Silicon Valley Bank: A Silver Lining

Silicon Valley Bank's Downfall

The most salient event in the last week was the failure of Silicon Valley Bank (SIVB), a prominent lender to venture-related companies and funds alike. As is being well-reported, SIVB had experienced sustained deposit inflows in recent years and invested those funds in both loans as well as longer-term securities such as Treasuries and mortgage instruments. As interest rates rose, the value of the bonds and mortgages fell and threatened the bank's solvency, because banks are leveraged corporations and so losses are magnified. It is worth specifying that the bank had approximately $16B in book equity capital as a cushion, and the nearly $15B in unrealized losses on its $100B bond portfolio threatened to consume nearly all of that equity.

The Fed's Stopgap

Because of the swift actions of the Fed and the FDIC, SIVB depositors have access to all of their funds, and so depositor companies will be able to pay their bills and make payroll. This eliminates the threat of a cascading spiral of non-payments.

However, it is worth pointing out that SIVB was not alone in having significant unrealized losses on bond portfolios. Most other banks invested some of their excess deposits in Treasuries or mortgage products, and they have suffered losses, albeit to a lesser proportion of its balance sheet than SIVB. And the Fed's new emergency program allows banks to borrow from the Fed as they need by pledging those bonds at face value without formally realizing losses, which is a considerable shot in the arm for depositor confidence.

The Soft Landing scenario is back in play: the events of the last week are a clear yellow flag for the Fed, who we believe will be more cautious about raising rates even as they do continue to do so. However, we think Shock and Awe is out and Soft Landing is back, and the Fed will focus on financial stability and can no longer prioritize inflation and ignore side effects of raising rates abruptly.

Raising the Bar?

The Fed may reset its 2% inflation target: Chair Powell has repeatedly said that the Fed would not abandon its 2% inflation target in favor of a 3% target, and maintaining the 2% goal is the central outcome. However, it may now be that raising interest rates is harder than previously expected, and there are several appealing aspects to raising the inflation target: it means the Fed will not have to raise interest rates as high or for as long; the economy will not face as severe headwinds with a 3% target as compared to a 2% target; and some policy makers prefer to have a wider gap between the inflation target and the 0% lower bound for interest rates, because it mathematically allows inflation-adjusted interest rates to move to more negative levels and thereby impart greater stimulus to the economy when needed (i.e. -3% versus -2% prior).

Bond Markets Step In?

The bond markets may take share from banks. While the Fed's bond buying program called Quantitative Easing (QE) increased deposits and the banks' balance sheets in general, we may have seen the limits of that expansion because of the "financial plumbing" problems evident with SIVB: the bank ran out of loans to make and so it parked assets in overvalued Treasury bonds. It is therefore plausible that borrowers and lenders alike will prefer to transfer more of those activities to the direct sales and purchases of bonds, as opposed to the deposit-and-lending model with intermediation by capital-constrained banks. This would not be exceptional, and different countries rely differently on banks versus the bond markets. But the punchline is that it is not overly cumbersome for the bond markets to step into the shoes of banks as lenders, especially if the banks find their balance sheets are constrained or if they are studying the lessons from SIVB and want to reduce their size and financial risk profile.

Other Banks?

As we mentioned above, the banking sector as a whole owns several trillion dollars worth of underwater Treasury bonds, and the plan and solution is that they can wait until those securities mature and roll off their balance sheets, to be replaced then with higher interest rate loans and instruments. The Fed's actions are designed to provide that sort of flexibility, in contrast to what SIVB faced.

However, it is worth noting that the Fed itself – and other major central banks such as the European Central Bank and, especially, the Bank of Japan -- have bought so many bonds that they too are sitting on losses. For the Fed, a recent tally noted unrealized losses of nearly $700B. So it is ironic that the ultimate guarantor of financial stability is technically sitting on significant losses in its bond portfolio.

Conclusion:

While there will still be some aftershocks from the sudden collapse of the bank, we believe that the emergency measures taken by the Federal Reserve and the FDIC will serve to stabilize the situation and reduce the turmoil faced by regional banks.

The potential for future Fed policy change and a reallocation of capital may herald a Goldilocks period for the bond markets --- an increased presence in lending and a benign economic environment characterized by less restrictive peak interest rates and better economic outcomes.

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