectors are on the cusp of interest rate relief which implies that many of the trends we have seen in recent months are not likely to reverse and some are likely to get worse such as for those seeking capital without a transparent path for growth like VC's or those in private markets given the premium that is required for illiquidity. VC companies are already facing a confluence of liquidity pressures in the current macro backdrop, with rising rates and depressed sentiment in public markets keeping exits on ice and extending hold periods.

The subsequent lack of exits/return of investor capital is now impeding new fundraising rounds and delaying much needed injections of fresh capital for managers and founders to extend cash runways for existing

portfolio companies as well as participate in new dealmaking activity. With capital already flowing less freely, the collapse of SVB will only tighten capital supply further at a time where demand for venture capital cash is increasing.

Every event that drives a fresh bout of selling within a broader bear market is problematic because it shakes already weak confidence. The speed at which SVB collapsed and the selling that resulted is a clear illustration of investor nervousness.

There will be debate around whether or not this is an idiosyncratic event, but regardless it might just be the catalyst for markets to reassess the near-term outlook which we think has diverged from extremely resilient equity

market performance. We think it is the prospect of further rate hikes and the ongoing withdrawal of liquidity which continues to add to economic growth risks that investors should remain most focused on. The longer the rate hike cycle continues, the greater the dispersion between good and bad lending risk whether it be business, consumer or investment led and against this backdrop, liquidity and size is the next best thing to certainty. Long bonds did their job as a risk hedge during last week's sell-off. We don't doubt they will continue to fulfil this role during further bouts of weakness.

Macquarie WM Investment Strategy Team

Investment Strategy Update #134 finalised on 13 March 2023.

Recommendation definitions (Macquarie Australia/New Zealand)

Outperform – return >3% in excess of benchmark return

Neutral – return within 3% of benchmark return

Underperform – return >3% below benchmark return

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