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Fed tightening “dynamite fishing” starts to hurt

DOWNGRADING EQUITIES TO CAUTIOUS

As an old adage says, Monetary policy tightening is like dynamite fishing: when the blast hits, it decimates everything in the vicinity. The small fishes rise to the surface first. But it can take some time for the whale(s) to show up.

With the unwind of a major bank (Silicon Valley Bank) last week and another (Signature Bank) over the weekend, it is clear that the aftershock of the Fed's policy tightening is starting to be felt. But should we see these two banks as whales or as just being those small fishes?

At this stage, it is very difficult to answer to this question. However, we believe that we have entered a new period of uncertainty which should lead to an Equity Risk Premium re-rating. As such, we are downgrading equities from positive to cautious.

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Syz PRIVATE BANKING

A lot has changed since last week

The collapse of Silicon Valley Bank (SVB), the largest bank failure since the 2008 financial crisis, has raised concerns about potential contagion and a broader banking crisis. But so far, the US government's quick response in guaranteeing that deposits will remain available and the UK government and Bank of England facilitating the sale of SVB's British arm have contained immediate fears. As SVB's vulnerability to rising interest rates is paralleled in other global banks, many analysts expect the Fed and other central banks worldwide to rethink further "aggressive" interest rate hikes. Some experts also expect SVB's collapse could lead to more regulatory safety nets for banks perceived as "too big to fail".

So what's next?

First, we do not believe that this is a systemic event similar to 2008. This financial event was serious enough for authorities to intervene but should not involve the largest banks. Generally speaking, the banking sector is well capitalised. The BTFP (Bank Term Funding Program) announced by the Fed and the Treasury will allow banks to fund deposit outflows without crystallising losses on depreciated assets by pledging them to the Fed instead. This should lower contagion risks. It can even be seen as a disguised Quantitative Easing.

Second, there is the risk that this is NOT the final "breakage" during this hiking cycle. Looking back to history, central banks hike rates until something breaks. The UK liability-driven-investments (LDI) crisis last Summer was the first episode. The SVB crisis came next. But a bigger crisis (a larger bank, hedge funds, commercial real estate, etc.) could be around the corner.

Third, SVB's failure will exacerbate headwinds facing the tech sector and make funding start-ups much more difficult. Higher rates and changing spending patterns post-pandemic were already problematic for the sector, and this knock to confidence won't help. The FDIC rescue plan which seeks to protect uninsured depositors should prevent a collapse though. But the cost of capital is expected to increase while some States (e.g California) reliant on innovation and new technologies are likely to suffer.

Fourth, this financial event makes the life of the Fed even more difficult. The US "macro" issue is not an overleveraged sector or financial excess. It is a too tight labour market which keeps service inflation way above the Fed's target. The only way out is higher interest rates. If the BTFP works, the FOMC should be able to continue hiking rates (maybe not +50bp hikes but rather +25bps). If the program doesn't work, we might see more failures (leading to a recession) which will force the Fed to abandon monetary policy tightening at the cost of seeing inflation staying too high for too long (as the disinflationary impact will not take place immediately). There is thus a risk for the Fed to face a "heads I lose, tails you win" type of scenario... As such, yesterday's developments were quite interesting. On one hand, the fact that we didn't get any further bad news from regional banks led to a compression of equity volatility and a relief rally. However, the 'good news' coming from the financial systemic risk front brings the inflation-fighting priority back to the front stage. Let's keep in mind that the Fed needs to address the current realities of economic data: US nominal GDP still running at 7.5%, a 3.6% unemployment-rate, headline CPI YoY running at 6.0% and core CPI less shelter MoM number at its highest level since September. The Fed still has a lot of work to do (if you recall Powell's rhetoric a week ago) and is likely to hike by 25 basis points in March (which might be seen as imprudent by many market participants). Ultimately, the Fed is likely to split the monetary policy (tightening) and financial stability (BTFP easing tool). This looks similar to what we described in our November 2022 Focus "10 surprises for 2023" when we said that a possible scenario for this year could be the Fed conducting QE for markets but QT / tightening for anyone else...Here we go.

Finally, the SVB "bailout" might pull the debt ceiling X date forward. A big $40b payment was made out of the Treasury for the FDIC. While the Treasury is denying that the expenditure will impact the debt ceiling X date, it didn't say why. Pulling forward the X date could create more volatility on equity markets.

Indicators review summary

Our tactical asset allocation process is based on five indicators.

Macro & Fundamental Factors
(Leading indicators)

- → Macro-economic cycle: POSITIVE
- → Liquidity: NEGATIVE
- → Earnings growth: NEGATIVE
- → Valuations: NEUTRAL

Market Factors
(Coincident indicators)

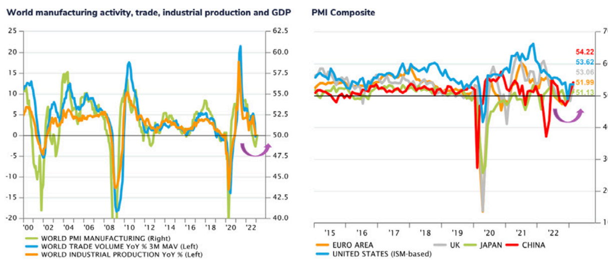
- → Market dynamics (Breadth, Sentiment, etc.): NEUTRAL

Indicator #1

Macro-economic cycle: Positive

Our core scenario remains a soft-landing of the global economy, with positive short-term momentum (fuelled by a resilient US consumer, European rebound and China reopening), higher nominal growth prospects but rising downside risks on the back of the financial events which have been taking place since last week. The disinflationary process has started but it will likely take time, as parts of the economy still experience inflationary pressures (see yesterday's data in the US).

Global growth momentum is positive (at least temporarily) on the back of a mild European winter, US resilience and China reopening.



Source: Banque Syz, FactSet

Indicator #2

Liquidity: Negative

The global rate hike cycle is not over yet as central bankers have to ensure domestic inflationary pressures cool down. The failures of SVB and Signature have been sharply tightening financial conditions. Any contagion of these events to the rest of the financial sector might force the Fed to pivot much earlier than expected. As such, monetary policy could turn neutral or positive very quickly. But it would probably happen because macroeconomic growth prospects would be expected to deteriorate sharply (aka recession risk).

Indicator #3

Earnings growth: Negative

Earnings growth dynamics remain negative, with further downside risk in case of financial contagion.

Indicator #4

Valuations: Neutral

Attractive outside the US but still too rich in the US: This is also why we believe that a risk premium re-rating might take place: there is not enough cushion on the valuation side for US equities.

Indicator #5

Market dynamics: Neutral

Our market dynamic indicators are still Neutral but with a clear deterioration over the last month. Market breadth (participation to the upside of the broad market) has been deteriorating over the last few weeks. We note that the trend could quickly turn negative again as the US market is close to breach some key levels (watch the 200 days moving average).

Overall, the deterioration of market dynamics and the downside risk to the macro pillar (not yet compensated by an improvement on the monetary policy pillar) leads us to downgrade our preference on equities.

Asset Allocation decisions

We believe that we have entered a new period of uncertainty, which should lead to an Equity Risk Premium re-rating. As such, we are downgrading equities from positive to cautious. We have keept an attractive stance on Investment Grade Credit but downgrade High Yield Credit from cautious to unattractive. We are also downgrading subordinated debt from positive to cautious. We remain cautious on Government bonds but are adding a small position in high duration US Treasuries as a "tail hedge". We remain positive EUR and JPY versus USD, positive Gold and maintain our attractive view on Commodities and Hedge Funds.

Tactical positioning: our asset allocation matrix

	Very Unattractive	Unattractive	Cautious	Positive	Attractive	Very Attractive
Portfolio risk			**Equities** ← Rates		Credit Spreads	
Equities			Japan EM Latam Other EM	Euro zone United Kingdom United States Switzerland	China&EM Asia	
Fixed Income		**HY Credit** ←	Government Bonds **Subordinated debt** ← EM Hard EM Local		IG Credit	
Yield curves		EUR "core" EUR "peripheral" CHF GBP	USD			
Forex (vs USD)			CHF EM currencies GBP	EUR JPY		
Commodities				Gold	Commodities	
Alternative Investments					Hedge Funds	

Source: Investment strategy group - 14 March 2023

Change from last month

→ More attractive

← Less attractive

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